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BADGER METER INC  
Form 10-Q  
August 07, 2006

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 JUNE 30, 2006

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 Company (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 Company 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 July 20, 2006, there were 14,073,936 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 JUNE 30, 2006

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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(R) radio frequency mobile AMR system, the absolute digital encoder (ADE(TM)) and the Galaxy(R) fixed network AMR system;
- changes in competitive pricing and bids in both the domestic and foreign marketplaces, and particularly in continued intense price

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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 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 housings as a result of increases in the commodity prices for copper and zinc at the supplier level and resin as a result of increases in petroleum and natural gas prices;
- the ability to improve operating results for foreign markets that have experienced historical losses;
- 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.

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### PART I - FINANCIAL INFORMATION

#### ITEM 1 FINANCIAL STATEMENTS

##### BADGER METER, INC. CONSOLIDATED CONDENSED BALANCE SHEETS

June 30, 2006	December 31, 2005
-----	-----
(Unaudited)	
(In thousands)	

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ASSETS

Current assets:

Cash	\$ 3,509	\$ 4,403
Receivables	38,255	30,450
Inventories:		
Finished goods	12,170	11,875
Work in process	8,688	9,048
Raw materials	15,412	11,047
	-----	-----
Total inventories	36,270	31,970
Prepaid expenses	2,998	2,309
Deferred income taxes	3,466	3,432
	-----	-----
Total current assets	84,498	72,564
Property, plant and equipment, at cost	114,519	109,810
Less accumulated depreciation	(68,009)	(65,940)
	-----	-----
Net property, plant and equipment	46,510	43,870
Intangible assets, at cost less accumulated amortization	1,108	1,026
Prepaid pension	16,822	17,726
Other assets	4,065	4,101
Goodwill	6,871	6,580
	-----	-----
Total assets	\$159,874	\$145,867
	=====	=====

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:

Short-term debt	\$ 20,858	\$ 8,847
Current portion of long-term debt	4,719	7,431
Payables	14,872	11,484
Accrued compensation and employee benefits	5,659	6,436
Warranty and after-sale costs	3,507	3,610
Income and other taxes	2,412	1,778
	-----	-----
Total current liabilities	52,027	39,586
Other long term liabilities	595	634
Deferred income taxes	6,597	6,584
Accrued non-pension postretirement benefits	4,129	3,955
Other accrued employee benefits	6,177	6,332
Long-term debt	6,966	15,360
Commitments and contingencies		
Shareholders' equity:		
Common stock	20,469	20,112
Capital in excess of par value	15,168	13,320
Reinvested earnings	80,455	74,258
Accumulated other comprehensive income	764	1
Less: Employee benefit and nonvested stock	(795)	(1,357)
Treasury stock, at cost	(32,678)	(32,918)
	-----	-----
Total shareholders' equity	83,383	73,416
	-----	-----
Total liabilities and shareholders' equity	\$159,874	\$145,867
	=====	=====

See accompanying notes to consolidated condensed financial statements.

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BADGER METER, INC.

## CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	(Unaudited)		(Unaudited)	
	(In thousands except share and per share amounts)			
	2006	2005	2006	2005
Net sales	\$ 62,405	\$ 57,432	\$ 123,441	\$ 111,864
Cost of sales	41,810	37,348	81,734	72,425
Gross margin	20,595	20,084	41,707	39,439
Selling, engineering and administration	12,900	12,585	26,329	25,454
Operating earnings	7,695	7,499	15,378	13,985
Interest expense	412	317	801	775
Earnings before income taxes	7,283	7,182	14,577	13,210
Provision for income taxes	3,234	3,023	6,297	5,495
Net earnings	\$ 4,049	\$ 4,159	\$ 8,280	\$ 7,715
Per share amounts:				
Earnings per share:				
Basic	\$ .29	\$ .31	\$ .60	\$ .57
Diluted	\$ .28	\$ .30	\$ .58	\$ .55
Dividends declared:	\$ .075	\$ .070	\$ .150	\$ .140
Shares used in computation of earnings per share:				
Basic	13,866,729	13,449,654	13,709,700	13,426,628
Impact of stock-based compensation	514,697	547,010	544,606	499,916
Diluted	14,381,426	13,996,664	14,254,306	13,926,544

See accompanying notes to consolidated condensed financial statements.

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BADGER METER, INC.

## CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

Six Months Ended  
June 30,  
-----  
(Unaudited)  
(In thousands)

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	2006	2005
	-----	-----
Operating activities:		
Net earnings	\$ 8,280	\$ 7,715
Adjustments to reconcile net earnings to net cash provided by (used for) operations:		
Depreciation	3,460	3,449
Amortization	182	117
Tax benefit on stock options	--	550
Deferred income taxes	(16)	(31)
Noncurrent employee benefits	2,365	1,127
Changes in:		
Receivables	(7,369)	(8,412)
Inventories	(3,869)	349
Prepaid expenses	(713)	(786)
Current liabilities other than debt	(1,534)	4,573
	-----	-----
Total adjustments	(7,494)	936
	-----	-----
Net cash provided by operations	786	8,651
	-----	-----
Investing activities:		
Property, plant and equipment	(5,540)	(2,302)
Other - net	(123)	(409)
	-----	-----
Net cash used for investing activities	(5,663)	(2,711)
	-----	-----
Financing activities:		
Net increase (decrease) in short-term debt	11,581	(10,100)
Issuance of long-term debt	--	10,000
Repayments of long-term debt	(11,106)	(5,066)
Dividends paid	(2,084)	(1,882)
Proceeds from exercise of stock options	2,024	629
Tax benefit on stock options	3,567	--
Treasury stock purchases	--	(1,653)
Issuance of treasury stock	312	576
	-----	-----
Net cash provided by (used for) financing activities	4,294	(7,496)
	-----	-----
Effect of exchange rate on cash	(311)	865
	-----	-----
Increase (decrease) in cash	(894)	(691)
Cash - beginning of period	4,403	2,834
	-----	-----
Cash - end of period	\$ 3,509	\$ 2,143
	=====	=====

See accompanying notes to consolidated condensed financial statements.

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1. 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) necessary to present fairly the Company's consolidated condensed financial position at June 30, 2006, results of operations for the three- and six-month periods ended June 30, 2006 and 2005, and cash flows for the six-month periods ended June 30, 2006 and 2005. 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.

On April 28, 2006, the Board of Directors declared a 2-for-1 stock split on the Company's Common Stock effected in the form of a 100% stock dividend, payable on June 15, 2006 to shareholders of record at the close of business on June 1, 2006. In this report, all the per share amounts and numbers of shares have been restated to reflect this stock split. In addition, Common Stock and capital in excess of par value have been adjusted to reflect this split for all periods presented.

Certain other reclassifications have been made to the 2005 consolidated condensed financial statements to conform to the 2006 presentation.

2. The consolidated condensed balance sheet at December 31, 2005 was derived from amounts included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. 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.

GOODWILL Goodwill increased from \$6.6 million at December 31, 2005 to \$6.9 million at June 30, 2006 as a result of translation adjustments for goodwill denominated in foreign currencies.

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. Changes in the Company's warranty and after-sale costs reserve for the six-month periods ended June 30, 2006 and 2005 are as follows:

(In thousands)	Balance at beginning of year -----	Net additions charged to earnings -----	Costs incurred -----	Balance at June 30 -----
2006	\$3,610	\$936	\$(1,039)	\$3,507
2005	\$3,817	\$803	\$ (942)	\$3,678

STOCK-BASED COMPENSATION PLANS At June 30, 2006, the Company has two types of stock-based employee compensation plans, which are described more fully in Note 1 "Summary of Significant Accounting Policies" under the heading "Stock-Based Compensation Plans" and Note 5 "Stock Option Plans" in the Notes to Consolidated Financial Statements in Part II, Item 8 of the

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Company's 2005 Annual Report on Form 10-K.

The Company recognizes the cost of share-based awards for the all of its stock-based compensation plans on a straight-line basis over the vesting period of the awards. Total stock compensation expense recognized by the Company for the three- and six-month periods ended June 30, 2006 was \$292,000 and \$510,000, respectively, compared to \$74,000 and \$106,000 for the same periods in 2005.

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### Stock Options:

The Company has six stock option plans which provide for the issuance of options to key employees and directors of the Company. Each plan authorizes the issuance of options to purchase up to an aggregate of 800,000 shares of Common Stock, with vesting periods of up to ten years and maximum option terms of ten years. As of June 30, 2006, options to purchase 546,576 shares remain available for grant under three of these plans.

Prior to January 1, 2006, the Company accounted for stock compensation plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25 (APB 25), "Accounting for Stock Issued to Employees," and related Interpretations, as permitted by Financial Accounting Standards Board (FASB) Statement No. 123 (SFAS 123), "Accounting for Stock-Based Compensation." No stock-based employee compensation cost was recognized for stock option awards in the Consolidated Statements of Operations for the periods prior to January 1, 2006 as all options granted under those plans had an exercise price equal to the market value of the underlying Common Stock on the date of grant.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R) (SFAS 123(R)), "Share-Based Payment," using the modified-prospective-transition method. Under this transition method, compensation cost recognized in the second quarter and first six months of 2006 includes compensation costs for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). The Company estimated the fair value of its option awards granted prior to January 1, 2006 using the Black-Scholes option-pricing formula, and continued to use this model. The Company records compensation expense for stock options ratably over the stock option plans' vesting period. Results for prior periods have not been restated.

As a result of adopting SFAS 123(R) on January 1, 2006, the Company's earnings before income taxes and net earnings for the three-month period ended June 30, 2006 were \$104,000 and \$72,000 lower, respectively, than if the Company had continued to account for share-based compensation under APB 25. For the six-month period ended June 30, 2006, earnings before income taxes and net earnings were \$211,000 and \$150,000 lower, respectively.

Prior to the adoption of SFAS 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Consolidated Condensed Statements of Cash Flows. SFAS 123(R) requires the cash flows resulting from the tax benefits of the tax deductions in excess of the compensation cost recognized for



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those options (excess tax benefits) to be classified as financing cash flows.

The following table illustrates the effects on net earnings and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock option plans during the three and six months ended June 30, 2005. These pro forma calculations only include the effects of stock-based compensation granted since January 1, 1995. The value of the options (net of forfeitures) is amortized to expense on a straight-line basis over their vesting periods.

(In thousands except per share amounts)	Three months ended June 30, 2005	Six months ended June 30, 2005
	-----	-----
Net earnings, as reported	\$4,159	\$7,715
Deduct: Incremental stock-based compensation determined under fair value based method for all awards since January 1, 1995, net of related tax effects	(62)	(138)
	-----	-----
Pro forma net earnings	\$4,097	\$7,577
	=====	=====
Earnings per share:		
Basic, as reported	\$ .31	\$ .57
Basic, pro forma	\$ .31	\$ .57
Diluted, as reported	\$ .30	\$ .55
Diluted, pro forma	\$ .29	\$ .54

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The following table summarizes the stock option transactions for the six-month periods ended June 30:

(In thousands except per share amounts)	2006		2005	
	Options	Weighted average exercise price	Options	Weighted average exercise price
	-----	-----	-----	-----
Options outstanding at January 1	1,290	\$ 7.35	1,618	\$ 7.01
Options granted	28	\$31.41	37	\$18.33
Options exercised	(310)	\$ 7.03	(171)	\$ 6.72
Options forfeited/cancelled	--	--	(38)	\$ 7.89
	-----		-----	
Options outstanding at June 30	1,008	\$ 8.12	1,446	\$ 7.31
	=====		=====	
Exercisable at June 30	664	\$ 7.05	899	\$ 7.20
	=====		=====	

The following assumptions were used for options granted in the six-month periods ended June 30:

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	2006	2005
	-----	-----
Per share fair value of options granted during the period	\$11.62	\$5.76
Risk-free interest rate	5.0%	3.9%
Dividend yield	.96%	1.42%
Volatility factor	34.0%	30.0%
Weighted-average expected life (in years)	5.39	6.1

The following table summarizes the aggregate intrinsic value related to options exercised, outstanding and exercisable as of and for the six-month periods ended June 30:

(In thousands)	2006	2005
	-----	-----
Exercised	\$ 6,606	\$ 1,580
Outstanding	\$19,028	\$15,349
Exercisable	\$13,247	\$ 9,636

Stock options outstanding at June 30, 2006 are as follows (options in thousands):

Price Range	Weighted average contractual life	Options	Weighted average exercise price
-----	-----	-----	-----
\$3.70 - \$ 5.75	3.3	335	\$ 5.67
\$6.03 - \$ 7.13	6.1	378	\$ 7.05
\$7.50 - \$31.42	4.9	295	\$12.28
	---	-----	
Options outstanding	5.1	1,008	\$ 8.12
	===	=====	
Options exercisable	4.5	664	\$ 7.05
	===	=====	

As of June 30, 2006, the unrecognized compensation cost related to stock options is approximately \$675,000 (\$431,000 on an after tax basis) which will be recognized over a weighted average period of 35 months.

Nonvested Stock:

Director Stock Grant Plan: Non-employee directors receive an annual award of 1,200 shares of Common Stock under the shareholder-approved 2002 Director Stock Grant Plan. The Company records compensation expense for this plan ratably over the annual service period beginning May 1. Director stock compensation expense recognized by the Company for the three- and six-month periods ended June 30, 2006 was \$49,000 and \$113,000, respectively, compared to \$42,000 and \$74,000 of compensation expense recognized for the same periods in 2005. As of June 30, 2006, the

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unrecognized compensation cost related to the nonvested director stock award that is expected to be recognized over the remaining ten months is estimated to be approximately \$162,000 (\$99,000 on an after tax basis).

**Restricted Stock:** On April 28, 2005, a restricted stock plan was approved which provides for the issuance of nonvested Common Stock to certain eligible employees. The Company records compensation expense for this plan ratably over the vesting period. The plan authorizes the issuance of up to an aggregate of 100,000

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shares of Common Stock, of which a net of 31,000 were issued in the second quarter of 2005 and 48,000 were issued in the second quarter of 2006. Restricted stock awards have a three-year cliff vesting period contingent on employment. Restricted stock compensation expense recognized by the Company for the three- and six-month periods ended June 30, 2006 was \$139,000 and \$186,000, respectively, compared to \$32,000 for the three- and six-month periods in 2005.

The fair value of nonvested shares is determined based on the market price of the Company's shares on the grant date.

(In thousands except per share amounts)	Shares	Fair value per share
	-----	-----
Nonvested at January 1	31	\$18.33
Granted	48	\$31.41
Vested	(1)	\$18.33
Forfeited	--	--
	---	-----
Nonvested at June 30, 2006	78	\$26.40
	===	=====

As of June 30, 2006, there was \$1.7 million (\$1.0 million on an after tax basis) of unrecognized compensation cost related to non-vested restricted stock that is expected to be recognized over a weighted average period of 2.6 years.

3. 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 June 30, 2006 and 2005 based on a September 30 measurement date:

(In thousands)	Pension benefits		Other postretirement benefits	
	2006	2005	2006	2005
	-----	-----	-----	-----

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Service cost	\$ 485	\$ 457	\$ 56	\$ 44
Interest cost	595	625	122	125
Expected return on plan assets	(918)	(910)	--	--
Amortization of prior service cost	(28)	(29)	(9)	(45)
Amortization of net loss	318	248	59	40
	-----	-----	-----	-----
Net periodic benefit cost	\$ 452	\$ 391	\$228	\$164
	=====	=====	=====	=====

The following table sets forth the components of net periodic benefit cost for the six months ended June 30, 2006 and 2005 based on a September 30 measurement date:

(In thousands)	Pension benefits		Other postretirement benefits	
	2006	2005	2006	2005
	-----	-----	-----	-----
Service cost	\$ 970	\$ 914	\$113	\$ 88
Interest cost	1,190	1,250	243	250
Expected return on plan assets	(1,836)	(1,820)	--	--
Amortization of prior service cost	(56)	(58)	(18)	(90)
Amortization of net loss	636	496	119	80
	-----	-----	-----	-----
Net periodic benefit cost	\$ 904	\$ 782	\$457	\$328
	=====	=====	=====	=====

The Company previously disclosed in its financial statements for the year ended December 31, 2005 that it did not expect to contribute funds to its pension plan in 2006. While the Company believes that it will not be required to make a contribution in 2006, such belief is based upon the estimated return on assets as of the annual measurement date of September 30, 2006.

The Company also disclosed in its financial statements for the year ended December 31, 2005 that it estimated it would pay \$1.0 million in other postretirement benefits in 2006. As of June 30, 2006, \$506,000 of such benefits were paid. The Company continues to believe that its estimated payments for the full year are reasonable. Note that the amount of benefits paid in calendar year 2006 will not impact the expense for postretirement benefits for the current year.

- The Company guarantees the debt of the Badger Meter Officers' Voting Trust ("BMOVOT"), from which the BMOVOT obtained loans from a bank on behalf of the officers of the Company in order to purchase shares of the Company's Common Stock. The officers' loan amounts are collateralized by the Company's shares that were purchased with the loans' proceeds. There have been no loans made to officers by the BMOVOT since July 2002. The Company has guaranteed \$0.5 million and \$1.1 million of the BMOVOT's debt at June 30, 2006 and December 31, 2005, respectively. The current loan matures in April 2007, at which time it is expected to be renewed. The fair market value of

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this guarantee at June 30, 2006 continues to be insignificant because the collateral 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 has no other off-balance sheet arrangements.

The Company guarantees the outstanding debt of the Badger Meter Employee Savings and Stock Ownership Plan ("ESSOP") that is recorded in 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 \$120,000 in the first quarter of 2006 reduced the loan from \$0.9 million at December 31, 2005 to \$0.8 million at June 30, 2006.

5. Total comprehensive income was \$4.6 million and \$3.2 million for the three-month periods ended June 30, 2006 and 2005, respectively. Included in the three-month periods ended June 30, 2006 and 2005 was a \$0.5 million gain and a \$0.9 million loss, respectively, of other comprehensive income related to foreign currency translation adjustments. Total comprehensive income was \$9.0 million and \$6.1 million for the six-month periods ended June 30, 2006 and 2005, respectively. Included in the six-month periods ended June 30, 2006 and 2005 was a \$0.8 million gain and a \$1.7 million loss, respectively, of other comprehensive income related to foreign currency translation adjustments.
6. 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 relative to environmental laws and regulations. Currently, the Company is in the process of resolving matters relative to two landfill sites. Provision has been made for all known settlement costs, which are not material.

The Company is also a defendant in numerous multi-party asbestos lawsuits pending in various states. These lawsuits assert claims alleging that certain industrial products were manufactured by the defendants and were the cause of injury and harm. 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.

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. The Company does not believe that there are any significant risks. However, the Company relies on single suppliers for certain castings and components in several of its product lines. Although 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 exposures on a periodic basis and makes adjustments to reserves as appropriate.

7. In June 2006, the FASB issued Financial Interpretation No. (FIN) 48, "Accounting for Uncertainty in Income Taxes," 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 is required to adopt FIN 48 on January 1, 2007 and is currently evaluating the impact that the adoption of FIN 48 will have on its consolidated financial condition, results of operations and cash flows.

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### 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 and systems, 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 product, Orion(R), which has 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(R) 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.

There is a base level of annual business for utility products driven by replacement units and, to a 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 15-20% of the 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

As noted above, the Company sells AMR products of other companies as well as its own proprietary product, Orion(R). 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(R) products, Itron water utility related products were a significant contributor to the Company's results. The Company's Orion(R) products directly compete with Itron water AMR products and, in recent years, many of the Company's customers have selected Orion(R) products. As a result, the Company's 2005 sales of Itron products decreased approximately 12%, while Orion(R) sales doubled compared to 2004. This trend continued as sales of Itron products decreased approximately 6% and 13% in the first and second quarters of 2006 respectively, while Orion(R) sales increased 43% and 20% compared to the corresponding periods of 2005. The Company expects this trend to continue, although it also believes that Itron products will remain a significant component of utility sales. Decreases in sales of Itron products have been offset by increases in sales of Orion(R) products, which produce a higher gross margin than the 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.

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### RESULTS OF OPERATIONS - THREE MONTHS ENDED JUNE 30, 2006

Net sales for the three-month period ended June 30, 2006 increased \$5.0 million, or 8.7%, over the same period in 2005. The overall sales increase was driven by increased sales in both local read and AMR meters as well as significant increases in commercial meters, all caused by volume increases, and by higher industrial sales.

Residential and commercial water meter sales represented 75.8% of total sales in the second quarter of 2006 compared to 75.0% in the second quarter of 2005. These sales increased \$4.2 million to \$47.3 million compared to \$43.1 million in the same period in 2005 due to increased sales of local (or manual) read water meter units, units utilizing AMR technologies and commercial meters. Most notable in the increase of AMR technologies was the increase in sales of the Company's proprietary AMR product, Orion(R), which increased approximately 20.0% over the amount sold in the second quarter of 2005. The increase in Orion(R) sales was somewhat offset by sales decreases in other AMR technologies.

Industrial sales were affected by economic conditions, domestically and internationally, in each of the markets served by the various product lines. In total, industrial products represented 24.2% of total sales for the three months ended June 30, 2006 compared to 25.0% for the same period in 2005. Industrial sales increased \$0.8 million to \$15.1 million in the second quarter of 2006 compared to \$14.3 million in the second quarter of 2005. The increase in sales was driven primarily by higher sales of electromagnetic meters.

Gross margins in total for the second quarter of 2006 were 33.0% compared to 35.0% in the second quarter of 2005. The decrease in gross margin was due to

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the Company experiencing considerable cost increases on purchased castings due to increased prices of raw material metals, particularly copper, which is a main component in purchased brass castings. The Company was unable to recoup these increases in the second quarter. The Company has announced price increases for the third quarter of 2006 which are intended to recover the increased cost of materials. Gross margins were also negatively affected by the net impact of lower margins on automotive fluid meters and related systems due to competition, offset somewhat by higher residential meter margins due to the higher mix of AMR products, particularly the Orion(R) product, which carries higher margins.

Selling, engineering and administration costs for the second quarter of 2006 were 20.7% as a percent of net sales compared to 21.9% for the same period in 2005. The decrease in selling, engineering and administration costs as a percent of net sales is the result of cost containment efforts and higher sales levels, offset by normal inflationary pressures. In addition, the second quarter of 2006 includes \$104,000 of additional compensation expense due to expensing stock options to comply with SFAS 123(R), "Share-Based Payment".

Interest expense for the second quarter of 2006 was less than \$0.1 million higher than the same period in the prior year primarily due to higher interest rates.

The effective tax rate for the second quarter of 2006 was 44.4% compared to 42.1% in the same period in the prior year. The effective tax rate for both periods exceeds normal statutory tax rates primarily as a result of the Company recognizing a full valuation reserve for the operating losses of the Company's French subsidiary. The French operation continues to generate losses and the Company is exploring options for the future of this business.

As a result of the above-mentioned items, net earnings for the second quarter of 2006 were \$4.0 million compared to net earnings in the second quarter of 2005 of \$4.2 million. On a diluted earnings per share basis, this equated to \$0.28 per share for the second quarter of 2006 compared to \$0.30 for the same period in 2005.

### RESULTS OF OPERATIONS - SIX MONTHS ENDED JUNE 30, 2006

Net sales for the six-month period ended June 30, 2006 increased \$11.6 million, or 10.3%, over the same period in 2005. The overall sales increase was driven by increased sales in both local read and AMR meters as well as significant increases in commercial meters, all caused by volume increases, offset by slightly lower industrial sales.

Residential and commercial water meter sales represented 76.6% of total sales for the first six months of 2006 compared to 74.1% for the same period in 2005. These sales increased \$11.6 million to \$94.5 million compared to \$82.9 million in the same period in 2005 due to increased sales of local (or manual) read water meter units, units utilizing AMR technologies and commercial meters. Most notable in the increase of AMR

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technologies was the increase in sales of the Company's proprietary AMR product, Orion(R), which increased 30.8% over the amount sold in the first six months of 2005. This was mitigated somewhat by sales decreases in other AMR technologies.

Industrial sales were affected by economic conditions, domestically and internationally, in each of the markets served by the various product lines. In total, industrial products represented 23.4% of total sales for the six months ended June 30, 2006 compared to 25.9% for the same period in 2005. Industrial



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sales decreased less than \$0.1 million to \$28.9 million for the first six months 2006 compared to \$29.0 million for the same period in 2005. This was driven primarily by decreases in automotive systems products sold by the Company's French subsidiary offset by higher sales of electromagnetic meters and industrial products.

Gross margins in total for the six months ending June 30, 2006 were 33.8% compared to 35.3% in the same period in 2005. The decrease in gross margin was due to the Company experiencing considerable cost increases on purchased castings due to increased prices of raw material metals, particularly copper, which is a main component in purchased brass castings. The Company was unable to recoup these increases in the first half of 2006. The Company has announced price increases for the third quarter of 2006 which are intended to recover the increased costs of materials. Gross margins were also negatively affected by the net impact of lower margins on automotive fluid meters and related systems due to competition, offset somewhat by higher residential meter margins due to the higher mix of AMR products, particularly the Orion(R) product, which carries higher margins, and higher margins on commercial meters due to increased volume.

Selling, engineering and administration costs for the six months ending June 30, 2006 were 21.3% as a percent of net sales compared to 22.8% for the same period in 2005. The decrease in selling, engineering and administration costs as a percent of net sales is the result of cost containment efforts and higher sales levels, offset by normal inflationary pressures. In addition, this six-month period of 2006 includes \$211,000 of additional compensation expense due to expensing stock options to comply with SFAS 123(R), "Share-Based Payment".

Interest expense for the first six months of 2006 was less than \$0.1 million higher than the same period in the prior year primarily due to higher interest rates.

The effective tax rate for the first six months of 2006 was 43.2% compared to 41.6% in the same period in the prior year. The effective tax rate for both periods exceeds normal statutory tax rates primarily as a result of the Company recognizing a full valuation reserve for the operating losses of the Company's French subsidiary. The French operation continues to generate losses and the Company is exploring options for the future of this business.

As a result of the above-mentioned items, net earnings for the six months ended June 30, 2006 were \$8.3 million compared to net earnings for the same period in 2005 of \$7.7 million. On a diluted earnings per share basis, this equated to \$0.58 per share for the first six months of 2006 compared to \$0.55 for the same period in 2005.

### LIQUIDITY AND CAPITAL RESOURCES

The main sources of liquidity for the Company typically are cash provided by operations and borrowing capacity. For the first six months of 2006, \$0.8 million of cash was provided by operations, primarily as the net result of increased earnings adjusted for depreciation and amortization, offset by increased inventory and receivables.

The change in the receivables balance from \$30.5 million at December 31, 2005 to \$38.3 million at June 30, 2006 was primarily due to increased sales and the timing of certain customer payments.

Inventories at June 30, 2006 have increased \$4.3 million to \$36.3 million from the December 31, 2005 balance of \$32.0 million due primarily to increased sales and higher material costs, particularly on brass castings.

Property, plant and equipment increased \$2.6 million since December 31,

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2005. This is the net result of \$5.5 million of capital expenditures and \$3.5 million of depreciation expense including the effects of currency adjustments.

Short-term debt and the current portion of long-term debt at June 30, 2006 increased \$9.3 million to a combined \$25.6 million versus a balance at December 31, 2005 of \$16.3 million. Long-term debt decreased to \$7.0 million at June 30, 2006 from \$15.4 million at December 31, 2005. Overall, the Company's total debt position has increased slightly due to changes in working capital accounts. Total debt is 28.1% of total

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capitalization (debt and equity) at June 30, 2006 compared to 30.1% at December 31, 2005. At June 30, 2006, none of the Company's debt carried financial covenants or required collateral.

Payables increased to \$14.9 million at June 30, 2006 from \$11.5 million at December 31, 2005 primarily as a result of the timing of payments and increased inventory levels. Accrued compensation and employee benefits decreased \$0.8 million since December 31, 2005 to \$5.7 million due to the first quarter 2006 payments of amounts accrued at December 31, 2005, offset somewhat by costs accrued for 2006 expenses to date.

Common stock and capital in excess of par value have increased from December 31, 2005 due to new shares issued in connection with the exercise of stock options. Employee benefit stock decreased as a result of a payment made on the ESSOP loan during the first quarter of 2006, amortization of nonvested stock expense and the adoption of SFAS 123(R), which required the reclassification of amounts from employee benefit stock to capital in excess of par value.

Badger Meter's financial condition remains strong. The Company believes that its operating cash flows, available borrowing capacity, including \$32.9 million of unused credit lines, and its ability to raise additional capital provide adequate resources to fund ongoing operating requirements, future capital requirements and the development of new products.

### 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 relative to environmental laws and regulations. Currently, the Company is in the process of resolving matters relative to two landfill sites. Provision has been made for all known settlement costs, which are not material.

The Company is also a defendant in numerous multi-party asbestos lawsuits pending in various states. These lawsuits assert claims alleging that certain industrial products were manufactured by the defendants and were the cause of injury and harm. 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.

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.

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### ACCOUNTING CHANGE

The Company began expensing the cost of stock options on January 1, 2006 when it adopted SFAS 123(R), "Share-Based Payment". See Note 2 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, 2005, and have not materially changed since that report was filed.

### 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, 2005, and have not materially changed since that report was filed.

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### 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 June 30, 2006. 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 June 30, 2006 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 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 June 30, 2006, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II - OTHER INFORMATION

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

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At the Company's Annual Meeting of Shareholders held on April 28, 2006, the following individuals were elected to the Board of Directors:

NAME	Votes FOR	Votes WITHHELD	Not Voted
Directors elected to three-year terms expiring at the 2009 Annual Meeting:			
Ulice Payne, Jr.	6,157,489	45,829	717,832
Andrew J. Policano	6,178,066	25,252	717,832
Steven J. Smith	6,165,378	37,939	717,833
Directors continuing in office with terms expiring at the 2007 Annual Meeting:			
Kenneth P. Manning			
John J. Stollenwerk			
Directors continuing in office with terms expiring at the 2008 Annual Meeting:			
Ronald H. Dix			
Thomas J. Fischer			
Richard A. Meeusen			

### ITEM 6 EXHIBITS

EXHIBIT NO.	DESCRIPTION
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: August 3, 2006

By /s/ Richard A. Meeusen

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Richard A. Meeusen

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Chairman, President and Chief  
Executive Officer

By /s/ Richard E. Johnson

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Richard E. Johnson  
Senior Vice President - Finance,  
Chief Financial Officer and Treasurer

By /s/ Beverly L.P. Smiley

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Beverly L.P. Smiley  
Vice President - Controller

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BADGER METER, INC.

QUARTERLY REPORT ON FORM 10-Q FOR PERIOD ENDED JUNE 30, 2006

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