

Edgar Filing: Omega Flex, Inc. - Form 10-Q

Omega Flex, Inc.
Form 10-Q
November 13, 2006
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

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

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

For the transition period from _____ to _____

Commission File Number **000-51372**

Omega Flex, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of incorporation or organization)
451 Creamery Way, Exton, PA
(Address of principal executive offices)

23-1948942
(I.R.S. Employer Identification No.)
19341
(Zip Code)

(610) 524-7272

Edgar Filing: Omega Flex, Inc. - Form 10-Q

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of The Exchange Act).

Yes No

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS

DURING THE PRECEDING FIVE YEARS.

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 12 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by the courts.

The number of shares of the registrant's common stock issued and outstanding as of November 10, 2006 was 10,153,633.

OMEGA FLEX, INC.

QUARTERLY REPORT ON FORM 10-Q

FOR THE NINE-MONTHS ENDED SEPTEMBER 30, 2006

INDEX

PART I - FINANCIAL INFORMATION	<u>Page No.</u>
Item 1 Financial Statements	
Condensed consolidated balance sheets at September 30, 2006 (unaudited) and December 31, 2005 (audited)	3
Condensed consolidated statements of operations for the three-months ended September 30, 2006 and 2005 and the nine-months ended September 30, 2006 and 2005 (unaudited)	4
Condensed consolidated statements of cash flows for the nine-months ended September 30, 2006 and 2005 (unaudited)	5
Notes to the condensed consolidated financial statements (unaudited)	6
Item 2- Management's Discussion and Analysis of Financial Condition and Results of Operations	15
Item 3 Quantitative and Qualitative Information About Market Risks	23
Item 4 Controls and Procedures	24
PART II - OTHER INFORMATION	
Item 1 Legal Proceedings	24
Item 6 - Exhibits	25
SIGNATURE	26

PART I - FINANCIAL INFORMATION**Item 1 - Financial Statements**

OMEGA FLEX, INC.

CONSOLIDATED BALANCE SHEETS

	September 30, 2006	December 31 2005
	(unaudited)	
	(Dollars in thousands)	
ASSETS		
Current Assets		
Cash and Cash Equivalents	\$11,316	\$9,882
Accounts Receivable - less allowances of \$63 and \$33, respectively	11,446	11,938
Inventories	7,670	6,228
Deferred taxes	2,723	252
Other Current Assets	<u>480</u>	<u>457</u>
Total Current Assets	<u>33,635</u>	<u>28,757</u>
Property and Equipment - net	6,606	5,749
Goodwill	3,526	3,526
Note Receivable from Mestek	3,250	3,250
Other Long Term Assets	<u>432</u>	<u>432</u>
Total Assets	<u>\$47,449</u>	<u>\$41,714</u>
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Current Portion of Long-Term Debt	\$---	\$186
Accounts Payable	963	1,554
Accrued Compensation	1,469	2,631
Accrued Commissions	539	638
Accrued Sales Incentives	4,360	5,299
Accrued Legal Settlement and Related Costs	6,519	85
Other Accrued Liabilities	<u>2,684</u>	<u>1,239</u>
Total Current Liabilities	16,534	11,632
Long-Term Debt	---	3,225
Deferred Taxes	---	639
Long-Term Accrued Legal Settlement	2,000	---
Other Long-Term Liabilities	<u>257</u>	<u>209</u>
Total Liabilities	<u>18,791</u>	<u>15,705</u>
Minority Interests	<u>42</u>	<u>23</u>
Shareholders' Equity:		
Common Stock 10,153,633 shares issued	102	102
Paid in Capital	11,739	11,739
Retained Earnings	16,097	13,873

Edgar Filing: Omega Flex, Inc. - Form 10-Q

Accumulated Other Comprehensive Income	<u>678</u>	<u>272</u>
Total Shareholders' Equity	<u>28,616</u>	<u>25,986</u>
Total Liabilities and Shareholders' Equity	\$47,449	\$41,714
	=====	=====

See Accompanying Notes to Consolidated Financial Statements.

OMEGA FLEX, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	For the three-months ended September 30,		For the nine-months ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
(Dollars in thousands, except earnings per Common Share)				
Net Sales	\$19,283	\$17,116	\$54,506	\$45,649
Cost of Goods Sold	<u>9,349</u>	<u>8,601</u>	<u>26,221</u>	<u>22,790</u>
Gross Profit	9,934	8,515	28,285	22,859
Selling Expense	3,040	2,513	8,472	7,339
General and Administrative Expense	1,239	1,467	4,950	4,753
Engineering Expense	467	415	1,410	1,047
Legal Settlement and Related Costs	<u>9,008</u>	<u>828</u>	<u>10,324</u>	<u>1,190</u>
Operating Profit (Loss)	(3,820)	3,292	3,129	8,530
Interest Income, Net	147	12	334	99
Other Income, Net	<u>91</u>	<u>127</u>	<u>306</u>	<u>134</u>
Income (Loss) Before Income Taxes	(3,582)	3,431	3,769	8,763
Income Tax Expense (Benefit)	<u>(1,263)</u>	<u>1,491</u>	<u>1,545</u>	<u>3,755</u>
Net Income (Loss)	<u>(\$2,319)</u>	<u>\$1,940</u>	<u>\$2,224</u>	<u>\$5,008</u>
	=====	=====	=====	=====
Basic Earnings (Loss) per Common Share:				
Net Income (Loss)	(\$0.23)	\$0.19	\$0.22	\$0.49
Basic Weighted Average Shares Outstanding	10,154	10,154	10,154	10,154
Diluted Earnings (Loss) per Common Share:				
Net Income (Loss)	(\$0.23)	\$0.19	\$0.22	\$0.49
Diluted Weighted Average Shares Outstanding	10,154	10,154	10,154	10,154
Dividends Declared per Share	---	---	---	\$0.92

See Accompanying Notes to Consolidated Financial Statements.

OMEGA FLEX, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

For the nine-months ended

	September 30,	
	<u>2006</u>	<u>2005</u>
	(Dollars in thousands)	
Cash Flows from Operating Activities:		
Net Income	\$2,224	\$5,008
Adjustments to Reconcile Net Income to		
Net Cash Provided by Operating Activities:		
Depreciation and Amortization	301	501
Stock Based Compensation Expense	---	587
Provision for Losses on Accounts Receivable, net of write-offs and recoveries	30	3
Change in Minority Interests	19	13
Changes in Assets and Liabilities:		
Accounts Receivable	462	(737)
Inventory	(1,442)	(1,075)
Accounts Payable	(591)	(857)
Accrued Compensation	(1,162)	(50)
Receivable from Mestek, Inc.	---	7,974
Accrued Legal Settlement and Related Costs	8,434	---
Other Liabilities	(184)	(2,979)
Other Assets	<u>(2,494)</u>	<u>(785)</u>
Net Cash Provided by Operating Activities	<u>5,597</u>	<u>7,603</u>
Cash Flows from Investing Activities:		
Capital Expenditures	<u>(1,158)</u>	<u>(591)</u>
Net Cash Used in Investing Activities	<u>(1,158)</u>	<u>(591)</u>
Cash Flows from Financing Activities:		
Principal Payments Under Long Term Debt Obligations	(3,411)	(140)
Proceeds from Issuance of Common Stock	---	50
Net Cash Used in Financing Activities	<u>(3,411)</u>	<u>(90)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	1,028	6,922
Translation effect on cash	406	123
Cash and Cash Equivalents Beginning of Period	<u>9,882</u>	<u>280</u>
Cash and Cash Equivalents End of Period	<u>\$11,316</u>	<u>\$7,325</u>
Schedule of Non-Cash Financing Activities		
Dividend To Mestek treated as reduction of receivable	---	8,041
Dividend recorded as a reduction of Put Liability	---	<u>1,309</u>
	\$---	<u>\$9,350</u>
	=====	=====

Edgar Filing: Omega Flex, Inc. - Form 10-Q

See Accompanying Notes to Consolidated Financial Statements.

-5-

OMEGA FLEX, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

Description of Business

The Company is a leading manufacturer of flexible metal hose, which is used in a variety of applications to carry gases and liquids within their particular applications. These applications include carrying liquefied gases in certain processing applications, fuel gases within residential and commercial buildings and vibration absorbers in high vibration applications. Our industrial flexible metal piping is used to carry other types of gases and fluids in a number of industrial applications where the customer requires the piping to have both a degree of flexibility and/or an ability to carry corrosive compounds or mixtures, or to carry at both very high and very low (cryogenic) temperatures.

The Company manufactures flexible metal hose at its facility in Exton, Pennsylvania, and sells its product through distributors, wholesalers and to original equipment manufacturers (OEMs) throughout North America, and in certain European markets.

The accompanying consolidated financial statements include the accounts of Omega Flex, Inc. (Omega) and its subsidiaries (collectively the Company). The Company s unaudited consolidated financial statements for the quarter ended September 30, 2006 have been prepared in accordance with generally accepted accounting principles for interim financial information, and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes that may be required by generally accepted accounting principles for complete financial statements. All material inter-company accounts and transactions have been eliminated in consolidation. In the opinion of management, the financial statements include all material adjustments (all of a normal and recurring nature) necessary for a fair presentation of the Company s financial position, results of operations and cash flows.

2. SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and

Edgar Filing: Omega Flex, Inc. - Form 10-Q

assumptions relate to revenue recognition, accounts receivable valuations, inventory valuations, goodwill valuation, intangible asset

-6-

valuations, warranty costs, investments, accounting for income taxes and the realization of deferred tax assets. Actual amounts could differ significantly from these estimates.

Revenue Recognition

The Company's revenue recognition activities relate almost entirely to the manufacture and sale of flexible metal hose and pipe. Under generally accepted accounting principles, revenues are considered to have been earned when the Company has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. The following criteria represent preconditions to the recognition of revenue:

Persuasive evidence of an arrangement for the sale of product or services must exist.

Delivery has occurred or services rendered.

The sales price to the customer is fixed or determinable.

Collection is reasonably assured.

The Company generally recognizes revenue upon shipment in accordance with the above principles.

Earnings per Common Share

Basic earnings per share have been computed using the weighted average number of common shares outstanding. Basic and diluted weighted average shares outstanding have been adjusted for all periods to give retroactive effect to the stock split which was completed on June 23, 2005, as more fully described in Note 3.

Stock Based Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment*, (SFAS 123R), using the statement's modified prospective application method. Prior to January 1, 2006, the Company followed SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock based Compensation Transition and Disclosure, an amendment to FASB Statement No. 123*, which required entities to recognize as expense over the vesting period the fair value of stock-based awards on the date of grant or measurement date.

Under the provisions of SFAS 123R, the Company recognizes the estimated fair value of stock based compensation in the consolidated statement of operations over the requisite service period of each option granted. Under the modified prospective application method of SFAS 123R, the Company applies the provisions of SFAS 123R to all awards granted or modified after January 1, 2006. The Company had no stock options outstanding at December 31, 2005 and made no option grants in the quarters or nine month periods ended September 30, 2006 and 2005. Accordingly, there was no compensation expense recorded in 2006 and the adoption of SFAS 123R had no impact on the Company's financial

statements.

-7-

Currency Translation

Assets and liabilities denominated in foreign currencies are translated into U.S. dollars at exchange rates prevailing on the balance sheet date. The Statement of Operations is translated at average exchange rates. Net foreign currency transactions are reported in the results of operations in U.S. dollars at average exchange rates. Adjustments resulting from the translation of financial statements are excluded from the determination of income and are accumulated in a separate component of shareholders' equity.

Income Taxes

The Company elected in prior years and up to the date of the Spin-Off as described in Note 3 below to file its federal income tax return as part of the Mestek, Inc. consolidated return. Mestek and the Company account for the Company's federal tax liabilities on the separate company basis method in accordance with SFAS No. 109, "Accounting for Income Taxes". Under this method the Company recorded tax expense and related deferred taxes and tax benefits in a manner comparable to that which it would have recorded if it were not affiliated with Mestek.

The Company filed a separate Federal income tax return for the five months of 2005 in which it was a separate company, and will file a separate Federal income tax return for 2006 in its entirety.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize the benefit, or that future deductibility is uncertain.

Other Comprehensive (Loss) Income

For the nine-months ended September 30, 2006 and September 30, 2005, respectively, the components of Other Comprehensive (Loss) Income consisted solely of foreign currency translation adjustments.

Reclassification

Reclassifications are made periodically to previously issued financial statements to conform to the current year presentation.

3. DISTRIBUTION FROM MESTEK, INC. (Spin-Off)

On January 19, 2005, Mestek, Inc. (Mestek) and the Company announced that Mestek intended to distribute its 86% equity interest in the Company in a Spin-Off, *pro rata*, to all of

-8-

Edgar Filing: Omega Flex, Inc. - Form 10-Q

Mestek's public shareholders as of a record date, which was subsequently established at June 23, 2005 (the Spin-Off). The Spin-Off was preceded by an amendment on April 19, 2005 to the Company's articles of incorporation to authorize a maximum of 20 million shares of common stock. The board of directors declared a share split on the Company's common stock on June 23, 2005 that resulted in a share split of 1 to 10,153.633 in order to effect a 1 for 1 share distribution under the Spin-Off. All references to shares and per share amounts in these Financial Statements have been retroactively restated to give effect to the stock split at the 1 to 10,153.633 ratio. In conjunction with the Spin-Off, the Company filed several preliminary registration statements on Form 10 with the Securities and Exchange Commission under the Securities Exchange Act of 1934. On July 22, 2005, the Company filed its definitive registration statement on Form 10 with the Securities and Exchange Commission and completed the Spin-Off on July 29, 2005. The Company's common shares began trading on the NASDAQ National Market under the trading symbol OFLX on August 1, 2005.

In connection with the Spin-Off, the Company executed certain agreements governing its relationship with Mestek subsequent to the date of the Spin-Off. These include:

A Separation and Distribution Agreement which relates to the events surrounding the distribution of Omega common shares to Mestek shareholders and certain aspects of the relationship between the companies thereafter.

A Tax Responsibility Allocation Agreement which relates to the allocation of tax liabilities between Mestek and the Company subsequent to the Spin-Off.

An Indemnification and Insurance Matters Agreement which provides for mutual indemnification relating to the respective company's liabilities and definitions relating to insurance rights and obligations.

A Transitional Services Agreement by which Mestek will continue to provide to the Company certain corporate services, including legal, financial and tax services, in exchange for a fixed annual fee of approximately \$70,000.

A Confidential Nondisclosure Agreement which imposes certain duties of confidentiality on the Company and Mestek.

All of the above agreements are described in greater detail in the Form 10 filing which has been made with the Securities and Exchange Commission by the Company in connection with the Spin-Off.

On January 12, 2005, the Company paid a dividend of \$9,350,000 to its shareholders of record as of January 1, 2005. Consistent with their shareholdings, 10% of the dividend was received by Kevin Hoben, President and Chief Executive Officer, 4% by Mark Albino, Executive Vice President and Chief Operating Officer (both treated as a reduction of the accrued put obligation), and 86%, or \$8,041,000 was received by Mestek, and charged against Retained Earnings. On July 1, 2005 and in anticipation of the Spin-Off, the Company stopped lending its daily cash receipts to Mestek, Inc., its 86% shareholder, in order to accumulate cash reserves necessary for working capital purposes prior to the effective date of the Spin-Off. At the

effective date of the Spin-Off, Mestek remained indebted to the Company in the amount of \$3,250,000 which was converted on the effective date of the Spin-Off to a 3-year note receivable from Mestek bearing interest at 100 basis points above the then prevailing 3 year US Treasury note yield.

4. INVENTORIES

	September 30, 2006 (unaudited) (dollars in thousands)	December 31, 2005
Finished Goods	\$5,566	\$4,280
Raw Materials	<u>2,104</u>	<u>1,948</u>
Total Inventory	<u>\$7,670</u> =====	<u>\$6,228</u> =====

5. SHAREHOLDERS EQUITY

As of December 31, 2004, the Company had authorized common stock of 1,000 shares with par value of \$60 per share. As of December 31, 2004, Mestek, Inc. owned 860 shares of the Company's common stock, or 86%, and Kevin R. Hoben and Mark F. Albino, the President and Executive Vice President of the Company respectively, collectively owned the remaining 14% of the Company's common stock. As explained more fully in Note 3, on June 23, 2005 the Company authorized a split of its common shares at a ratio of 1 to 10,153.633 in connection with the planned Spin-Off of Omega Flex common shares to Mestek Stockholders. All references to shares and per share amounts in these Financial Statements have been retroactively restated to give effect to the stock split at the above ratio.

The Company has paid two special dividends on its common stock, but these special dividends were declared and paid prior to the date that our common stock was registered with the Securities and Exchange Commission and began trading on the NASDAQ National Market in August, 2005. The first dividend was declared and paid to shareholders of record as of October 13, 2004, and the amount of the dividend was \$0.886 per share on a fully diluted basis and after giving effect to the forward split as part of the distribution, as described in Note 3 under the caption Spin-Off. On January 12, 2005, the second dividend was paid to record shareholders as of January 1, 2005, and was \$0.92 per share on a fully diluted basis and after giving effect to the forward split as part of the distribution. The 2005 dividend totaling \$9,350,000 was recorded as a reduction to retained earnings for the portion related to Mestek, its 86% shareholder, and the remaining 14% portion relating to Mr. Hoben and Mr. Albino was recorded as a reduction to Common Stock Subject to Put Obligation in Current Liabilities, as described in Note 7. Our future decisions concerning the payment of dividends on our common stock will depend upon our results of operations, financial condition and capital expenditure plans, as well as such other factors as the Board of Directors, in its sole discretion, may consider relevant.

6. COMMITMENTS AND CONTINGENCIES

Commitments:

On September 4, 2006 the Company entered into a Stipulation and Settlement Agreement with the Class Representatives and Class Counsel, to settle and resolve the allegations brought forth in the lawsuit titled *Berry, et al. v. Titeflex, Inc., et al.* in the Arkansas Circuit Court, Clark County. All of the other defendants in the case also signed the Settlement Agreement. The lawsuit relates to allegations that the Company's CSST products posed an unreasonable risk of fire due to lightning strikes. **Both the Company and the other defendants deny these allegations, and deny any wrongdoing or legal liability, but have agreed to settle this matter to avoid further cost and the uncertainty and risk of the outcome of further litigation.**

The Settlement Agreement is subject to notice to the Class of the proposed settlement, and final approval by the Court after hearings on the fairness of the Settlement. It is expected that the fairness hearing and hearings on final court approval will not be scheduled before December 31, 2006.

Under the Settlement Agreement, the Company has agreed to pay the value of each payment voucher redeemed by a class member for the installation of a lightning protection system or bonding and grounding of the Company's CSST product. The amount of the voucher is dependent on the geographical area in the United States where the building is located and the size of the heated or air-conditioned area of the building, as set forth in the Settlement Agreement. The Company has also agreed to pay a fixed amount of administrative expenses in providing notice to the class, and establishing and operating a claim system under which class members may obtain information, submit claims, and have claims processed. Finally, the Company has agreed to pay attorneys' fees to the Class Counsel to resolve this matter.

The Company cannot determine the exact amount for which it may be liable for the costs of the payment vouchers tendered under the claim program because of the number of unknown variables associated with this liability, including; the number of buildings in the United States that contain the Company's CSST product; the number of payment vouchers that are properly and timely submitted by claimants; the extent to which vouchers are for lightning protection systems or for bonding and grounding; the geographical location of the building within the United States; and the size of the building in which the CSST is located. However, the Company estimates that the total amount of the liability relating to the settlement of the litigation will fall within a range of \$8.8 million and \$10.2 million. Accordingly, the Company recorded a pre-tax charge to operations of approximately \$8.8 million in the third quarter of 2006. This amount is based on currently available information and certain estimates and judgments, and is subject to revision as actual claims are received, and a claim history is established.

The Company is obligated under Indemnity Agreements executed on behalf of 16 of the Company's officers and directors. Under the terms of the Agreement, the Company is contingently liable for costs which may be incurred by the officers and directors in connection with claims arising by reason of these individuals' roles as officers and directors.

As of December 31, 2005, the Company was a guarantor of the debt of its wholly-owned subsidiary, Exton Ranch, Inc., related to the mortgage note established on April 16, 2004 with Sovereign Bank for the purchase of the Company's main operating facility in Exton, Pennsylvania. However, on April 27, 2006, the Company paid the entire outstanding principal balance (and accrued interest) of the \$3.348 million mortgage note that was obtained from Sovereign Bank in 2004.

The Company has entered into salary continuation agreements with two employees which provide for monthly payments to each of the employee or his designated beneficiary upon the employee's retirement or death. The payment benefits range from \$1,000 per month to \$3,000 per month with the term of such payments limited to 15 years after the employee's retirement at age 65. The agreements also provide for survivorship benefits if the employee dies before attaining age 65; and severance payments if the employee is terminated without cause, the amount of which is dependent on the length of company service at the date of termination. The net present value of the retirement payments is included in Other Long-term Liabilities. The Company has obtained and is the beneficiary of two whole life insurance policies in respect of the two employees, and the cash surrender value of such policies (included in Other Assets) exceeds the net present value of the Company's obligations for the retirement payments at September 30, 2006.

Contingencies:

The Company retains significant obligations under its commercial insurance policies for losses occurring in the policy years in which it was a subsidiary of Mestek, Inc. For the policy year ending October 1, 2004, the Company retained liability for the first \$2,000,000 per occurrence of commercial general liability claims (including product liability claims), subject to an agreed aggregate. For losses occurring in the policy year ended October 31, 2003, the Company retained liability for the first \$500,000 per occurrence of commercial general liability claims (including product liability claims), subject to an agreed aggregate. In addition, for 2004 and 2003 the Company retained liability for the first \$250,000 per occurrence of workers compensation coverage, subject to an agreed aggregate. However, for policy years beginning on July 22, 2005 (the effective date of the Spin-Off), the Company retained liability for the first \$25,000 per occurrence of commercial liability claims (including products liability claims), subject to an agreed aggregate, and the Company is currently insured on a first dollar basis for workers' compensation subject to statutory limits. The Company maintains reserves for its obligations under these various policies based on claim experience and the reserves established by the insurers in relation to these claims. The reserve balances at September 30, 2006 and December 31, 2005 were not material in amount.

Prior to the Spin-Off, the Company self-insured a substantial portion of the health benefits provided for its employees and maintained reserves in this regard and relied upon a recognized actuarial consulting firm to help it set and maintain these reserves. After the Spin-Off, the Company's liability is limited to \$30,000 per case and an aggregate of \$600,000 annually.

The Company was obligated as a guarantor with respect to the debt of Mestek, Inc. under Mestek's primary commercial bank line of credit. As of the effective date of the Spin-Off (as disclosed in Note 3), the guaranty was cancelled and is no longer in effect.

Warranty Commitments:

Gas transmission products such as those made by the Company carry potentially serious personal injury risks in the event of failures in the field. As a result, the Company has extensive internal testing and other quality control procedures and historically the Company has not had a meaningful failure rate in the field due to the extensive nature of these quality controls. Due to the Company's quality systems, the warranty expense is *de minimis*, and accordingly, the Company does not maintain a warranty reserve beyond a nominal amount.

7. STOCK OPTION PLANS

The Company adopted a stock option plan (the "Plan"), effective July 1, 1996 which provided for the granting of both Incentive and Non-Qualified Stock Options (as those terms are defined in the Internal Revenue Code) of up to (pre-split) 200 shares of stock to certain employees of the Company for the purchase of the Company's common stock at fair market value as of the date of grant. The Plan was approved by Mestek, Inc., then the Company's sole shareholder. Options to purchase an aggregate of (pre-split) 140 shares of the common stock of the Company, representing a 14% equity share were granted to two executives, Kevin Hoben, President and Mark Albino, Executive Vice President, effective July 1, 1996. The options vested over a five-year period commencing May 1, 1999 and ending on May 1, 2004. All of the options granted were exercised on October 13, 2004, in connection with which the Company received the \$1,260,000 exercise price. Through a separate agreement, the option holders (now shareholders in the Company) had a put right after exercise which allowed them to sell their shares to the Company at an amount based upon book value and the Company had a corresponding call option at an amount based upon book value. In accordance with APB 25, the

Company has reflected pre-tax charges to earnings for the third quarter ended September 30, 2006 and 2005, of \$0 and \$587,000, respectively, for the compensation value in those periods of the options granted. These charges, which reflected the potential obligations of the Company relative to the put rights, were credited to Common Stock Subject to Put Obligation. In July 2005 in coordination with the Spin-Off described in Note 3 the Company and Mr. Hoben and Mr. Albino mutually terminated their respective call and put rights at which time the Company reclassified the remaining liability (approximately \$2,743,000) to the put rights to Paid In Capital. No stock options were outstanding at or after December 31, 2005.

8. DEBT

Long-term Debt:

Long-term debt consisted of the following at September 30, 2006 and December 31, 2005

	<u>2006</u>	<u>2005</u>
	(in thousands)	
Mortgage Note	\$---	\$3,411
Less Current Maturities	<u>---</u>	<u>(186)</u>
	\$---	\$3,225
	=====	=====

On April 27, 2006, the Company's subsidiary Exton Ranch, Inc. paid the entire outstanding principal balance (and accrued interest) of the \$3.348 million Mortgage Note that was obtained from Sovereign Bank in 2004 to purchase the Company's main facility in Exton, Pennsylvania.

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

This report contains forward-looking statements, which are subject to inherent uncertainties. These uncertainties include, but are not limited to, variations in weather, changes in the regulatory environment, customer preferences, general economic conditions, increased competition, the outcome of outstanding litigation, and future developments affecting environmental matters. All of these are difficult to predict, and many are beyond the ability of the Company to control.

Certain statements in this Quarterly Report on Form 10-Q that are not historical facts, but rather reflect the Company's current expectations concerning future results and events, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words believes, expects, intends, plans, anticipates, hopes, likely, will, and similar expressions identify such forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of the Company, or industry results, to differ materially from future results, performance or achievements expressed or implied by such forward-looking statements.

Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's view only as of the date of this Form 10-Q. The Company undertakes no obligation to update the result of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, conditions or circumstances.

OVERVIEW

As disclosed in Note 3 to the financial statements, the Company is a former subsidiary of Mestek, Inc. On July 29, 2005, Mestek, Inc. effected a distribution of its 86% ownership of the Company's common stock to the Mestek record shareholders. This distribution was preceded by the filing on July 22, 2005 of a definitive registration statement of the Company's common stock on Form 10 with the Securities and Exchange Commission. The Company's common shares began trading on the NASDAQ National Market under the trading symbol OFLX on August 1, 2005.

The Company is a leading manufacturer of flexible metal hose, and is currently engaged in a number of different markets, including residential and commercial construction, transportation, petrochemical, pharmaceutical, semi-conductor, and medical industries.

The Company's business is controlled as a single operating segment that consists of the manufacture and sale of flexible metal hose and accessories. The Company's products are concentrated in residential and commercial construction, and general industrial markets. The Company's primary product line, TracPipe® flexible gas piping, is used for gas piping within residential and commercial buildings. Through its flexibility and ease of use with patented fittings distributed under the trademark, AutoFlare®, the TracPipe® flexible gas piping allows

users to substantially cut the time required to install the gas piping, as compared to traditional methods. All of the Company's hose products are manufactured at the Company's Exton, Pennsylvania facility. A majority of the Company's sales across all industries are generated through independent outside sales organizations such as sales representatives, wholesalers and distributors, or a combination of both. The Company has a broad distribution network in North America and to a lesser extent in other global markets.

CHANGES IN FINANCIAL CONDITION

On April 27, 2006, the Company paid the remaining outstanding principal balance (and accrued interest) of \$3,348,000 million on the mortgage note that was obtained from Sovereign Bank in 2004. The balance at December 31, 2005 was \$3,411,000.

On September 4, 2006 the Company entered into a Stipulation and Settlement Agreement with the Class Representatives and Class Counsel, to settle and resolve the allegations brought forth in the lawsuit titled *Berry, et al. v. Titeflex, Inc., et al.* in the Arkansas Circuit Court, Clark County. The Company estimates that the total amount of the liability relating to the settlement of the litigation will fall within a range of \$8.8 million and \$10.2 million. Accordingly, the Company recorded a pre-tax charge to operations of approximately \$8.8 million in the third quarter of 2006. This amount is based on currently available information and certain estimates and judgments, and is subject to revision as actual claims are received, and a claim history is established.

RESULTS OF OPERATIONS**Three-months ended September 30, 2006 vs. September 30, 2005**

The Company reported comparative results from continuing operations for the three-months period ended September 30, 2006 and 2005 as follows:

	<u>Three-months ended September 30,</u>			
	(in thousands)			
	<u>2006</u>	<u>2006</u>	<u>2005</u>	<u>2005</u>
	<u>(\$000)</u>	<u>%</u>	<u>(\$000)</u>	<u>%</u>
Net Sales	\$19,283	100.0%	\$17,116	100.0%
Gross Profit	\$9,934	51.5%	\$8,515	49.7%
Operating Profits	(\$3,820)	(19.8%)	\$3,292	19.2%

The Company's sales increased \$2,167,000 (12.7%) from \$17,116,000 in the three-months period ended September 30, 2005 as compared to \$19,283,000 in the three-months period ended September 30, 2006 due to continued strong sales of the Company's flagship TracPipe® flexible gas piping product and its patented AutoFlare® connection system. TracPipe[®] is a corrugated stainless steel tubing product developed especially for use in the piping of fuel gas lines within residential and commercial buildings. Although sales in the quarter to established contractors in the residential construction sector may have been slightly affected by the current weakening of the residential market, overall sales of TracPipe[®] flexible gas piping were sustained by conversion of competitive products in the Company's largest market (residential construction), and strategic initiatives resulting in accelerating sales in the commercial market. Of the \$2,167,000 increase in sales from the three-months period ended September 30, 2005 to the three-months period ended September 30, 2006, approximately two-thirds of such increase were as a result of price increases to address rapidly increasing raw material costs with the remainder due to increases in sales volume.

The Company's gross profit margins increased from 49.7% in the three-months period ended September 30, 2005 to 51.5% in the three-months period ended September 30, 2006 indicative of management's ability to find manufacturing efficiencies and effectively price our products despite inflationary pressures effecting stainless steel and other commodities.

Selling Expenses. Selling expenses consist primarily of employee salaries and associated overhead costs, commissions, and the cost of marketing programs such as advertising, trade shows and related communication costs. Selling expense was \$3,040,000 and \$2,513,000 for the three-months ended September 30, 2006 and 2005, respectively. The \$527,000 increase in selling expenses is principally due to increased sales commissions as a result of higher volume. Staffing expenses and sales travel also contributed to the increase. Sales expense as a percentage of sales increased from 14.7% for the three-months ended September 30, 2005 to 15.8% for the three-months ended September 30, 2006.

Edgar Filing: Omega Flex, Inc. - Form 10-Q

General and Administrative Expenses. General and administrative expenses consist primarily of employee salaries, benefits for administrative, executive and finance personnel, legal and accounting, and corporate general and administrative services (2005 only). General and administrative expenses were \$1,239,000 and \$1,467,000 for the three-months ended September 30, 2006 and 2005, respectively. The \$228,000 decrease in expenses is mainly attributable to a decrease in incentive compensation offset slightly by increases in staffing expenses. For the preceding reasons, general and administrative expense, as a percentage of sales, decreased from 8.6% for the three-months ended September 30, 2005 to 6.4% for the three-months ended September 30, 2006.

Engineering Expense. Engineering expenses consist of development expenses associated with the development of new products and enhancements to existing products, and manufacturing engineering costs. Engineering expenses were \$467,000 and \$415,000 for the three-months ended September 30, 2006 and 2005 respectively. As a percentage of sales, engineering expenses were in line with the prior year at 2.4%.

Legal Settlement and Related Costs. Legal charges related to the pending Arkansas litigation for the three-months ended September 30, 2006 and 2005, were \$9,008,000 and \$828,000, respectively. Further details are provided in Note 6, Commitments and Contingencies. We do not expect to incur at any time during the foreseeable future further charges for legal expenses or settlements on the scale recorded in the third quarter.

Reflecting the factors mentioned above, Operating Profit margins decreased \$7,112,000 from a profit of \$3,292,000 in the three-months period ended September 30, 2005 to a loss of \$3,820,000 in the three-months period ended September 30, 2006. Excluding \$9,008,000 and \$828,000 of legal charges related to the pending Arkansas litigation for the three-months ending September 30, 2006 and 2005, respectively, operating profits actually increased \$1,068,000, or 25.9%.

Interest Income-Net. Interest income-net includes interest income on the note receivable from Mestek and interest income on our interest-bearing investments.

Other Income-Net. Other Income-net primarily consists of realized foreign currency exchange gains (losses) on Omega Flex Limited payments for accounts payable, interest and management fee to Omega Flex, Inc., its parent corporation.

Income Tax Expense. The Company's effective tax rate reflects the anticipated benefit of future deductions from payments relating to the Arkansas litigation.

Nine-months ended September 30, 2006 vs. September 30, 2005

The Company reported comparative results from continuing operations for the nine-months period ended September 30, 2006 and 2005 as follows:

	<u>Nine-months ended September 30,</u>			
	(in thousands)			
	<u>2006</u>	<u>2006</u>	<u>2005</u>	<u>2005</u>
	<u>(\$000)</u>	<u>%</u>	<u>(\$000)</u>	<u>%</u>
Net Sales	\$54,506	100.0%	\$45,649	100.0%
Gross Profit	\$28,285	51.9%	\$22,859	50.1%
Operating Profits	\$3,129	5.7%	\$8,530	18.7%

The Company's sales increased \$8,857,000 or 19.4% from \$45,649,000 in the nine-months period ended September 30, 2005 as compared to \$54,506,000 in the nine-months period ended September 30, 2006 due to continued strong sales of the Company's flagship TracPipe® flexible gas piping product and its patented AutoFlare[®] connection system. TracPipe[®] is a corrugated stainless steel tubing product developed especially for use in the piping of fuel gas lines within residential and commercial buildings. Although sales in the quarter to established contractors in the residential construction sector may have been slightly affected by the current weakening of the residential market, overall sales of TracPipe[®] flexible gas piping were sustained by conversion of competitive products in the Company's largest market (residential construction), and strategic initiatives resulting in accelerating sales in the commercial market. Approximately 71% of the increase in sales from the nine-months period ended September 30, 2005 to the nine-months period ended September 30, 2006 was volume-related, with the remaining volume attributable to price increases implemented to meet rapidly escalating raw material costs.

The Company's gross profit margins have increased from 50.1% in the nine-months period ended September 30, 2005 to 51.9% in the nine-months period ended September 30, 2006 indicative of management's ability to find manufacturing efficiencies and effectively price our products despite inflationary pressures affecting stainless steel and other commodities.

Selling Expenses. Selling expense was \$8,472,000 and \$7,339,000 for the nine-months ended September 30, 2006 and 2005, respectively. The \$1,133,000 increase in selling expenses is principally due to increased sales commissions but also attributable to freight costs and sales travel. Sales expense as a percentage of sales was favorable at 15.5% for the nine-months ended September 30, 2006 versus 16.1% for the nine-months ended September 30, 2005.

General and Administrative Expenses. General and administrative expenses consist primarily of employee salaries, benefits for administrative, executive and finance personnel, legal and accounting, and corporate general and administrative services (2005 only). General and administrative expenses were \$4,950,000 and \$4,753,000 for the nine-months ended September 30, 2006 and 2005, respectively. The \$197,000 increase in expenses is mainly attributable to an increase in staffing expenses offset slightly by decreases in incentive compensation. As a percentage of sales general and administrative expenses have actually decreased from 10.4% for the nine-months ended September 30, 2005 to 9.1% for the nine-months ended September 30, 2006.

Engineering Expense. Engineering expenses were \$1,410,000 and \$1,047,000 for the nine-months ended September 30, 2006 and 2005, respectively. The \$363,000 increase in engineering expenses is largely due to increases in staffing expenses but also attributable to experimental material expenditures associated with the development of new products. Engineering expenses as a percentage of sales were 2.6% for the nine-months ended September 30, 2006 and 2.3% for the nine-months ended September 30, 2005.

Legal Settlement and Related Costs - Legal charges related to the pending Arkansas litigation for the nine-months ended September 30, 2006 and 2005, were \$10,324,000 and \$1,190,000, respectively. Further details are provided in Note 6, Commitments and Contingencies. We do not expect to incur at any time during the foreseeable future further charges for legal expenses or settlements on the scale recorded in the third quarter.

Reflecting the factors mentioned above, Operating Profit margins decreased \$5,401,000 from \$8,530,000 in the nine-months period ended September 30, 2005 to \$3,129,000 in the nine-months period ended September 30, 2006. Excluding \$10,324,000 and \$1,190,000 of legal charges related to the pending Arkansas litigation for the three-months ending September 30, 2006 and 2005, respectively, operating profits actually increased \$3,733,000, or 38%.

Interest Income-Net. Interest income-net includes interest income on the note receivable from Mestek and interest income on our interest-bearing investments, reduced by interest expense associated with the Company's variable rate first mortgage on our manufacturing facility. On April 27, 2006 the Company repaid the entire outstanding principal balance (and accrued interest) of the \$3,348 million Mortgage Note that was obtained from Sovereign Bank in 2004 to purchase the Company's main facility in Exton, Pennsylvania.

Other Income-Net. Other Income-net primarily consists of realized foreign currency exchange gains (losses) on Omega Flex Limited payments for accounts payable, interest and management fee to Omega Flex, Inc., its parent corporation.

Income Tax Expense. The Company's effective tax rate reflects the anticipated benefit of future deductions from payments relating to the Arkansas litigation.

CRITICAL ACCOUNTING POLICIES AND USE OF ESTIMATES

Financial Reporting Release No. 60, released by the Securities and Exchange Commission, requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note 2 of the Notes to the Consolidated Financial Statements includes a summary of the significant accounting policies and methods used in the preparation of our Consolidated Financial Statements. The following is a brief discussion of the Company's more significant accounting policies.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to revenue recognition,

accounts receivable valuations, inventory valuations, goodwill valuation, intangible asset valuations, product liability costs, workers compensation claims reserves, health care claims reserves, and accounting for income taxes. Actual amounts could differ significantly from these estimates.

Our critical accounting policies and significant estimates and assumptions are described in more detail as follows:

Revenue Recognition

The Company's revenue recognition activities relate almost entirely to the manufacture and sale of its flexible metal hose and related products. Under generally accepted accounting principles, revenues are considered to have been earned when the Company has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. With respect to sales of the Company's products, the following criteria represent preconditions to the recognition of revenue:

- * persuasive evidence of an arrangement must exist;
- * delivery has occurred or services rendered;
- * the sales price to the customer is fixed or determinable; and
- * collection is reasonably assured.

The Company generally recognizes revenue upon shipment in accordance with the above principles.

Accounting for Income Taxes

Up to the date of the Spin-Off, the Company elected to file its federal income tax return as part of the Mestek, Inc. parent company, consolidated return. Mestek and Omega accounted for Omega's federal tax liabilities on the separate company basis method in accordance with FAS 109, Accounting for Income Taxes. Under this method Omega recorded tax expense and related deferred taxes and tax benefits in a manner comparable to that which it would record if it were not affiliated with Mestek.

The Company filed a separate Federal income tax return for the five months of 2005 in which it was a separate and public company and will file a separate Federal income tax return for 2006 in its entirety.

By agreement, the Company will be responsible for and hold Mestek harmless from, any liability for its income taxes for all taxable periods, whether before or after the Spin-Off.

The preparation of the Company's Consolidated Financial Statements requires it to estimate its income taxes in each of the jurisdictions in which it operates, including those outside the United States which may be subject to certain risks that ordinarily would not be expected in the United States. The income tax accounting process involves estimating its actual current exposure together with assessing temporary differences resulting from differing treatment of items such as depreciation, stock based compensation, and legal settlements for tax and

accounting purposes. These differences result in the recognition of deferred tax assets and liabilities. The Company must then record a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. Significant management judgment is required in determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against deferred tax assets. In the event that actual results differ from these estimates or the Company adjusts these estimates in future periods, it could materially impact its financial position and results of operations.

IMPACT OF INFLATION