UNIVERSAL COMPRESSION HOLDINGS INC
Form 10-Q
November 08, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2006

OR

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

For the transition period from to

Commission File Numbers: 001-15843

333-48279

UNIVERSAL COMPRESSION HOLDINGS, INC.
UNIVERSAL COMPRESSION, INC.

(Exact name of registrants as specified in their charters)

DELAWARE **TEXAS** (States or Other Jurisdictions of Incorporation or Organization)	**13-3989167** **74-1282680** (I.R.S. Employer Identification Nos.)
4444 BRITTMOORE ROAD **HOUSTON, TEXAS** (Address of Principal Executive Offices)	**77041** (Zip Code)

(713) 335-7000

(Registrants telephone number, including area code)

Indicate by check mark whether the registrants (1) have 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 registrants were required to file such reports), and (2) have been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrants are large accelerated filers, accelerated filers, or non-accelerated filers (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer x	Accelerated Filer o	Non-Accelerated Filer o (Universal Compression Holdings, Inc.)
Large Accelerated Filer o	Accelerated Filer o	Non-Accelerated Filer x (Universal Compression, Inc.)

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

Yes o No x

UNIVERSAL COMPRESSION, INC. MEETS THE CONDITIONS SET FORTH IN GENERAL INSTRUCTION H(1)(a) AND (b) OF FORM 10-Q AND IS THEREFORE FILING THIS FORM 10-Q WITH THE REDUCED DISCLOSURE FORMAT.

As of November 2, 2006, there were 30,413,014 shares of Universal Compression Holdings, Inc. s common stock, $0.01 par value, outstanding and 4,910 shares of Universal Compression, Inc. s common stock, $10.00 par value, outstanding.

PART I. FINANCIAL INFORMATION

ITEM 1. ***Financial Statements***

UNIVERSAL COMPRESSION HOLDINGS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)
(unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 16,862	$ 39,262
Restricted cash	5,594	4,187
Accounts receivable, net of allowance for bad debts of $4,718 and $3,616 as of September 30, 2006 and December 31, 2005, respectively	199,030	121,642
Inventories, net of reserve for obsolescence of $9,947 and $10,896 as of September 30, 2006 and December 31, 2005, respectively	165,028	108,273
Deferred income taxes	5,581	7,447
Other	21,817	19,787
Total current assets	413,912	300,598
Contract compression equipment	1,688,612	1,567,470
Other property	195,317	167,946
Accumulated depreciation and amortization	(462,010)	(375,575)
Net property, plant and equipment	1,421,919	1,359,841
Goodwill	404,653	403,261
Derivative financial instruments	7,586	6,954
Other assets	35,057	24,641
Total assets	$ 2,283,127	$ 2,095,295
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable, trade	$ 85,759	$ 55,014
Accrued liabilities	50,517	43,796
Unearned revenue	77,092	36,367
Accrued interest	6,103	2,458
Current portion of long-term debt and capital lease obligations	19,572	18,249
Total current liabilities	239,043	155,884
Capital lease obligations	112	285
Long-term debt	894,432	904,807
Deferred income taxes	204,870	186,632
Derivative financial instruments	4,896	6,006
Other liabilities	12,112	10,369
Total liabilities	1,355,465	1,263,983
Commitments and contingencies (Note 9)		
Stockholders equity:		
Common stock	328	323
Treasury stock	(100,626)	(100,011)
Additional paid-in capital	774,721	759,105
Deferred compensation		(6,065)
Accumulated other comprehensive loss	(4,800)	(12,428)
Retained earnings	258,039	190,388
Total stockholders equity	927,662	831,312

Total liabilities and stockholders equity		$	2,283,127		$	2,095,295

See accompanying notes to unaudited consolidated financial statements.

UNIVERSAL COMPRESSION HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenue:				
Domestic contract compression	$ 101,058	$ 81,964	$ 296,563	$ 238,554
International contract compression	36,251	31,076	104,554	90,115
Fabrication	57,642	28,193	152,479	132,066
Aftermarket services	51,981	39,895	141,120	121,713
Total revenue	246,932	181,128	694,716	582,448
Costs and expenses:				
Cost of sales (excluding depreciation and amortization expense):				
Domestic contract compression	34,866	29,849	103,572	86,865
International contract compression	8,968	8,087	25,795	22,961
Fabrication	47,594	24,769	131,496	122,737
Aftermarket services	41,304	31,782	113,470	98,110
Depreciation and amortization	31,154	26,439	90,966	76,462
Selling, general and administrative	30,149	21,012	86,191	61,522
Interest expense, net	15,152	13,034	43,814	39,890
Debt extinguishment costs				26,068
Asset impairment expense				3,080
Foreign currency gain	(45)	(610)	(355)	(1,344)
Other (income) loss, net	3	(524)	(1,090)	(1,069)
Total costs and expenses	209,145	153,838	593,859	535,282
Income before income taxes	37,787	27,290	100,857	47,166
Income tax expense	12,827	9,611	33,206	15,841
Net income	$ 24,960	$ 17,679	$ 67,651	$ 31,325
Weighted average common and common equivalent shares outstanding:				
Basic	30,037	31,902	29,855	31,889
Diluted	31,163	32,836	31,015	32,864
Earnings per share Basic	$ 0.83	$ 0.55	$ 2.27	$ 0.98
Earnings per share Diluted	$ 0.80	$ 0.54	$ 2.18	$ 0.95

See accompanying notes to unaudited consolidated financial statements.

UNIVERSAL COMPRESSION HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 67,651	$ 31,325
Adjustments to reconcile net income to cash provided by operating activities, net of effect of acquisitions:		
Depreciation and amortization	90,966	76,462
Loss on early extinguishment of debt		26,068
Loss on asset impairment		3,080
Gain on asset sales	(311)	(731)
Amortization of debt issuance costs	1,401	1,885
Stock-based compensation expense	5,356	1,242
Increase (decrease) in deferred taxes	22,430	10,101
(Increase) decrease in other assets	(1,632)	(1,477)
(Increase) decrease in receivables	(73,793)	(5,859)
(Increase) decrease in inventories	(56,548)	(20,349)
Increase (decrease) in accounts payable	28,885	3,474
Increase (decrease) in accrued liabilities	4,072	3,075
Increase (decrease) in unearned revenue	40,725	4,663
Increase (decrease) in accrued interest	3,646	(11,307)
Net cash provided by operating activities	132,848	121,652
Cash flows from investing activities:		
Additions to property, plant and equipment	(156,686)	(118,811)
Proceeds from sale of property, plant and equipment	10,930	14,279
Cash paid for acquisitions, net of cash acquired	(6,285)	(1,922)
Increase in restricted cash	(1,407)	(4,801)
Net cash used in investing activities	(153,448)	(111,255)
Cash flows from financing activities:		
Principal repayments of long-term debt	(77,253)	(719,221)
Proceeds from issuance of debt	67,994	693,225
Debt extinguishment premium and costs		(19,527)
Debt issuance costs	(1,455)	(2,456)
Proceeds from common stock issuance	9,740	10,510
Purchase of treasury stock	(615)	
Payments on capital lease agreements	(64)	(407)
Net cash used in financing activities	(1,653)	(37,876)
Effect of exchange rate changes on cash and cash equivalents	(147)	500
Net decrease in cash and cash equivalents	(22,400)	(26,979)
Cash and cash equivalents at beginning of period	39,262	53,958
Cash and cash equivalents at end of period	$ 16,862	$ 26,979

See accompanying notes to unaudited consolidated financial statements.

UNIVERSAL COMPRESSION, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands)

(unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 16,862	$ 39,262
Restricted cash	5,594	4,187
Accounts receivable, net of allowance for bad debts of $4,718 and $3,616 as of September 30, 2006 and December 31, 2005, respectively	199,030	121,642
Inventories, net of reserve for obsolescence of $9,947 and $10,896 as of September 30, 2006 and December 31, 2005, respectively	165,028	108,273
Deferred income taxes	5,581	7,447
Other	21,817	19,787
Total current assets	413,912	300,598
Contract compression equipment	1,688,612	1,567,470
Other property	195,317	167,946
Accumulated depreciation and amortization	(462,010)	(375,575)
Net property, plant and equipment	1,421,919	1,359,841
Goodwill	404,653	403,261
Notes receivable - affiliate	88,535	100,277
Derivative financial instruments	7,586	6,954
Other assets	35,057	24,641
Total assets	$ 2,371,662	$ 2,195,572
LIABILITIES AND STOCKHOLDER S EQUITY		
Current liabilities:		
Accounts payable, trade	$ 85,759	$ 55,014
Accrued liabilities	50,517	43,796
Unearned revenue	77,092	36,367
Accrued interest	6,103	2,458
Current portion of long-term debt and capital lease obligations	19,572	18,249
Total current liabilities	239,043	155,884
Capital lease obligations	112	285
Long-term debt	894,432	904,807
Deferred income taxes	206,546	186,729
Derivative financial instruments	4,896	6,006
Other liabilities	12,112	10,369
Total liabilities	1,357,141	1,264,080
Commitments and contingencies (Note 9)		
Stockholder s equity:		
Common stock	49	49
Additional paid-in capital	750,746	745,876
Accumulated other comprehensive loss	(4,800)	(12,428)
Retained earnings	268,526	197,995
Total stockholder s equity	1,014,521	931,492
Total liabilities and stockholder s equity	$ 2,371,662	$ 2,195,572

See accompanying notes to unaudited consolidated financial statements.

UNIVERSAL COMPRESSION, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenue:				
Domestic contract compression	$ 101,058	$ 81,964	$ 296,563	$ 238,554
International contract compression	36,251	31,076	104,554	90,115
Fabrication	57,642	28,193	152,479	132,066
Aftermarket services	51,981	39,895	141,120	121,713
Total revenue	246,932	181,128	694,716	582,448
Costs and expenses:				
Cost of sales (excluding depreciation and amortization expense):				
Domestic contract compression	34,866	29,849	103,572	86,865
International contract compression	8,968	8,087	25,795	22,961
Fabrication	47,594	24,769	131,496	122,737
Aftermarket services	41,304	31,782	113,470	98,110
Depreciation and amortization	31,154	26,439	90,966	76,462
Selling, general and administrative	30,149	21,012	86,191	61,522
Interest expense, net	15,152	13,034	43,814	39,890
Interest income from affiliate	(1,469)		(4,459)	
Debt extinguishment costs				26,068
Asset impairment expense				3,080
Foreign currency gain	(45)	(610)	(355)	(1,344)
Other (income) loss, net	3	(524)	(1,090)	(1,069)
Total costs and expenses	207,676	153,838	589,400	535,282
Income before income taxes	39,256	27,290	105,316	47,166
Income tax expense	13,341	9,611	34,785	15,841
Net income	$ 25,915	$ 17,679	$ 70,531	$ 31,325

See accompanying notes to unaudited consolidated financial statements.

UNIVERSAL COMPRESSION, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 70,531	$ 31,325
Adjustments to reconcile net income to cash provided by operating activities, net of effect of acquisitions:		
Depreciation and amortization	90,966	76,462
Loss on early extinguishment of debt		26,068
Loss on asset impairment		3,080
Gain on asset sales	(311)	(731)
Amortization of debt issuance costs	1,401	1,885
Stock-based compensation expense	5,356	1,242
Increase (decrease) in deferred taxes	24,009	10,101
(Increase) decrease in other assets	(1,632)	(1,477)
(Increase) decrease in receivables	(73,793)	(5,859)
(Increase) decrease in inventories	(56,548)	(20,349)
Increase (decrease) in accounts payable	28,885	3,474
Increase (decrease) in accrued liabilities	4,072	3,075
Increase (decrease) in unearned revenue	40,725	4,663
Increase (decrease) in accrued interest	3,646	(11,307)
Net cash provided by operating activities	137,307	121,652
Cash flows from investing activities:		
Additions to property, plant and equipment	(156,686)	(118,811)
Proceeds from sale of property, plant and equipment	10,930	14,279
Cash paid for acquisitions, net of cash acquired	(6,285)	(1,922)
Repayment of loan to affiliate	4,666	
Increase in restricted cash	(1,407)	(4,801)
Net cash used in investing activities	(148,782)	(111,255)
Cash flows from financing activities:		
Principal repayments of long-term debt	(77,253)	(719,221)
Proceeds from issuance of debt	67,994	693,225
Debt extinguishment premium and costs		(19,527)
Debt issuance costs	(1,455)	(2,456)
Capital contributions from stockholder		10,510
Payments on capital lease agreements	(64)	(407)
Net cash used in financing activities	(10,778)	(37,876)
Effect of exchange rate changes on cash and cash equivalents	(147)	500
Net decrease in cash and cash equivalents	(22,400)	(26,979)
Cash and cash equivalents at beginning of period	39,262	53,958
Cash and cash equivalents at end of period	$ 16,862	$ 26,979

See accompanying notes to unaudited consolidated financial statements.

UNIVERSAL COMPRESSION HOLDINGS, INC.

UNIVERSAL COMPRESSION, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

1. Basis of Presentation

These notes apply to the unaudited consolidated financial statements of both Universal Compression Holdings, Inc. (Holdings) and Universal Compression, Inc. (Universal) and their subsidiaries. The term Company will be used if a statement is applicable to both Holdings and Universal. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements presented in the Company s Transition Report on Form 10-K for the nine months ended December 31, 2005. That report contains a more comprehensive summary of the Company s major accounting policies. In the opinion of management, the accompanying unaudited consolidated financial statements contain all appropriate adjustments, all of which are normally recurring adjustments unless otherwise noted, considered necessary to present fairly the financial position of the Company and its consolidated subsidiaries and the results of operations and cash flows for the respective periods. Operating results for the three-month and nine-month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the twelve months ending December 31, 2006.

Earnings per share

Net income per share, basic and diluted, is calculated for Holdings in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, Earnings per Share.

The only potentially dilutive securities issued by Holdings are stock options and unvested restricted stock grants, neither of which would impact the calculation of net income for dilutive earnings per share purposes.

The dilutive effect of stock options and unvested restricted stock grants outstanding for the three and nine months ended September 30, 2006 was 1,126,000 shares and 1,160,000 shares, respectively. The dilutive effect of stock options and unvested restricted stock grants outstanding for the three and nine months ended September 30, 2005 was 934,000 shares and 975,000 shares, respectively. For the three and nine months ended September 30, 2006, outstanding stock options of zero shares and 12,000 shares, respectively, were excluded from the computation of diluted earnings per share as the options exercise prices were greater than the average market price of the common stock for such periods. For the three and nine months ended September 30, 2005, outstanding stock options of 2,000 shares and 191,000 shares, respectively, were excluded from the computation of diluted earnings per share as the options exercise prices were greater than the average market price of the common stock for such periods.

Goodwill

Goodwill and intangible assets acquired in connection with business combinations represent the excess of consideration over the fair value of tangible net assets acquired. Certain assumptions and estimates are employed in determining the fair value of assets acquired and liabilities assumed, as well as in determining the allocation of goodwill to the appropriate reporting unit.

The Company performs an impairment test for goodwill assets annually, or more often, if indicators of potential impairment exist. The Company s goodwill impairment test involves a comparison of the fair value of each of its reporting units with their carrying value. The fair value is determined using discounted cash flows and other market-related valuation models. Certain estimates and judgments are required in the application of the fair value models. As of February 2006, the Company performed its annual impairment analysis in accordance with SFAS No. 142, Goodwill and Other Intangible Assets, and determined that no impairment had occurred. If for any reason the fair value of the Company s goodwill or that of any of its reporting units declines below the carrying value in the future, the Company may incur charges for the impairment.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted SFAS No. 123R, Share-Based Payment, which requires that compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Prior to 2006, the Company accounted for stock options in accordance with Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees . Under APB 25, stock option expense was not recognized in net income as the exercise price of stock options granted was equal to the market value of the stock on the date of grant. The Company has previously provided footnote disclosure of pro forma net income and earnings per share amounts as if stock option expense had been recognized based on fair value.

The Company adopted SFAS No. 123R utilizing the modified prospective transition method. As a result, prior periods have not been restated to reflect the impact of SFAS No. 123R. For the three and nine months ended September 30, 2006, the adoption of SFAS No. 123R impacted our results of operation by increasing stock-based compensation expense by $1.2 million ($0.8 million, net of tax) and $3.7 million ($2.5 million, net of tax), respectively, as compared to the expense that would have been recognized under APB 25. The adoption of SFAS No. 123R decreased each of Holdings basic and diluted earnings per share for the three months ended September 30, 2006 by $0.03 per share. The adoption of SFAS No. 123R decreased each of Holdings basic and diluted earnings per share for the nine months ended September 30, 2006 by $0.08 per share.

2. Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, Inventory Costs - an amendment of ARB 43, Chapter 4. SFAS No. 151 provides clarification that abnormal amounts of idle facility expense, freight, handling costs and wasted material be recognized as current period charges. In addition, SFAS No. 151 requires the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 did not have a material impact on the Company s financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 did not have a material impact on the Company s financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. FIN 48 was issued to clarify the accounting for uncertainty in income taxes recognized in an entity s financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that the adoption of FIN 48 will have on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact that the adoption of SFAS No. 157 will have on its financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. The Company is currently evaluating the impact that the adoption of SAB 108 will have on its financial statements.

3. Inventories, Net

Inventories, net consisted of the following (in thousands):

	September 30, 2006	December 31, 2005
Raw materials	$ 82,422	$ 67,125
Work-in-progress	92,524	50,810
Finished goods	29	1,234
Total inventories	174,975	119,169
Reserve for obsolescence	(9,947)	(10,896)
Inventories, net	$ 165,028	$ 108,273

4. Long-Term Debt

As of September 30, 2006, the Company had approximately $913.7 million in outstanding debt consisting of $468.2 million outstanding under the seven-year term loan, $171.2 million outstanding under the 7 1/4 % senior notes, $190.3 million outstanding under the asset-backed securitization facility (the ABS Facility) and $84.0 million outstanding under the revolving credit facility. Covenants in the credit facilities require that the Company maintain various financial ratios. As of September 30, 2006, the Company was in compliance with all financial covenants. See note 11 regarding debt refinancing activities which occurred subsequent to September 30, 2006.

5. Stock-Based Compensation

The following table presents the stock-based compensation expense included in the Company s results of operations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Stock options	$ 1,156	$	$ 3,402	$
Restricted stock	652	438	1,749	1,241
Employee Stock Purchase Plan	54		304	
Total stock-based compensation expense	1,862	438	5,455	1,241
Income tax benefit	(632)	(153)	(1,770)	(434)
Total after-tax stock-based compensation expense	$ 1,230	$ 285	$ 3,685	$ 807

There was no stock-based compensation cost capitalized during the three or nine-month periods ended September 30, 2006 or 2005.

Stock options

The Company utilizes stock options under its incentive stock option plan in order to motivate and retain key employees. Stock options granted under the plan are exercisable over a ten-year period. Options generally vest over the following time period:

Year 1	33⅓ %
Year 2	33⅓ %
Year 3	33⅓ %

Under the incentive stock option plan, options to purchase common stock may be granted until 2011. Options are granted at fair market value at the date of grant, are exercisable in installments beginning one year from the date of grant, and expire ten years after the date of grant.

The weighted average fair values at date of grant for options granted during the nine months ended September 30, 2006 and 2005 were $18.22 and $16.81, respectively, and were estimated using the Black-Scholes option valuation model with the following weighted average assumptions:

	Nine Months Ended September 30,			
	2006		2005	
Expected life in years	6.0		5.9	
Risk-free interest rate	4.72	%	4.25	%
Volatility	33.15	%	38.54	%
Dividend yield	0.00	%	0.00	%

The expected life represents the period of time the stock options are expected to be outstanding prior to exercise and is based on the simplified model. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant for a period commensurate with the estimated expected life of the stock options. Expected volatility is based on the historical volatility of the Company s stock over the most recent period commensurate with the expected life of the stock options and other factors. The Company has not historically paid a dividend and does not expect to pay a dividend during the expected life of the stock options. Under SFAS No. 123R, the Company is required to record compensation cost from stock-based compensation utilizing an estimated forfeiture rate. Historical data related to forfeitures experienced by the Company was used to estimate forfeiture rates.

The following table presents stock option activity for the nine months ended September 30, 2006 (remaining life in years, intrinsic value in thousands):

	Stock Options		Weighted Average Exercise Price		Weighted Average Remaining Life	Aggregate Intrinsic Value	
Options outstanding, December 31, 2005	2,219,014		$	25.92			
Granted	318,550		43.87				
Exercised	(368,521	)	23.01				
Cancelled	(15,639	)	34.34				
Options outstanding, September 30, 2006	2,153,404		$	29.42	6.4	$	52,628
Options exercisable at September 30, 2006	1,643,852		$	25.62	5.6	$	45,754

Intrinsic value is the difference between the market value of the Company s stock and the exercise price of each option multiplied by the number of options outstanding. The total intrinsic value of stock options exercised during the nine months ended September 30, 2006 and 2005 was $12.1 million and $9.6 million, respectively. The total grant date fair value of stock options that vested during the nine months ended September 30, 2006 and 2005 was $4.5 million and $6.2 million, respectively. As of September 30, 2006, $6.7 million of unrecognized compensation cost related to non-vested stock options is expected to be recognized over the weighted-average period of 1.9 years.

Cash received from stock option exercises during the nine months ended September 30, 2006 and 2005 was $8.5 million and $9.8 million, respectively.

Restricted Stock

The Company utilizes grants of restricted stock as long-term compensation for designated employees. The Company s restricted stock plan provides for the award of up to 1,350,000 shares of the Company s common stock to certain officers and designated employees. Generally, common stock subject to restricted stock grants will vest 0% upon the first anniversary of the grant and 25% on each anniversary thereafter through the fifth anniversary.

Under APB 25, prior to January 1, 2006, deferred compensation was charged for the market value of restricted shares granted. The deferred compensation balance is shown as a reduction to Holdings stockholders equity in the accompanying consolidated balance sheet at December 31, 2005. Upon adoption of SFAS No. 123R, the deferred compensation balance at January 1, 2006 was reversed and recorded to additional paid-in capital. Under both APB 25 and SFAS No. 123R, the market value of the restricted shares granted is amortized ratably over the restricted period of five years.

Prior to January 1, 2006, under APB 25, the Company recorded the effect of forfeitures on compensation expense related to restricted stock as it actually occurred. Effective January 1, 2006, under SFAS No. 123R, the Company is required to record

11

compensation cost from stock-based compensation utilizing an estimated forfeiture rate. Historical data related to forfeitures experienced by the Company was used to estimate forfeiture rates. The impact on previously recognized expense from the change in forfeiture rates was immaterial.

The following table presents restricted stock activity for the nine months ended September 30, 2006:

	Shares		Weighted Average Grant-Date Fair Value	
Non-vested restricted stock, December 31, 2005	242,194		$	33.01
Granted	137,050		44.00	
Vested	(39,250	)	26.20	
Cancelled	(6,025	)	43.49	
Non-vested restricted stock, September 30, 2006	333,969		$	38.13

The total grant date fair value of restricted stock that vested during the nine months ended September 30, 2006 and 2005 was $1.0 million and $0.6 million, respectively. As of September 30, 2006, $9.3 million of unrecognized compensation cost related to non-vested restricted stock is expected to be recognized over the weighted-average period of 3.8 years.

Employee Stock Purchase Plan

The Employee Stock Purchase Plan (ESPP) is intended to encourage employees to participate in the Company s growth by providing them the opportunity to acquire an interest in the Company s long-term performance and success through the purchase of shares of common stock at a price typically less than fair market value. An employee is eligible to participate after completing 90 days of employment. Each quarter, an eligible employee may elect to withhold up to 10% of his or her eligible pay to purchase shares of the Company s common stock at a price equal to 85% to 100% of the fair market value of the stock as of the first trading day of the quarter or the last trading day of the quarter, whichever is lower. The ESPP will terminate on the date that all shares of common stock authorized for sale under the ESPP have been purchased, except as otherwise extended by authorizing additional shares under the ESPP. At September 30, 2006, 297,818 shares remained available for purchase under the ESPP. Under SFAS No. 123R, the Company s ESPP plan is compensatory, and as a result, the amount of the discount from the fair market value of the stock price at the end of the quarter received by the employee upon purchase of the stock is recorded as expense in that quarter.

2005 Pro Forma Results

The following table summarizes results as if the Company had recorded compensation expense under the provisions of SFAS No. 123 (earnings per share information is for Holdings only) (in thousands, except per share amounts):

	Three Months Ended September 30, 2005			Nine Months Ended September 30, 2005		
Net income, as reported	$	17,679		$	31,325	
Add: Stock-based compensation for restricted stock awards included in reported net income, net of tax	285			807		
Deduct: Stock-based compensation determined under the fair value method, net of tax	(1,033		)	(3,111		)
Pro forma net income	$	16,931		$	29,021	
Basic earnings per share:						
As reported	$	0.55		$	0.98	
Pro forma	$	0.53		$	0.91	
Diluted earnings per share:						
As reported	$	0.54		$	0.95	
Pro forma	$	0.52		$	0.88	

6. Accounting for Interest Rate Swaps

In accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, all derivative instruments must be recognized on the balance sheet at fair value, and changes in such fair values are recognized in earnings unless

12

specific hedging criteria are met. Changes in the values of derivatives that meet these hedging criteria will ultimately offset related earnings effects of the hedged item pending recognition in earnings.

As of September 30, 2006, the Company had interest rate swap agreements with a notional amount of $171.3 million related to the $190.3 million outstanding under the ABS Facility. The swaps outstanding at September 30, 2006 amortize ratably through 2019 and have a weighted average fixed rate of 4.94%. In accordance with SFAS No. 133, the Company s balance sheet at September 30, 2006 included a $1.0 million derivative asset related to the interest rate swap agreements.

As of September 30, 2006, the Company had interest rate swap agreements with a notional amount of $300.0 million related to the $468.2 million outstanding under the seven-year term loan. The swaps outstanding at September 30, 2006 amortize ratably from June 2007 through March 2010 and have a weighted average fixed rate of 4.02%. In accordance with SFAS No. 133, the Company s balance sheet at September 30, 2006 included a $6.0 million derivative asset related to the interest rate swap agreements.

In August 2006, the Company entered into a forward starting swap agreement related to a notional amount of $125.0 million of the Company s floating rate debt. The effective date of the swap agreement is December 1, 2006. The swap agreement terminates in December 2011 and has a fixed rate of 5.28%. In accordance with SFAS No. 133, the Company s balance sheet at September 30, 2006 included a $0.5 million derivative liability related to the interest rate swap agreement.

These swaps, which the Company has designated as cash flow hedging instruments, meet the specific hedge criteria and any changes in their fair values were recognized in accumulated other comprehensive income or loss. Because the terms of the hedged item and the swaps substantially coincide, the hedge is expected to exactly offset changes in expected cash flows due to fluctuations in the variable rate and, therefore, the Company currently does not expect any ineffectiveness.

As of September 30, 2006, the Company had interest rate swap agreements to hedge $100.0 million of its 7 1/4% senior notes. The swaps are used to hedge the change in fair value of the debt and, in effect, convert the fixed interest payment to a variable interest payment based on six-month LIBOR in arrears. The swaps are accounted for in accordance with SFAS No. 133 and, as such, are recorded at fair value on the balance sheet. The Company s balance sheet at September 30, 2006, included a $3.8 million derivative liability related to the interest rate swap agreements. The change in the debt s fair value for that portion which is hedged is recorded as an adjustment to the carrying value of debt with the offset being recorded to interest expense. The swaps, which the Company has designated as fair value hedging instruments, meet the specific hedge criteria and any changes in their fair values were recognized in interest expense. For the three and nine months ended September 30, 2006, the change in the debt s fair value and the change in the swaps fair value exactly offset and did not impact net income. Because the terms of the hedged item and the swaps substantially coincide, the hedge is expected to exactly offset changes in fair values due to fluctuations in the variable rate and, therefore, the Company currently does not expect any ineffectiveness.

The counterparties to the Company s interest rate swap agreements are major international financial institutions. The Company monitors the credit quality of these financial institutions and does not expect non-performance by them.

7. Comprehensive Income

Comprehensive income consisted of the following (in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Net income	$ 24,960	$ 17,679	$ 67,651	$ 31,325
Other comprehensive income, net of tax:				
Interest rate swap gain (loss)	(6,282)	3,963	688	3,181
Cumulative translation adjustment	1,052	6,185	6,940	5,118
Comprehensive income	$ 19,730	$ 27,827	$ 75,279	$ 39,624

The components of comprehensive income were identical for Holdings and Universal, except for the three and nine months ended September 30, 2006, Universal s net income was $25.9 million and $70.5 million, respectively, and total comprehensive net income was $20.7 million and $78.2 million, respectively.

8. Industry Segments

The Company has four principal business segments: domestic contract compression, international contract compression, fabrication and aftermarket services. The domestic contract compression segment provides natural gas compression services to customers in the United States. The international contract compression segment provides natural gas compression services to international

13

customers, including those in Canada. The fabrication segment provides services related to the design, engineering and assembly of natural gas compressors for sale to third parties in addition to those that the Company uses in its contract compression fleet. The aftermarket services segment sells parts and components and provides maintenance, operations and repair services to customers who own compression equipment and customers who use equipment provided by other companies. Fabrication and aftermarket services revenue presented in the table below include only sales to third parties.

The Company s reportable segments are strategic business units that offer distinct products and services. They are managed separately since each business segment requires different marketing strategies due to customer specifications. The Company evaluates the performance of its reportable segments based on segment gross margin. Gross margin is defined as total revenue less cost of sales (excluding depreciation and amortization expense). The segment gross margin measure used by management for evaluation purposes excludes inter-segment transactions and, accordingly, there is no inter-segment revenue to be reported.

The following table presents unaudited revenue and gross margin by business segment (in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Revenue:				
Domestic contract compression	$ 101,058	$ 81,964	$ 296,563	$ 238,554
International contract compression	36,251	31,076	104,554	90,115
Fabrication	57,642	28,193	152,479	132,066
Aftermarket services	51,981	39,895	141,120	121,713
Total	$ 246,932	$ 181,128	$ 694,716	$ 582,448
Gross Margin:				
Domestic contract compression	$ 66,192	$ 52,115	$ 192,991	$ 151,689
International contract compression	27,283	22,989	78,759	67,154
Fabrication	10,048	3,424	20,983	9,329
Aftermarket services				