TIMKEN CO
Form 10-Q
November 08, 2006

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

þ **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 number: 1-1169

THE TIMKEN COMPANY

(Exact name of registrant as specified in its charter)

OHIO	**34-0577130**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1835 Dueber Ave., SW, Canton, OH	**44706-2798**
(Address of principal executive offices)	(Zip Code)

330.438.3000

(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 Yes þ No o

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 þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at October 31, 2006
Common Stock, without par value	94,135,297 shares

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
THE TIMKEN COMPANY AND SUBSIDIARIES
Condensed Consolidated Balance Sheet
(Dollars in thousands)
(Unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 54,069	$ 65,417
Accounts receivable, less allowances: 2006- $45,352; 2005-$40,618	734,631	711,783
Inventories, net	1,077,792	998,368
Deferred income taxes	92,369	104,978
Deferred charges and prepaid expenses	16,077	17,926
Other current assets	88,569	84,837
Total Current Assets	2,063,507	1,983,309
Property, plant and equipment	3,809,742	3,657,641
Less allowances for depreciation	(2,202,960)	(2,110,597)
Property, Plant and Equipment net	1,606,782	1,547,044
Other Assets		
Goodwill	216,961	204,129
Other intangible assets	180,114	184,624
Deferred income taxes	16,705	5,834
Other non-current assets	59,985	68,794
Total Other Assets	473,765	463,381
Total Assets	$ 4,144,054	$ 3,993,734
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Accounts payable and other liabilities	$ 506,866	$ 501,423
Short-term debt and current portion of long-term debt	204,166	159,279
Accrued expenses	373,708	410,624
Total Current Liabilities	1,084,740	1,071,326
Non-Current Liabilities		
Long-term debt	548,611	561,747
Accrued pension cost	209,052	246,692
Accrued postretirement benefits cost	519,792	513,771
Other non-current liabilities	84,556	103,131

Total Non-Current Liabilities	**1,362,011**	1,425,341
Shareholders Equity		
Common stock	**799,053**	767,645
Earnings invested in the business	**1,196,878**	1,052,871
Accumulated other comprehensive loss	**(298,628)**	(323,449)
Total Shareholders Equity	**1,697,303**	1,497,067
Total Liabilities and Shareholders Equity	**$ 4,144,054**	$ 3,993,734

See accompanying Notes to Condensed Consolidated Financial Statements.

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Consolidated Statement of Income
(Dollars in thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	**2006**	2005
Net sales	**$ 1,272,922**	$ 1,258,133	**$ 4,008,027**	$ 3,887,351
Cost of products sold	**1,024,438**	1,005,722	**3,159,132**	3,086,278
Gross Profit	**248,484**	252,411	**848,895**	801,073
Selling, administrative and general expenses	**163,999**	163,021	**514,515**	488,802
Impairment and restructuring charges	**2,682**	24,451	**21,162**	24,407
Operating Income	**81,803**	64,939	**313,218**	287,864
Interest expense	**(11,704)**	(12,842)	**(37,487)**	(39,376)
Interest income	**854**	874	**3,338**	2,219
Other expense net	**(1,942)**	(4,273)	**(8,937)**	(9,446)
Income Before Income Taxes	**69,011**	48,698	**270,132**	241,261
Provision for income taxes	**22,465**	8,867	**82,955**	75,861
Net Income	**$ 46,546**	$ 39,831	**$ 187,177**	$ 165,400
Earnings Per Share*	**$ 0.50**	$ 0.43	**$ 2.01**	$ 1.81
Earnings Per Share assuming dilution**	**$ 0.49**	$ 0.43	**$ 1.99**	$ 1.79
Dividends Per Share	**$ 0.16**	$ 0.15	**$ 0.46**	$ 0.45
* Average shares outstanding	**93,500,491**	91,688,231	**93,239,292**	91,238,444
** Average shares outstanding assuming dilution	**94,376,937**	92,821,344	**94,238,413**	92,181,013

See accompanying Notes to Condensed Consolidated Financial Statements.

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Condensed Consolidated Statement of Cash Flows
(Dollars in thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2006	2005
CASH PROVIDED (USED)		
Operating Activities		
Net income	**$ 187,177**	$ 165,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**151,226**	160,765
Loss on impairment	**1,792**	
Loss on disposals of property, plant and equipment	**2,130**	7,374
Loss (gain) on divestiture	**9,311**	(2,832)
Deferred income tax credit	**(26,541)**	(13,143)
Stock-based compensation expense	**11,760**	4,398
Changes in operating assets and liabilities:		
Accounts receivable	**(14,082)**	(110,262)
Inventories	**(57,837)**	(162,106)
Other assets	**(8,732)**	(28,671)
Accounts payable and accrued expenses	**(73,963)**	79,190
Foreign currency translation (gain) loss	**(9,891)**	5,581
Net Cash Provided By Operating Activities	**172,350**	105,694
Investing Activities		
Capital expenditures	**(179,419)**	(128,605)
Proceeds from disposals of assets	**6,243**	3,661
Divestments	**(2,723)**	11,729
Acquisitions	**(4,299)**	(6,629)
Other	**(85)**	3,186
Net Cash Used by Investing Activities	**(180,283)**	(116,658)
Financing Activities		
Cash dividends paid to shareholders	**(43,170)**	(41,238)
Net proceeds from common share activity	**22,066**	30,740
Accounts receivable securitization financing borrowings	**140,000**	185,000
Accounts receivable securitization financing payments	**(50,000)**	(106,500)
Payments on long-term debt	**(291,477)**	(257,977)
Proceeds from issuance of long-term debt	**191,615**	246,700
Short-term debt activity net	**24,984**	(28,824)
Net Cash (Used) Provided by Financing Activities	**(5,982)**	27,901
Effect of exchange rate changes on cash	**2,567**	(4,799)

(Decrease) Increase In Cash and Cash Equivalents	**(11,348)**	12,138
Cash and cash equivalents at beginning of year	**65,417**	50,967
Cash and Cash Equivalents at End of Period	**$ 54,069**	$ 63,105

See accompanying Notes to the Condensed Consolidated Financial Statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1 Basis of Presentation

The accompanying Condensed Consolidated Financial Statements (unaudited) for The Timken Company (the company) have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and footnotes required by the U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) and disclosures considered necessary for a fair presentation have been included. For further information, refer to the Consolidated Financial Statements and footnotes included in the company s Annual Report on Form 10-K for the year ended December 31, 2005. Certain amounts in the 2005 Condensed Consolidated Financial Statements have been reclassified to conform to the 2006 presentation.

Note 2 Stock-Based Compensation

On January 1, 2006, the company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R) (SFAS No. 123(R)), Share-Based Payment, and elected to use the modified prospective transition method. The modified prospective method requires that compensation cost be recognized in the financial statements for all stock option awards granted after the date of adoption and for all unvested stock option awards granted prior to the date of adoption. In accordance with SFAS No. 123(R), prior period amounts were not restated. Prior to the adoption of SFAS No. 123(R), the company utilized the intrinsic-value based method of accounting under APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, and adopted the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation.

Under the company s long-term incentive plan, shares of common stock have been made available to grant at the discretion of the Compensation Committee of the Board of Directors to officers and key associates in the form of stock option awards. Stock option awards typically have a ten-year term and generally vest in 25% increments annually beginning on the date of grant. In addition to stock option awards, the company has granted restricted shares under the long-term incentive plan. Restricted shares typically vest in 25% increments annually beginning on the date of grant and have historically been expensed over the vesting period.

Prior to January 1, 2006, no stock-based compensation expense was recognized for stock option awards under the intrinsic-value based method. The adoption of SFAS No. 123(R) reduced operating income for the third quarter of 2006 by $1.5 million, reduced net income for the third quarter of 2006 by $0.9 million ($.01 per basic and diluted share), reduced operating income for the first nine months of 2006 by $4.6 million and reduced net income for the first nine months of 2006 by $2.9 million ($.03 per basic and diluted share).

The effect on net income and earnings per share as if the company had applied the fair value recognition provisions of SFAS No. 123 to all outstanding and nonvested stock option awards is as follows for the three and nine months ended September 30, 2005:

(Dollars in thousands, except earnings per share data)	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 39,831	$ 165,400
Add: Stock-based employee compensation expense, net of related taxes	1,055	3,017
Deduct: Stock-based employee compensation expense determined under fair value based methods for all awards, net of related taxes	(2,355)	(6,356)
Pro forma net income	$ 38,531	$ 162,061
Earnings per share:		
Basic as reported	$ 0.43	$ 1.81

Basic pro forma	$	0.42	$	1.78
Diluted as reported	$	0.43	$	1.79
Diluted pro forma	$	0.42	$	1.76

The fair value for significant stock option awards granted during the nine months ended September 30, 2006 and 2005 was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

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Note 2 Stock-Based Compensation (continued)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Assumptions:		
Fair value per option	**$ 9.59**	$ 7.85
Risk-free interest rate	**4.53%**	4.12%
Dividend yield	**2.14%**	3.28%
Expected stock volatility	**0.348**	0.360
Expected life years	**5**	8

Historical information was the primary basis for the selection of the expected dividend yield, expected volatility and the expected lives of the options. The dividend yield was revised in 2006 from five years quarterly dividends to the last dividend prior to the grant compared to the trailing 12 months daily stock prices. The risk-free interest rate was based upon yields of U.S. zero coupon issues and U.S. Treasury issues, with a term equal to the expected life of the option being valued, for 2006 and 2005, respectively. Effective January 1, 2006, forfeitures were estimated at 2%.
A summary of stock option award activity for the nine-month period ended September 30, 2006 is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (000 s)
Balance at December 31, 2005	5,439,913	$22.78		
Granted	817,150	$30.94		
Exercised	(858,052)	$21.06		
Other*	(58,670)	$30.83		
Outstanding at September 30, 2006	5,340,341	$24.21	6	$39,240
Exercisable at September 30, 2006	3,407,051	$23.01	5	$29,542

* Includes cancelled, expired and forfeited

The total intrinsic value of stock option awards exercised during the nine months ended September 30, 2006 and 2005 was $10.6 million and $15.3 million, respectively. Net cash proceeds from the exercise of stock options were $17.6 million and $32.9 million for the nine months ended September 30, 2006 and 2005, respectively. Income tax benefits of $3.8 million and $4.4 million were realized from stock option exercises during the nine months ended September 30, 2006 and 2005, respectively.
A summary of nonvested restricted share activity for the nine-month period ended September 30, 2006 is as follows:

	Weighted Average Grant Date

	Number of Shares	Fair Value
Nonvested at December 31, 2005	755,290	$ 24.46
Granted	433,861	$ 31.19
Vested	(237,760)	$ 25.21
Other*	(16,918)	$ 27.81
Nonvested at September 30, 2006	934,473	$ 27.34

* Includes cancelled, expired and forfeited

Note 2 Stock-Based Compensation (continued)
Nonvested shares consist primarily of restricted shares for key employees and directors, and also include deferred shares.

The company recognized compensation expense of $7.2 million and $4.4 million for the nine-month periods ended September 30, 2006 and 2005, respectively, related to nonvested shares. As of September 30, 2006, the company had unrecognized compensation expense of $27.8 million, before taxes, related to stock option awards and nonvested shares. The unrecognized compensation expense is expected to be recognized over a total weighted average period of two years.

Note 3 Inventories

(Dollars in thousands)	**September 30 2006**	December 31, 2005
Inventories:		
Manufacturing supplies	**$ 79,759**	$ 74,188
Work in process and raw materials	**490,701**	469,517
Finished products	**507,332**	454,663
Inventories, net	**$1,077,792**	$998,368

An actual valuation of the inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations must necessarily be based on management s estimates of expected year-end inventory levels and costs. Because these are subject to many forces beyond management s control, annual results are subject to the final year-end LIFO inventory valuation.

Note 4 Financing Arrangements
Short-term debt:

(Dollars in thousands)	**September 30, 2006**	December 31, 2005
Variable-rate Accounts Receivable Asset Securitization with an interest rate of 5.82% at September 30, 2006	**$ 90,000**	$
Variable-rate lines of credit for certain of the company s European and Asian subsidiaries with various banks with interest rates ranging from 3.44% to 5.75% at September 30, 2006	**68,090**	23,884
Variable-rate Ohio Water Development Authority revenue bonds for PEL		23,000
Fixed-rate mortgage for PEL with an interest rate of 9.00%		11,491
Fixed-rate Short-term loans of an Asian subsidiary with interest rates ranging from 6.58% to 6.84% at September 30, 2006	**10,213**	
Other	**4,973**	5,062
Short-term debt	**$173,276**	$63,437

In January 2006, the company repaid, in full, the $23.0 million balance outstanding of the revenue bonds held by PEL Technologies, LLC (PEL), an equity investment of the company. In June 2006, the company continued to liquidate assets of PEL with land and buildings exchanged for the fixed-rate mortgage. Refer to Note 10 Equity Investments for additional discussion.

Borrowings under the Accounts Receivable Securitization financing agreement (Asset Securitization), which provides for borrowings up to $200 million subject to certain borrowing base limitations, are secured by certain trade receivables. Under the terms of the Asset Securitization, the company sells, on an ongoing basis, certain domestic trade receivables to Timken Receivables Corporation, a wholly owned consolidated subsidiary, which in turn uses the trade receivables to secure the borrowings, which are funded through a vehicle that issues commercial paper in the short-term market. As of September 30, 2006, outstanding borrowings under this facility totaled $90.0 million. The yield on the commercial paper, which is the commercial paper rate plus program fees, is considered a financing cost and is included in interest expense on the Consolidated Statement of Income. As of September 30, 2006, the company had issued letters of credit totaling $16.7 million under the Asset Securitization, which further reduced the availability under this facility to $93.3 million.

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Note 4 Financing Arrangements (continued)

The lines of credit of the company s European and Asian subsidiaries provide for borrowings up to $196.5 million. At September 30, 2006, the company had borrowings outstanding of $68.1 million, which reduced the availability under these facilities to $128.4 million.

Long-term debt:

(Dollars in thousands)	**September 30, 2006**	December 31, 2005
Fixed-rate Medium-term Notes, Series A, due at various dates through May 2028, with interest rates ranging from 6.20% to 7.76%	**$211,644**	$286,474
Variable-rate State of Ohio Air Quality and Water Development Revenue Refunding Bonds, maturing on November 1, 2025 (3.62% at September 30, 2006)	**21,700**	21,700
Variable-rate State of Ohio Pollution Control Revenue Refunding Bonds, maturing on June 1, 2033 (3.62% at September 30, 2006)	**17,000**	17,000
Variable-rate State of Ohio Water Development Revenue Refunding Bonds, maturing on May 1, 2007 (3.62% at September 30, 2006)	**8,000**	8,000
Variable-rate State of Ohio Water Development Authority Solid Waste Revenue Bonds, maturing on July 1, 2032		24,000
Variable-rate Unsecured Canadian Note, maturing on December 22, 2010 (4.91% at September 30, 2006)	**51,722**	49,759
Fixed-rate Unsecured Notes, maturing on February 15, 2010 with an interest rate of 5.75%	**247,875**	247,651
Variable-rate credit facility with US Bank for Advanced Green Products, LLC, maturing on July 18, 2008 (6.33% at September 30, 2006)	**12,240**	
Other	**9,320**	3,005
	579,501	657,589
Less current maturities	**30,890**	95,842
Long-term debt	**$548,611**	$561,747

The company has a $500 million Amended and Restated Credit Agreement (Senior Credit Facility) that matures on June 30, 2010. At September 30, 2006, the company had no outstanding borrowings under the Senior Credit Facility, and had issued letters of credit under this facility totaling $35.2 million, which reduced the availability under the Senior Credit Facility to $464.8 million. Under the Senior Credit Facility, the company has two financial covenants: a consolidated leverage ratio and a consolidated interest coverage ratio. At September 30, 2006, the company was in full compliance with the covenants under the Senior Credit Facility and its other debt agreements.

In December 2005, the company entered into a 57.8 million Canadian dollar unsecured loan in Canada. The principal balance of the loan is payable in full on December 22, 2010. The interest rate is variable based on the Canadian LIBOR rate and interest payments are due quarterly.

In August 2006, the company repaid, in full, the $24.0 million balance outstanding under the variable-rate State of Ohio Water Development Authority Solid Waste Revenue Bonds.

Advanced Green Components, LLC (AGC) is a joint venture of the company formerly accounted for using the equity method. The company is the guarantor of $6.1 million of AGC s credit facility. Effective September 30, 2006, the company consolidated AGC and its outstanding debt. Refer to Note 10 Equity Investments for additional discussion.

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Note 5 Income Tax Provision

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	**2006**	2005	**2006**	2005
Provision for income taxes	**$22,465**	$8,867	**$82,955**	$75,861
Effective tax rate	**32.6%**	18.2%	**30.7%**	31.4%

The company s provision for income taxes in interim periods is computed by applying an estimated annual effective tax rate against income before income taxes for the period. In addition, non-recurring or discrete items are recorded during the period in which they occur.

For the first nine months of 2006, the effective tax rate was less than the U.S. federal statutory tax rate due to the favorable impact of taxes on foreign income, including earnings of certain foreign subsidiaries being taxed at a rate less than 35%, the extraterritorial income exclusion on U.S. exports, and tax holidays in China and the Czech Republic. In addition, the effective tax rate was favorably impacted by certain U.S. tax benefits, including a net reduction in the company s tax reserves related primarily to the settlement of certain prior year tax matters with the Internal Revenue Service during the second quarter, accrual of the tax-free Medicare prescription drug subsidy, deductible dividends paid to the company s Employee Stock Ownership Plan (ESOP), and the domestic manufacturing deduction provided by the American Jobs Creation Act of 2004. These benefits were offset partially by U.S. state and local income taxes, taxes on foreign remittances, losses at certain foreign operations that were not available to reduce overall tax expense, and other permanent differences.

For the first nine months of 2005, the effective tax rate was less than the U.S. federal statutory tax rate primarily due to beneficial foreign tax rates, tax holidays and other U.S. tax benefits, including export tax incentives. These benefits were partially offset by losses at certain foreign operations that were not available to reduce overall tax expense, taxes paid to U.S. state and local jurisdictions, tax on foreign remittances, and other permanent differences.

In July 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes. This interpretation clarifies the accounting for uncertain tax positions recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. It prescribes requirements and other guidance for financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. The company is required to adopt this interpretation in the first quarter of 2007. Management is currently evaluating the requirements of FIN 48 and has not yet determined the estimated impact on the company s Consolidated Financial Statements.

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Note 6 Shareholders Equity

(Dollars in thousands)	**September 30, 2006**	December 31, 2005
Class I and Class II serial preferred stock without par value:		
Authorized 10,000,000 shares each class Issued none	**$**	$
Common Stock without par value:		
Authorized 200,000,000 shares		
Issued (including shares in treasury) 2006 - 94,192,311 shares 2005 - 93,160,285 shares		
Stated Capital	**53,064**	53,064
Other paid-in capital	**748,004**	719,001
Less cost of Common Stock in treasury 2006 - 61,145 shares 2005 - 154,374 shares	**(2,015)**	(4,420)
	$799,053	$767,645

An analysis of the change in capital and earnings invested in the business is as follows:

	Common Stock		Earnings	Accumulated		
		Other	Invested	Other		
	Stated	Paid-In	in the	Comprehensive	Treasury	
	Capital	Capital	Business	Income	Stock	Total
Balance December 31, 2005	$ 53,064	$ 719,001	$ 1,052,871	($323,449)	($4,420)	$ 1,497,067
Net income			187,177			187,177
Foreign currency translation adjustment				30,744		30,744
Minimum pension adjustment				(5,462)		(5,462)
Change in fair value of derivative financial instruments, net of reclassifications				(461)		(461)
Total comprehensive income						211,998
Dividends $0.46 per share			(43,170)			(43,170)
Tax benefit from exercise of stock options		4,635				4,635
Issuance of 93,229 shares from treasury and 1,032,026 shares from authorized related to		24,368			2,405	26,773

stock option plans						
Balance September 30, 2006	$ 53,064	$ 748,004	$ 1,196,878	($298,628)	($2,015)	$ 1,697,303

The total comprehensive income for the three months ended September 30, 2006 and 2005 was $43,581 and $54,103, respectively. Total comprehensive income for the nine months ended September 30, 2005 was $137,018.

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Note 7 Impairment and Restructuring Charges
Impairment and restructuring charges by segment are comprised of the following:
For the three months ended September 30, 2006:

(Dollars in thousands)	**Industrial**	**Auto**	**Steel**	**Total**