

NORTECH SYSTEMS INC
Form 10-Q
November 12, 2010
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**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, 2010

OR

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

For the transition period from _____ to _____

NORTECH SYSTEMS INCORPORATED

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Commission file number **0-13257**

State of Incorporation: **Minnesota**

IRS Employer Identification No. **41-1681094**

Executive Offices: **1120 Wayzata Blvd E., Suite 201, Wayzata, MN 55391**

Telephone number: **(952) 345-2244**

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer

Smaller Reporting Company

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

Number of shares of \$.01 par value common stock outstanding at November 1, 2010 - 2,742,992

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Table of Contents**PART 1****ITEM 1. FINANCIAL STATEMENTS****NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

| ASSETS | SEPTEMBER 30 2010 (Unaudited) | DECEMBER 31 2009 |
|--|--|-----------------------------|
| Current Assets | | |
| Cash and Cash Equivalents | \$ | \$ 245,381 |
| Accounts Receivable, Less Allowance for Uncollectible Accounts | 14,817,398 | 12,021,378 |
| Inventories | 18,350,712 | 15,806,669 |
| Prepaid Expenses | 604,510 | 542,643 |
| Income Taxes Receivable | 323,994 | 2,515,906 |
| Deferred Income Taxes | 719,000 | 753,000 |
| Total Current Assets | 34,815,614 | 31,884,977 |
| Property and Equipment, Net | 7,607,188 | 8,239,161 |
| Finite Life Intangible Assets, Net of Accumulated Amortization | 237,301 | 343,549 |
| Deferred Income Taxes | 114,000 | 348,000 |
| Other Assets | 313,518 | 313,518 |
| Total Assets | \$ 43,087,621 | \$ 41,129,205 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

| LIABILITIES AND SHAREHOLDERS EQUITY | SEPTEMBER 30 2010 (Unaudited) | DECEMBER 31 2009 |
|---|-------------------------------------|----------------------|
| Current Liabilities | | |
| Line of Credit | \$ 6,258,635 | \$ 5,490,607 |
| Current Maturities of Long-Term Debt | 1,079,239 | 1,013,920 |
| Accounts Payable | 10,481,318 | 9,050,684 |
| Accrued Payroll and Commissions | 3,141,317 | 1,449,528 |
| Accrued Health and Dental Claims | 220,000 | 310,000 |
| Other Accrued Liabilities | 812,614 | 1,354,438 |
| Total Current Liabilities | 21,993,123 | 18,669,177 |
| Long-Term Liabilities | | |
| Long-Term Debt, Net of Current Maturities | 1,831,398 | 3,572,264 |
| Other Long-Term Liabilities | 129,170 | 160,912 |
| Total Long-Term Liabilities | 1,960,568 | 3,733,176 |
| Total Liabilities | 23,953,691 | 22,402,353 |
| Shareholders Equity | | |
| Preferred Stock, \$1 par value; 1,000,000 Shares Authorized: 250,000 Shares Issued and Outstanding | 250,000 | 250,000 |
| Common Stock - \$0.01 par value; 9,000,000 Shares Authorized: 2,742,992 and 2,738,992 Shares Issued and Outstanding at September 30, 2010 and December 31, 2009, respectively | 27,430 | 27,390 |
| Additional Paid-In Capital | 15,690,416 | 15,654,160 |
| Accumulated Other Comprehensive Loss | (72,841) | (73,909) |
| Retained Earnings | 3,238,925 | 2,869,211 |
| Total Shareholders Equity | 19,133,930 | 18,726,852 |
| Total Liabilities and Shareholders Equity | \$ 43,087,621 | \$ 41,129,205 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

| | THREE MONTHS ENDED SEPTEMBER 30 | |
|--|------------------------------------|---------------|
| | 2010 | 2009 |
| Net Sales | \$ 25,957,327 | \$ 18,650,684 |
| Cost of Goods Sold | 23,064,208 | 17,027,206 |
| Gross Profit | 2,893,119 | 1,623,478 |
| Operating Expenses: | | |
| Selling Expenses | 784,283 | 1,024,824 |
| General and Administrative Expenses | 1,942,646 | 1,395,327 |
| Restructuring and Impairment Charges | | 352,578 |
| Total Operating Expenses | 2,726,929 | 2,772,729 |
| Income (Loss) From Operations | 166,190 | (1,149,251) |
| Other Income (Expense) | | |
| Interest Expense | (99,434) | (150,026) |
| Miscellaneous Income (Expense), net | 153,562 | (77,417) |
| Total Other Income (Expense) | 54,128 | (227,443) |
| Income (Loss) Before Income Taxes | 220,318 | (1,376,694) |
| Income Tax Expense (Benefit) | 93,000 | (523,000) |
| Net Income (Loss) | \$ 127,318 | \$ (853,694) |
| Earnings (Loss) Per Common Share: | | |
| Basic and Diluted | \$ 0.05 | \$ (0.31) |
| Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings (Loss) Per Common Share | 2,742,992 | 2,738,989 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30 | |
|--|-----------------------------------|----------------|
| | 2010 | 2009 |
| Net Sales | \$ 72,393,274 | \$ 60,092,430 |
| Cost of Goods Sold | 63,749,870 | 56,537,733 |
| Gross Profit | 8,643,404 | 3,554,697 |
| Operating Expenses: | | |
| Selling Expenses | 2,305,207 | 3,563,159 |
| General and Administrative Expenses | 5,361,255 | 4,486,283 |
| Restructuring and Impairment Charges | | 997,696 |
| Total Operating Expenses | 7,666,462 | 9,047,138 |
| Income (Loss) From Operations | 976,942 | (5,492,441) |
| Other Income (Expense) | | |
| Interest Expense | (325,375) | (385,048) |
| Miscellaneous Income (Expense), net | 116,147 | (121,205) |
| Total Other Expense | (209,228) | (506,253) |
| Income (Loss) Before Income Taxes | 767,714 | (5,998,694) |
| Income Tax Expense (Benefit) | 398,000 | (2,309,000) |
| Net Income (Loss) | \$ 369,714 | \$ (3,689,694) |
| Earnings (Loss) Per Common Share: | | |
| Basic and Diluted | \$ 0.13 | \$ (1.35) |
| Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings (Loss) Per Common Share | 2,742,186 | 2,738,972 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30 | |
|--|-----------------------------------|----------------|
| | 2010 | 2009 |
| Cash Flows From Operating Activities | | |
| Net Income (Loss) | \$ 369,714 | \$ (3,689,694) |
| Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by (Used in) Operating Activities: | | |
| Depreciation | 1,181,745 | 1,365,267 |
| Amortization | 106,248 | 112,591 |
| Stock-Based Compensation | 23,796 | 93,888 |
| Interest on Swap Valuation | (19,492) | (12,504) |
| Restructuring Charges | | 451,953 |
| Property and Equipment Impairment Charges | | 545,743 |
| Deferred Income Taxes | 268,000 | 163,000 |
| Loss on Disposal of Property and Equipment | 901 | 5,587 |
| Foreign Currency (Gain) Loss | (240) | 2,607 |
| Changes in Current Operating Items, Net of Effects of Business Acquisition | | |
| Accounts Receivable | (2,790,649) | 1,437,846 |
| Inventories | (2,241,074) | 4,930,929 |
| Prepaid Expenses and Other Assets | (61,368) | 147,691 |
| Income Taxes Receivable | 2,191,702 | (1,998,839) |
| Accounts Payable | 1,561,006 | (3,450,805) |
| Accrued Payroll and Commissions | 1,686,377 | (1,591,934) |
| Accrued Health and Dental Claims | (90,000) | (81,102) |
| Other Accrued Liabilities | (554,437) | (1,066,112) |
| Net Cash Provided by (Used in) Operating Activities | 1,632,229 | (2,633,888) |
| Cash Flows from Investing Activities: | | |
| Proceeds from Sale of Property and Equipment | | 44,900 |
| Business Acquisition | (402,969) | |
| Purchase of Property and Equipment | (447,261) | (465,600) |
| Net Cash Used in Investing Activities | (850,230) | (420,700) |
| Cash Flows from Financing Activities: | | |
| Net Borrowings on Line of Credit | 768,028 | 2,687,045 |
| Proceeds from Long-Term Debt | | 616,397 |
| Principal Payments on Long-Term Debt | (1,808,408) | (841,166) |
| Proceeds from Issuance of Common Stock | 12,500 | 132 |
| Net Cash Provided by (Used in) Financing Activities | (1,027,880) | 2,462,408 |
| Effect of Exchange Rate Changes on Cash | 500 | 155 |
| Net Increase in Cash and Cash Equivalents | (245,381) | (592,025) |
| Cash and Cash Equivalents - Beginning | 245,381 | 803,041 |
| Cash and Cash Equivalents - Ending | \$ | \$ 211,016 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash Paid During the Period for Interest | \$ 352,004 | \$ 403,901 |
| Cash Paid During the Period for Income Taxes | 377,115 | 802 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements for the interim periods have been prepared in accordance with Generally Accepted Accounting Principles in the United States of America (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the financial information and footnotes required by GAAP for complete financial statements, although we believe the disclosures are adequate to make the information presented not misleading. It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in our latest shareholders' annual report on Form 10-K. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year or for any other interim period. In our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. In preparing these consolidated financial statements, we have made our best estimates and judgments of certain amounts included in the consolidated financial statements, giving due consideration to materiality. Changes in the estimates and assumptions used by us could have a significant impact on our financial results, since actual results could differ from those estimates.

Principles of Consolidation

The consolidated financial statements include the accounts of Nortech Systems Incorporated and its wholly owned subsidiary, Manufacturing Assembly Solutions of Monterrey, Inc. All significant intercompany accounts and transactions have been eliminated.

Revenue Recognition

We recognize revenue upon shipment of manufactured products to customers, when title has passed, all contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. We also provide engineering services separate from the manufacture of a product. Revenue for engineering services is recognized upon completion of the engineering process, providing standalone fair value to our customers. Our engineering services are short-term in nature. In addition, we have another separate source of revenue that comes from short-term repair services, which are recognized upon completion of the repairs and shipment of product back to the customer. Shipping and handling costs charged to our customers are included in net sales, while the corresponding shipping expenses are included in cost of goods sold.

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Following is the status of all stock options as of September 30, 2010, including changes during the nine-month period then ended:

| | Shares | | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Contractual Term (in years) | | Aggregate Intrinsic Value |
|----------------------------------|----------|----|---|--|----|---------------------------|
| Outstanding - January 1, 2010 | 736,750 | \$ | 7.20 | | | |
| Exercised | (4,000) | \$ | 3.13 | | | |
| Forfeited | (67,500) | \$ | 6.27 | | | |
| Outstanding - September 30, 2010 | 665,250 | \$ | 7.32 | 5.80 | \$ | 364 |
| Exercisable - September 30, 2010 | 291,250 | \$ | 7.37 | 4.42 | \$ | |

The total intrinsic value of options exercised during the three and nine months ended September 30, 2010 was \$0 and \$20, respectively. Cash received from option exercises during the three and nine months ended September 30, 2010 was \$0 and \$12,500, respectively. There were no options exercised during the three and nine months ended September 30, 2009.

Stock Options with Time-Based Vesting

Total compensation expense related to stock options with time-based vesting for the three months ended September 30, 2010 and 2009 was \$7,932 and \$31,296, respectively. Total compensation expense related to stock options with time-based vesting for the nine months ended September 30, 2010 and 2009 was \$23,796 and \$93,888, respectively. At September 30, 2010 we had 315,250 time-based options outstanding.

As of September 30, 2010 there was approximately \$35,000 of unrecognized compensation expense related to unvested option awards that we expect to recognize over a weighted-average period of 1.10 years.

Segment Reporting Information

For the three and nine months ended September 30, 2010 and 2009 all of our operations fall under the Contract Manufacturing segment within the Electronic Manufacturing Services industry. We strategically direct production between our various manufacturing facilities based on a number of considerations to best meet our customers' requirements. We share resources for sales, marketing, cash and risk management, banking, credit and collections, human resources, payroll, internal control, audit, taxes, SEC reporting and corporate accounting. Consolidated financial information is available that is evaluated regularly by the chief operating decision maker in assessing performance and allocating resources. Export sales represented 6% and 5% of consolidated net sales for the three and nine months ended September 30, 2010, respectively and 4% of consolidated net sales for the three and nine months ended September 30, 2009.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market (based on the lower of replacement cost or net realizable value). Costs include material, labor, and overhead required in the warehousing and production of our products. Inventory reserves are maintained for the estimated

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value of the inventories that may have a lower value than stated or quantities in excess of future production needs.

Inventories are as follows:

| | September 30 2010 | December 31 2009 |
|-----------------|------------------------------|-----------------------------|
| Raw Materials | \$ 13,228,493 | \$ 11,137,853 |
| Work in Process | 3,892,335 | 3,304,725 |
| Finish Goods | 2,351,132 | 2,459,521 |
| Reserve | (1,121,248) | (1,095,430) |
| Total | \$ 18,350,712 | \$ 15,806,669 |

Finite Life Intangible Assets

Finite life intangible assets at September 30, 2010 and December 31, 2009 are as follows:

| | September 30, 2010 | | | |
|-------------------|--|--------------------------------------|-------------------------------------|---------------------------|
| | Remaining Lives (Years) | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Bond Issue Costs | 11 | \$ 79,373 | \$ 22,490 | \$ 56,883 |
| Customer Base | 2 | 676,557 | 496,139 | 180,418 |
| Other Intangibles | 0 | 28,560 | 28,560 | |
| Totals | | \$ 784,490 | \$ 547,189 | \$ 237,301 |

| | December 31, 2009 | | | |
|-------------------|--|--------------------------------------|-------------------------------------|---------------------------|
| | Remaining Lives (Years) | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Bond Issue Costs | 12 | \$ 79,373 | \$ 18,522 | \$ 60,851 |
| Customer Base | 3 | 676,557 | 394,655 | 281,902 |
| Other Intangibles | 1 | 28,560 | 27,764 | 796 |
| Totals | | \$ 784,490 | \$ 440,941 | \$ 343,549 |

Estimated future amortization expense related to these assets is as follows:

| | |
|-------------------|-----------|
| Remainder of 2010 | \$ 35,000 |
| 2011 | 141,000 |
| 2012 | 17,000 |

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| | | |
|------------|----|---------|
| 2013 | | 5,000 |
| 2014 | | 5,000 |
| Thereafter | | 34,000 |
| Total | \$ | 237,000 |

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NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. With regard to cash and cash equivalents, we maintain our excess cash balances in checking accounts at one high-credit quality financial institution. This account may at times exceed federally insured limits. We do not require collateral on our accounts receivable.

One customer accounted for 10% or more of our net sales for the three and nine months ended September 30, 2010. Two customers accounted for 10% or more of our sales for the three and nine months ended September 30, 2009. G.E.'s Medical Division accounted for 17% and 18% of net sales for the three and nine months ended September 30, 2010, respectively and 19% and 14% of net sales for the three and nine month periods ended September 30, 2009, respectively. GE's Transportation Division accounted for 6% and 8% of net sales for the three and nine months ended September 30, 2010, respectively and 18% and 14% for the three and nine month periods ended September 30, 2009, respectively. GE's Medical and Transportation Divisions combined accounted for 23% and 27% of net sales for the three and nine month periods ended September 30, 2010, respectively and 37% and 28% of net sales for the three and nine month periods ended September 30, 2009, respectively. Accounts receivable from G.E.'s Medical and Transportation Divisions represented 14% of total accounts receivable at September 30, 2010. Additionally, Northrop Grumman Corp. accounted for 9% and 12% of net sales for the three and nine month periods ended September 30, 2009, respectively.

NOTE 3. FINANCING ARRANGEMENTS

On May 27, 2010 we entered into a third amended and restated credit agreement with Wells Fargo Bank (WFB), which provides for a line of credit arrangement of \$12 million, which expires if not renewed, on May 31, 2013. The credit arrangement also has a real estate term note with a maturity date of May 31, 2012. Both the line of credit and real estate term note are subject to variations in LIBOR rates. The line of credit and real estate term note with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. On September 30, 2010, we had an outstanding balance of \$6.3 million under the line of credit, unused availability of \$3.1 million supported by our borrowing base and were in compliance with all covenants.

NOTE 4. DERIVATIVE INSTRUMENTS AND HEDGING STRATEGIES

We are exposed to interest rate risk associated with fluctuations in the interest rates on our variable interest rate debt. In order to manage some of the risk, we have entered into an interest rate swap agreement with a notional amount of \$1.4 million with a goal to effectively convert our industrial revenue bond debt from a variable rate to a fixed rate of 4.07% for five years, maturing on June 28, 2011. We do not use this interest rate swap for speculative purposes. The fair value of the swap of approximately \$26,000 and \$46,000 was recorded in other long-term liabilities at September 30, 2010 and December 31, 2009 respectively. The change in fair value of \$20,000 and \$13,000 for the nine-month periods ended September 30, 2010 and 2009, respectively, was recorded as a component of interest expense.

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NOTE 5. NET INCOME (LOSS) PER COMMON SHARE

For the three and nine months ended September 30, 2010 and 2009, the effect of all stock options is antidilutive either due to the net loss incurred in 2009 or because to include them would be antidilutive in 2010. Therefore, no outstanding options were included in the computation of per-share amounts.

NOTE 6. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances by each tax jurisdiction. The effective tax rates for the quarters ended September 30, 2010 and 2009 were approximately 42% and 38%, respectively. The year-to-date effective tax rates for the nine months ending September 30, 2010 and 2009 were 52% and 38%, respectively. The increase in the quarterly tax rate is primarily due to the increased FIN 48 reserve. The increase in the nine month effective tax rate from 2009 to 2010 relates primarily to the true-up of our net operating loss (NOL) carryback which resulted in additional tax expense of approximately \$103,000.

At September 30, 2010 we had \$102,750 of net uncertain tax benefit positions recorded in other long-term liabilities that would reduce our effective income tax rate if recognized. The \$12,250 decrease from December 31, 2009 relates primarily to the NOL carryback which resulted in the loss of domestic production deductions.

NOTE 7. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes gains and losses resulting from foreign currency translations. The details of comprehensive income (loss) are as follows:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---------------------------------|------------------------------------|--------------|-----------------------------------|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net Income (Loss) | \$ 127,318 | \$ (853,694) | \$ 369,714 | \$ (3,689,694) |
| Other Comprehensive Loss: | | | | |
| Currency Translation Adjustment | 2,625 | 30,312 | 1,068 | 3,978 |
| Comprehensive Income (Loss) | \$ 129,943 | \$ (823,382) | \$ 370,782 | \$ (3,685,716) |

NOTE 8. RESTRUCTURING AND IMPAIRMENT CHARGES

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To better align our cost structure with changes in customer demand, our Board of Directors approved a restructuring plan in the second quarter of fiscal year 2009. This restructuring resulted in the closing of our Garner, Iowa facility at the end of August 2009 with production moving to Merrifield, Minnesota and closing our Fairmont Aerospace assembly production facilities and moving these activities to Blue Earth, Minnesota. One building in Fairmont was sold and another is held for sale at September 30, 2010 and is included in Other Assets on the balance sheet. As a result of these decisions, we recognized approximately \$0.4 million and \$1.0 million of restructuring and impairment charges for the three and nine months ended September 30, 2009, respectively, in Income (Loss) from Operations. Total cash paid during the three and nine months ended September 30, 2010 related to

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this restructuring was \$0 and \$16,000, respectively. All accrued liabilities relating to the restructuring were paid as of September 30, 2010.

NOTE 9. ACQUISITION

On May 4, 2010, we acquired all of the intellectual property and assets, excluding cash and receivables, of Trivirix Corporation, Milaca, MN for \$403,000 which consisted of \$303,000 in inventory and \$100,000 in property and equipment. This operation specializes in design, manufacturing and post-production services of complex electronic and electromechanical medical devices for diagnostic, analytical and other life-science applications. This acquisition expands our capabilities and expertise serving medical electronics manufacturers.

The acquisition has been accounted for as a purchase and results of operations for Milaca since the date of acquisition are included in the consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview:

We are a Wayzata, Minnesota based full-service Electronics Manufacturing Services (EMS) contract manufacturer of wire and cable assemblies, printed circuit board assemblies, higher-level assemblies and box builds for a wide range of industries. We provide value added services and technical support including design, testing, prototyping and supply chain management to customers mainly in the Aerospace and Defense, Medical, and Industrial Equipment markets. We maintain manufacturing facilities in Baxter, Bemidji, Blue Earth, Fairmont, Merrifield, and Milaca, Minnesota; Augusta, Wisconsin; and Monterrey, Mexico.

Summary of Results:

For the quarter ended September 30, 2010, we reported net sales of \$26.0 million compared to \$18.7 million reported in the same quarter of 2009, a 39% improvement. Net sales of \$72.4 million for the first nine months of 2010 increased 20% over the \$60.1 million reported for the first nine months of 2009. We continue to see increased confidence by our customers. Our 90-day backlog increased to \$23.5 million as of September 30, 2010 compared to \$14.2 million for the same period last year and \$21.3 million at the start of the quarter.

Our gross margin in the third quarter of 2010 was 11.1% compared to 8.7% in the third quarter of 2009. The volume increase, cost controls and continuous improvement programs favorably impacted our third quarter gross margin results.

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Income from operations for the third quarter of 2010 totaled \$0.2 million, compared to loss from operations of \$1.1 million in the same quarter of 2009, which included one-time restructuring and impairment charges of \$0.4 million. Income from operations for the first nine months of 2010 totaled \$1.0 million compared to a loss from operations of \$5.5 million reported in the first nine months of 2009, which included one-time restructuring and impairment charges of \$1.0 million.

Net income for the third quarter of 2010 totaled \$0.1 million or \$0.05 per diluted common share, compared to net loss of \$0.9 million, or \$0.31 per diluted common share, including one-time restructuring and impairment charges, or \$0.23 excluding one-time restructuring and impairment charges, reported in the third quarter of 2009. Net income for the nine months ended September 30, 2010 was \$0.4 million or \$0.13 per diluted common share, compared to a loss of \$3.7 million or \$1.35 per diluted common share, including one-time restructuring and impairment charges, or \$1.13

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excluding one-time restructuring and impairment charges, for the nine months ended September 30, 2009.

Cash flow provided by operating activities for the nine months ended September 30, 2010 was \$1.6 million compared to cash used in operations of \$2.6 million for the same period in 2009.

(1.) Results of Operations:

The following table presents statement of operations data as percentages of total net sales for the periods indicated:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|--------------------------------------|------------------------------------|--------|-----------------------------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Net Sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of Goods Sold | 88.9 | 91.3 | 88.1 | 94.1 |
| Gross Profit | 11.1 | 8.7 | 11.9 | 5.9 |
| Selling Expenses | 3.0 | 5.5 | 3.2 | 5.9 |
| General and Administrative Expenses | 7.5 | 7.4 | 7.4 | 7.5 |
| Restructuring and Impairment Charges | 0.0 | 2.0 | 0.0 | 1.6 |
| Income (Loss) from Operations | 0.6 | (6.2) | 1.3 | (9.1) |
| Other Income (Expenses), Net | 0.2 | (1.2) | (0.3) | (0.8) |
| Income Before Income Taxes | 0.8 | (7.4) | 1.0 | (9.9) |
| Income Tax Expense (Benefit) | 0.3 | (2.8) | 0.5 | (3.8) |
| Net Income (Loss) | 0.5% | (4.6)% | 0.5% | (6.1)% |

Net Sales:

We reported net sales of \$26.0 million and \$18.7 million for the three months ended September 30, 2010 and 2009, respectively. Sales for the nine months ended September 30, 2010 and 2009 were \$72.4 million and \$60.1 million, respectively. The Milaca medical device operation acquired in May 2010 accounted for \$1.4 million and \$2.3 million of net sales for the three and nine months ended September 30, 2010. Net sales by industry markets for the three and nine-month periods ended September 30, 2010 and 2009 are as follows:

| (in thousands) | Three Months Ended September 30 | | | Nine Months Ended September 30 | | |
|-----------------------|------------------------------------|------------|-------------|-----------------------------------|------------|-------------|
| | 2010 \$ | 2009 \$ | % Change | 2010 \$ | 2009 \$ | % Change |
| Aerospace and Defense | 3,930 | 4,978 | (21) | 12,003 | 21,531 | (44) |
| Medical | 7,004 | 4,721 | 48 | 18,965 | 12,597 | 51 |
| Industrial | 15,023 | 8,952 | 68 | 41,426 | 25,964 | 60 |

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| | | | | | | |
|-------------|--------|--------|----|--------|--------|----|
| Total Sales | 25,957 | 18,651 | 39 | 72,394 | 60,092 | 20 |
|-------------|--------|--------|----|--------|--------|----|

Net sales to our Aerospace and Defense customers decreased due to the end of major contracts and the timing of new replacement business. Net sales from our Medical and Industrial customers continued

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to see significant increases as the overall economy stabilized and we began to see more new business opportunities and improved buying confidence from our existing customer base.

Backlog:

Our 90-day order backlog as of September 30, 2010 was approximately \$23.5 million, compared to approximately \$21.3 million at the beginning of the quarter and \$14.2 million at September 30, 2009. During the quarter we continued to see increased customer activity along with increased levels of quoting from both new and existing customers. Our Aerospace and Defense quarter end backlog is beginning to show signs of recovery with an increase of 2% over the start of the quarter. The Milaca medical device operation acquired in May 2010 accounted for \$1.1 million of the 90 day medical and total backlog at September 30, 2010. Backlog by industry market is shown below.

| (in thousands) | Backlog as of the Quarter Ended | | | % Change | |
|-----------------------|---------------------------------|--------|-----------------|----------|----|
| | September 30 2010 | | June 30 2010 | | |
| Aerospace and Defense | \$ | 4,668 | \$ | 4,559 | 2 |
| Medical | | 6,969 | | 6,537 | 7 |
| Industrial | | 11,874 | | 10,212 | 16 |
| Total Backlog | \$ | 23,511 | \$ | 21,308 | 10 |

Gross Profit:

Gross profit percentage for the three months and nine months ended September 30, 2010 was 11.1% and 11.9% of net sales, respectively. Gross profit percentage for the three and nine months ended September 30, 2009 was 8.7% and 5.9%, of net sales, respectively. We continue to see gross profit improvement year over year due to higher volumes and increased absorption of our fixed overhead costs, along with our continuous improvement programs. Our quarter over quarter gross profit percentage was down from the 12.6% reported in the second quarter due to the re-instatement of wages, merit increases, 401K matching and incentive programs on July 1, 2010.

Selling Expense:

We had selling expenses of \$0.8 million or 3.0% of net sales and 2.3 million or 3.2% of net sales for the three and nine months ended September 30, 2010, respectively. Selling expenses for the three and nine months ended September 30, 2009 were \$1.0 million or 5.5% of net sales and \$3.6 million or 5.9% of net sales, respectively. Selling expenses are down as a result of lower spending, lower commissionable sales, and reduced payroll related expenses.

General and Administrative Expense:

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General and administrative expenses as a percent of net sales remained relatively flat for the three and nine-month periods ended September 30, 2010 and 2009. Our general and administrative expenses were \$1.9 million or 7.5% of net sales and \$5.4 million or 7.4% of net sales for the three and nine months ended September 30, 2010, respectively. General and administrative expenses for the three and nine months ended September 30, 2009 were \$1.4 million or 7.4% of net sales and \$4.5 million or 7.5% of net sales, respectively. The increase in general and administrative expense in 2010 is related to the re-instatement of wages, merit increases, 401K matching and incentive programs on July 1, 2010.

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Other Income (Expense):

Other income for the three months ended September 30, 2010 was \$54,128 while other expense for the three months ended September 30, 2009 was \$227,443. Other expense for the nine months ended September 30, 2010 and 2009 was \$209,228 and \$506,253, respectively. In the three months ended September 30, 2010 we experienced favorable interest expense along with miscellaneous income from research consulting activities.

Income Taxes:

Income tax expense for the three and nine months ended September 30, 2010 was \$93,000 and \$398,000 or approximately 42% and 52%, respectively. The projected annual effective tax rate for 2010 is expected to be approximately 37% without regard for discrete items. The increase in the nine month effective tax rate over the expected annual effective rate is primarily the result of a true up of our federal tax refund which resulted in additional tax expense of approximately \$103,000 in the third quarter. The income tax benefit for the three and nine months ended September 30, 2009 was \$523,000 and \$2,309,000 or approximately 38%. The annual effective rate for 2009 was 37% without regard for discrete items.

Liquidity and Capital Resources:

We have satisfied our liquidity needs over the past several years through revenue generated from operations and an operating line of credit through WFB. Both the line of credit and real estate term note are subject to fluctuations in the LIBOR rates. The line of credit and real estate term note with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under our line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line of credit is secured by substantially all of our assets. On September 30, 2010, we had an outstanding balance of \$6.3 million under the line of credit and unused availability of \$3.1 million supported by our borrowing base. We believe our financing arrangements and cash flows provided by operations will be sufficient to satisfy our future working capital needs.

The following unaudited ratios are not required under the SEC guidelines or accounting principles generally accepted in the United States of America, however, we believe they are meaningful measures and are useful to readers of our consolidated financial statements.

| | September 30, 2010 | December 31, 2009 | December 31, 2008 | December 31, 2007 |
|---|-----------------------|----------------------|----------------------|----------------------|
| Current Ratio (Current Assets / Current Liabilities) | 1.58 | 1.71 | 1.74 | 1.68 |
| Working Capital (Current Assets - Current Liabilities) | \$ 12,822,491 | \$ 13,215,800 | \$ 15,777,784 | \$ 14,812,352 |
| Quick Ratio (Cash + Accounts Receivable / Current Liabilities) | 0.67 | 0.66 | 0.65 | 0.75 |

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| | | | | |
|---|------|------|------|------|
| Accounts Receivable to Working Capital (Average Accounts Receivable/ Working Capital) | 1.05 | 0.90 | 0.97 | 1.01 |
| Inventories to Working Capital (Average Inventories/ Working Capital) | 1.33 | 1.19 | 1.33 | 1.18 |

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Our working capital of \$12.8 million as of September 30, 2010 decreased from \$13.2 million at December 31, 2009 partially due to the decrease in income taxes receivable of \$2.2 million, higher accounts payable of \$1.6 million and higher accrued payroll and benefits of \$1.7 million, which were partially offset by increases in inventories of \$2.2 million and accounts receivables of \$2.8 million during the first nine months of 2010.

Net cash provided by operations for the nine months ended September 30, 2010 was \$1.6 million. The cash flow provided by operations for the nine months ended September 30, 2010 is the result of net income of \$0.4 million, adjusted for noncash adjustments including depreciation, amortization, and stock-based compensation expense which combined totaled \$1.6 million in positive adjustments. In addition, the increases in inventories of \$2.2 million and accounts receivable of \$2.8 million were partially offset by increases in accounts payable and accruals of \$2.6 million and a decrease in prepaids and income taxes receivable of \$2.2 million. The inventories and accounts receivable increases are related to increased net sales and customer orders in the first nine months of 2010.

Net cash used in investing activities of \$0.9 million for the nine months ended September 30, 2010 is comprised of \$0.4 million in property and equipment purchases to support the business and \$0.4 million for the Milaca operation acquisition (see Note 9).

Net cash used in financing activities for the nine months ended September 30, 2010 was \$1.0 million, due to principal debt payments of \$1.8 million, partially offset by the increase in borrowing on the line of credit of \$0.8 million.

Critical Accounting Policies and Estimates

Our significant accounting policies and estimates are summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2009. There have been no significant changes in these critical accounting policies since December 31, 2009. Some of our accounting policies require us to exercise significant judgment in selecting the appropriate assumptions for calculating financial estimates. Such judgments are subject to an inherent degree of uncertainty. These judgments are based on our historical experience, known trends in our industry, terms of existing contracts and other information from outside sources, as appropriate. Actual results could differ from these estimates.

Forward-Looking Statements:

Those statements in the foregoing report that are not historical facts are forward-looking statements made pursuant to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements generally will be accompanied by words such as anticipate, believe, estimate, expect, forecast, intend, possible, potential, predict, project, or other similar words that convey the uncertainty of future outcomes. Although we believe these forward-looking statements are reasonable, they are based upon a number of assumptions concerning future conditions, any or all of which may ultimately prove to be inaccurate. Forward-looking statements involve a number of risks and uncertainties. Important factors that could cause actual results to differ materially from the forward-looking statements include, without limitation:

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- Volatility in the marketplace which may affect market supply and demand for our products;
- Increased competition;
- Changes in the reliability and efficiency of operating facilities or those of third parties;
- Risks related to availability of labor;
- Increase in certain raw material costs such as copper;

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- Commodity and energy cost instability;
- General economic, financial and business conditions that could affect our financial condition and results of operations;
- Additional impairment or restructuring charges;
- Potential costs or issues association with the integration of the Milaca acquisition

The factors identified above are believed to be important factors (but not necessarily all of the important factors) that could cause actual results to differ materially from those expressed in any forward-looking statement made by us. Unpredictable or unknown factors not discussed herein could also have material adverse effects on forward-looking statements. All forward-looking statements included in this Form 10-Q are expressly qualified in their entirety by the forgoing cautionary statements. We undertake no obligations to update publicly any forward-looking statement (or its associated cautionary language) whether as a result of new information or future events.

Please refer to forward-looking statements and risks as previously disclosed in our report on Form 10-K for the fiscal year ended December 31, 2009.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures:

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and Executive Vice President and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting:

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II

ITEM 1. LEGAL PROCEEDINGS

We are subject to various legal proceedings and claims that arise in the ordinary course of business.

ITEM 6. EXHIBITS

Exhibits.

- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 32 Certification of the Chief Executive Officer and Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Nortech Systems Incorporated and Subsidiary

Date: November 11, 2010

by

/s/ Michael J. Degen

Michael J. Degen
President and Chief
Executive Officer

Date: November 11, 2010

by

/s/ Richard G. Wasielewski

Richard G. Wasielewski
Chief Financial Officer