

LAYNE CHRISTENSEN CO

Form 10-Q

December 08, 2006

Table of Contents

**FORM 10-Q**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

(Mark One)

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

**For the quarterly period ended October 31, 2006**

**OR**

☐ **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 0-20578**

**Layne Christensen Company**

(Exact name of registrant as specified in its charter)

Delaware

48-0920712

State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

1900 Shawnee Mission Parkway, Mission Woods,  
Kansas

66205

(Address of principal executive offices)

(Zip Code)

(Registrant's telephone number, including area code) (913) 362-0510

Not Applicable

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

Yes ☐ No ☒

There were 15,390,242 shares of common stock, \$.01 par value per share, outstanding on November 20, 2006.

**TABLE OF CONTENTS**

**PART I**

Item 1. Financial Statements

Item 1A. Risk Factors

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

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

ITEM 4. Controls and Procedures

**PART II**

ITEM 1 Legal Proceedings

ITEM 2 Changes in Securities

ITEM 3 Defaults Upon Senior Securities

ITEM 4 Submission of Matters to a Vote of Security Holders

ITEM 5 Other Information

ITEM 6 Exhibits and Reports on Form 8-K

**SIGNATURES**

EX-31.1

EX-31.2

EX-32.1

EX-32.2

---

**Table of Contents****PART I****Item 1. Financial Statements**

**LAYNE CHRISTENSEN COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

	October 31, 2006 (unaudited)	January 31, 2006 (unaudited)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 17,710	\$ 17,983
Customer receivables, less allowance of \$6,410 and \$5,573, respectively	102,529	91,159
Costs and estimated earnings in excess of billings on uncompleted contracts	45,674	36,538
Inventories	18,043	16,663
Deferred income taxes	15,014	11,976
Income taxes receivable	199	1,284
Other	4,769	5,975
Total current assets	203,938	181,578
Property and equipment:		
Land	8,402	9,486
Buildings	21,107	19,595
Machinery and equipment	240,942	222,531
Gas transportation facilities and equipment	23,794	12,526
Oil and gas properties	54,825	34,308
Mineral interest in oil and gas properties	10,193	8,430
	359,263	306,876
Less Accumulated depreciation and depletion	(166,984)	(148,751)
Net property and equipment	192,279	158,125
Other assets:		
Investment in affiliates	23,195	21,741
Goodwill	61,293	57,857
Other intangible assets, net	16,212	16,948
Restricted cash	5,709	9,143
Other	4,964	3,943
Total other assets	111,373	109,632
	\$ 507,590	\$ 449,335



**Table of Contents**

LAYNE CHRISTENSEN COMPANY AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS (Continued)  
(in thousands, except share data)

	October 31, 2006 (unaudited)	January 31, 2006 (unaudited)
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 50,854	\$ 43,695
Accrued compensation	25,888	20,025
Cash purchase price adjustments		6,120
Accrued insurance expense	6,458	5,562
Other accrued expenses	17,059	12,212
Income taxes payable	8,950	2,606
Billings in excess of costs and estimated earnings on uncompleted contracts	31,462	21,362
Total current liabilities	140,671	111,582
Noncurrent and deferred liabilities:		
Long-term debt	131,000	128,900
Acquisition escrow obligations	9,287	9,143
Accrued insurance expense	6,344	6,228
Deferred income taxes	21,274	19,555
Other	2,706	2,301
Total noncurrent and deferred liabilities	170,611	166,127
Common stock, par value \$.01 per share, 30,000,000 shares authorized, 15,390,242 and 15,233,472 shares issued and outstanding, respectively	154	152
Capital in excess of par value	145,939	141,067
Retained earnings	57,489	37,893
Accumulated other comprehensive loss	(7,247)	(7,442)
Unearned compensation	(27)	(44)
Total stockholders' equity	196,308	171,626
	\$ 507,590	\$ 449,335

See Notes to Consolidated Financial Statements.

**Table of Contents**

LAYNE CHRISTENSEN COMPANY AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(in thousands, except share and per share data)

	Three Months Ended October 31, (unaudited)		Nine Months Ended October 31, (unaudited)	
	2006	2005	2006	2005
Revenues	\$ 185,824	\$ 113,526	\$ 529,687	\$ 316,286
Cost of revenues (exclusive of depreciation shown below)	135,502	83,457	391,587	232,326
Gross profit	50,322	30,069	138,100	83,960
Selling, general and administrative expenses	26,724	16,834	75,324	49,196
Depreciation, depletion and amortization	8,673	5,094	23,139	13,122
Other income (expense):				
Equity in earnings of affiliates	1,388	972	2,892	3,244
Interest	(2,551)	(1,577)	(7,180)	(3,653)
Other, net	452	471	1,299	1,004
Income from continuing operations before income taxes and minority interest	14,214	8,007	36,648	22,237
Income tax expense	6,452	3,716	17,052	10,618
Minority interest		(10)		(50)
Net income from continuing operations before discontinued operations	7,762	4,281	19,596	11,569
Gain (loss) from discontinued operations, net of income tax		5		(4)
Net income	\$ 7,762	\$ 4,286	\$ 19,596	\$ 11,565
Basic income per share:				
Net income from continuing operations	\$ 0.51	\$ 0.31	\$ 1.28	\$ 0.89
Loss from discontinued operations, net of income taxes				
Income per share	\$ 0.51	\$ 0.31	\$ 1.28	\$ 0.89
Diluted income per share:				
Net income from continuing operations	\$ 0.50	\$ 0.31	\$ 1.27	\$ 0.86
Loss from discontinued operations, net of income taxes				
Net income per share	\$ 0.50	\$ 0.31	\$ 1.27	\$ 0.86

Edgar Filing: LAYNE CHRISTENSEN CO - Form 10-Q

Weighted average shares outstanding	15,334,000	13,697,000	15,282,000	12,988,000
Dilutive stock options	190,000	234,000	190,000	515,000
	15,524,000	13,931,000	15,472,000	13,503,000

See Notes to Consolidated Financial Statements.

4

---



**Table of Contents**

LAYNE CHRISTENSEN COMPANY AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOW  
(in thousands)

	Nine Months Ended October 31, (unaudited)	
	2006	2005
Cash flow from (used in) operating activities:		
Net income	\$ 19,596	\$ 11,565
Adjustments to reconcile net income to cash from operations:		
Loss from discontinued operations, net of tax		4
Depreciation, depletion and amortization	23,139	13,122
Deferred income taxes	(2,064)	1,584
Share-based compensation	1,661	
Equity in earnings of affiliates	(2,892)	(3,244)
Dividends received from affiliates	1,038	1,316
Minority interest		50
Gain on sale of joint venture		(1,289)
(Gain) loss from disposal of property and equipment	(789)	325
Changes in current assets and liabilities, net of effects of acquisitions:		
Increase in customer receivables	(10,275)	(12,310)
Increase in costs and estimated earnings in excess of billings on uncompleted contracts	(8,721)	(2,784)
Increase in inventories	(1,067)	(918)
(Increase) decrease in other current assets	1,243	(779)
Increase in accounts payable and accrued expenses	25,412	4,259
Increase (decrease) in billings in excess of costs and estimated earnings on uncompleted contracts	10,012	(202)
Other, net	(729)	(71)
Cash from continuing operations	55,564	10,628
Cash from discontinued operations		27
Cash from operating activities	55,564	10,655
Cash flow from (used in) investing activities:		
Additions to property and equipment	(23,899)	(15,413)
Additions to gas transportation facilities and equipment	(11,268)	(3,189)
Additions to oil and gas properties	(19,441)	(6,989)
Additions to mineral interests in oil and gas properties	(1,339)	(1,902)
Proceeds from disposal of property and equipment	3,372	849
Proceeds from sale of joint venture		2,355
Acquisition of businesses, net of cash acquired	(3,809)	(60,351)
Acquisition of oil and gas transportation facilities and equipment	(1,500)	(1,445)
Acquisition of oil and gas properties and mineral interests		(4,704)
Payment of cash purchase price adjustments on prior year acquisition	(6,120)	
Deposit of cash into restricted accounts	(1,887)	
Release of cash from restricted accounts	5,597	

Edgar Filing: LAYNE CHRISTENSEN CO - Form 10-Q

Net investment in affiliates	400	(69)
Cash used in investing activities	(59,894)	(90,858)
Cash flow from (used in) financing activities:		
Borrowings under revolving credit facility	267,400	273,255
Repayments under revolving credit facility	(265,300)	(197,755)
Debt issuance costs		(605)
Payments on DrillCorp promissory note		(960)
Issuance of common stock upon exercise of stock options	1,161	3,216
Excess tax benefit on exercise of share-based instruments	571	
Cash from financing activities	3,832	77,151
Effects of exchange rate changes on cash	225	(257)
Net decrease in cash and cash equivalents	(273)	(3,309)
Cash and cash equivalents at beginning of period	17,983	14,408
Cash and cash equivalents at end of period	\$ 17,710	\$ 11,099

See Notes to Consolidated Financial Statements.

**Table of Contents**

LAYNE CHRISTENSEN COMPANY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Accounting Policies and Basis of Presentation**

*Principles of Consolidation* The consolidated financial statements include the accounts of Layne Christensen Company and its subsidiaries (together, the Company). All significant intercompany transactions have been eliminated. Investments in affiliates (20% to 50% owned) in which the Company exercises influence over operating and financial policies are accounted for by the equity method. The unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements of the Company for the year ended January 31, 2006 as filed in its Annual Report on Form 10-K.

The accompanying unaudited consolidated financial statements include all adjustments (consisting only of normal recurring accruals) which, in the opinion of management, are necessary for a fair presentation of financial position, results of operations and cash flows. Results of operations for interim periods are not necessarily indicative of results to be expected for a full year.

*Use of Estimates in Preparing Financial Statements* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Actual results could differ from those estimates.

*Revenue Recognition* Revenue is recognized on large, long-term contracts using the percentage of completion method based upon the ratio of costs incurred to total estimated costs at completion. Contract price and cost estimates are reviewed periodically as work progresses and adjustments proportionate to the percentage of completion are reflected in contract revenues and gross profit in the reporting period when such estimates are revised. Changes in job performance, job conditions and estimated profitability, including those arising from contract penalty provisions, change orders and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Revenue is recognized on smaller, short-term contracts using the completed contract method. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined.

*Goodwill and Other Intangibles* Goodwill and other intangible assets with indefinite useful lives are not amortized, and instead are periodically tested for impairment. The Company performs its annual impairment test as of December 31 each year. The process of evaluating goodwill for impairment involves the determination of the fair value of the Company's reporting units. Inherent in such fair value determinations are certain judgments and estimates, including the interpretation of current economic indicators and market valuations, and assumptions about the Company's strategic plans with regard to its operations. The Company believes at this time that the carrying value of the remaining goodwill is appropriate, although to the extent additional information arises or the Company's strategies change, it is possible that the Company's conclusions regarding impairment of the remaining goodwill could change and result in a material effect on its financial position or results of operations.

*Other Long-lived Assets* In evaluating the carrying value of long-lived assets, including the Company's gas transportation facilities and equipment, the Company performs an analysis of the anticipated future net cash flows of the related long-lived assets and reduces their carrying value by the excess, if any, of the result of such calculation. The Company believes at this time that the carrying values and useful lives of its long-lived assets continues to be appropriate.

*Restricted Cash* Restricted cash as of October 31, 2006 was escrow funds of \$5,709,000 associated with the acquisition of Reynolds as described in Note 2 of the Notes to Consolidated Financial Statements.

*Accrued Insurance Expense* The Company maintains insurance programs where it is responsible for a certain amount of each claim up to a self-insured limit. Costs estimated to be incurred in the future for employee medical benefits, property, workers' compensation and casualty insurance programs resulting from claims which have occurred are accrued currently. These estimated costs are primarily based on actuarially determined projections of future payments under these programs. Should a greater amount of insurance claims occur compared to what was estimated or medical costs increase beyond what was anticipated, reserves recorded may not be sufficient and additional costs

would have to be recorded in the consolidated financial statements.

Under the terms of the Company's agreement with the various insurance carriers administering these claims, the Company is not required to remit the total premium until the claims are actually paid by the insurance companies. These required payments are not expected to significantly impact liquidity in future periods.

## **Table of Contents**

*Income Taxes* Income taxes are provided using the asset/liability method, in which deferred taxes are recognized for the tax consequences of temporary differences between the financial statement carrying amounts and tax bases of existing assets and liabilities. Deferred tax assets are reviewed for recoverability and valuation allowances are provided as necessary. Provision for U.S. income taxes on undistributed earnings of foreign subsidiaries and affiliates is made only on those amounts in excess of funds considered to be invested indefinitely.

*Oil and Gas Properties and Mineral Interests* The Company follows the full-cost method of accounting for oil and gas properties. Under this method, all productive and nonproductive costs incurred in connection with the exploration for and development of oil and gas reserves are capitalized. Such capitalized costs include lease acquisition, geological and geophysical work, delay rentals, drilling, completing and equipping oil and gas wells, and salaries, benefits and other internal salary-related costs directly attributable to these activities. Costs associated with production and general corporate activities are expensed in the period incurred. Normal dispositions of oil and gas properties are accounted for as adjustments of capitalized costs, with no gain or loss recognized.

The Company is required to review the carrying value of its oil and gas properties under the full cost accounting rules of the SEC. Under these rules, capitalized costs of proved oil and gas properties, as adjusted for asset retirement obligations, may not exceed the present value of estimated future net revenues from proved reserves, discounted at 10% (the Ceiling Test). Application of the Ceiling Test generally requires pricing future revenue at the unescalated prices in effect as of the last day of the period, with effect given to the Company's fixed-price natural gas contracts, and requires a write-down for accounting purposes if the ceiling is exceeded. Unproved oil and gas properties are not amortized, but are assessed for impairment either individually or on an aggregated basis using a comparison of the carrying values of the unproved properties to net future cash flows. The Company believes at this time that the carrying value of its oil and gas properties is appropriate.

*Reserve Estimates* The Company's estimates of unconventional gas reserves, by necessity, are projections based on geologic and engineering data, and there are uncertainties inherent in the interpretation of such data as well as the projection of future rates of production and the timing of development expenditures. Reserve engineering is a subjective process of estimating underground accumulations of gas that are difficult to measure. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation and judgment. Estimates of economically recoverable gas reserves and future net cash flows depend upon a number of variable factors and assumptions, such as historical production from the area compared with production from other producing areas, the assumed effects of regulations by governmental agencies and assumptions governing natural gas prices, future operating costs, severance, ad valorem and excise taxes, development costs and workover and remedial costs, all of which may in fact vary considerably from actual results. For these reasons, estimates of the economically recoverable quantities of gas attributable to any particular group of properties, classifications of such reserves based on risk of recovery, and estimates of the future net cash flows expected there from may vary substantially. Any significant variance in the assumptions could materially affect the estimated quantity and value of the reserves, which could affect the carrying value of the Company's oil and gas properties and the rate of depletion of the oil and gas properties. Actual production, revenues and expenditures with respect to the Company's reserves will likely vary from estimates, and such variances may be material.

*Litigation and Other Contingencies* The Company is involved in litigation incidental to its business and accrues its best estimate of the probable cost for the resolution of legal claims. Such estimates are developed in consultation with outside counsel handling these matters and are based upon a combination of litigation and settlement strategies. To the extent additional information arises or the Company's strategies change, it is possible that the Company's estimate of its probable liability in these matters may change. While the disposition of these claims is not expected to have a material effect on the Company's business, financial position, results of operations or cash flows, it is possible that future results of operations for any particular quarterly or annual period could be affected by changes in the Company's estimates related to these proceedings.

*Derivatives* The Company follows SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended, which requires derivative financial instruments to be recorded on the balance sheet at fair value and establishes criteria for designation and effectiveness of hedging relationships. Under SFAS 133, the Company accounts for its unrealized hedges of forecasted costs as cash flow hedges, such that changes in fair value

for the effective portion of hedge contracts, if material, are recorded in accumulated other comprehensive income in stockholders' equity. Changes in the fair value of the effective portion of hedge contracts are recognized in accumulated other comprehensive income until the hedged item is recognized in operations. The ineffective portion of the derivatives change in fair value, if any, is immediately recognized in operations. In addition, the Company has entered into fixed-price natural gas contracts

**Table of Contents**

to manage fluctuations in the price of natural gas. These contracts result in the Company physically delivering gas, and as a result, are exempt from the requirements of SFAS 133 under the normal purchases and sales exception. Accordingly, the contracts are not reflected in the balance sheet at fair value and revenues from the contracts are recognized as the natural gas is delivered under the terms of the contracts (see Note 6 for disclosure regarding the fair value of derivative instruments). The Company does not enter into derivative financial instruments for speculative or trading purposes.

*Earnings Per Share* Earnings per share are based upon the weighted average number of common and dilutive equivalent shares outstanding. Options to purchase common stock are included based on the treasury stock method for dilutive earnings per share, except when their effect is antidilutive.

*Unearned Compensation* Unearned compensation expense associated with the issuance of restricted stock is amortized on a straight-line basis as the restrictions on the stock expire.

*Stock-based Compensation* The Company adopted SFAS No. 123R (revised December 2004), Shared-Based Payment effective February 1, 2006, which requires the recognition of all share-based instruments in the financial statements and establishes a fair-value measurement of the associated costs. The Company has elected to adopt the new standard using the Modified Prospective Method which requires recognition of compensation expense related to all unvested share-based instruments as of the effective date over the remaining term of the instrument. An expense of \$540,000 and \$1,661,000 was recognized in the three and nine months ended October 31, 2006, respectively, as a result of the adoption of this method. The total income tax benefit recognized on this expense in the three and nine months ended October 31, 2006 was \$165,000 and \$511,000, respectively. The Modified Prospective Method has no financial impact on prior fiscal years. As of October 31, 2006, the Company had unrecognized compensation expense of \$5,456,000 to be recognized over a weighted average period of 2.90 years. The Company determines the fair value of stock-based compensation using the Black-Scholes model.

Stock-based compensation prior to the effective date of SFAS No. 123R may be accounted for either based on the estimated fair value of the awards at the date they are granted (the SFAS 123 Method ) or based on the difference, if any, between the market price of the stock at the date of grant and the amount the employee must pay to acquire the stock (the APB 25 Method ). The Company used the APB 25 Method to account for its stock-based compensation programs that were vested prior to the effective date of SFAS No. 123R and recognized no compensation expense under this method.

Pro forma net income and earnings per share for the three and nine months ended October 31, 2005, determined as if the SFAS No. 123 Method had been applied, is presented in the following table (in thousands, except per share amounts):

	Three Months Ended October 31, 2005	Nine Months Ended October 31, 2005
Net income, as reported	\$ 4,286	\$ 11,565
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(96)	(218)
Pro forma net income	\$ 4,190	\$ 11,347
Income per share:		
Basic as reported	\$ 0.31	\$ 0.89
Basic pro forma	\$ 0.31	\$ 0.87
Diluted as reported	\$ 0.31	\$ 0.86

Edgar Filing: LAYNE CHRISTENSEN CO - Form 10-Q

Diluted pro forma	\$	0.30	\$	0.84
-------------------	----	------	----	------

*Consolidated Statements of Cash Flows* Highly liquid investments with an original maturity of three months or less at the time of purchase are considered cash equivalents.

*Supplemental Cash Flow Information* The amounts paid for income taxes and interest are as follows (in thousands):

		Nine Months Ended October	
		31,	
		2006	2005
Income taxes	\$	10,871	\$ 3,756
Interest		7,012	3,526

8



**Table of Contents**

*Supplemental Disclosure of Non-Cash Investing and Financing Activities* The Company had earnings on restricted cash of \$144,000 for the nine months ended October 31, 2006, which was treated as a non-cash item as it was restricted for the account of the escrow beneficiaries.

**2. Acquisitions**

In July 2006, the Company purchased certain gas wells and mineral interests in oil and gas properties from an unrelated operator for \$1,500,000 in cash. The acquisition complemented the Company's existing operation in the mid-continent region of the United States. The purchase price was allocated \$1,076,000 to oil and gas properties and \$424,000 to mineral interests in oil and gas properties.

On June 16, 2006 (the CWI Closing Date), the Company acquired 100% of the stock of Collector Wells International, Inc. (CWI), a privately held specialty water services company that designs and constructs water supply systems. CWI will be combined with a similar service line acquired in the acquisition of Reynolds, Inc. The purchase price for CWI was \$5,442,000, consisting of \$3,150,000 cash, 45,563 shares of Layne common stock (valued at \$1,263,000), cash purchase price adjustments and costs of \$1,029,000. Layne common stock was valued in the transaction based upon a five-day average of the closing price of the stock two days before and two days after the CWI Closing Date. The stock was placed in escrow to secure certain representations, warranties and indemnifications under the purchase agreement and will be released in three annual installments. The cash purchase price adjustments are based on the amount by which working capital at the CWI Closing Date exceeded a threshold amount established in the purchase agreement. In addition, there is contingent consideration up to a maximum of \$1,400,000 (the CWI Earnout Amount), which is based on a percentage of the amount by which CWI's earnings before interest, taxes, depreciation and amortization exceed a threshold amount during the thirty-six months following the acquisition. If earned, up to 20% of the CWI Earnout Amount may be paid with Layne common stock, at the Company's discretion. Any portion of the CWI Earnout Amount which is ultimately paid will be accounted for as additional purchase consideration.

The purchase price has been allocated based on the fair value of the assets and liabilities acquired, determined based on CWI's historical cost basis of assets and liabilities and other analyses. Such amounts may be subject to revision as CWI is integrated into the Company and the revisions may be significant and will be recorded by the Company as further adjustments to the purchase price allocation.

Based on the Company's allocation of the purchase price, the acquisition had the following effect on the Company's consolidated financial position (in thousands):

Working capital	\$ 1,016
Property and equipment	1,580
Goodwill	3,436
Deferred income taxes	(590)
 Total purchase price	 \$ 5,442

The results of operations of CWI have been included in the Company's consolidated Statements of Income as of the CWI Closing Date. The acquisition did not have a significant effect on the Company's results of operations or cash flows.

On September 28, 2005 (the Reynolds Closing Date), the Company acquired 100% of the outstanding stock of Reynolds, Inc. (Reynolds), a privately held company and a major supplier of products and services to the water and wastewater industries. The acquisition will expand the capabilities of the Company in the areas of water and wastewater infrastructure. Reynolds' primary service lines include designing and building of water and wastewater treatment plants, water and wastewater transmission lines, cured in place pipe (CIPP) services for sewer rehabilitation, water supply wells and Ranney collector wells.

The purchase price for Reynolds was \$112,356,000, consisting of \$60,000,000 cash, 2,222,216 shares of Layne common stock (valued at \$45,053,000), cash purchase price adjustments of \$6,120,000 (paid in subsequent periods) and costs of \$1,183,000. Layne common stock was valued in the transaction based upon a five-day average of the closing price of the stock two days before and two days after the terms of the acquisition were agreed to and publicly

announced. Of the cash and stock consideration, \$9,000,000 and 333,333 shares of Layne common stock were placed in escrow to secure certain representations, warranties and indemnifications under the purchase agreement (the

Reynolds Escrow Fund ). The cash purchase price adjustments consist primarily of an adjustment based on the amount by which working capital at the Reynolds Closing Date exceeded a threshold amount established in the purchase agreement. Pursuant to the purchase agreement, this amount was paid to the Reynolds shareholders during April 2006 from the Reynolds Escrow Fund, which will be replenished during the twenty-four months following the Reynolds Closing Date based on the collection of certain contract retainage amounts. The balance of the Reynolds Escrow Fund, including any investment earnings or losses, will be released to the Reynolds shareholders twenty four months following the Reynolds Closing Date, subject to any pending

**Table of Contents**

claims. The cash portion of the Reynolds Escrow Fund and related obligations to the Reynolds shareholders are recorded in the Company's consolidated balance sheet as Restricted cash and Acquisition escrow obligation. In addition, there is contingent consideration up to a maximum of \$15,000,000 (the Reynolds Earnout Amount), which is based on Reynolds' operating performance over a period of thirty-six months following the Reynolds Closing Date (the Reynolds Earnout Period). The Reynolds Earnout Amount is based on a multiple of Reynolds' earnings before interest, taxes, depreciation and amortization which exceed a threshold amount during the Reynolds Earnout Period. If earned, the contingent payment will be paid 60% in cash and 40% in Layne common stock, subject to stockholder approval of the shares to be issued, if required. Any shares not approved for issuance will be paid in cash. Any portion of the Reynolds Earnout Amount which is ultimately paid will be accounted for as additional purchase consideration.

The purchase price has been allocated based on the fair value of the assets and liabilities acquired, determined based on Reynolds' historical cost basis of assets and liabilities, appraisals and other analyses. Based on the Company's allocation of the purchase price, the acquisition had the following effect on the Company's consolidated financial position (in thousands):

Working capital	\$ 20,998
Property and equipment	40,508
Goodwill	49,832
Tradenames	16,000
Other intangible assets	586
Deferred income taxes	(15,568)
 Total purchase price	 \$ 112,356

The results of operations of Reynolds have been included in the Company's consolidated Statements of Income as of the Reynolds Closing Date. Assuming Reynolds had been acquired as of the beginning of the period, the unaudited pro forma consolidated revenues, net income from continuing operations, net income and net income per share would have been as follows (in thousands, except per share data):

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2006	2005	2006	2005
Revenues	\$ 185,824	\$ 155,135	\$ 529,687	\$ 454,052
Net income from continuing operations	7,762	4,882	19,596	14,829
Net income	7,762	4,887	19,596	14,825
Basic earnings per share from continuing operations	\$ 0.51	\$ 0.31	\$ 1.28	\$ 0.97
 Diluted earnings per share from continuing operations	 \$ 0.50	 \$ 0.30	 \$ 1.27	 \$ 0.94
 Basic earnings per share	 \$ 0.51	 \$ 0.31	 \$ 1.28	 \$ 0.97
 Diluted earnings per share	 \$ 0.50	 \$ 0.30	 \$ 1.27	 \$ 0.94

The pro forma information provided above is not necessarily indicative of the results of operations that would actually have resulted if the acquisition were made as of those dates or of results that may occur in the future.

In October 2005, the Company purchased the remaining 25% working interest in various gas wells, saltwater disposal wells and a pipeline from Colt Natural Gas LLC and Colt Pipeline LLC (Colt), which are affiliates of a working interest partner, for \$6,149,000 in cash. An additional \$257,000 is payable by the Company upon satisfaction of certain conditions by Colt. The acquisition furthers the Company's expansion of its energy presence in the

mid-continent region of the United States. The acquisition did not have a significant effect on the Company's results of operations or cash flows and had the following effect on the Company's consolidated financial position (in thousands):

Mineral interest in oil and gas properties	\$ 2,479
Oil and gas properties	2,428
Gas transportation facilities and equipment	987
Minority interest	512
Total purchase price	\$ 6,406

**Table of Contents**

The Company made two acquisitions in March and June 2005 to broaden its membrane technologies capabilities. The total purchase price for the acquisitions was \$453,000, which consisted of cash payments of \$359,000 and a note payable to the shareholder of one of the entities. The acquisitions did not have a significant effect on the Company's results of operations or cash flows and had the following effect on the Company's consolidated financial position (in thousands):

Working capital	\$ (10)
Property and equipment	84
Other intangible assets	379
Total purchase price	\$ 453

**3. Discontinued Operations**

During the third quarter of fiscal 2004, the Company reclassified the results of operations of its Toledo Oil and Gas ( Toledo ) business to discontinued operations based on its intent to sell the operation, which occurred in January 2004. Toledo was historically reported in the Company's energy segment and offered conventional oilfield fishing services and coil tubing fishing services.

On January 30, 2004, the Company sold its Layne Christensen Canada Ltd. ( Layne Canada ) subsidiary for \$15,914,000. Layne Canada was a component of the Company's energy segment and provided drilling services to the shallow, unconventional oil and gas market.

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the results of operations for Toledo and Layne Canada have been classified as discontinued operations. The discontinued operations had no revenue for the three or nine months ended October 31, 2006 or 2005. The impact of discontinued operations, net of income taxes, was a gain of \$5,000 for the three months and a loss of \$4,000 for the nine months ended October 31, 2005.

**4. Goodwill and Other Intangible Assets**

Goodwill and other intangible assets consist of the following (in thousands):

	October 31, 2006			January 31, 2006		
	Gross Carrying Amount	Accumulated Amortization	Weighted Average Amortization Period in years	Gross Carrying Amount	Accumulated Amortization	Weighted Average Amortization Period in years
Goodwill (non tax deductible)	\$ 61,293	\$		\$ 57,857	\$	
Other amortizable intangible assets:						
Tradenames	\$ 16,000	(663)	32	\$ 16,000	\$ (204)	32
Customer-related	227	(109)	2	227	(34)	2
Patents	359	(130)	3	359	(40)	3
Non-competition agreements	379	(115)	5	379	(58)	5
Other	724	(460)	23	730	(411)	23
Total amortizable intangible assets	\$ 17,689	\$ (1,477)		\$ 17,695	\$ (747)	

Amortizable intangible assets are being amortized over their estimated useful lives of two to 40 years with a weighted average amortization period of 30 years. Total amortization expense for other intangible assets was \$730,000 and \$69,000 for the nine months ended October 31, 2006 and 2005, respectively, and \$244,000 and \$31,000 for the three months ended October 31, 2006 and 2005, respectively.

The carrying amount of goodwill attributed to each operating segment was as follows (in thousands):

11

---

**Table of Contents**

	Energy	Water and Wastewater Infrastructure	Total
Balance February 1, 2006	\$ 950	\$ 56,907	\$ 57,857
Additions		3,436	3,436
Balance, October 31, 2006	\$ 950	\$ 60,343	\$ 61,293

**5. Indebtedness**

On July 31, 2003, the Company entered into an agreement ( Master Shelf Agreement ) whereby it could issue up to \$60,000,000 in unsecured notes. Upon closing, the Company issued \$40,000,000 of notes ( Series A Senior Notes ) under the Master Shelf Agreement. The Series A Senior Notes bear a fixed interest rate of 6.05% and are due on July 31, 2010, with annual principal payments of \$13,333,000 beginning July 31, 2008. Proceeds from the issuance were used to refinance borrowings outstanding under the Company's previous term loan and revolving credit facility. The Company issued an additional \$20,000,000 of notes under the Master Shelf Agreement in October 2004 ( Series B Senior Notes ). The Series B Senior Notes bear a fixed interest rate of 5.40% and are due on September 29, 2011, with annual principal payments of \$6,667,000 beginning September 29, 2009. Proceeds of the issuance were used to finance the acquisition of Beylik Drilling and Pump Service, Inc. ( Beylik ) and general corporate purposes. Concurrent with the acquisition of Reynolds, the Company amended the Master Shelf Agreement to increase the amount of senior notes available to be issued from \$60,000,000 to \$100,000,000, thus, creating an available facility amount of \$40,000,000, and reinstated and extended the available issuance period to September 15, 2007.

Also, concurrent with the acquisition of Reynolds, the Company expanded its existing revolving credit facility with LaSalle Bank National Association, as Administrative Agent, and a group of additional banks by entering into an Amended and Restated Loan Agreement (the Credit Agreement ) with LaSalle Bank National Association, as Administrative Agent and as Lender (the Administrative Agent ), and the other Lenders listed therein (the Lenders ), which increased the Company's revolving loan commitment from \$40,000,000 to \$130,000,000, less any outstanding letter of credit commitments (which are subject to a \$30,000,000 sublimit). Approximately \$80,000,000 of the facility was used to pay the cash portion of the acquisition of Reynolds and refinance the outstanding borrowings under the previous credit agreement. The Credit Agreement provides for interest at variable rates equal to, at the Company's option, a LIBOR rate plus 1.00% to 2.00%, or a base rate, as defined in the Credit Agreement plus up to 0.50%, depending upon the Company's leverage ratio. The Credit Agreement is unsecured and is due and payable September 24, 2010. On October 31, 2006, there were letters of credit of \$9,910,000 and borrowings of \$71,000,000 outstanding on the Credit Agreement resulting in available capacity of \$49,090,000.

The Master Shelf Agreement and the Credit Agreement contain certain covenants including restrictions on the incurrence of additional indebtedness and liens, investments, acquisitions, transfer or sale of assets, transactions with affiliates, payment of dividends and certain financial maintenance covenants, including among others, fixed charge coverage, maximum debt to EBITDA and minimum tangible net worth. The Company was in compliance with its covenants as of October 31, 2006.

Debt outstanding as of October 31, 2006 and January 31, 2006 was as follows (in thousands):

	October 31, 2006	January 31, 2006
Long-term debt:		
Credit Agreement	\$ 71,000	\$ 68,900
Senior Notes	60,000	60,000
Total long-term debt	\$ 131,000	\$ 128,900

**6. Derivatives**

The Company's energy division is exposed to fluctuations in the price of natural gas and has entered into fixed-price physical delivery contracts to manage natural gas price risk for a portion of its production. As of October 31, 2006, the Company had committed to deliver 3,965,000 million British Thermal Units ( MMBtu ) of natural gas through March 2008. The prices on these contracts range from \$8.51 to \$9.66 per MMBtu.

The fixed-price physical delivery contracts will result in the physical delivery of natural gas, and as a result, are exempt from the requirements of SFAS 133 under the normal purchases and sales exception. Accordingly, the contracts are not reflected in



**Table of Contents**

the balance sheet at fair value and revenues from the contracts are recognized as the natural gas is delivered under the terms of the contracts. The estimated fair value of such contracts at October 31, 2006 was \$5,202,000.

Additionally, the Company has foreign operations that have significant costs denominated in foreign currencies, and thus is exposed to risks associated with changes in foreign currency exchange rates. At any point in time, the Company might use various hedge instruments, primarily foreign currency option contracts, to manage the exposures associated with forecasted expatriate labor costs and purchases of operating supplies. The Company does not enter into foreign currency derivative financial instruments for speculative or trading purposes.

The Company held option contracts with an aggregate U.S. dollar notional value of \$2,500,000 as of October 31, 2006 to hedge the risks associated with forecasted Australian dollar denominated costs in its African operations. The contracts settle in various increments through January 2007. The fair value of the instruments of \$87,000 at October 31, 2006 was recorded in other current assets and in accumulated other comprehensive income net of income taxes of \$34,000. Aggregate losses of \$67,000 on foreign currency hedging transactions were recognized for the nine months ended October 31, 2006 as the forecasted transactions being hedged occurred and were recorded primarily in cost of revenues in the Company's Consolidated Statements of Income.

**7. Other Comprehensive Income (Loss)**

Components of other comprehensive income (loss) are summarized as follows (in thousands):

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2006	2005	2006	2005
Net income	\$ 7,762	\$ 4,286	\$ 19,596	\$ 11,565
Other comprehensive income (loss), net of taxes:				
Foreign currency translation adjustments	(60)	(36)	142	(346)
Change in unrecognized pension liability				(154)
Unrealized gain (loss) on foreign exchange contracts	(56)	(55)	53	12
Other comprehensive income	\$ 7,646	\$ 4,195	\$ 19,791	\$ 11,077

The components of accumulated other comprehensive loss for the nine months ended October 31, 2006 and 2005 are as follows (in thousands):

	Cumulative	Unrecognized	Unrealized Gain on Exchange Contracts	Accumulated Other Comprehensive Loss
Balance, February 1, 2006	\$ (7,442)	\$	\$	\$ (7,442)
Period change	142		53	195
Balance, October 31, 2006	\$ (7,300)	\$	\$ 53	\$ (7,247)

	Cumulative	Unrecognized	Unrealized Gain on Exchange Contracts	Accumulated Other Comprehensive Loss
Balance, February 1, 2005	\$ (7,165)	\$ (1,902)	\$	\$ (9,067)
Period change	(346)	(154)	12	(488)

Balance, October 31, 2005	\$ (7,511)	\$ (2,056)	\$ 12	\$ (9,555)
---------------------------	------------	------------	-------	------------

13

---

**Table of Contents****8. Employee Benefit Plans**

The Company sponsors a pension plan covering certain hourly employees not covered by union-sponsored, multi-employer plans. Benefits are computed based mainly on years of service. The Company makes annual contributions to the plan substantially equal to the amounts required to maintain the qualified status of the plans. Contributions are intended to provide for benefits related to past and current service with the Company. Effective December 31, 2003, the Company froze the pension plan. Benefits will no longer be accrued after December 31, 2003, and no further employees will be added to the Plan. The Company expects to maintain the assets of the Plan to pay normal benefits accrued through December 31, 2003. Assets of the plan consist primarily of stocks, bonds and government securities.

Net periodic pension cost for the three and nine months ended October 31, 2006 and 2005 includes the following components (in thousands):

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2006	2005	2006	2005
Service cost	\$ 22	\$ 18	\$ 64	\$ 54
Interest cost	110	109	329	327
Expected return on assets	(130)	(121)	(387)	(363)
Net amortization	62	67	185	201
Net periodic pension cost	\$ 64	\$ 73	\$ 191	\$ 219

The Company has recognized the full amount of its actuarially determined pension liability and the related intangible asset (if applicable). The unrecognized pension cost has been recorded as a charge to consolidated stockholders' equity after giving effect to the related future tax benefit.

The Company also provides supplemental retirement benefits to its chief executive officer. Benefits are computed based on the compensation earned during the highest five consecutive years of employment reduced for a portion of Social Security benefits and an annuity equivalent of the chief executive's defined contribution plan balance. The Company does not contribute to the plan or maintain any investment assets related to the expected benefit obligation. The Company has recognized the full amount of its actuarially determined pension liability. Net periodic pension cost of the supplemental retirement benefits for the three and nine months ended October 31, 2006 and 2005 include the following components (in thousands):

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2006	2005	2006	2005
Service cost	\$ 25	\$ 30	\$ 75	\$ 90
Interest cost	22	19	66	57
Net periodic pension cost	\$ 47	\$ 49	\$ 141	\$ 147

**9. Stock and Stock Option Plans**

In October 1998, the Company adopted a Rights Agreement whereby the Company has authorized and declared a dividend of one preferred share purchase right ( "Right" ) for each outstanding common share of the Company. Subject to limited exceptions, the Rights are exercisable if a person or group acquires or announces a tender offer for 25% or more of the Company's common stock. Each Right will entitle shareholders to buy one one-hundredth of a share of a newly created Series A Junior Participating Preferred Stock of the Company at an exercise price of \$45.00. The Company is entitled to redeem the Right at \$.01 per Right at any time before a person has acquired 25% or more of the Company's outstanding common stock. The Rights expire 10 years from the date of grant.

The Company has stock option and employee incentive plans that provide for the granting of options to purchase or the issuance of shares of common stock up to an aggregate of 2,600,000 shares of common stock at a price fixed by the Board of Directors or a committee. As of October 31, 2006, there were 513,000 shares available to be granted under the plans. The Company has the ability to issue shares under the plans either from new issuances or from treasury, although it has previously always issued new shares and expects to continue to issue new shares in the future. Significant option groups outstanding at October 31, 2006, and related exercise price and remaining contractual term follows:

**Table of Contents**

Grant Date	Options Outstanding	Options Exercisable	Exercise Price	Remaining Contractual Term (Months)
4/97	3,264	3,264	\$ 11.400	6
2/98	100,000	100,000	14.000	15
4/98	5,144	5,144	10.290	18
4/99	9,773	9,773	4.125	30
4/99	117,375	117,375	5.250	30
2/00	3,500	3,500	5.500	40
4/00	16,885	16,885	3.495	42
8/00	2,500	2,500	5.125	46
6/04	25,000	25,000	16.600	92
6/04	251,589	125,795	16.650	93
6/05	12,000	12,000	17.540	105
9/05	250,000	62,500	23.050	109
1/06	210,231		27.870	112
6/06	12,000	12,000	29.290	117
6/06	70,000		29.290	117
10/06	3,000	3,000	30.110	120
	1,092,261	498,736		

All options were granted at an exercise price equal to the fair market value of the Company's common stock at the date of grant. The options have terms of five to ten years from the date of grant and generally vest ratably over periods of four to five years. Certain option awards provide for accelerated vesting if there is a change of control (as defined in the plans) and for equitable adjustments in the event of changes in the Company's equity structure. The Company does not expect any unvested shares to be forfeited. The fair value of options at date of grant was estimated using the Black-Scholes model. The weighted average fair value at the date of grant for options granted during the nine months ended October 31, 2006 was \$12.679. The fair value was based on an expected life of six years, no dividend yield, an average interest rate of 4.95% and assumed volatility of 35%. Transactions for stock options for the period ended October 31, 2006 were as follows:

	Number of Options	Weighted Average Exercise Price	Stock Options Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands)
Stock Option Activity Summary:				
Outstanding at February 1, 2006	1,116,718	\$ 17.728		
Granted	87,000	29.318		
Exercised	(110,207)	10.535		\$ 2,019
Canceled				
Forfeited	(1,250)	16.65		\$ 16,750
Expired				

Outstanding at October 31, 2006	1,092,261	\$	18.185	7.18	\$	11,023
Shares Exercisable	498,736	\$	13.534	5.05	\$	7,858

The aggregate intrinsic value was calculated using the difference between the current market price and the exercise price for only those options that have an exercise price less than the current market prices.

#### **10. Operating Segments**

The Company is a multinational company that provides sophisticated services and related products to a variety of markets, as well as being a producer of unconventional natural gas for the energy market. Management defines the Company's operational organizational structure into discrete divisions based on its primary product lines. Each division comprises a combination of individual district offices, which primarily offer similar types of services and serve similar types of markets. Should an office's primary responsibility move from one division president to another, that office's results going forward would be reclassified between divisions at that time. The Company's reportable segments are defined as follows:

**Table of Contents****Water and Wastewater Infrastructure Division**

This division provides a full line of water-related services and products including hydrological studies, site selection, well design, drilling and well development, pump installation, and repair and maintenance. The division's offerings include the design and construction of water treatment facilities and the manufacture and sale of products to treat volatile organics and other contaminants such as nitrates, iron, manganese, arsenic, radium and radon in groundwater. The division also offers environmental services to assess and monitor groundwater contaminants. With the acquisition of Reynolds in September 2005, the division expanded its capabilities in the area of the design and build of water and wastewater treatment plants, Ranney collector wells, sewer rehabilitation and water and wastewater transmission lines.

Effective February 1, 2006, the Company's Geoconstruction division, previously a separate segment, was reorganized under the operational leadership of the water and wastewater infrastructure division. The Company's segment disclosures for all periods have been reorganized accordingly for comparative purposes. This division focuses on services that improve soil stability, primarily jet grouting, grouting, vibratory ground improvement, drilled micropiles, stone columns, anchors and tiebacks. The division also manufactures a line of high-pressure pumping equipment used in grouting operations and geotechnical drilling rigs used for directional drilling.

**Mineral Exploration Division**

This division provides a complete range of drilling services for the mineral exploration industry. Its aboveground and underground drilling activities include all phases of core drilling, diamond, reverse circulation, dual tube, hammer and rotary air-blast methods.

**Energy Division**

This division focuses entirely on exploration and production of unconventional gas properties in the United States. To date this division has been concentrated on projects in the mid-continent region of the United States. Historically, the division has also included service businesses in shallow gas and tar sands exploration drilling, conventional oilfield fishing services and coil tubing fishing services. In fiscal 2006, the division completed its shift in focus to unconventional gas development activities and has reclassified the results of all other service operations to the Other division.

**Other**

Other includes two small specialty energy service companies previously classified in the energy division and any other specialty operations not included in one of the other divisions.

Revenues and income from continuing operations pertaining to the Company's operating segments are presented below (in thousands). Intersegment revenues are accounted for based on the fair market value of the services provided.

Unallocated corporate expenses primarily consist of general and administrative functions performed on a company-wide basis and benefiting all operating segments. These costs include accounting, financial reporting, internal audit, safety, treasury, corporate and securities law, tax compliance, certain executive management (chief executive officer, chief financial officer and general counsel) and board of directors. Beginning February 1, 2006, corporate expenses also include expenses associated with share-based payments.

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2006	2005	2006	2005
Revenues				
Water and wastewater infrastructure	\$ 136,586	\$ 77,596	\$ 387,607	\$ 210,542
Mineral exploration	39,749	30,764	111,615	94,433
Energy	6,814	3,733	17,803	7,836
Other	2,675	1,433	12,662	3,475
Total revenues	\$ 185,824	\$ 113,526	\$ 529,687	\$ 316,286

Edgar Filing: LAYNE CHRISTENSEN CO - Form 10-Q

Equity in earnings of affiliates				
Mineral exploration	\$ 1,388	\$ 874	\$ 2,892	\$ 2,838
Water and wastewater infrastructure		98		406
Total equity in earnings of affiliates	\$ 1,388	\$ 972	\$ 2,892	\$ 3,244

16

---



**Table of Contents**

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2006	2005	2006	2005
Income from continuing operations before income taxes and minority interest				
Water and wastewater infrastructure	\$ 10,015	\$ 7,725	\$ 27,423	\$ 20,415
Mineral exploration	7,789	3,375	19,963	13,057
Energy	2,362	1,011	6,340	1,431
Other	829	230	3,550	426
Unallocated corporate expenses	(4,230)	(2,757)	(13,448)	(9,439)
Interest	(2,551)	(1,577)	(7,180)	(3,653)
Total income from continuing operations before income taxes and minority interest	\$ 14,214	\$ 8,007	\$ 36,648	\$ 22,237
Revenues by geographic region				
United States	\$ 148,406	\$ 86,876	\$ 431,720	\$ 232,771
Africa/Australia	23,054	16,815	60,219	55,737
Mexico	9,423	5,804	22,934	15,852
Other foreign	4,941	4,031	14,814	11,926
Total revenues	\$ 185,824	\$ 113,526	\$ 529,687	\$ 316,286

**11. Contingencies**

The Company's drilling activities involve certain operating hazards that can result in personal injury or loss of life, damage and destruction of property and equipment, damage to the surrounding areas, release of hazardous substances or wastes and other damage to the environment, interruption or suspension of drill site operations and loss of revenues and future business. The magnitude of these operating risks is amplified when the Company, as is frequently the case, conducts a project on a fixed-price, turnkey basis where the Company delegates certain functions to subcontractors but remains responsible to the customer for the subcontracted work. In addition, the Company is exposed to potential liability under foreign, federal, state and local laws and regulations, contractual indemnification agreements or otherwise in connection with its services and products. Litigation arising from any such occurrences may result in the Company being named as a defendant in lawsuits asserting large claims. Although the Company maintains insurance protection that it considers economically prudent, there can be no assurance that any such insurance will be sufficient or effective under all circumstances or against all claims or hazards to which the Company may be subject or that the Company will be able to continue to obtain such insurance protection. A successful claim or damage resulting from a hazard for which the Company is not fully insured could have a material adverse effect on the Company. In addition, the Company does not maintain political risk insurance with respect to its foreign operations.

The Company is involved in various matters of litigation, claims and disputes which have arisen in the ordinary course of the Company's business. The Company believes that the ultimate disposition of these matters will not, individually and in the aggregate, have a material adverse effect upon its business or consolidated financial position, results of operations or cash flows.

**12. New Accounting Pronouncements**

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108,

Quantifying Misstatements (SAB 108), which states that registrants should use both a balance sheet (iron curtain) approach and an income statement (rollover) approach when quantifying and evaluating the materiality of a misstatement. SAB 108 also provides guidance on correcting errors under this dual approach as well as transition

guidance for correcting previously immaterial errors that are now considered material based on the approach in the bulletin. The Company will be required to adopt this bulletin in the fourth quarter of the fiscal year ending January 31, 2007. The Company is in the process of evaluating the expected effect of SAB 108 on its consolidated financial statements and is not currently in a position to determine such effects.

In September 2006, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standard No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. The Company will be required to adopt this standard in the first quarter of the fiscal year ending January 31, 2009. The Company is in the process of evaluating the expected effect of SFAS 157 on its consolidated financial statements and is not currently in a position to determine such effects.

## **Table of Contents**

In September 2006, the FASB issued SFAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (SFAS 158), which amends SFAS 87 and SFAS 106 by addressing certain deficiencies in the original pension accounting guidance. SFAS 158 requires a company that sponsors a postretirement benefit plan to fully recognize, as an asset or liability, the overfunded or underfunded status of its benefit plan(s) in its year-end balance sheet. In addition, SFAS 158 also generally requires a company to measure its plan assets and benefit obligations as of its fiscal year-end balance sheet date (with certain exceptions). The Company will be required to adopt this standard in the fiscal year ending January 31, 2007. The Company is in the process of evaluating the expected effect of SFAS 158 on its consolidated financial statements and is not currently in a position to determine such effects.

In July 2006, the FASB released FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This interpretation establishes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. This interpretation will be effective for the Company in the first quarter of the fiscal year ending January 31, 2008. The Company is in the process of evaluating the expected effect of FIN 48 on its consolidated financial statements and is not currently in a position to determine such effects.

In April 2006, the FASB issued FASB Staff Position FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*, (FSP FIN 46(R)-6) which became effective for the Company in the second quarter of 2007. FSP FIN No. 46(R)-6 clarifies that the variability to be considered in applying FASB Interpretation 46(R) shall be based on an analysis of the design of the variable interest entity. The adoption of this pronouncement did not have an effect on the Company's consolidated financial statements.

### **13. Subsequent Events**

In November 2006, the Company acquired 100% of the stock of Underground Infrastructure Group (UIG), a privately held provider of CIPP services for sewer line rehabilitation in the United States. UIG will geographically expand the Company's existing sewer line rehabilitation services. The preliminary purchase price was \$28.6 million in cash, subject to a post-closing adjustment based on the closing balance sheet.

This acquisition of UIG was financed with the Company's Credit Agreement, which, concurrent with the acquisition of UIG, was amended to increase the revolving loan commitment from \$130,000,000 to \$200,000,000. The Credit Agreement remains unsecured and provides for interest at variable rates equal to, at the Company's option, a Libor rate plus 0.75% to 2.00% per annum or a base rate, as defined in the facility, plus up to 0.50% per annum, depending on the Company's leverage ratio.

### **Item 1A. Risk Factors**

There have been no significant changes to the risk factors disclosed under Item 1A in our Annual Report on Form 10-K for the year ended January 31, 2006.

### **Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition Cautionary Language Regarding Forward-Looking Statements**

This Form 10-Q may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act of 1934. Such statements may include, but are not limited to, statements of plans and objectives, statements of future economic performance and statements of assumptions underlying such statements, and statements of management's intentions, hopes, beliefs, expectations or predictions of the future. Forward-looking statements can often be identified by the use of forward-looking terminology, such as *should*, *intended*, *continue*, *believe*, *may*, *hope*, *anticipate*, *will*, *will be*, *goal*, *forecast*, *plan*, *estimate* phrases. Such statements are based on current expectations and are subject to certain risks, uncertainties and assumptions, including but not limited to prevailing prices for various commodities, unanticipated slowdowns in the Company's major markets, the risks and uncertainties normally incident to the construction industry and exploration for and development and production of oil and gas, the impact of competition, the effectiveness of operational changes expected to increase efficiency and productivity, worldwide economic and political conditions and foreign currency fluctuations that may affect worldwide results of operations. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially and adversely from

those anticipated, estimated or projected. These forward-looking statements are made as of the date of this filing, and the Company assumes no obligation to update such forward-looking

**Table of Contents**

statements or to update the reasons why actual results could differ materially from those anticipated in such forward-looking statements.

**Results of Operations**

The following table presents, for the periods indicated, the percentage relationship which certain items reflected in the Company's consolidated statements of income bear to revenues and the percentage increase or decrease in the dollar amount of such items period to period.

	Three Months Ended October 31,		Nine Months Ended October 31,		Period-to-Period Change	
	2006	2005	2006	2005	Three Months	Nine Months
Revenues:						
Water and wastewater infrastructure	73.5%	68.4%	73.2%	66.6%	76.0%	84.1%
Mineral exploration	21.4	27.1	21.1	29.9	29.2	18.2
Energy	3.7	3.3	3.4	2.5	82.5	127.2
Other	1.4	1.2	2.3	1.0	86.7	264.4
Total net revenues	100.0%	100.0%	100.0%	100.0%	63.7	67.5
Cost of revenues	72.9	73.5	73.9	73.5	62.4	68.6
Gross profit	27.1	26.5	26.1	26.5	67.4	64.5
Selling, general and administrative expenses	14.4	14.8	14.2	15.6	58.8	53.1
Depreciation, depletion and amortization	4.7	4.5	4.4	4.1	70.3	76.3
Other income (expense):						
Equity in earnings of affiliates	0.7	0.9	0.5	1.0	42.8	(10.9)
Interest	(1.4)	(1.4)	(1.4)	(1.1)	61.8	96.6
Other income, net	0.4	0.4	0.3	0.3	(4.0)	29.4
Income from continuing operations before income taxes and minority interest	7.7	7.1	6.9	7.0	77.5	64.8
Income tax expense	3.5	3.3	3.2	3.3	73.6	60.6
Minority interest					*	*
Net income from continuing operations before discontinued operations	4.2	3.8	3.7	3.7	81.3	69.4
Loss from discontinued operations, net of income taxes					*	*
Net income	4.2%	3.8%	3.7%	3.7%	81.1%	69.4%

\* Not meaningful.

Revenues and income from continuing operations pertaining to the Company's operating segments are presented below. Intersegment revenues are accounted for based on the fair market value of the services provided. Unallocated corporate expenses primarily consist of general and administrative functions performed on a company-wide basis and benefiting all operating segments. These costs include accounting, financial reporting, internal audit, safety, treasury,

corporate and securities law, tax compliance, certain executive management (chief executive officer, chief financial officer and general counsel) and board of directors. Beginning February 1, 2006, corporate expenses also include expenses associated with share-based payments. Operating segment revenues and income from continuing operations are summarized as follows (in thousands):

19

---

**Table of Contents**

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2006	2005	2006	2005
Revenues				
Water and wastewater infrastructure	\$ 136,586	\$ 77,596	\$ 387,607	\$ 210,542
Mineral exploration	39,749	30,764	111,615	94,433
Energy	6,814	3,733	17,803	7,836
Other	2,675	1,433	12,662	3,475
Total revenues	\$ 185,824	\$ 113,526	\$ 529,687	\$ 316,286
Equity in earnings of affiliates				
Mineral exploration	\$ 1,388	\$ 874	\$ 2,892	\$ 2,838
Water and wastewater infrastructure		98		406
Total equity in earnings of affiliates	\$ 1,388	\$ 972	\$ 2,892	\$ 3,244
Income from continuing operations before income taxes and minority interest				
Water and wastewater infrastructure	\$ 10,015	\$ 7,725	\$ 27,423	\$ 20,415
Mineral exploration	7,789	3,375	19,963	13,057
Energy	2,362	1,011	6,340	1,431
Other	829	230	3,550	426
Unallocated corporate expenses	(4,230)	(2,757)	(13,448)	(9,439)
Interest	(2,551)	(1,577)	(7,180)	(3,653)
Total income from continuing operations before income taxes and minority interest	\$ 14,214	\$ 8,007	\$ 36,648	\$ 22,237

Revenues for the three months ended October 31, 2006 increased \$72,298,000, or 63.7%, to \$185,824,000 while revenues for the nine months ended October 31, 2006 increased \$213,401,000, or 67.5%, to \$529,687,000 from the same periods last year. Revenues were up across all divisions with the main increase in the water and wastewater infrastructure division, primarily resulting from the acquisition of Reynolds, Inc. ( Reynolds ) that closed on September 28, 2005. A further discussion of results of operations by division is presented below.

Gross profit as a percentage of revenues was 27.1% and 26.1% for the three and nine months ended October 31, 2006 compared to 26.5% for the same periods last year. The increase in the gross profit percentage for the three months was primarily the result of improved margins in the mineral exploration division due to improved pricing and efficiency and the energy division due to the increased production of unconventional gas, offset by reduced margins in the water and wastewater infrastructure division arising from the change in product mix with the acquisition of Reynolds. The decrease in gross profit percentage for the nine months was primarily due to the impact of the Reynolds product mix. Selling, general and administrative expenses were \$26,724,000 and \$75,324,000 for the three and nine months ended October 31, 2006, compared to \$16,834,000 and \$49,196,000 for the same periods last year. The increases for the three and nine months ended October 31, 2006, respectively, were primarily the result of \$3,604,000 and \$11,324,000 in expenses added from the Reynolds acquisition and from various other categories, including increases in compensation expense of \$540,000 and \$1,661,000 associated with stock options under SFAS 123R Share-Based Payments, additional incentive compensation expense of \$2,980,000 and \$5,320,000 from increased profitability and

wage and benefit increases of \$796,000 and \$2,730,000.

Depreciation, depletion and amortization was \$8,673,000 and \$23,139,000 for the three and nine months ended October 31, 2006, compared to \$5,094,000 and \$13,122,000 for the same periods last year. The increases for the three and nine months ended October 31, 2006, respectively, were primarily the result of increased depreciation and amortization of \$1,736,000 and \$5,503,000 associated with the Reynolds acquisition and increased depletion expense of \$846,000 and \$2,033,000 resulting from the increase in production of unconventional gas from the Company's energy operations.

Equity in earnings of affiliates was \$1,388,000 and \$2,892,000 for the three and nine months ended October 31, 2006, compared to \$972,000 to \$3,244,000, for the same periods last year. The increase for the three months reflects increased earnings of \$514,000 from foreign affiliates in mineral exploration. The decrease for the nine months reflects decreased earnings of \$406,000 from a non-recurring domestic joint venture in the water and wastewater infrastructure division in the prior year.



**Table of Contents**

Interest expense was \$2,551,000 and \$7,180,000 for the three and nine months ended October 31, 2006, compared to \$1,577,000 and \$3,653,000 for same periods last year. The increases were primarily a result of increases in the Company's average borrowings for the periods in conjunction with the financing of the Reynolds acquisition.

Other, net earnings were \$452,000 and \$1,299,000 for the three and nine months ended October 31, 2006, compared to \$471,000 and \$1,004,000 for the same periods last year. The amounts were primarily due to gains on sales of non-strategic assets.

Income tax expense was recorded at an effective tax rate of 45.4% and 46.5% for the three and nine months ended October 31, 2006 compared to an effective rate of 46.4% and 47.8% for the same periods last year. The improvement in the effective rates was primarily attributable to an increase in pre-tax earnings, especially in international operations. The effective rates in excess of the statutory federal rate for the periods were due primarily to the impact of nondeductible expenses and the tax treatment of certain foreign operations.

**Water and Wastewater Infrastructure Division**

(in thousands)

	Three months ended October 31,		Nine months ended October 31,	
	2006	2005	2006	2005
Revenues	\$136,586	\$77,596	\$387,607	\$210,542
Income from continuing operations before income taxes	10,015	7,725	27,423	20,415

At the beginning of the first quarter, the Company established the water and wastewater infrastructure division. The division is a combination of the Company's legacy water businesses, its geoconstruction division and the Reynolds company.

Water and wastewater infrastructure revenues increased 76.0% to \$136,586,000 and 84.1% to \$387,607,000 for the three and nine months ended October 31, 2006, compared to \$77,596,000 and \$210,542,000 for the same periods last year. The increases in revenues were primarily attributable to increases of \$42,106,000 and \$147,371,000 from the Company's acquisition of Reynolds and additional revenues of \$5,368,000 and \$13,650,000 from the Company's continued expansion into water treatment markets for the three and nine months ended October 31, 2006.

Income from continuing operations for the water and wastewater infrastructure division increased 29.6% to \$10,015,000 for the three months ended October 31, 2006, and 34.3% to \$27,423,000 for the nine months ended October 31, 2006, compared to \$7,725,000 and \$20,415,000 for the same periods last year. The increases in income from continuing operations for the three and nine months ended October 31, 2006 were primarily attributable to increases of \$1,846,000 and \$7,235,000 from the Reynolds acquisition and an increase from earnings of the Company's water treatment initiatives of \$343,000 and \$1,888,000, partially offset for the nine months by reduced operating earnings of \$2,705,000 as a result of a slowdown in the geoconstruction operations.

**Mineral Exploration Division**

(in thousands)

	Three months ended October 31,		Nine months ended October 31,	
	2006	2005	2006	2005
Revenues	\$39,749	\$30,764	\$111,615	\$94,433
Income from continuing operations before income taxes	7,789	3,375	19,963	13,057

Mineral exploration revenues increased 29.2% to \$39,749,000 and 18.2% to \$111,615,000 for the three and nine months ended October 31, 2006, compared to revenues of \$30,764,000 and \$94,433,000 for the same periods last year. The increases for the periods were primarily attributable to continued strength in worldwide exploration activity as a result of the relatively high gold and base metal prices.

Income from continuing operations for the mineral exploration division increased 130.8% to \$7,789,000 and 52.9% to \$19,963,000 for the three and nine months ended October 31, 2006, compared to \$3,375,000 and \$13,057,000 for the same periods last year. The improved earnings in the division were primarily attributable to the impact of increased exploration activity in most of the Company's markets. The improved earnings were partially offset by an increase in accrued incentive compensation of \$516,000 and \$1,199,000 for the three and nine months ended October 31, 2006, due to higher profitability in the current year.

**Table of Contents****Energy Division**

(in thousands)

	Three months ended October 31,		Nine months ended October 31,	
	2006	2005	2006	2005
Revenues	\$6,814	\$3,733	\$17,803	\$7,836
Income from continuing operations before income taxes	2,362	1,011	6,340	1,431

Energy division revenues increased \$3,081,000, or 82.5%, to \$6,814,000 and \$9,967,000, or 127.2%, to \$17,803,000 for the three and nine months ended October 31, 2006, compared to revenues of \$3,733,000 and \$7,836,000 for the same periods last year. The increase in revenues was primarily attributable to increased production from the Company's unconventional gas properties.

Income from continuing operations increased \$1,351,000, or 133.6%, to \$2,362,000 and \$4,909,000, or 343.0%, to \$6,340,000 for the three and nine months ended October 31, 2006, compared to \$1,011,000 and \$1,431,000 for the same periods last year. The increases in income from continuing operations were due to the increase in revenues noted above.

**Other**

(in thousands)

	Three months ended October 31,		Nine months ended October 31,	
	2006	2005	2006	2005
Revenues	\$2,675	\$1,433	\$12,662	\$3,475
Income from continuing operations before income taxes	829	230	3,550	426

The increases in revenues and income from continuing operations in both the three and nine month periods ended October 31, 2006 as compared to the prior year were primarily due to a non-recurring contract to provide equipment and supplies to an international oil exploration company. Revenues of \$8,798,000 were recognized during the nine months ended October 31, 2006, primarily in the second quarter, as the equipment and supplies were delivered and accepted.

**Unallocated Corporate Expenses**

Corporate expenses not allocated to individual divisions, primarily included in selling, general and administrative expenses were \$4,230,000 and \$13,448,000 for the three and nine months ended October 31, 2006, compared to \$2,757,000 and \$9,439,000 for the same periods last year. The increases for the three and nine months ended October 31, 2006 were primarily due to the recognition of compensation expense under SFAS No. 123R (revised December 2004), Share Based Payments of \$540,000 and \$1,661,000, increases in wage and benefit costs of \$260,000 and \$708,000 and increases in consulting services of \$184,000 and \$612,000.

**Changes in Financial Condition**

Management exercises discretion regarding the liquidity and capital resource needs of its business segments. This includes the ability to prioritize the use of capital and debt capacity, to determine cash management policies and to make decisions regarding capital expenditures.

The Company maintains an agreement (the Master Shelf Agreement) whereby it has \$100,000,000 of unsecured notes available to be issued before September 15, 2007. At October 31, 2006, the Company has \$60,000,000 in notes outstanding under the Master Shelf Agreement. Additionally, the Company holds a revolving credit facility (the Credit Agreement) composed of an unsecured \$130,000,000 revolving facility, less any outstanding letter of credit commitments (which are subject to a \$30,000,000 sublimit). Amounts outstanding under the Credit Agreement are due and payable September 28, 2010. At October 31, 2006, the Company had \$71,000,000 outstanding under the Credit Agreement (see Note 5 of the Notes to Consolidated Financial Statements). The Company was in compliance

with its financial covenants at October 31, 2006 and expects to remain in compliance through the foreseeable future. The Company's working capital as of October 31, 2006 and October 31, 2005 was \$63,267,000 and \$85,578,000, respectively. The decrease in working capital at October 31, 2006 was attributable to an increase in billings in excess of costs of \$13,836,000 and an increase in accrued compensation of \$7,432,000 primarily due to increased incentive compensation. The Company believes it will have sufficient cash from operations and access to credit facilities to meet the Company's operating cash requirements and to fund its budgeted capital expenditures for fiscal 2007.

**Table of Contents****Operating Activities**

Cash from operating activities was \$55,564,000 for the nine months ended October 31, 2006 as compared to cash from of \$10,655,000 for the nine months ended October 31, 2005. The improvement was primarily due to increased earnings and improved working capital requirements, as discussed above.

**Investing Activities**

The Company's capital expenditures, net of disposals, of \$52,575,000 for the nine months ended October 31, 2006, were directed primarily toward the Company's expansion into unconventional gas exploration and production. The expenditures related to the Company's unconventional gas efforts totaled \$32,048,000 for the nine months ended October 31, 2006, including the construction of gas pipeline infrastructure near the Company's development projects. Also, during the nine months ended October 31, 2006, the Company invested \$3,809,000 to acquire the business of Collector Wells International, Inc., invested \$1,500,000 to acquire certain producing oil and gas properties and mineral interests, paid cash purchase price adjustments in accordance with the Reynolds purchase agreement of \$6,120,000, and had a net inflow from restricted funds of \$3,710,000 as a result of activity in the Reynolds Escrow Fund (see Note 2 of the Notes to Consolidated Financial Statements).

**Financing Activities**

For the nine months ended October 31, 2006, the Company had net borrowings of \$2,100,000 under its credit facilities primarily to fund capital expenditures.

The Company's contractual obligations and commercial commitments as of October 31, 2006, are summarized as follows (in thousands):

	Payments/Expiration by Period				
	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Contractual obligations and other commercial commitments					
Senior notes	\$ 60,000	\$	\$ 33,333	\$ 26,667	\$
Credit agreement	71,000			71,000	
Operating leases	17,405	5,720	8,209	3,203	273
Mineral interest obligations	495	105	189	183	18
 Total contractual cash obligations	 \$ 148,900	 \$ 5,825	 \$ 41,731	 \$ 101,053	 \$ 291
 Standby letters of credit	 9,910	 9,910			
Asset retirement obligations	764				764
 Total contractual obligations and commercial commitments	 \$ 159,574	 \$ 15,735	 \$ 41,731	 \$ 101,053	 \$ 1,055

The Company expects to meet its contractual cash obligations in the ordinary course of operations, and that the standby letters of credit will be renewed in connection with its annual insurance renewal process. Payments related to the credit agreement and senior notes do not include interest payments. Interest is payable on the senior notes at fixed interest rates of 6.05% and 5.40%. Interest is payable on the credit agreement at variable interest rates equal to, at the Company's option, a LIBOR rate plus 1.00% to 2.00%, or a base rate, as defined in the Credit Agreement plus up to 0.50%, depending on the Company's leverage ratio (See Note 5 of the Notes to Consolidated Financial Statements). The Company incurs additional obligations in the ordinary course of operations. These obligations, including but not limited to, interest payments on debt, income tax payments and pension fundings are expected to be met in the normal course of operations.



## **Table of Contents**

### **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments, which are based on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our accounting policies are more fully described in Note 1 of the Notes to Consolidated Financial Statements, located in Item 1 of this Form 10-Q. We believe that the following represent our more critical estimates and assumptions used in the preparation of our consolidated financial statements, although not all inclusive.

**Revenue Recognition** Revenue is recognized on large, long-term contracts using the percentage of completion method based upon the ratio of costs incurred to total estimated costs at completion. Contract price and cost estimates are reviewed periodically as work progresses and adjustments proportionate to the percentage of completion are reflected in contract revenues and gross profit in the reporting period when such estimates are revised. Changes in job performance, job conditions and estimated profitability, including those arising from contract penalty provisions, change orders and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Revenue is recognized on smaller, short-term contracts using the completed contract method. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined.

**Goodwill and Other Intangibles** The Company accounts for goodwill and other intangible assets in accordance with the Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets. Other intangible assets primarily consist of trademarks, customer-related intangible assets and patents obtained through business acquisitions. Amortizable intangible assets are being amortized over their estimated useful lives, which range from two to 40 years.

The impairment evaluation for goodwill is conducted annually, or more frequently, if events or changes in circumstances indicate that an asset might be impaired. The evaluation is performed by using a two-step process. In the first step, the fair value of each reporting unit is compared with the carrying amount of the reporting unit, including goodwill. The estimated fair value of the reporting unit is generally determined on the basis of discounted future cash flows. If the estimated fair value of the reporting unit is less than the carrying amount of the reporting unit, then a second step must be completed in order to determine the amount of the goodwill impairment that should be recorded. In the second step, the implied fair value of the reporting unit's goodwill is determined by allocating the reporting unit's fair value to all of its assets and liabilities other than goodwill (including any unrecognized intangible assets) in a manner similar to a purchase price allocation. The resulting implied fair value of the goodwill that results from the application of this second step is then compared to the carrying amount of the goodwill and an impairment charge is recorded for the difference.

The impairment evaluation of the carrying amount of intangible assets with indefinite lives is conducted annually or more frequently if events or changes in circumstances indicate that an asset might be impaired. The evaluation is performed by comparing the carrying amount of these assets to their estimated fair value. If the estimated fair value is less than the carrying amount of the intangible assets with indefinite lives, then an impairment charge is recorded to reduce the asset to its estimated fair value. The estimated fair value is generally determined on the basis of discounted future cash flows.

The assumptions used in the estimate of fair value are generally consistent with the past performance of each reporting unit and are also consistent with the projections and assumptions that are used in current operating plans. Such assumptions are subject to change as a result of changing economic and competitive conditions.

**Other Long-lived Assets** In evaluating the carrying value of long-lived assets, including the Company's gas transportation facilities and equipment, the Company performs an analysis of the anticipated future net cash flows of the related long-lived assets and reduces their carrying value by the excess, if any, of the result of such calculation.

**Accrued Insurance Expense** The Company maintains insurance programs where it is responsible for a certain amount of each claim up to a self-insured limit. Costs estimated to be incurred in the future for employee medical benefits, property, workers' compensation and casualty insurance programs resulting from claims which have occurred are accrued currently. These estimated costs are primarily based on actuarially determined projections of future payments under these programs. Should a greater amount of insurance claims occur compared to what was estimated or medical costs increase beyond what



## **Table of Contents**

was anticipated, reserves recorded may not be sufficient and additional costs would have to be recorded in the consolidated financial statements.

Under the terms of the Company's agreement with the various insurance carriers administering these claims, the Company is not required to remit the total premium until the claims are actually paid by the insurance companies. These required payments are not expected to significantly impact liquidity in future periods.

**Income Taxes** Income taxes are provided using the asset/liability method, in which deferred taxes are recognized for the tax consequences of temporary differences between the financial statement carrying amounts and tax bases of existing assets and liabilities. Deferred tax assets are reviewed for recoverability and valuation allowances are provided as necessary. Provision for U.S. income taxes on undistributed earnings of foreign subsidiaries and affiliates is made only on those amounts in excess of funds considered to be invested indefinitely.

**Oil and gas properties and mineral interests** The Company follows the full-cost method of accounting for oil and gas properties. Under this method, all productive and nonproductive costs incurred in connection with the exploration for and development of oil and gas reserves are capitalized. Such capitalized costs include lease acquisition, geological and geophysical work, delay rentals, drilling, completing and equipping oil and gas wells, and salaries, benefits and other internal salary-related costs directly attributable to these activities. Costs associated with production and general corporate activities are expensed in the period incurred. Normal dispositions of oil and gas properties are accounted for as adjustments of capitalized costs, with no gain or loss recognized.

The Company is required to review the carrying value of its oil and gas properties under the full cost accounting rules of the SEC. Under these rules, capitalized costs of proved oil and gas properties, as adjusted for asset retirement obligations, may not exceed the present value of estimated future net revenues from proved reserves, discounted at 10% (the Ceiling Test). Application of the Ceiling Test generally requires pricing future revenues at the unescalated prices in effect as of the last day of the period, with effect given to the Company's fixed-price physical delivery contracts, and requires a write-down for accounting purposes if the ceiling is exceeded. Unproved oil and gas properties are not amortized, but are assessed for impairment either individually or on an aggregated basis using a comparison of the carrying values of the unproved properties to net future cash flows.

**Reserve Estimates** The Company's estimates of natural gas reserves, by necessity, are projections based on geologic and engineering data, and there are uncertainties inherent in the interpretation of such data as well as the projection of future rates of production and the timing of development expenditures. Reserve engineering is a subjective process of estimating underground accumulations of gas that are difficult to measure. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation and judgment. Estimates of economically recoverable gas reserves and future net cash flows necessarily depend upon a number of variable factors and assumptions, such as historical production from the area compared with production from other producing areas, the assumed effects of regulations by governmental agencies and assumptions governing natural gas prices, future operating costs, severance, ad valorem and excise taxes, development costs and workover and remedial costs, all of which may in fact vary considerably from actual results. For these reasons, estimates of the economically recoverable quantities of gas attributable to any particular group of properties, classifications of such reserves based on risk of recovery, and estimates of the future net cash flows expected there from may vary substantially. Any significant variance in the assumptions could materially affect the estimated quantity and value of the reserves, which could affect the carrying value of the Company's oil and gas properties and the rate of depletion of the oil and gas properties. Actual production, revenues and expenditures with respect to the Company's reserves will likely vary from estimates, and such variances may be material.

**Litigation and Other Contingencies** The Company is involved in litigation incidental to its business and accrues its best estimate of the probable cost for the resolution of legal claims. Such estimates are developed in consultation with outside counsel handling these matters and are based upon a combination of litigation and settlement strategies. To the extent additional information arises or the Company's strategies change, it is possible that the Company's estimate of its probable liability in these matters may change. While the disposition of these claims is not expected to have a material effect on the Company's financial position or results of operations, it is possible that future results of operations for any particular quarterly or annual period could be materially affected by changes in the Company's assumptions related to these proceedings.

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

The principal market risks to which the Company is exposed are interest rates on variable rate debt, foreign exchange rates giving rise to translation and transaction gains and losses and fluctuations in the price of natural gas.

25

---

## **Table of Contents**

The Company centrally manages its debt portfolio considering overall financing strategies and tax consequences. A description of the Company's debt is in Note 13 of the Notes to Consolidated Financial Statements appearing in the Company's January 31, 2006 Form 10-K and Note 5 of this Form 10-Q. As of October 31, 2006, \$60,000,000 of the Company's long-term debt outstanding carries a fixed-rate and \$71,000,000 is variable rate debt. An instantaneous change in interest rates of one percentage point would change the Company's annual interest expense by \$710,000. Operating in international markets involves exposure to possible volatile movements in currency exchange rates.

Currently, the Company's primary international operations are in Australia, Africa, Mexico and Italy. The operations are described in Note 1 of the Notes to Consolidated Financial Statements appearing in the Company's January 31, 2006 Form 10-K and Note 9 of this Form 10-Q. The majority of the Company's contracts in Africa and Mexico are U.S. dollar based, providing a natural reduction in exposure to currency fluctuations. The Company also may utilize various hedge instruments, primarily foreign currency option contracts, to manage the exposures associated with fluctuating currency exchange rates (see Note 6 of the Notes to Consolidated Financial Statements).

As currency exchange rates change, translation of the income statements of the Company's international operations into U.S. dollars may affect year-to-year comparability of operating results. We estimate that a ten percent change in foreign exchange rates would not have significantly impacted income from continuing operations for the nine months ended October 31, 2006 and 2005. This quantitative measure has inherent limitations, as it does not take into account any governmental actions, changes in customer purchasing patterns or changes in the Company's financing and operating strategies.

The Company is also exposed to fluctuations in the price of natural gas, which result from the sale of the energy division's unconventional gas production. The price of natural gas is volatile and the Company has entered into fixed-price physical contracts covering a portion of its production to manage price fluctuations and to achieve a more predictable cash flow. As of October 31, 2006, the Company held contracts for physical delivery of 3,965,000 million British Thermal Units (MMBtu) of natural gas at prices ranging from \$8.51 to \$9.66 per MMBtu. The estimated fair value of such contracts at October 31, 2006 was \$5,202,000. We estimate that a ten percent change in the price of natural gas would have impacted income from continuing operations before taxes by approximately \$1,318,000 for the nine months ended October 31, 2006.

### **ITEM 4. Controls and Procedures**

Based on an evaluation of disclosure controls and procedures for the period ended October, 2006, conducted under the supervision and with the participation of the Company's management, including the Principal Executive Officer and the Principal Financial Officer, the Company concluded that its disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Based on an evaluation of internal controls over financial reporting conducted under the supervision and the participation of the Company's management, including the Principal Executive Officer and Principal Financial Officer, for the period ended October 31, 2006, the Company concluded that its internal control over financial reporting is effective as of October 31, 2006. The Company has not made any significant changes in internal controls or in other factors that could significantly affect internal controls since such evaluation. The Company excluded from its assessment any changes in internal control over financial reporting at the Reynolds, Inc. business, which was acquired on September 28, 2005, and whose financial statements reflect total assets and revenues constituting 32% and 30%, respectively, of the related consolidated financial statement amounts as of and for the nine months ended October 31, 2006. The Company will include Reynolds, Inc. in its evaluation of the design and effectiveness of internal control over financial reporting as of January 31, 2007.

**Table of Contents**

**PART II**

ITEM 1 Legal Proceedings

NONE

ITEM 2 Changes in Securities

NOT APPLICABLE

ITEM 3 Defaults Upon Senior Securities

NOT APPLICABLE

ITEM 4 Submission of Matters to a Vote of Security Holders

NONE

ITEM 5 Other Information

NONE

ITEM 6 Exhibits and Reports on Form 8-K

a) Exhibits

4(1) Second Amendment to Amended and Restated Loan Agreement, dated as of November 20, 2006, by and among Layne Christensen Company, LaSalle Bank National Association, as Administrative Agent and as Lender, and the other Lenders listed therein (filed as Exhibit 4.1 to the Company's Form 8-K filed on November 27, 2006, and incorporated herein by reference).

4(2) Letter Amendment No. 4 to Master Shelf Agreement, dated as of November 20, 2006, by and among Layne Christensen Company, Prudential Investment Management, Inc., The Prudential Insurance Company of America, Pruco Life Insurance Company, Security Life of Denver Insurance Company and such other Purchasers of the Notes as may be named in the Master Shelf Agreement from time to time (filed as Exhibit 4.2 to the Company's Form 8-K filed on November 27, 2006 and incorporated herein by reference).

31(1) Section 302 Certification of Chief Executive Officer of the Company.

31(2) Section 302 Certification of Chief Financial Officer of the Company.

32(1) Section 906 Certification of Chief Executive Officer of the Company.

32(2) Section 906 Certification of Chief Financial Officer of the Company.

b) Reports on Form 8-K

Form 8-K filed on August 28, 2006, regarding the adoption of Water and Wastewater Infrastructure Group Incentive Compensation Plan.

Form 8-K filed on August 30, 2006, related to the Company's second quarter press release.

Form 8-K filed on September 19, 2006, related to the Company's press release announcing a Letter of Intent to acquire the stock of American Water's Underground Infrastructure Group.

**Table of Contents**

\* \* \* \* \*

**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.

Layne Christensen Company

(Registrant)

DATE: December 8, 2006

*/s/ A.B. Schmitt*

A.B. Schmitt, President  
and Chief Executive Officer

DATE: December 8, 2006

*/s/ Jerry W. Fanska*

Jerry W. Fanska, Sr. Vice President  
Finance and Treasurer

28