NORTECH SYSTEMS INC
Form 10-Q
August 12, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

OR

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

For the transition period from to

NORTECH SYSTEMS INCORPORATED

Commission file number **0-13257**

State of Incorporation: **Minnesota**

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

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

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

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

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

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

Large Accelerated Filer o	Accelerated Filer o
Non-accelerated Filer o	Smaller Reporting Company x

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

Number of shares of $.01 par value common stock outstanding at July 29, 2010 - 2,742,992

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PART 1

ITEM 1. FINANCIAL STATEMENTS

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

ASSETS	**JUNE 30 2010 (Unaudited)**	**DECEMBER 31 2009**
Current Assets		
Cash and Cash Equivalents	$ 722,314	$ 245,381
Accounts Receivable, Less Allowance for Uncollectible Accounts	14,352,640	12,021,378
Inventories	17,970,715	15,806,669
Prepaid Expenses	449,756	542,643
Income Taxes Receivable	2,338,435	2,515,906
Deferred Income Taxes	867,000	753,000
Total Current Assets	36,700,860	31,884,977
Property and Equipment, Net	7,776,376	8,239,161
Finite Life Intangible Assets, Net of Accumulated Amortization	272,452	343,549
Deferred Income Taxes	210,000	348,000
Other Assets	313,518	313,518
Total Assets	$ 45,273,206	$ 41,129,205

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

LIABILITIES AND SHAREHOLDERS EQUITY	**JUNE 30 2010 (Unaudited)**	**DECEMBER 31 2009**
Current Liabilities		
Line of Credit	$ 6,792,610	$ 5,490,607
Current Maturities of Long-Term Debt	1,077,081	1,013,920
Accounts Payable	10,975,877	9,050,684
Accrued Payroll and Commissions	3,029,637	1,449,528
Accrued Health and Dental Claims	375,000	310,000
Other Accrued Liabilities	966,993	1,354,438
Total Current Liabilities	23,217,198	18,669,177
Long-Term Liabilities		
Long-Term Debt, Net of Current Maturities	2,930,945	3,572,264
Other Long-Term Liabilities	129,008	160,912
Total Long-Term Liabilities	3,059,953	3,733,176
Total Liabilities	26,277,151	22,402,353
Shareholders Equity		
Preferred Stock, $1 par value; 1,000,000 Shares Authorized: 250,000 Shares Issued and Outstanding	250,000	250,000
Common Stock - $0.01 par value; 9,000,000 Shares Authorized: 2,742,992 and 2,738,992 Shares Issued and Outstanding at June 30, 2010 and December 31, 2009, respectively	27,430	27,390
Additional Paid-In Capital	15,682,484	15,654,160
Accumulated Other Comprehensive Loss	(75,466)	(73,909)
Retained Earnings	3,111,607	2,869,211
Total Shareholders Equity	18,996,055	18,726,852
Total Liabilities and Shareholders Equity	$ 45,273,206	$ 41,129,205

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	THREE MONTHS ENDED JUNE 30	
	2010	**2009**
Net Sales	$ 24,694,506	$ 19,891,110
Cost of Goods Sold	21,583,889	18,790,455
Gross Profit	3,110,617	1,100,655
Operating Expenses:		
Selling Expenses	765,502	1,125,744
General and Administrative Expenses	1,860,145	1,549,943
Restructuring and Impairment Charges		645,118
Total Operating Expenses	2,625,647	3,320,805
Income (Loss) From Operations	484,970	(2,220,150)
Other Income (Expense)		
Interest Expense	(100,550)	(140,170)
Miscellaneous Income (Expense), net	7,692	(53,462)
Total Other Expense	(92,858)	(193,632)
Income (Loss) Before Income Taxes	392,112	(2,413,782)
Income Tax Expense (Benefit)	245,000	(867,000)
Net Income (Loss)	$ 147,112	$ (1,546,782)
Earnings (Loss) Per Common Share:		
Basic and Diluted	$ 0.05	$ (0.56)
Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings (Loss) Per Common Share	2,742,992	2,738,989

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2010	**2009**
Net Sales	$ 46,435,947	$ 41,441,746
Cost of Goods Sold	40,685,662	39,510,527
Gross Profit	5,750,285	1,931,219
Operating Expenses:		
Selling Expenses	1,520,924	2,538,335
General and Administrative Expenses	3,418,609	3,090,956
Restructuring and Impairment Charges		645,118
Total Operating Expenses	4,939,533	6,274,409
Income (Loss) From Operations	810,752	(4,343,190)
Other Income (Expense)		
Interest Expense	(226,075)	(235,276)
Miscellaneous Expense, net	(37,281)	(43,534)
Total Other Expense	(263,356)	(278,810)
Income (Loss) Before Income Taxes	547,396	(4,622,000)
Income Tax Expense (Benefit)	305,000	(1,786,000)
Net Income (Loss)	$ 242,396	$ (2,836,000)
Earnings (Loss) Per Common Share:		
Basic and Diluted	$ 0.09	$ (1.04)
Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings (Loss) Per Common Share	2,741,777	2,738,972

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2010	**2009**
Cash Flows From Operating Activities		
Net Income (Loss)	$ 242,396	$ (2,836,000)
Adjustments to Reconcile Net Income (Loss) to Net Cash		
Provided by (Used in) Operating Activities:		
Depreciation	797,061	954,088
Amortization	71,097	75,061
Stock-Based Compensation	15,864	62,592
Interest on Swap Valuation	(12,404)	(7,875)
Restructuring Charges		103,307
Property and Equipment Impairment Charges		541,811
Deferred Income Taxes	24,000	(173,000)
Loss on Disposal of Property and Equipment	876	5,733
Foreign Currency Gain	(3,458)	(31,495)
Changes in Current Operating Items, Net of Effects of Business Acquisition		
Accounts Receivable	(2,330,092)	1,159,907
Inventories	(1,861,077)	3,818,667
Prepaid Expenses and Other Assets	93,034	321,483
Income Taxes Receivable	177,501	(1,624,323)
Accounts Payable	1,925,180	(2,932,660)
Accrued Payroll and Commissions	1,579,335	(701,661)
Accrued Health and Dental Claims	65,000	13,898
Other Accrued Liabilities	(407,140)	(522,870)
Net Cash Provided by (Used in) Operating Activities	377,173	(1,773,337)
Cash Flows from Investing Activities:		
Proceeds from Sale of Property and Equipment		100
Business Acquisition	(402,969)	
Purchase of Property and Equipment	(233,651)	(204,266)
Net Cash Used in Investing Activities	(636,620)	(204,166)
Cash Flows from Financing Activities:		
Net Borrowings on Line of Credit	1,302,003	1,992,045
Proceeds from Long-Term Debt		616,397
Principal Payments on Long-Term Debt	(578,158)	(620,339)
Proceeds from Issuance of Common Stock	12,500	132
Net Cash Provided by Financing Activities	736,345	1,988,235
Effect of Exchange Rate Changes on Cash	35	4,657
Net Increase in Cash and Cash Equivalents	476,933	15,389
Cash and Cash Equivalents - Beginning	245,381	803,041
Cash and Cash Equivalents - Ending	$ 722,314	$ 818,430
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for interest	$ 237,425	$ 250,032
Cash paid during the period for income taxes	151,615	502

See Accompanying Condensed Notes to Consolidated Financial Statements

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

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

Principles of Consolidation

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

Revenue Recognition

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

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Stock Options

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

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding - January 1, 2010	736,750	$ 7.20		
Exercised	(4,000)	$ 3.13		
Forfeited	(67,500)	$ 6.27		
Outstanding - June 30, 2010	665,250	$ 7.32	6.05	$ 997
Exercisable - June 30, 2010	291,250	$ 7.37	4.67	$

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

Stock Options with Time-Based Vesting

Total compensation expense related to stock options with time-based vesting for the three months ended June 30, 2010 and 2009 was $7,931 and $31,296, respectively. Total compensation expense related to stock options with time-based vesting for the six months ended June 30, 2010 and 2009 was $15,864 and $62,592, respectively. At June 30, 2010 we had 315,250 time-based options outstanding.

As of June 30, 2010 there was approximately $43,000 of unrecognized compensation expense related to unvested option awards that we expect to recognize over a weighted-average period of 1.36 years.

Segment Reporting Information

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

Inventories

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

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Inventories are as follows:

	June 30 2010	December 31 2009
Raw materials	$ 12,510,214	$ 11,137,853
Work in process	3,890,988	3,304,725
Finish goods	2,768,372	2,459,521
Reserve	(1,198,859)	(1,095,430)
Total	$ 17,970,715	$ 15,806,669

Finite Life Intangible Assets

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

	June 30, 2010			
	Remaining Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Bond Issue Costs	11	$ 79,373	$ 21,168	$ 58,205
Customer Base	2	676,557	462,310	214,247
Other Intangibles	0	28,560	28,560	
Totals		$ 784,490	$ 512,038	$ 272,452

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

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

Remainder of 2010	$ 70,000
2011	141,000
2012	17,000
2013	5,000
2014	5,000
Thereafter	34,000
Total	$ 272,000

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NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

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

One customer accounted for 10% or more of our net sales for the three and six months ended June 30, 2010. Two customers accounted for 10% or more of our sales for the three and six months ended June 30, 2009. G.E. s Medical Division accounted for 19% of net sales for the three and six months ended June 30, 2010 and 13% and 12% of net sales for the three and six month periods ended June 30, 2009, respectively. GE s Transportation Division accounted for 10% of net sales for the three and six months ended June 30, 2010 and 13% and 11% for the three and six month periods ended June 30, 2009, respectively. GE s Medical and Transportation Divisions combined accounted for 29% of net sales for the three and six month periods ended June 30, 2010 and 25% and 24% of net sales for the three and six month periods ended June 30, 2009, respectively. Accounts receivable from G.E. s Medical and Transportation Divisions represented 19% of total accounts receivable at June 30, 2010. Additionally, Northrop Grumman Corp. accounted for 13% of net sales for the three and six month periods ended June 30, 2009.

NOTE 3. FINANCING ARRANGEMENTS

On May 27, 2010 we entered into a third amended and restated credit agreement with Wells Fargo Bank (WFB), which provides for a line of credit arrangement of $12 million, which expires if not renewed, on May 31, 2013. The credit arrangement also has a real estate term note with a maturity date of May 31, 2012. Both the line of credit and real estate term note are subject to variations in LIBOR rates. The line of credit and real estate term note with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. On June 30, 2010, we had an outstanding balance of $6.8 million under the line of credit and were in compliance with all covenants.

NOTE 4. DERIVATIVE INSTRUMENTS AND HEDGING STRATEGIES

We are exposed to interest rate risk associated with fluctuations in the interest rates on our variable interest rate debt. In order to manage some of the risk, we have entered into an interest rate swap agreement with a notional amount of $1.4 million with a goal to effectively convert our industrial revenue bond debt from a variable rate to a fixed rate of 4.07% for five years, maturing on June 28, 2011. We do not use this interest rate swap for speculative purposes. The fair value of the swap of approximately $34,000 and $46,000 was recorded in other long-term liabilities at June 30, 2010 and December 31, 2009 respectively. The change in fair value of $12,000 and $8,000 for the six-month periods ended June 30, 2010 and 2009, respectively, was recorded as a component of interest expense.

NOTE 5. NET INCOME (LOSS) PER COMMON SHARE

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

amounts.

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NOTE 6. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances by each tax jurisdiction. The effective tax rates for the quarters ended June 30, 2010 and 2009 were approximately 62% and 36%, respectively. The year-to-date effective tax rates for the six months ending June 30, 2010 and 2009 were 56% and 39%, respectively. The increase in the second quarter effective tax rate from 2009 to 2010 relates primarily to the finalization of our 2009 research and experimentation credits and the true-up of our net operating loss (NOL) carryback which resulted in additional tax expense of approximately $101,000.

At June 30, 2010 we had $95,500 of net uncertain tax benefit positions recorded in other long-term liabilities that would reduce our effective income tax rate if recognized. The $19,500 decrease from December 31, 2009 relates primarily to the NOL carryback which resulted in the loss of domestic production deductions.

NOTE 7. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended June 30, 2010		Six Months Ended June 30, 2010	
	2010	2009	2010	2009
Net Income (Loss), as reported	$ 147,112	$ (1,546,782)	$ 242,396	$ (2,836,000)
Other Comprehensive Loss:				
Currency Translation Adjustment	(1,349)	(13,632)	(1,557)	(26,334)
Comprehensive Income (Loss)	$ 145,763	$ (1,560,414)	$ 240,839	$ (2,862,334)

NOTE 8. RESTRUCTURING AND IMPAIRMENT CHARGES

To better align our cost structure with changes in customer demand, our Board of Directors approved a restructuring plan in the second quarter of fiscal year 2009. This restructuring resulted in the closing of our Garner, Iowa facility at the end of August 2009 with production moving to Merrifield, Minnesota and closing our Fairmont Aerospace assembly production facilities and moving these activities to Blue Earth, Minnesota. One building in Fairmont was sold and another is held for sale at June 30, 2010 and was reclassified to Other Assets on the balance sheet. As a result of these moves, we recognized approximately $645,000 of restructuring and impairment charges for the three and six months ended June 30, 2009, in Income (Loss) from Operations. Total cash paid during the three and six months ended June 30, 2010 related to this restructuring was $8,000 and $16,000, respectively. All accrued liabilities relating to the restructuring have been paid as of June 30, 2010.

NOTE 9. ACQUISITION

On May 4, 2010, we acquired all of the intellectual property and assets, excluding cash and receivables, of Trivirix Corporation, Milaca, MN for $403,000 which consisted of $303,000 in inventory and $100,000 in property and equipment. This operation specializes in design, manufacturing and post-production services of complex electronic and electromechanical medical

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devices for diagnostic, analytical and other life-science applications. This acquisition expands our capabilities and expertise serving medical electronics manufacturers.

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

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

Overview:

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

In the second quarter we experienced a net sales increase of 24% over the prior year and a 12% increase in 90 day backlog from the start of the quarter. The increased volume had a positive impact on both our gross profit and operating income in the quarter. Gross profit rose to 12.6% of net sales and income from operations increased to $485,000. Our six months cash from operations was $0.4 million and we entered into a new three year financing arrangement with Wells Fargo Bank (see Note 3).

Summary of Results:

The second quarter of 2010 saw higher net sales than the previous five quarters and we made progress in improving profitability. For the quarter ended June 30, 2010, we reported net sales of $24.7 million compared to $19.9 million reported in the same quarter of 2009, a 24% improvement. Net sales of $46.4 million for the first six months of 2010 increased 12% over the $41.4 million reported for the first six months of 2009. We continue to see increased confidence by our customers to place orders as the 90-day backlog increased approximately 53% to $21.3 million as of June 30, 2010 compared to $13.9 million for the same period last year. Leveraging from our volume increase, cost controls and continuous improvement programs increased our second quarter gross margin to 12.6%, up from 12.1% in the previous quarter and single digits throughout most of 2009.

Income from operations for the second quarter of 2010 totaled $0.5 million, compared to loss from operations of $2.2 million in the same quarter of 2009, which included one-time restructuring and impairment charges of $0.6 million. Income from operations for the first six months of 2010 totaled $0.8 million compared to a loss from operations of $4.3 million, which included one-time restructuring and impairment charges of $0.6 million, reported in the first six months of 2009. Net income for the second quarter of 2010 totaled $0.1 million or $0.05 per diluted common share, compared to net loss of $1.5 million, or $0.56 per diluted common share, including one-time restructuring and impairment charges, or $0.42 excluding one-time restructuring and impairment charges, reported in the second quarter of 2009. Net income for the six months ended June 30, 2010 was $0.2 million or $0.09 per diluted common share, compared to a loss of $2.8 million or $1.04 per diluted common share, including one-time restructuring and impairment charges, or $0.90 excluding one-time restructuring and impairment charges, for the six months ended June 30, 2009.

Cash flow provided by operating activities for the six months ended June 30, 2010 was $0.4 million despite adding $1.9 million of inventories. This is compared to cash used in operations of $1.8 million

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for the same period in 2009. In addition, we entered into a new three year financing arrangement with Wells Fargo Bank (see Note 3).

(1.) Results of Operations:

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

	Three Months Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
Net Sales	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold	87.4%	94.5%	87.6%	95.3%
Gross Profit	12.6%	5.5%	12.4%	4.7%
Selling Expenses	3.1%	5.7%	3.3%	6.1%
General and Administrative Expenses	7.5%	7.8%	7.4%	7.5%
Restructuring and Impairment Charges	0.0%	3.2%	0.0%	1.6%
Income (Loss) from Operations	2.0%	-11.2%	1.7%	-10.5%
Other Expenses, Net	0.4%	1.0%	0.6%	0.6%
Income Tax Expense (Benefit)	1.0%	-4.4%	0.6%	-4.3%
Net Income (Loss)	0.6%	-7.8%	0.5%	-6.8%

Net Sales:

We reported net sales of $24.7 million and $19.9 million for the three months ended June 30, 2010 and 2009, respectively. Sales for the six months ended June 30, 2010 and 2009 were $46.4 million and $41.4 million, respectively. The Milaca medical device operation acquired in May 2010 accounted for $874,000 of net sales in both the three and six months ended June 30, 2010. Net sales by industry markets for the three and six-month periods ended June 30, 2010 and 2009 are as follows:

	Three Months Ended June 30			Six Months Ended June 30		
	2010	2009	%	2010	2009	%
(in thousands)	$	$	Change	$	$	Change
Aerospace and Defense	3,445	7,692	(55)	8,073	16,553	(51)
Medical	6,567	3,657	80	11,960	7,876	52
Industrial	14,683	8,542	72	26,403	17,013	55
Total Sales	24,695	19,891	24	46,436	41,442	12

Net sales to our Aerospace and Defense customers were down due to the end of major contracts and the timing of new replacement business while net sales from our Medical and Industrial customers saw significant increases as the overall economy stabilized and we began to see increased buying confidence in these industry sectors.

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Backlog:

Our 90-day order backlog as of June 30, 2010 was approximately $21.3 million, compared to approximately $19.0 million at the beginning of the quarter and $13.9 million at June 30, 2009. During the quarter we continued to see increased customer activity along with increased levels of quoting from both new and existing customers. The Milaca medical device operation acquired in May 2010 accounted for $1.7 million of the 90 day medical and total backlog at June 30, 2010. Backlog by industry market is shown below.

	Backlog as of the Quarter Ended		
(in thousands)	June 30 2010	March 31 2010	% Change
Aerospace and Defense	$ 4,559	$ 4,227	8
Medical	6,537	4,493	45
Industrial	10,212	10,249	
Total Backlog	$ 21,308	$ 18,969	12

Gross Profit:

Gross profit percentage for the three months and six months ended June 30, 2010 was 12.6% and 12.4% of net sales, respectively. Gross profit percentage for the three and six months ended June 30, 2009 was 5.5% and 4.7%, of net sales, respectively. We continue to see gross profit improvement from our higher volumes which increased absorption of our fixed overhead costs and continuous improvement programs.

Selling Expense:

We had selling expenses of $0.8 million or 3.1% of net sales and 1.5 million or 3.3% of net sales for the three and six months ended June 30, 2010, respectively. Selling expenses for the three and six months ended June 30, 2009 were $1.1 million or 5.7% of net sales and $2.5 million or 6.1% of net sales, respectively. Selling expenses are down as a result of lower spending, lower commissionable sales, and reduced payroll related expenses.

General and Administrative Expense:

General and administrative expenses as a percent of net sales remained relatively flat for the three and six-month periods ended June 30, 2010 and 2009. Our general and administrative expenses were $1.9 million or 7.5% of net sales and $3.4 million or 7.4% of net sales for the three and six months ended June 30, 2010, respectively. General and administrative expenses for the three and six months ended June 30, 2009 were $1.5 million or 7.8% of net sales and $3.1 million of 7.5% of net sales, respectively.

Other Expense:

Other expenses, net were $92,858 and $193,632 for the three months ended June 30, 2010 and 2009, respectively. Other expenses, net were $263,356 and $278,810 for the six months ended June 30, 2010 and 2009. The decrease in other expenses from second quarter of 2010 compared to second quarter of 2009 relate primarily to exchange rate fluctuations and decreased interest expense.

Income Taxes:

Income tax expense for the three and six months ended June 30, 2010 was $245,000 and $305,000 or approximately 62% and 56%, respectively. The annual effective tax rate for 2010 is expected to be approximately 36%. The increase in the quarterly effective tax rate over the expected annual effective rate is primarily the result of a true up of our federal tax refund which resulted in additional tax

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expense of approximately $101,000 in the second quarter. The income tax benefit for the three and six months ended June 30, 2009 was $867,000 and $1,786,000 or approximately 39% and 42%, respectively. The annual effective rate for 2009 was 37%. The slight decrease in rate from 2009 principally relates to the addition of the domestic production deduction offset in part by the reduction in benefit from the absence of a federal R&D benefit.

Liquidity and Capital Resources:

We have satisfied our liquidity needs over the past several years through revenue generated from operations and an operating line of credit through WFB. Both the line of credit and real estate term note are subject to fluctuations in the LIBOR rates. The line of credit and real estate term note with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under our line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line of credit is secured by substantially all of our assets. On June 30, 2010, we had an outstanding balance of $6.8 million under the line of credit and unused availability of $1.4 million supported by our borrowing base. We believe our financing arrangements and cash flows provided by operations, including the subsequent receipt of $2.4 million of income tax refunds received on July 3rd, will be sufficient to satisfy our working capital needs.

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

	June 30, 2010	December 31, 2009	December 31, 2008	December 31, 2007
Current Ratio (Current Assets / Current Liabilities)	1.58	1.71	1.74	1.68
Working Capital (Current Assets Current Liabilities)	$ 13,483,662	$ 13,215,800	$ 15,777,784	$ 14,812,352
Quick Ratio (Cash + Accounts Receivable / Current Liabilities)	0.65	0.66	0.65	0.75
Accounts Receivable to Working Capital (Average Accounts Receivable/ Working Capital)	0.97	0.90	0.97	1.01
Inventories to Working Capital (Average Inventories/ Working Capital)	1.32	1.19	1.33	1.18

Our working capital of $13.5 million as of June 30, 2010 increased from $13.2 million at December 31, 2009 partially due to the increases in inventories of $1.9 million and accounts receivables of $2.3 million during the first six months of 2010, which were partially offset by higher accounts payable of $1.9 million and higher accrued payroll and benefits of $1.6 million.

Net cash provided by operations for the six months ended June 30, 2010 was $0.4 million. The cash flow provided by operations for the six months ended June 30, 2010 is the result of net income of $0.2 million, adjusted for noncash adjustments including depreciation, amortization, and stock-based

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compensation expense which combined totaled $0.9 million in positive adjustments. In addition, the increases in inventories of $1.9 million and accounts receivable of $2.3 million were offset by increases in accounts payable and accruals of $3.2 million and a decrease in prepaids and income taxes receivable of $0.3 million. The inventories and accounts receivable increases are related to increased net sales and customer orders in the first six months of 2010.

Net cash used in investing activities of $0.6 million for the six months ended June 30, 2010 is comprised of $0.2 million in property and equipment purchases to support the business and $0.4 million for the Milaca operation acquisition (see Note 9).

Net cash provided by financing activities for the six months ended June 30, 2010 was $0.7 million, due to the increase in borrowings on the line of credit of $1.3 million, partially offset by principal debt payments of $0.6 million.

Critical Accounting Policies and Estimates

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

Forward-Looking Statements:

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

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

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

The factors identified above are believed to be important factors (but not necessarily all of the important factors) that could cause actual results to differ materially from those expressed in any forward-looking statement made by us. Unpredictable or unknown factors not discussed herein could also have material adverse effects on forward-looking statements. All forward-looking statements

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included in this Form 10-Q are expressly qualified in their entirety by the forgoing cautionary statements. We undertake no obligations to update publicly any forward-looking statement (or its associated cautionary language) whether as a result of new information or future events.

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

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures:

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

Changes in Internal Control Over Financial Reporting:

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

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PART II

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 6. EXHIBITS

(a) Exhibits

10.6	Third Amended and Restated Credit and Security Agreement between the Company and Wells Fargo Bank, National Association.
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
32	Certification of the Chief Executive Officer and Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signatures

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

Nortech Systems Incorporated and Subsidiary

Date: August 12, 2010	by	/s/ Michael J. Degen
	Michael J. Degen President and Chief Executive Officer	
Date: August 12, 2010	by	/s/ Richard G. Wasielewski
	Richard G. Wasielewski Chief Financial Officer	