

ALBANY INTERNATIONAL CORP /DE/
Form 10-Q
August 08, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended: June 30, 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: 0-16214

ALBANY INTERNATIONAL CORP.

(Exact name of registrant as specified in its charter)

Delaware

14-0462060

(State or other jurisdiction of
incorporation or organization)

(IRS Employer Identification No.)

1373 Broadway, Albany, New York

12204

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code 518-445-2200

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.

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Large accelerated filer x

Accelerated filer o

Non-accelerated filer o

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

The registrant had 25,846,321 shares of Class A Common Stock and 3,236,098 shares of Class B Common Stock outstanding as of June 30, 2006.

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ALBANY INTERNATIONAL CORP.
CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS
(in thousands except per share data)
(unaudited)

Three Months Ended June 30,			Six Months Ended June 30,	
2006	2005		2006	2005
\$ 261,630	\$ 247,406	Net sales	\$ 512,853	\$ 488,470
157,621	146,231	Cost of goods sold	304,868	288,960
104,009	101,175	Gross profit	207,985	199,510
75,064	69,139	Selling, technical, general and research expenses	149,626	137,680
28,945	32,036	Operating income	58,359	61,830
2,712	3,125	Interest expense, net	4,591	6,814
(137)	263	Other (income)/expense, net	772	1,581
26,370	28,648	Income before income taxes	52,996	53,435
7,749	8,595	Income tax expense	15,737	14,643
18,621	20,053	Income before associated companies	37,259	38,792
66	298	Equity in earnings of associated companies	243	468
18,687	20,351	Net income	37,502	39,260
511,156	450,432	Retained earnings, beginning of period	495,018	434,057
(2,945)	(2,548)	Dividends declared	(5,622)	(5,082)
\$ 526,898	\$ 468,235	Retained earnings, end of period	\$ 526,898	\$ 468,235
Earnings per share:				
\$ 0.63	\$ 0.64	Basic	\$ 1.23	\$ 1.24
\$ 0.62	\$ 0.63	Diluted	\$ 1.21	\$ 1.22
Shares used in computing earnings per share:				
29,554	31,770	Basic	30,481	31,653
30,094	32,374	Diluted	31,019	32,304
\$ 0.10	\$ 0.08	Dividends per share	\$ 0.19	\$ 0.16

The accompanying notes are an integral part of the financial statements.

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ALBANY INTERNATIONAL CORP.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	(unaudited) June 30, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	\$ 103,575	\$ 72,771
Accounts receivable, net	146,681	132,247
Note receivable	18,332	17,827
Inventories	220,528	194,398
Deferred taxes	19,239	22,012
Prepaid expenses	9,154	7,892
Total current assets	517,509	447,147
Property, plant and equipment, net	361,788	335,446
Investments in associated companies	6,968	6,403
Intangibles	15,242	12,076
Goodwill	168,351	153,001
Deferred taxes	77,124	75,875
Cash surrender value of life insurance policies	39,486	37,778
Other assets	28,719	19,321
Total assets	\$ 1,215,187	\$ 1,087,047
LIABILITIES AND SHAREHOLDERS EQUITY		
Notes and loans payable	\$ 6,705	\$ 6,151
Accounts payable	44,497	36,775
Accrued liabilities	129,418	116,395
Current maturities of long-term debt	11,157	1,009
Income taxes payable and deferred	11,465	14,793
Total current liabilities	203,242	175,123
Long-term debt	331,857	162,597
Other noncurrent liabilities	151,351	144,905
Deferred taxes and other credits	31,659	29,504
Total liabilities	718,109	512,129
Commitments and Contingencies		
SHAREHOLDERS EQUITY		
Preferred stock, par value \$5.00 per share; authorized 2,000,000 shares; none issued		
Class A Common Stock, par value \$.001 per share; authorized 100,000,000 shares; issued 34,387,512 in 2006 and 34,176,010 in 2005	34	34
Class B Common Stock, par value \$.001 per share; authorized 25,000,000 shares; issued and outstanding 3,236,098 in 2006 and 3,236,476 in 2005	3	3
Additional paid in capital	312,218	319,372
Retained earnings	526,898	495,018
Accumulated items of other comprehensive income:		
Translation adjustments	(42,469)	(71,205)
Pension liability adjustment	(40,340)	(40,340)
	756,344	702,882

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Less treasury stock (Class A), at cost (8,541,191 shares in 2006 and 5,050,159 shares in 2005)	259,266	127,964
Total shareholders' equity	497,078	574,918
Total liabilities and shareholders' equity	\$ 1,215,187	\$ 1,087,047

The accompanying notes are an integral part of the financial statements.

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ALBANY INTERNATIONAL CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30,	
	2006	2005
OPERATING ACTIVITIES		
Net income	\$ 37,502	\$ 39,260
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in earnings of associated companies	(243)	(468)
Depreciation	26,936	26,317
Amortization	1,961	1,989
Provision for deferred income taxes, other credits and long-term liabilities	5,024	5,412
Provision for write-off of equipment	321	1,262
Increase in cash surrender value of life insurance	(1,708)	(1,596)
Unrealized currency transaction gains and losses	1,436	(1,867)
Shares contributed to ESOP	4,183	3,364
Stock option expense	770	
Tax benefit of options exercised	(529)	2,050
Changes in operating assets and liabilities, net of business acquisition:		
Accounts receivable	(7,976)	(3,663)
Note receivable	(505)	(913)
Inventories	(20,055)	(14,097)
Prepaid expenses	(999)	(425)
Accounts payable	(3,048)	(3,101)
Accrued liabilities	8,834	1,404
Income taxes payable	(2,551)	(5,209)
Other, net	(3,562)	107
Net cash provided by operating activities	45,791	49,826
INVESTING ACTIVITIES		
Purchases of property, plant and equipment	(32,352)	(18,478)
Purchased software	(147)	(1,647)
Proceeds from sale of assets		5,067
Acquisitions, net of cash acquired	(8,112)	
Net cash used in investing activities	(40,611)	(15,058)
FINANCING ACTIVITIES		
Proceeds from borrowings	192,996	15,586
Principal payments on debt	(15,677)	(23,362)
Purchase of treasury shares	(131,499)	(1,576)
Purchase of call options on common stock	(47,688)	
Sale of common stock warrants	32,961	
Proceeds from options exercised	1,926	5,936
Tax benefit of options exercised	529	
Debt issuance costs	(5,434)	
Dividends paid	(5,658)	(5,044)
Net cash provided by/(used in) financing activities	22,456	(8,460)
Effect of exchange rate changes on cash flows	3,168	(7,919)

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Increase in cash and cash equivalents	30,804	18,389
Cash and cash equivalents at beginning of year	72,771	58,982
Cash and cash equivalents at end of period	\$ 103,575	\$ 77,371

The accompanying notes are an integral part of the financial statements.

ALBANY INTERNATIONAL CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Management Opinion

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments necessary for a fair presentation of results for such periods. The results for any interim period are not necessarily indicative of results for the full year. The preparation of financial statements for interim periods does not require all of the disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. These consolidated financial statements should be read in conjunction with financial statements and notes thereto for the year ended December 31, 2005.

As more fully discussed in Note 11, the Company adopted Financial Accounting Standard No. 123 (Revised) Share-Based Payment (FAS No. 123R) effective January 1, 2006. The Company adopted the modified prospective transition method provided under FAS No. 123R and, accordingly, has not retroactively adjusted results of prior periods.

2. Inventories

Inventories consist of the following:

(in thousands)	June 30, 2006	December 31, 2005
Finished goods	\$ 122,526	\$ 105,800
Work in process	55,842	55,039
Raw material and supplies	42,160	33,559
Total inventories	\$ 220,528	\$ 194,398

Inventories are stated at the lower of cost or market and are valued at average cost, net of reserves. The Company records a provision for obsolete inventory based on the age and category of the inventories.

3. Goodwill and other Intangible Assets

The Company accounts for goodwill and other intangible assets under the provisions of Statement of Financial Accounting Standards No. 142 (FAS No. 142), Goodwill and Other Intangible Assets. FAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually.

The Company performs the test for goodwill impairment during the second quarter of each year. As a result of the test performed in the second quarter of 2006, no impairment provision was required. Goodwill and other long-lived assets are reviewed for impairment whenever events, such as significant changes in the business climate, plant closures, changes in product offerings, or other circumstances indicate that the carrying amount may not be recoverable.

The Company is continuing to amortize certain patents, trade names and customer contracts that have finite lives.

The changes in intangible assets and goodwill from December 31, 2005 to June 30, 2006, were as follows:

(in thousands)	Balance at December 31, 2005	Increases	Amortization	Currency translation	Balance at June 30, 2006
Amortized intangible assets:					
Trade names	\$ 2,658	\$ 70	(\$288)	75	2,515
Patents	2,756		(237)	98	2,617
Customer contracts		3,630	(182)		3,448
Deferred pension costs	6,662				6,662
Total amortized intangible assets	\$ 12,076	\$ 3,700	(\$707)	\$ 173	\$ 15,242

(in thousands)	Balance at December 31, 2005	Increases	Currency translation	Balance at June 30, 2006
Goodwill	\$ 153,001	\$ 7,531	\$ 7,819	\$ 168,351

The increase in goodwill relates to the acquisition of Texas Composite Inc. (TCI) and the purchase of certain assets of Aztex, Inc. TCI and Aztex are aerospace composite manufacturing companies. These acquisitions have been integrated into Albany Engineered Composites, a business of the Applied Technologies segment.

The Company paid \$6.7 million in January 2006, and expects to pay \$8.0 million in the fourth quarter of 2006 for the purchase of TCI. The purchase price was allocated as follows: \$7.1 million to property, plant and equipment, \$4.9 million to goodwill, \$3.7 million to intangibles, \$4.0 million to other assets, and \$5.0 million to liabilities. The Company has not completed its purchase price allocation for deferred taxes that relate to the TCI acquisition.

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The Company has not completed its purchase price allocation related to the Aztex transaction, principally due to an ongoing valuation analysis of intangible assets.

As of June 30, 2006, goodwill included \$115.9 million in the Paper Machine Clothing segment, \$23.5 million in the Applied Technologies segment, and \$29.0 million in the Albany Door Systems segment.

Estimated amortization expense of intangibles for the years ending December 31, 2006 through 2010, is as follows:

Year	Annual amortization (in thousands)
2006	\$ 1,600
2007	1,500
2008	1,500
2009	1,400
2010	1,300
	\$ 7,300

4. Other Expense, Net

Other expense, net consists of the following:

(in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Currency transactions	(\$ 1,520)	(\$ 314)	(\$ 2,283)	(\$ 1,362)
Debt costs	447	314	928	640
Securitization program	889	702	1,681	1,555
License expense/(income)	166	(145)	112	404
Settlement of legal claims		(6)	240	229
Other miscellaneous (income)/expense	(119)	(288)	94	115
Total	(\$ 137)	\$ 263	\$ 772	\$ 1,581

The Company has a program whereby it may sell, without recourse, certain North American accounts receivable to a Qualified Special Purpose Entity (QSPE), as defined under Financial Accounting Standard, No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (FAS No. 140). The QSPE is a wholly owned subsidiary of the Company and, in accordance with FAS No. 140, its financial statements are not consolidated with the financial statements of the Company.

The QSPE finances a portion of the accounts receivable purchased by selling an undivided ownership interest in the pool of purchased receivables to an unrelated third party for cash. The balance of the purchase price is financed by the Company, in exchange for a note receivable. In addition to financing a portion of the purchase price, the Company performs certain administration functions for the QSPE, including collecting the accounts receivable, in exchange for a fee. Eligible accounts receivable are sold at a discount to the QSPE on an ongoing basis at the discretion of the Company and the amount is subject to change. The Company does not retain an interest in the accounts receivable sold. The eligibility of accounts receivable is based on certain criteria agreed to by the Company and the unrelated third party. The discount rate is determined by the average time the accounts receivable are outstanding, current interest rates, and estimated credit losses.

The amount of receivables sold as of June 30, 2006 was approximately \$61.0 million. The Company received \$40.3 million in cash and a note receivable that has a balance of \$18.3 million in exchange for the accounts receivable sold. The discount is included in Other expense, net, and was \$1.7 million and \$1.6 million for the six months ending June 30, 2006 and 2005, respectively.

The QSPE receives cash from an unrelated third party in exchange for an undivided ownership interest in the accounts receivable. As of June 30, 2006, the QSPE had assets of \$19.1 million consisting primarily of the \$61.0 million of accounts receivable sold to it by the Company, net of the \$40.3 million interest sold to the unrelated third party, and an allowance for doubtful accounts. As of June 30, 2006, the liabilities of the QSPE were \$18.4 million consisting principally of the note payable to the Company, and equity was \$0.7 million.

5. Earnings Per Share

Earnings per share are computed using the weighted average number of shares of Class A Common Stock and Class B Common Stock outstanding during the period. Diluted earnings per share include the effect of all potentially dilutive securities.

The amounts used in computing earnings per share, including the effect on income and the weighted average number of shares of potentially dilutive securities, are as follows:

(in thousands, except market price data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income available to common shareholders	\$ 18,687	\$ 20,351	\$ 37,502	\$ 39,260
Weighted average number of shares:				
Weighted average number of shares used in calculating basic earnings per share	29,554	31,770	30,481	31,653
Effect of dilutive stock-based compensation plans:				
Stock options	491	604	489	651
Long-term incentive plan	49		49	
Weighted average number of shares used in calculating diluted earnings per share	30,094	32,374	31,019	32,304
Average market price of common stock used for calculation of dilutive shares	\$ 39.68	\$ 31.54	\$ 38.38	\$ 32.14
Earnings per share:				
Basic	\$ 0.63	\$ 0.64	\$ 1.23	\$ 1.24
Diluted	\$ 0.62	\$ 0.63	\$ 1.21	\$ 1.22

There were no option shares that were excluded from the computation of diluted earnings per share in any of the periods presented. As of June 30, 2006, there was no dilution resulting from convertible debt instrument, purchased call option, and warrant that are described in Note 13.

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The following table presents the number of shares issued and outstanding:

	Class A Shares	Class B Shares	Less: Treasury Shares	Net shares Outstanding
December 31, 2005	34,176,010	3,236,476	(5,050,159)	32,362,327
March 31, 2006	34,307,097	3,236,098	(7,791,439)	29,751,756
June 30, 2006	34,387,512	3,236,098	(8,541,191)	29,082,419

6. Comprehensive Income

Comprehensive income consists of the following:

(in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income	\$ 18,687	\$ 20,351	\$ 37,502	\$ 39,260
Other comprehensive income/(loss), before tax:				
Foreign currency translation adjustments	22,019	(29,119)	28,736	(54,915)
Current period change in fair value of interest rate swaps		1,808		4,146
Income taxes related to the change in fair value of interest rate swaps		(705)		(1,617)
Other comprehensive income/(loss), net of tax	22,019	(28,016)	28,736	(52,386)
Comprehensive income/(loss)	\$ 40,706	(\$ 7,665)	\$ 66,238	(\$ 13,126)

7. Changes in Stockholders' Equity

The following table summarizes changes in Stockholders' Equity:

(in thousands)	Class A Common Stock	Class B Common Stock	Additional paid in capital	Retained earnings	Accumulated items of other comprehensive income	Treasury stock	Total Shareholders Equity
December 31, 2005	\$ 34	\$ 3	\$ 319,372	\$ 495,018	(\$ 111,545)	(\$ 127,964)	\$ 574,918
Net income				37,502			37,502
Shares contributed to ESOP			4,183				4,183
Purchase of treasury shares						(131,499)	(131,499)
Purchase of call options on common stock			(47,688)				(47,688)
Sale of common stock warrants			32,961				32,961
Proceeds from options exercised			1,926				1,926
Dividends declared				(5,622)			(5,622)
Stock option expense			770				770
Tax benefit of options exercised			529				529
Cummulative translation adjustment/other			165		28,736	197	29,098
June 30, 2006	\$ 34	\$ 3	\$ 312,218	\$ 526,898	(\$ 82,809)	(\$ 259,266)	\$ 497,078

8. Operating Segment Data

The following table shows data by operating segment, reconciled to consolidated totals included in the financial statements:

(in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net Sales				
Paper Machine Clothing	\$ 194,461	\$ 185,265	\$ 378,357	\$ 364,842
Applied Technologies	37,765	34,485	75,607	66,646
Albany Door Systems	29,404	27,656	58,889	56,982
Consolidated total	\$ 261,630	\$ 247,406	\$ 512,853	\$ 488,470
Operating Income				
Paper Machine Clothing	\$ 40,232	\$ 42,065	\$ 80,788	\$ 83,969
Applied Technologies	5,107	6,007	11,255	11,461
Albany Door Systems	1,214	624	3,499	2,390
Research expense	(7,997)	(7,114)	(16,536)	(14,214)
Unallocated expenses	(9,611)	(9,546)	(20,647)	(21,776)
Operating income before reconciling items	28,945	32,036	58,359	61,830
Reconciling items:				
Interest expense, net	(2,712)	(3,125)	(4,591)	(6,814)
Other income/(expense), net	137	(263)	(772)	(1,581)
Consolidated income before income taxes	\$ 26,370	\$ 28,648	\$ 52,996	\$ 53,435

There were no material changes in the total assets of the reportable segments during the six months ended June 30, 2006.

9. Income Taxes

The effective income tax rate was 29.4 percent for the second quarter of 2006, compared to 30.0 percent for the same period of 2005. For the first six months of 2006, the effective income tax rate was 29.7 percent, compared to 27.4 percent for the same period of 2005, which included the favorable resolution of certain income tax contingencies. The Company currently anticipates its consolidated tax rate in 2006 will not exceed 30 percent before any discrete items, although there can be no assurance that this will not change.

10. Contingencies

Albany International Corp. (Albany) is a defendant in suits brought in various courts in the United States by plaintiffs who allege that they have suffered personal injury as a result of exposure to asbestos-containing products previously manufactured by Albany. Albany produced asbestos-containing paper machine clothing synthetic dryer fabrics marketed during the period from 1967 to 1976 and used in certain paper mills. Such fabrics generally had a useful life of three to twelve months.

Albany was defending against 20,246 claims as of August 4, 2006. This compares with 20,726 such claims as of April 21, 2006, 24,451 claims as of December 31, 2005, 24,406 claims as of October 21, 2005, 29,411 claims as of December 31, 2004, 28,838 claims as of December 31, 2003, 22,593 claims as of December 31, 2002, 7,347 claims as of December 31, 2001, 1,997 claims as of December 31, 2000, and 2,276 claims as of December 31, 1999. These suits allege a variety of lung and other diseases based on alleged exposure to products previously manufactured by Albany.

Albany anticipates that additional claims will be filed against it and the related companies in the future but is unable to predict the number and timing of such future claims. These suits typically involve claims against from twenty to over two hundred defendants, and the complaints usually fail to identify the plaintiffs work history or the nature of the plaintiffs alleged exposure to Albany s products. Pleadings and discovery responses in those cases in which work histories have been provided indicate claimants with paper mill exposure in less than 10% of total claims reported; and only a portion of those claimants have alleged time spent in a paper mill to which Albany is believed to have supplied asbestos-containing products.

As of August 4, 2006, approximately 13,641 of the claims pending against Albany are pending in Mississippi, in either State or Federal courts. This compares to 19,166 claims as of July 22, 2005, 24,865 claims as of July 23, 2004, and approximately 24,646 claims as of August 1, 2003.

A Mississippi Supreme Court decision rendered in 2004 resulted in the dismissal of a number of claims pending against Albany in Mississippi and may continue to impact the remaining claims. In that decision, the Mississippi Supreme Court ruled on the practice of filing multi-plaintiff asbestos cases against numerous defendants. As a result, State courts in counties throughout Mississippi began to issue orders severing the individual claims of plaintiffs in mass joinder asbestos cases. Once severed, the plaintiffs were ordered to file amended complaints with more detailed information regarding their allegations of asbestos exposure to establish proper jurisdiction and venue, with the stated intention that any improperly filed claim would be dismissed or transferred. As a consequence, a number of plaintiffs voluntarily dismissed their claims and others were dismissed by Court order. In cases where plaintiffs filed amended complaints, their cases were transferred to the proper counties within Mississippi. In approximately 2,582 cases the plaintiffs arranged for the removal of their cases to Federal court, either with or without filing amended complaints. As of August 4, 2006, approximately 7,466 of the claims against Albany pending in Mississippi are now in Federal court, either through removal or original jurisdiction.

Those Federal Court claims are before the Federal Multidistrict Litigation (MDL) Panel for asbestos cases. A number of procedural challenges have been made at the MDL, but the Company cannot predict the outcomes of those challenges. The Company does expect that a small number of the remaining claims pending in Mississippi State courts could yet be dismissed, or transferred as the Mississippi Supreme Court ruling continues to be implemented, though not at the rates previously seen. At that point the only claimants remaining in Mississippi State courts will be those who are residents of, or who allege exposure to asbestos in, that State, and whose amended complaints satisfy the requirement for specific information regarding their exposure claims. The Company expects that only a portion of these remaining claimants will be able to demonstrate time spent in a paper mill to which Albany supplied asbestos-containing products during a period in which Albany s asbestos-containing products were in use. Based on past experience, communications from

certain plaintiffs' counsel and the advice of the Company's Mississippi counsel, the Company expects the percentage of claimants with paper mill exposure in the Mississippi proceedings to be considerably lower than the total number of claims previously asserted. However, due to the fact that the effects of the mandate of the Mississippi Supreme Court are taking time to be fully realized, the Company does not believe a meaningful estimate can be made regarding the expected reduction in claims or the range of possible loss with respect to the remaining claims.

It is the position of Albany and the other paper machine clothing defendants that there was insufficient exposure to asbestos from any paper machine clothing products to cause asbestos-related injury to any plaintiff. Furthermore, asbestos contained in Albany's synthetic products was encapsulated in a resin-coated yarn woven into the interior of the fabric, further reducing the likelihood of fiber release. While the Company believes it has meritorious defenses to these claims, it has settled certain of these cases for amounts it considers reasonable given the facts and circumstances of each case. The Company's insurer, Liberty Mutual, has defended each case and funded settlements under a standard reservation of rights. As of August 4, 2006, the Company had resolved, by means of settlement or dismissal, 19,648 claims. The total cost of resolving all claims was \$6,671,000. Of this amount, \$6,636,000, or 99%, was paid by the Company's insurance carrier. The Company has approximately \$130 million in confirmed insurance coverage that should be available with respect to current and future asbestos claims, as well as additional insurance coverage that it should be able to access.

Brandon Drying Fabrics, Inc.

Brandon Drying Fabrics, Inc. (Brandon), a subsidiary of Geschmay Corp., is also a separate defendant in many of the asbestos cases in which Albany is named as a defendant. Brandon was defending against 9,399 claims as of August 4, 2006. This compares with 9,753 such claims as of April 21, 2006, 9,566 claims as of December 31, 2005, 9,608 claims as of October 21, 2005, 9,985 claims as of December 31, 2004, 10,242 claims as of December 31, 2003, 11,802 claims as of December 31, 2002, 8,759 claims as of December 31, 2001, 3,598 claims as of December 31, 2000, and 1,887 claims as of December 31, 1999. The Company acquired Geschmay Corp., formerly known as Wangner Systems Corporation, in 1999. Brandon is a wholly-owned subsidiary of Geschmay Corp. In 1978, Brandon acquired certain assets from Abney Mills (Abney), a South Carolina textile manufacturer. Among the assets acquired by Brandon from Abney were assets of Abney's wholly-owned subsidiary, Brandon Sales, Inc. which, among other things, had sold dryer fabrics containing asbestos made by its parent, Abney. It is believed that Abney ceased production of asbestos-containing fabrics prior to the 1978 transaction. Although Brandon manufactured and sold dryer fabrics under its own name subsequent to the asset purchase, none of such fabrics contained asbestos. Under the terms of the Assets Purchase Agreement between Brandon and Abney, Abney agreed to indemnify, defend, and hold Brandon harmless from any actions or claims on account of products manufactured by Abney and its related corporations prior to the date of the sale, whether or not the product was sold subsequent to the date of the sale. It appears that Abney has since been dissolved. Nevertheless, a representative of Abney has been notified of the pendency of these actions and demand has been made that it assume the defense of these actions. Because Brandon did not manufacture asbestos-containing products, and because it does not believe that it was the legal successor to, or otherwise responsible for obligations of, Abney with respect to products manufactured by Abney, it believes it has strong defenses to the claims that have been asserted against it. In some instances, plaintiffs have voluntarily dismissed claims against it, while in others it has entered into what it considers to be reasonable settlements. As of August 4, 2006, Brandon has resolved, by means of settlement or dismissal, 7,945 claims for a total of \$152,499. Brandon's insurance carriers initially agreed to pay 88.2% of the total indemnification and defense costs related to these proceedings, subject to the standard reservation of rights. The remaining 11.8% of the costs had been borne directly by Brandon. During 2004, Brandon's insurance carriers agreed to cover 100% of indemnification and defense costs, subject to policy limits and the

standard reservation of rights, and to reimburse Brandon for all indemnity and defense costs paid directly by Brandon related to these proceedings.

Mount Vernon

In some of these asbestos cases, the Company is named both as a direct defendant and as the successor in interest to Mount Vernon Mills (Mount Vernon). The Company acquired certain assets from Mount Vernon in 1993. Certain plaintiffs allege injury caused by asbestos-containing products alleged to have been sold by Mount Vernon many years prior to this acquisition. Mount Vernon is contractually obligated to indemnify the Company against any liability arising out of such products. The Company denies any liability for products sold by Mount Vernon prior to the acquisition of the Mount Vernon assets. Pursuant to its contractual indemnification obligations, Mount Vernon has assumed the defense of these claims. On this basis, the Company has successfully moved for dismissal in a number of actions.

While the Company does not believe, based on currently available information and for the reasons stated above, that a meaningful estimate of a range of possible loss can be made with respect to such claims, based on its understanding of the insurance policies available, how settlement amounts have been allocated to various policies, its recent settlement experience, the absence of any judgments against the Company or Brandon, the ratio of paper mill claims to total claims filed, and the defenses available, the Company currently does not anticipate any material liability relating to the resolution of the aforementioned pending proceedings in excess of existing insurance limits. Consequently, the Company currently does not anticipate, based on currently available information, that the ultimate resolution of the aforementioned proceedings will have a material adverse effect on the financial position, results of operations or cash flows of the Company. Although the Company cannot predict the number and timing of future claims, based on the foregoing factors and the trends in claims against it to date, the Company does not anticipate that additional claims likely to be filed against it in the future will have a material adverse effect on its financial position, results of operations or cash flows. However, the Company is aware that litigation is inherently uncertain, especially when the outcome is dependent primarily on determinations of factual matters to be made by juries. The Company is also aware that numerous other defendants in asbestos cases, as well as others who claim to have knowledge and expertise on the subject, have found it difficult to anticipate the outcome of asbestos litigation, the volume of future asbestos claims and the anticipated settlement values of those claims. For these reasons, there can be no assurance that the foregoing conclusions will not change.

Legislation has again been introduced in the United States Senate that is intended to address asbestos litigation by creating a privately funded trust to provide compensation to persons injured as the result of exposure to asbestos. The Fairness In Asbestos Injury Resolution Act Of 2006 (Fair Act) was introduced by Senators Leahy and Specter on May 25, 2006. If enacted into law, the Company would be required to make payments of up to \$1, 000,000 per year for up to 30 years to the privately funded, publicly administered trust fund. The payments would not be covered by any of the Company s insurance policies. The Company cannot predict whether the Fair Act, or any asbestos legislation, will ultimately be enacted into law.

11. Stock Options

Effective January 1, 2006, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Financial Accounting Standard No. 123 (Revised) Share-Based Payment (FAS No. 123R), as interpreted by SEC Staff Accounting Bulletin No. 107. The Company adopted the modified prospective transition method provided under FAS No. 123R, and, accordingly, has not retroactively adjusted results of prior periods. Under this transition method, compensation cost associated with stock options recognized in 2006 includes amortization related to the remaining unvested portion of all stock option awards granted prior to January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of FAS No. 123. For the six months ended June 30, 2006, the Company recognized approximately \$0.8 million in stock-based compensation expense, all of which was recorded in Selling, technical, general and research expenses. Adoption of FAS 123R had the effect of reducing net income by \$0.02 per share for the first six months of 2006. No stock-based compensation cost was recognized prior to January 1, 2006.

During 1988, 1992 and 1998, the shareholders approved stock option plans for key employees. The 1988 and 1992 plans, under which options can no longer be granted, each provided for the granting of up to 2,000,000 shares of Class A Common Stock. The 1998 plan provides for the granting of up to 5,000,000 shares of Class A Common Stock. In addition, in 1997 the Board of Directors granted one option outside these plans for 250,000 shares of Class A Common Stock. Options are normally exercisable in five cumulative annual amounts beginning 12 months after date of grant. Option exercise prices were normally equal to and were not permitted to be less than the market value on the date of grant. The option granted by the Board in 1997 is not exercisable unless the Company's share price reaches \$48 per share and exercise is then limited to 10% of the total number of shares multiplied by the number of full years of employment elapsed since the grant date. During 2000, the Board of Directors approved an amendment to increase the period after retirement to exercise options from 5 years to 10 years. This amendment, however, does not change the original termination date of each option. Unexercised options generally terminate twenty years after the date of grant for all plans.

There have been no stock options granted since November 2002. For options granted, the fair value of each option granted was estimated on the grant date using the Black-Scholes option-pricing model. No adjustments were made for certain factors that are generally recognized to reduce the value of option contracts because such impact was not considered material. These factors include limited transferability, a 20% per year vesting schedule, a share price threshold with vesting based on years of employment, and the risk of forfeiture of the non-vested portion if employment were terminated. The expected life of the options was based on employee groups and ranged from 11 to 20 years. Prior to 2006, the Company applied Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, in accounting for the stock option plans and, accordingly no compensation cost was recognized.

Prior to the adoption of FAS 123R, the Company presented all tax benefits for deductions resulting from the exercise of stock options and disqualifying dispositions as operating cash flows in the Consolidated Statement of Cash Flows. FAS 123R requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow. Total cash flow will remain unchanged from what would have been reported under prior accounting rules.

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If compensation cost of the Company's stock-based compensation plans had been determined consistent with FAS No. 123 for years prior to 2006, net income and earnings per share would have been adjusted to the following pro forma amounts:

(in thousands, except per share amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income, as reported	\$ 18,687	\$ 20,351	\$ 37,502	\$ 39,260
Deduct:				
Total stock-based employee compensation expense determined under fair value based method for all awards, net of taxes		(368)		(736)
Net income, pro forma	\$ 18,687	\$ 19,983	\$ 37,502	\$ 38,524
Basic net income per share:				
As reported	\$ 0.63	\$ 0.64	\$ 1.23	\$ 1.24
Pro forma	0.63	0.63	1.23	1.22
Diluted net income per share:				
As reported	\$ 0.62	\$ 0.63	\$ 1.21	\$ 1.22
Pro forma	0.62	0.62	1.21	1.19

A summary of option activity as of December 31, 2005 and year to date changes is presented below:

	Option shares	Weighted Average Exercise price	Remaining life	Aggregate Intrinsic value (000 s)
Outstanding at December 31, 2005	1,453,120	\$ 20.26		\$ 29,499
Exercised	(100,150)	19.23		2,136
Canceled	(18,950)	20.56		379
Outstanding at June 30, 2006	1,334,020	20.33	11.2	\$ 26,984
Exercisable at June 30, 2006	932,420	18.89	10.4	\$ 20,204

As of June 30, 2006, there were 515,455 shares available for future option grants.

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A summary of the Company's nonvested option shares as of December 31, 2005 and year to date changes is presented below:

	Option shares	Weighted Average Exercise price
Nonvested at December 31, 2005	233,700	\$ 21.64
Vested during period	(13,150)	20.56
Canceled	(18,950)	20.56
 Nonvested at June 30, 2006	 201,600	 \$ 21.81

The following is a summary of the status of options outstanding at June 30, 2006:

Exercise Price Range	Vested	Nonvested	Outstanding Options		Exercisable Options	
			Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
\$10.56	88,020		12.3	\$ 10.56	88,020	\$ 10.56
\$15.00 - \$15.69	95,900		10.3	15.51	95,900	15.51
\$16.25 - \$16.75	53,100		4.9	16.46	53,100	16.46
\$18.63 - \$18.75	59,200		7.4	18.73	59,200	18.73
\$19.38	85,900		10.3	19.38	85,900	19.38
\$19.75	73,900		10.2	19.75	73,900	19.75
\$20.45 - \$20.63	296,250	151,600	13.7	20.55	296,250	20.53
\$22.25	180,150		8.6	22.25	180,150	22.25
\$25.56	200,000	50,000	11.4	25.56		
	1,132,420	201,600	11.2	\$ 20.33	932,420	\$ 18.89

As of June 30, 2006, the aggregate intrinsic value of vested and nonvested options was \$22.9 million and \$4.1 million, respectively.

As of June 30, 2006, there was \$3.3 million of total unrecognized compensation cost related to stock option grants. The Company expects approximately \$1.6 million of compensation cost to be recognized in 2006, \$0.8 million in 2007, and \$160,000 per year from 2008 to 2017.

In 2005, shareholders approved the Albany International 2005 Incentive Plan. The plan provides key members of management with incentive compensation based on achieving certain performance targets. The incentive compensation award is paid out over three years, partly in cash and partly in shares of Class A Common Stock. In March 2006, cash payments totaling \$1.2 million were made under this plan. Shares that are expected to be paid out are included in the calculation of diluted earnings per share. If a person terminates employment prior to the award becoming fully vested, the person will forfeit a portion of the incentive compensation award. In accordance with FASB Interpretation No. 28,

Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, expense associated with this plan is recognized over the vesting period which includes the year for which performance targets are measured and the two subsequent years.

12. Pensions and Other Benefits

The Company sponsors defined benefit pension plans in various countries. The amount of contributions to the plans is based on several factors including the funding rules in each country. The Company expects to contribute approximately \$26.5 million to its pension plans in 2006. The Company also provides certain medical, dental and life insurance benefits (Other Benefits) for retired United States employees that meet program qualifications. The Company currently funds this plan as claims are paid.

The components of net periodic benefit cost for the three months ended June 30, 2006 and 2005 are, as follows:

(in thousands)	Pension Plans		Other Benefits	
	2006	2005	2006	2005
Service cost	\$ 1,761	\$ 1,735	\$ 556	\$ 1,221
Interest cost	4,471	4,652	1,366	2,474
Expected return on plan assets	(4,405)	(4,245)		
Amortization:				
Transition obligation	27	6		
Prior service cost/(credit)	237	257	(1,138)	(236)
Net actuarial loss	1,361	1,355	980	1,417
Net periodic benefit costs	\$ 3,452	\$ 3,760	\$ 1,764	\$ 4,876

The components of net periodic benefit cost for the six months ended June 30, 2006 and 2005 are, as follows:

(in thousands)	Pension Plans		Other Benefits	
	2006	2005	2006	2005
Service cost	\$ 3,522	\$ 3,470	\$ 1,308	\$ 2,016
Interest cost	8,942	9,303	2,919	4,296
Expected return on plan assets	(8,810)	(8,491)		
Amortization:				
Transition obligation	54	13		
Prior service cost/(credit)	474	515	(2,276)	(473)
Net actuarial loss	2,722	2,709	2,183	2,211
Net periodic benefit costs	\$ 6,904	\$ 7,519	\$ 4,134	\$ 8,050

13. Long Term Debt

Long term debt consists of the following:

(in thousands)	June 30, 2006	December 31, 2005
Convertible notes issued in March 2006 with fixed interest rates of 2.25%, due in year 2026	\$ 180,000	
Private placement with a fixed interest rate of 5.34%, due in years 2013 through 2017	150,000	150,000
Various notes and mortgages relative to operations principally outside the United States, at an average rate of 5.76% in 2006 and 5.91% in 2005 due in varying amounts through 2021	1,900	2,312
Industrial revenue financings at an average interest rate of 6.97% in 2006 and 6.89% in 2005, due in varying amounts through 2009	11,114	11,294
Long term debt	343,014	163,606
Less: current portion	(11,157)	(1,009)
Long term debt, net of current portion	\$ 331,857	\$ 162,597

The weighted average rate for all debt decreased from 5.93% on December 31, 2005 to 3.73% on June 30, 2006.

In March 2006, the Company issued \$180 million principal amount of 2.25% convertible notes. The notes are convertible upon the occurrence of specified events and at any time on or after February 15, 2013, into cash up to the principal amount of notes converted and shares of the Company's Class A common stock with respect to the remainder, if any, of the Company's conversion obligation at an initial conversion rate of 22.462 shares per \$1,000 principal amount of notes (equivalent to an initial conversion price of \$44.52 per share of Class A common stock).

In connection with the offering, the Company has entered into convertible note hedge and warrant transactions with respect to its Class A common stock at a net cost of \$14.7 million. These transactions are intended to reduce the potential dilution upon conversion of the notes by providing the Company with the option, subject to certain exceptions, to acquire shares which offset the delivery of newly issued shares upon conversion of the notes.

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Emerging Issues Task Force (EITF) Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, (EITF 00-19) provides guidance for distinguishing between permanent equity, temporary equity and assets and liabilities. The convertible feature of the notes, the convertible note hedge, and the warrant transactions each meet the requirements of EITF 00-19 to be accounted for as equity instruments. As such, the convertible feature of the notes has not been accounted for as a derivative (which would be marked to market each reporting period) and in the event the debt is converted, no gain or loss is recognized as the cash payment of principal reduces the recorded liability and the issuance of common shares would be recorded in stockholders' equity.

In addition, the amount paid for the call option and the premium received for the warrant were recorded as additional paid-in capital in the accompanying consolidated balance sheet and are not accounted for as derivatives (which would be marked to market each reporting period). Incremental net shares for the convertible note feature and the warrant agreement will be included in future diluted earnings per share calculations for those periods in which the Company's average common stock price exceeds \$44.52 per share in the case of the Senior Notes and \$52.25 per share in the case of the warrants. The purchased call option is anti-dilutive and is excluded from the diluted earnings per share calculation.

On April 14, 2006, the Company entered into a new \$460 million five-year revolving credit agreement, which is currently undrawn. The agreement replaced a similar \$460 million revolving credit facility. Under the terms of the new agreement, commitment fees on the unused portion of the facility were reduced from 0.25 percent to 0.09 percent and the term was extended from 2009 to 2011. The applicable interest rate for borrowings under the new agreement, as well as under the old agreement, is LIBOR plus a spread, based on the Company's leverage ratio at the time of borrowing. Spreads under the new agreement are 15 to 50 basis points lower than under the old agreement. The new agreement includes covenants similar to the old agreement, which could limit the Company's ability to purchase Common Stock, pay dividends, or acquire other companies or dispose of its assets. The Company is also required to maintain a leverage ratio of not greater than 3.50 to 1.00 and a minimum interest coverage of at least 3.00 to 1.00. As of June 30, 2006, the Company's leverage ratio under the agreement was 1.43 to 1.00 and the interest coverage ratio was 15.71 to 1.00. The Company may purchase its Common Stock or pay dividends to the extent its leverage ratio remains at or below 2.50 to 1.00, and may make acquisitions provided its leverage ratio would not exceed 3.00 to 1.00 after giving pro forma effect to the acquisition.

14. Recent Accounting Pronouncements

In November 2004, the FASB issued FAS No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4. This Standard requires that items such as idle facility expense and excess spoilage be recognized as current period charges. Under ARB No. 43, such costs were considered inventoriable costs unless they were considered so abnormal as to require immediate expensing. The Company was required to adopt the Standard on January 1, 2006 and it did not have any effect on its financial statements.

In December 2004, the FASB issued FAS No. 123 (Revised) *Share-Based Payment* (FAS No. 123R). This Standard establishes accounting guidelines for transactions in which an entity exchanges its equity instruments for goods or services. The Standard focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. In April 2005, the Securities and Exchange Commission amended Regulation S-X to amend the date for compliance with FAS No. 123R, *Share-Based Payment* to fiscal years beginning on or after June 15, 2005. FAS 123R also requires that certain tax benefits resulting from stock options be classified in the Statement of Cash Flows as financing activities, instead of operating activities. The Company adopted the provisions of this Standard on January 1, 2006 and used the modified prospective transition method. Accordingly, the Company will recognize share-based compensation expense over the requisite service period of the awards. The Company expects that the adoption of this Standard will result in additional compensation expense for unvested options that were granted prior to 2003 of approximately \$1.6 million in 2006, \$0.8 million in 2007, and \$0.2 million per year from 2008 to 2017.

In May 2005, the FASB issued FAS No. 154, *Accounting Changes and Error Corrections* a replacement of APB Opinion No. 20 and FAS Statement No. 3. This Standard requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This Standard also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. In addition, this Standard requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate affected by a change in accounting principle. The Company adopted the Standard on January 1, 2006 and it did not have any effect on its financial statements.

In March 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, an Interpretation of FAS No. 143. This interpretation provides additional guidance as to when companies should record the fair value of a liability for a conditional asset retirement obligation when there is uncertainty about the timing and/or method of settlement of the obligation. The Company obtained documentation from each of its locations in order to determine whether there were any asset retirement obligations that required accrual or disclosure. The Company adopted the Standard on December 31, 2005 and it did not have any effect on its financial statements.

In February 2006, the FASB issued FAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, an amendment of FASB statements No. 133 and 140 (FAS No. 155). This Standard resolves and clarifies the accounting and reporting for certain financial instruments including, hybrid financial instruments with embedded derivatives, interest-only strips, and securitized financial instruments. FAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company will be required to adopt this Standard on January 1, 2007 and has not determined the effect that adopting FAS No. 155 will have on the financial statements.

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In March 2006, the FASB issued FAS No. 156, *Accounting for Servicing of Financial Assets*, an amendment of FAS No. 140. This Standard amends the accounting treatment with respect to separately recognized servicing assets and servicing liabilities, and is effective for fiscal years beginning after September 15, 2006. The Company does not expect adoption of this Standard to have a material effect on its financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an Interpretation of FAS No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation is effective for fiscal years beginning after December 15, 2006, and the Company is currently evaluating what impact it will have on its financial statements.

15. Subsequent event

On August 3, 2006, the Company announced a reduction in manufacturing capacity in North America. The Company intends to discontinue dryer fabric manufacturing operations at its facility in Quebec, Canada, and to shut down seaming capacity at its Menasha, Wisconsin forming fabric operation. The actions are the result of shifting paper machine clothing demand in the Americas, and the continuing closure of paper and paperboard machines in North America, especially Canada.

The Company estimates that it will incur termination and severance charges of approximately \$2.0 million and other cash charges of approximately \$0.5 million in connection with these actions. These charges will be reflected in third-quarter results, with the bulk of the cash payments to be made during the third quarter. In addition, the Company expects to incur additional charges of from \$2.0 to \$2.5 million related to the relocation or retirement of equipment at the affected locations. The timing and nature of these charges (i.e., cash or non-cash; operating or restructuring/non-operating) has not been determined, pending final determination by the Company of the ultimate disposition of each item.

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

For the Three and Six Month Periods Ended June 30, 2006

The following should be read in conjunction with the Consolidated Financial Statements and Notes thereto.
Critical Accounting Policies and Assumptions

The Company's discussion and analysis of its financial condition and results of operations are based on the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities.

The Company records sales when persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed, and collectibility is reasonably assured. The timing of revenue recognition is dependent upon the contractual arrangement between the Company and its customers. These arrangements, which may include provisions for transfer of title and guarantees of workmanship, are specific to each customer. Sales contracts in the Albany Door Systems segment may include product and installation services. For these sales, the Company applies the provisions of EITF 00-21, Revenue Arrangements with Multiple Deliverables. The Company's contracts that include product and installation services generally do not qualify as separate units of accounting and, accordingly, revenue for the entire contract value is recognized upon completion of installation services. The Company limits the concentration of credit risk in receivables by closely monitoring credit and collection policies. The Company records allowances for sales returns as a deduction in the computation of net sales. Such provisions are recorded on the basis of written communication with customers and/or historical experience.

The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Goodwill and other long-lived assets are reviewed for impairment whenever events such as significant changes in the business climate, plant closures, changes in product offerings, or other circumstances indicate that the carrying amount may not be recoverable. The Company performs a test for goodwill impairment at least annually. The determination of whether these assets are impaired involves significant judgments based on short and long-term projections of future performance. Changes in strategy and/or market conditions may result in adjustments to recorded asset balances.

The Company has investments in other companies that are accounted for under equity method of accounting and are reported in the caption Investments in associated companies. The Company performs regular reviews of the financial condition of the investees to determine if its investment is impaired. If the financial condition of the investees were to no longer support their valuations, the Company would record an impairment provision.

The Company has pension and postretirement benefit costs and liabilities that are developed from actuarial valuations. Inherent in these valuations are key assumptions, including discount rates and expected return on plan assets, which are updated on an annual basis. The Company is required to consider current market conditions, including changes in interest rates, in making these assumptions. Changes in the related pension and postretirement benefit costs or credits may occur in the future due to changes in the assumptions. The amount of annual pension plan funding and annual expense is subject to many variables, including the investment return on pension plan assets and interest rates. Assumptions used for determining pension plan

liabilities and expenses are evaluated and updated at least annually. Discount rate assumptions are based on the population of plan participants and a mixture of high-quality fixed income investments for which the average maturity approximates the average remaining service period of plan participants. The assumption for expected return on plan assets is based on historical and expected returns on various categories of plan assets. The actual return on assets in the U.S. pension plan for 2005 was greater than the assumption. As of September 30, 2005, the measurement date for pension plans, the largest portion of pension plan assets (45% for the U.S. plan and 72% for non-U.S. plans) was invested in equities. For the U.S. pension plan mortality assumption, the Company uses the 1983 Group Annuity Mortality assumption updated to 1993. The Company has studied its actual mortality data for a recent six year period and found it to be consistent with that mortality table. Weakness in investment returns and low interest rates, or deviations in results from other assumptions, could result in the Company making equal or greater pension plan contributions in future years, as compared to 2005. The Company expects pension plan contributions to be approximately \$26.5 million in 2006, compared to actual contributions for 2005 of \$16.9 million.

The Company records deferred income tax assets and liabilities for the tax consequences of differences between financial statement and tax bases of existing assets and liabilities. A tax valuation allowance is established, as needed, to reduce net deferred tax assets to the amount expected to be realized. In the event it becomes more likely than not that some or all of the deferred tax asset allowances will not be needed, the valuation allowance will be adjusted.

The Company has a trade accounts receivable program whereby it sells, without recourse, certain North American accounts receivable to a qualified special purpose entity (QSPE), as defined under Financial Accounting Standard No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (FAS No. 140). The QSPE is a wholly owned subsidiary of the Company and, in accordance with FAS No. 140, its financial statements are not consolidated with the financial statements of the Company. The securitization program can be terminated at any time, with thirty days notice, by the Company or the unrelated third party. If the securitization program were terminated, the Company would not be required to repay cash received from the sale of accounts receivable, but no additional receivables would be sold under the program. Accounts receivable would increase as new sales were made, and the note receivable would decrease as the sold accounts receivable were collected. The Company might need to borrow from its existing credit facilities or use existing cash to fund operations until cash flow from accounts receivable returned to normal levels.

The QSPE receives cash from an unrelated third party in exchange for an undivided ownership interest in the accounts receivable. As of June 30, 2006, the QSPE had assets of \$19.1 million consisting primarily of the \$61.0 million of accounts receivable sold to it by the Company, net of the \$40.3 million interest sold to the unrelated third party, and an allowance for doubtful accounts. As of June 30, 2006, the liabilities of the QSPE were \$18.4 million consisting principally of the note payable to the Company, and equity was \$0.7 million.

The Company has contingent liabilities for litigation, claims and assessments that result from the ordinary course of business. These matters are more fully described in Note 10 to the Consolidated Financial Statements.

Overview

The Company is engaged in three business segments: Paper Machine Clothing, Applied Technologies and Albany Door Systems.

The Company's largest segment is Paper Machine Clothing, which includes paper machine clothing and process belts (PMC), which are technologically sophisticated consumable products designed, manufactured

and marketed for each section of the paper machine. The design and material composition of clothing and belts can have a considerable effect on the quality of paper products produced and the efficiency of paper machines on which they are used. Paper machine clothing and belts have finite lives and must be replaced on a regular basis. The Company invests in research and development to maintain what it believes to be its position as the technology leader in the marketplace, and to continually improve the production processes and deliver increased value to customers. The Company's operations are strategically located in the major paper-producing regions of the world.

The Applied Technologies segment includes the businesses that apply the Company's core competencies in advanced textiles and materials to other industries including specialty materials and composite structures for aircraft and other applications (Albany Engineered Composites); fabrics, wires, and belting products for the nonwovens and pulp industries (Albany Engineered Fabrics); specialty filtration products for wet and dry applications (Albany Filtration Technologies); industrial belts for Tannery, Textile and Corrugator applications (Albany Industrial Process Belts); and insulation for personal outerwear and home furnishings (PrimaLoft®).

Albany Door Systems produces and services high-performance doors, which are primarily marketed to industrial and commercial enterprises requiring interior or external doors that involve either frequent openings or environmental contrasts between the two areas separated by the doors. High-performance doors open and close very rapidly, and may utilize electrical systems that assure automatic opening and closing under circumstances desired by customers. Although the Company's high-performance doors are marketed globally, its largest manufacturing operations are in Europe and North America.

Industry Trends

The Paper Machine Clothing segment has experienced significant change since 1999 as consolidation and restructuring impacted the global paper and paperboard industry and reduced the number of major paper machine clothing competitors.

Albany International is the paper machine clothing market leader, with a worldwide market share of approximately 30% for the year 2005. The market shares of each of the next largest competitors were approximately half that of Albany International's market share for the year 2005.

As part of the Company's long-term strategy to provide value to customers and to improve returns to shareholders, the Company has rationalized production capacity by closing and consolidating manufacturing facilities in North America and Europe, and announced that production capacity will be increased in Asia to meet that fast growing market.

According to published data, world paper and paperboard production volumes have grown at an annual rate of approximately 2.7% over the last ten years ending in 2005. Of the thousands of paper machines operating in the world, the Company estimates that approximately 5,000 machines represent the target market for the Company's paper machine clothing products. During the three year period ending December 2005, more than 150 paper machines in North America and Europe were shut down. These machine closures were partially offset by the start-up of approximately 45 new paper machines located around the world during the same period. Increases in paper production have a positive impact on demand for paper machine clothing, while the shutdown of paper machines, combined with increases in the efficiency of the remaining paper machines and the useful life of paper machine clothing, has a negative impact on demand. The Company anticipates continued growth for the long term in world paper and paperboard production. However, demand can be negatively affected in the shorter term by paper industry consolidation and rationalization.

Technological advances in paper machine clothing, while contributing to the papermaking efficiency of customers, have in some cases lengthened the useful life of the Company's products and reduced the number

of pieces required to produce the same volume of paper. While the Company is often able to charge higher prices for its products as a result of these improvements, increased prices may not always be sufficient to offset completely a decrease in the number of fabrics sold.

Although Paper Machine Clothing segment sales were higher in 2005 as compared to 2004, the Company's net sales of Paper Machine Clothing decreased in each of the three previous fiscal years after adjusting for currency translation effects. The trend toward a decrease in the ratio of PMC consumed to paper produced and the recent period of consolidation and rationalization may be significant contributors to the decline in sales for 2002, 2003 and 2004. The Company's strategy for dealing with these trends is to continue to focus on providing solutions for customers through new products and services, improving the Company's product mix and price structure, while at the same time identifying additional cost-saving opportunities and growing sales in other industries.

Challenges, Risks and Opportunities

The Paper Machine Clothing segment of the business is very competitive. Some competitors tend to compete more on the basis of price, while others, including the Company, attempt to compete more on the basis of technical performance of products and services. During the past three years, the Company has spent an average of 3% of its consolidated net sales on research and development, and expects to spend similar amounts in future periods. Failure to maintain or increase the product and service value delivered to customers in future periods could have a material impact on sales in this segment.

Some competitors in this segment have the ability to bundle sales of PMC with other papermaking equipment. This can result in additional discounts in their paper machine clothing.

The basic papermaking process, while it has undergone dramatic increases in efficiency and speed, has always relied on paper machine clothing. In the event that a paper machine builder or other person were able to develop a commercially viable manner of paper manufacture that did not require paper machine clothing, sales of the Company's products in this segment could be expected to decline significantly.

The Applied Technologies segment has experienced significant growth in net sales during the last two to three years, due to the introduction of new products and growth in demand and application of previously existing products. While opportunities for continued growth remain excellent, there can be no assurances that the growth in sales enjoyed during the last two to three years will continue.

Albany Door Systems derives most of its revenue from the sale of high-performance doors. The purchase of these doors is normally a capital expenditure item for customers and, as such, market opportunities tend to fluctuate with industrial capital spending. The majority of the segment's revenues are derived from sales and manufacturing outside of the United States, which can cause the reported financial results to be more sensitive to changes in currency rates than the other segments of the Company.

Foreign Currency

Albany International operates in many geographic regions of the world and has more than half of its business in countries outside the United States. A substantial portion of the Company's sales are denominated in euros or other currencies. In some locations, the profitability of transactions is affected by the fact that sales are denominated in a currency different from the currency in which the costs to manufacture and distribute the products are denominated. As a result, changes in the relative values of U.S. dollars, euros and other

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currencies affect revenues and profits as the results are translated into U.S. dollars in the consolidated financial statements.

From time to time, the Company enters into foreign currency or other derivative contracts in order to enhance cash flows or to mitigate volatility in the financial statements that can be caused by changes in currency exchange rates.

Results of Operations:

Total Company three months ended June 30, 2006

Net sales were \$261.6 million for the three months ended June 30, 2006 as compared to \$247.4 million for the three months ended June 30, 2005. Changes in currency translation rates had the effect of increasing net sales by \$2.9 million. Excluding the effect of changes in currency translation rates, net sales increased 4.6 percent as compared to the same period last year.

Second-quarter 2006 results reflected the continuation of the trends of the past several quarters. The highlights were record net sales, driven by continued top-line strength in PMC and growth in the emerging businesses, and the formal agreements in the aerospace composites business with Snecma and Messier-Dowty. These agreements validate the significant growth potential for Albany Engineered Composites.

The following table presents 2006 and 2005 net sales by segment and the effect of changes in currency translation rates:

(in thousands)	Three months ended June 30,		Percent change	Increase in 2006 sales due to changes in currency translation rates	Percent change Excluding currency rate effect
	2006	2005			
Paper Machine Clothing	\$ 194,461	\$ 185,265	5.0%	\$ 2,545	3.6%
Applied Technologies	37,765	34,485	9.5%	241	8.8%
Albany Door Systems	29,404	27,656	6.3%	82	6.0%
Consolidated total	\$ 261,630	\$ 247,406	5.7%	\$ 2,868	4.6%

Gross profit was 39.8 percent of net sales in the second quarter of 2006, compared to 40.9 percent for the same period of 2005. The decrease in the second quarter compared to the same period last year is due principally to the costs associated with the integration of Texas Composite Inc. (TCI) and the ramp-up of manufacturing to meet the TCI order backlog. Higher petroleum prices increased the cost of materials by approximately \$9 million, compared to the second quarter of 2005. The adverse impact of these material cost increases on gross profit percentages was offset by a combination of revenue growth, price improvements, and efficiency gains.

Selling, technical, general, and research expenses increased from 27.9 percent of net sales in the second quarter of 2005 to 28.7 percent for the same period of 2006. The increase is due mainly to the implementation of incentive compensation programs, and the effect of changes in currency translation rates on accounts receivable and other balances held in currencies other than the local currency.

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In the first quarter of 2006, the Company adopted the provisions of FAS 123R, Share-Based Payment, for its stock option plans. The Company has not granted options since 2002, but must record compensation expense for the value of options that vest after 2005. Included in compensation expense for the second quarter of 2006 was \$0.4 million related to stock options. No comparable expense was recorded for the same period of 2005. The Company anticipates that the full-year 2006 expense related to stock options will be \$1.6 million.

Operating income was \$28.9 million in the second quarter of 2006, compared to \$32.0 million in the same period of 2005. The decline in operating income was attributable to the decline in gross profit percentage and increased selling, technical, general and research expenses. Following is a table of operating income by segment:

(in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Operating Income				
Paper Machine Clothing	\$ 40,232	\$ 42,065	\$ 80,788	\$ 83,969
Applied Technologies	5,107	6,007	11,255	11,461
Albany Door Systems	1,214	624	3,499	2,390
Research expense	(7,997)	(7,114)	(16,536)	(14,214)
Unallocated expenses	(9,611)	(9,546)	(20,647)	(21,776)
Operating income before reconciling items	28,945	32,036	58,359	