
**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
July 1, 2006**

or

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

**Commission file number
001-07283**



REGAL-BELOIT CORPORATION
(Exact name of registrant as specified in its charter)

Wisconsin
(State of other jurisdiction of incorporation)

39-0875718
(IRS Employer Identification No.)

200 State Street, Beloit, Wisconsin 53511
(Address of principal executive office)

(608) 364-8800
Registrant's telephone number, including area code

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

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

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

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

30,873,784 Shares, Common Stock, \$.01 Par Value (as of July 25, 2006)

REGAL-BELOIT CORPORATION

INDEX

| | <u>Page</u> |
|--|--|
| <u>PART I - FINANCIAL INFORMATION</u> | |
| <u>Item 1 -</u> | <u>Financial Statements (Unaudited)</u> |
| | <u>Condensed Consolidated Balance Sheets</u> 3 |
| | <u>Condensed Consolidated Statements of Earnings</u> 4 |
| | <u>Condensed Consolidated Statements of Cash Flows</u> 5 |
| | <u>Notes to Condensed Consolidated Financial Statements</u> 6 |
| <u>Item 2 -</u> | <u>Management's Discussion and Analysis of Financial</u> |
| | <u>Condition and Results of Operations</u> 14 |
| <u>Item 3 -</u> | <u>Quantitative and Qualitative Disclosures about Market Risk</u> 17 |
| <u>Item 4 -</u> | <u>Controls and Procedures</u> 18 |
| <u>PART II - OTHER INFORMATION</u> | |
| <u>Item 1 -</u> | <u>Legal Proceedings</u> 18 |
| <u>Item 1A -</u> | <u>Risk Factors</u> 19 |
| <u>Item 4 -</u> | <u>Submission of Matters to a Vote of Security Holders</u> 19 |
| <u>Item 6 -</u> | <u>Exhibits</u> 20 |
| <u>Signature</u> | 20 |
| <u>Index to Exhibits</u> | 21 |

CAUTIONARY STATEMENT

The following is a cautionary statement made under the Private Securities Litigation Reform Act of 1995: With the exception of historical facts, the statements contained in this Quarterly Report on Form 10-Q or incorporated by reference may be forward- looking statements. Forward-looking statements represent our management's judgment regarding future events. In many cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "plan," "expect," "anticipate," "estimate," "believe," "predict," "intend," "potential" or "continue" or the negative of these terms or other words of similar import, although some forward-looking statements are expressed differently. We cannot guarantee the accuracy of the forward-looking statements, and you should be aware that results and events could differ materially and adversely from those contained in the forward -looking statements due to a number of factors, including:

- unexpected issues and costs arising from the integration of acquired companies and businesses, such as our acquisitions of the HVAC motors and capacitors businesses and the Commercial AC motors business from General Electric Company ("GE") in 2004;
- marketplace acceptance of acquisitions, including the loss of, or a decline in business from, any significant customers;
- unanticipated fluctuations in commodity prices and raw material costs and issues affecting our ability to pass increased costs on to our customers;
- cyclical downturns affecting the markets for capital goods;
- substantial increases in interest rates that impact the cost of our outstanding debt;
- the impact of capital market transactions that we may effect;
- unanticipated costs associated with litigation matters;
- the success of our management in increasing sales and maintaining or improving the operating margins of our businesses;
- actions taken by our competitors;
- difficulties in staffing and managing foreign operations;
- our ability to satisfy various covenant requirements under our credit facility; and
- other risks and uncertainties described in Item 1A "Risk Factors" of the 2005 Annual Report on Form 10-K filed on March 15, 2006 and from time to time in our reports filed with U.S. Securities and Exchange Commission.

All subsequent written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the applicable cautionary statements. The forward-looking statements included in this Form 10-Q are made only as of their respective dates, and we undertake no obligation to update these statements to reflect subsequent events or circumstances.

PART I - FINANCIAL INFORMATION
REGAL-BELOIT CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands of Dollars)

ITEM I. FINANCIAL STATEMENTS

| ASSETS | (Unaudited) | (From Audited Statements) |
|---|-------------------------|--------------------------------------|
| | July 1, 2006 | December 31, 2005 |
| Current Assets: | | |
| Cash and Cash Equivalents | \$ 24,570 | \$ 32,747 |
| Receivables, less Allowances for Doubtful Accounts of \$5,522 in 2006 and \$2,653 in 2005 | 257,429 | 197,118 |
| Inventories | 231,942 | 224,316 |
| Prepaid Expenses and Other Current Assets | 28,310 | 16,121 |
| Future Income Tax Benefits | 15,133 | 16,978 |
| Total Current Assets | 557,384 | 487,280 |
| Property, Plant and Equipment: | | |
| Land and Improvements | 17,955 | 18,624 |
| Buildings and Improvements | 99,816 | 100,036 |
| Machinery and Equipment | 335,023 | 336,171 |
| Property, Plant and Equipment, at Cost | 452,794 | 454,831 |
| Less - Accumulated Depreciation | (201,308) | (210,502) |
| Net Property, Plant and Equipment | 251,486 | 244,329 |
| Goodwill | 547,390 | 546,168 |
| Purchased Intangible Assets, net of Amortization | 45,321 | 45,674 |
| Other Noncurrent Assets | 19,669 | 19,103 |
| Total Assets | \$ 1,421,250 | \$ 1,342,554 |
| LIABILITIES AND SHAREHOLDERS' INVESTMENT | | |
| Current Liabilities: | | |
| Accounts Payable | \$ 111,908 | \$ 82,513 |
| Commercial Paper Borrowings | 45,000 | 25,000 |
| Dividends Payable | 4,320 | 3,985 |
| Accrued Compensation and Employee Benefits | 46,636 | 41,127 |
| Other Accrued Expenses | 54,179 | 46,559 |
| Income Taxes Payable | 10,690 | 18,923 |
| Current Maturities of Long-Term Debt | 1,269 | 684 |
| Total Current Liabilities | 274,002 | 218,791 |
| Long-Term Debt | 346,906 | 386,332 |
| Deferred Income Taxes | 59,694 | 59,993 |
| Other Non-Current Liabilities | 25,008 | 18,394 |
| Minority Interest in Consolidated Subsidiaries | 9,990 | 11,048 |
| Shareholders' Investment: | | |
| Common Stock, \$.01 par value, 50,000,000 shares authorized, 31,635,384 issued in 2006 and 31,429,736 issued in 2005 | 316 | 315 |
| Additional Paid-In Capital | 323,433 | 316,426 |
| Less-Treasury Stock, at cost, 774,100 shares in 2006 and 2005 | (15,228) | (15,228) |
| Retained Earnings | 391,947 | 343,161 |
| Unearned Compensation | -- | (657) |
| Accumulated Other Comprehensive Income | 5,182 | 3,979 |
| Total Shareholders' Investment | 705,650 | 647,996 |
| Total Liabilities and Shareholders' Investment | \$ 1,421,250 | \$ 1,342,554 |

See accompanying notes to Condensed Consolidated Financial Statements

REGAL-BELOIT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
(In Thousands of Dollars, Except Per Share Data)

| | (Unaudited) | | | |
|--|---------------------|----------------------|---------------------|----------------------|
| | Three Months Ended | | Six Months Ended | |
| | <u>July 1, 2006</u> | <u>June 29, 2005</u> | <u>July 1, 2006</u> | <u>June 29, 2005</u> |
| Net Sales | \$ 435,269 | \$ 368,768 | \$ 833,595 | \$ 706,591 |
| Cost of Sales | <u>331,244</u> | <u>288,950</u> | <u>636,290</u> | <u>558,329</u> |
| Gross Profit | 104,025 | 79,818 | 197,305 | 148,262 |
| Operating Expenses | <u>46,159</u> | <u>44,007</u> | <u>95,821</u> | <u>86,586</u> |
| Income From Operations | 57,866 | 35,811 | 101,484 | 61,676 |
| Interest Expense | 5,454 | 5,894 | 10,249 | 11,348 |
| Interest Income | <u>140</u> | <u>28</u> | <u>260</u> | <u>76</u> |
| Income Before Taxes and Minority Interest | 52,552 | 29,945 | 91,495 | 50,404 |
| Provision For Income Taxes | <u>18,847</u> | <u>10,996</u> | <u>33,189</u> | <u>18,638</u> |
| Income Before Minority Interest | 33,705 | 18,949 | 58,306 | 31,766 |
| Minority Interest in Income, Net of Tax | <u>396</u> | <u>504</u> | <u>1,209</u> | <u>1,035</u> |
| Net Income | <u>\$ 33,309</u> | <u>\$ 18,445</u> | <u>\$ 57,097</u> | <u>\$ 30,731</u> |
| Per Share of Common Stock: | | | | |
| Earnings Per Share - Basic | <u>\$ 1.08</u> | <u>\$.63</u> | <u>\$ 1.86</u> | <u>\$ 1.06</u> |
| Earnings Per Share - Assuming Dilution | <u>\$.99</u> | <u>\$.62</u> | <u>\$ 1.71</u> | <u>\$ 1.03</u> |
| Cash Dividends Declared | <u>\$.14</u> | <u>\$.13</u> | <u>\$.27</u> | <u>\$.25</u> |
| Average Number of Shares Outstanding-Basic | <u>30,816,156</u> | <u>29,064,518</u> | <u>30,759,004</u> | <u>29,049,209</u> |
| Average Number of Shares Outstanding- Assuming Dilution | <u>33,644,909</u> | <u>29,720,400</u> | <u>33,301,719</u> | <u>29,982,397</u> |

See accompanying notes to Condensed Consolidated Financial Statements.

REGAL-BELOIT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands of Dollars)

| | (Unaudited) Six Months Ended | |
|--|---------------------------------|---------------|
| | July 1, 2006 | June 29, 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 57,097 | \$ 30,731 |
| Adjustments to reconcile net income to net cash provided by operating activities; net of effect of acquisitions | | |
| Depreciation and amortization | 16,826 | 18,845 |
| Gain on sale of assets | (1,850) | (101) |
| Stock-based compensation expense | 1,725 | 416 |
| Change in assets and liabilities | (37,568) | (16,297) |
| Net cash provided by operating activities | 36,230 | 33,594 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Additions to property, plant and equipment | (17,873) | (15,549) |
| Purchases of short-term investments | (10,263) | -- |
| Business acquisitions, net of cash acquired | (10,962) | (5,490) |
| Sale of property, plant and equipment | 15,541 | 4,156 |
| Other, net | -- | (344) |
| Net cash used in investing activities | (23,557) | (17,227) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Repayment of long-term debt | (38,841) | (11,018) |
| Proceeds from commercial paper borrowings | 20,000 | -- |
| Dividends paid to shareholders | (7,980) | (6,968) |
| Proceeds from the exercise of stock options | 4,239 | 1,146 |
| Excess tax benefits from stock-based compensation | 1,750 | 163 |
| Distribution to minority partners | -- | (1,315) |
| Net cash used in financing activities | (20,832) | (17,992) |
| EFFECT OF EXCHANGE RATE ON CASH | (18) | (584) |
| Net decrease in cash and cash equivalents | (8,177) | (2,209) |
| Cash and cash equivalents at beginning of period | 32,747 | 31,275 |
| Cash and cash equivalents at end of period | \$ 24,570 | \$ 29,066 |
| Cash paid for: | | |
| Interest | \$ 10,189 | \$ 10,628 |
| Income taxes | \$ 37,852 | \$ 5,497 |

See accompanying notes to Condensed Consolidated Financial Statements.

REGAL-BELOIT CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
July 1, 2006
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited Condensed Consolidated Financial Statements of REGAL-BELOIT CORPORATION (the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The condensed consolidated balance sheet data as of December 31, 2005 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. The Company's significant accounting policies are disclosed in its fiscal Annual Report on Form 10-K for the year ended December 31, 2005 (the "2005 Annual Report on Form 10-K"). For additional information, refer to the consolidated financial statements and related footnotes in the Company's 2005 Annual Report on Form 10-K.

In the opinion of management, all adjustments considered necessary for a fair presentation of financial results have been made. Except as otherwise discussed, such adjustments consist of only those of a normal recurring nature. Operating results for the three months ended July 1, 2006 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2006.

2. SHORT-TERM INVESTMENTS

Short-term marketable investments include investments with maturities of greater than three months and less than one year. Such marketable investments were classified as available-for-sale and are reported at fair market value and classified within Prepaid Expenses and Other Current Assets. Mark-to-market gains on such investments are not material.

3. INVENTORIES

Cost for approximately 82% of the Company's inventory is determined using the last-in, first-out (LIFO) inventory valuation method. The approximate percentage distribution between major classes of inventories was as follows:

| | <u>July 1, 2006</u> | <u>December 31, 2005</u> |
|------------------------------------|---------------------|--------------------------|
| Raw Material | 15% | 13% |
| Work-in Process | 27% | 25% |
| Finished Goods and Purchased Parts | 58% | 62% |

4. COMPREHENSIVE INCOME

The Company's comprehensive income for the second quarter and first six months of 2006 and 2005 was as follows:

| | (In Thousands of Dollars) | | | |
|--|---------------------------|----------------------|---------------------|----------------------|
| | Second Quarter Ended | | Six Months Ended | |
| | <u>July 1, 2006</u> | <u>June 29, 2005</u> | <u>July 1, 2006</u> | <u>June 29, 2005</u> |
| Net income as reported | \$ 33,309 | \$ 18,445 | \$ 57,097 | \$ 30,731 |
| Comprehensive income (expense) from: | | | | |
| Cumulative translation adjustments | 296 | (729) | 512 | (1,978) |
| Changes in fair value of hedging activities, net of tax | 2,641 | 2,409 | 4,628 | 5,108 |
| Hedging activities reclassified into earnings from accumulated other comprehensive income ("AOCI"), net of tax | (529) | (73) | (3,924) | (1,178) |
| Additional Pension Liability | -- | -- | (13) | -- |
| Comprehensive income | <u>\$ 35,717</u> | <u>\$ 20,052</u> | <u>\$ 58,300</u> | <u>\$ 32,683</u> |

5. WARRANTY COSTS

The Company recognizes the cost associated with its standard warranty on its products at the time of sale. The amount recognized is based on historical experience. The following is a reconciliation of the changes in accrued warranty costs for the second quarter and first six months of 2006 and 2005:

| | (In Thousands of Dollars) | | | |
|-------------------|---------------------------|---------------|------------------|---------------|
| | Second Quarter Ended | | Six Months Ended | |
| | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 |
| Beginning balance | \$ 5,652 | \$ 5,237 | \$ 5,679 | \$ 5,007 |
| Deduct: Payments | (1,761) | (1,149) | (3,120) | (2,805) |
| Add: Provision | 1,618 | 1,527 | 2,950 | 3,413 |
| Ending balance | \$ 5,509 | \$ 5,615 | \$ 5,509 | \$ 5,615 |

6. BUSINESS SEGMENTS

The Company operates two strategic businesses that are reportable segments, Mechanical and Electrical:

| | (Unaudited) | | | | | | | |
|---------------------------|--------------------|---------------|--------------|---------------|--------------------|---------------|--------------|---------------|
| | Mechanical Segment | | | | Electrical Segment | | | |
| | Second Quarter | | Six Months | | Second Quarter | | Six Months | |
| | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 |
| Net Sales | \$ 53,042 | \$ 51,546 | \$ 106,003 | \$ 100,147 | \$ 382,227 | \$ 317,222 | \$ 727,592 | \$ 606,444 |
| Income from | | | | | | | | |
| Operations | \$ 7,134 | \$ 3,139 | \$ 10,841 | \$ 5,876 | \$ 50,732 | \$ 32,672 | \$ 90,643 | \$ 55,800 |
| % of Net Sales | 13.4% | 6.1% | 10.2% | 5.9% | 13.3% | 10.3% | 12.5% | 9.2% |
| Goodwill at end of period | 530 | 530 | 530 | 530 | 546,860 | 553,508 | 546,860 | 553,508 |

7. GOODWILL AND OTHER INTANGIBLES

Changes in the carrying amount of goodwill for the six months ending July 1, 2006 were as follows:

| | (In Thousands of Dollars) | | |
|------------------------------------|---------------------------|--------------------|------------|
| | Electrical Segment | Mechanical Segment | Total |
| Balance as of December 31, 2005 | \$ 545,638 | \$ 530 | \$ 546,168 |
| Acquisition of Sinya (see Note 14) | 1,222 | -- | 1,222 |
| Balance as of July 1, 2006 | \$ 546,860 | \$ 530 | \$ 547,390 |

Other intangible assets consisted of the following:

Summary of Intangible Assets with Definite Lives

| Asset Description | Useful Life (years) | (In Thousands of Dollars) | | |
|------------------------|---------------------|---------------------------|--------------------------|----------------|
| | | July 1, 2006 | | |
| | | Gross Value | Accumulated Amortization | Net Book Value |
| Non-Compete Agreements | 5 years | \$ 5,329 | \$ 816 | \$ 4,513 |
| Trademarks | 3 - 5 years | 4,960 | 2,446 | 2,514 |
| Patents | 9 - 10.5 years | 15,410 | 2,336 | 13,074 |
| Engineering Drawings | 10 years | 1,200 | 187 | 1,013 |
| Customer Relationships | 10 years | 28,600 | 4,393 | 24,207 |
| Total | | \$ 55,499 | \$ 10,178 | \$ 45,321 |

| Asset Description | Useful Life (years) | December 31, 2005 | | |
|------------------------|------------------------|-------------------|-----------------------------|-------------------|
| | | Gross Value | Accumulated Amortization | Net Book Value |
| Non-Compete Agreements | 5 years | \$ 2,440 | \$ 520 | \$ 1,920 |
| Trademarks | 3 - 5 years | 4,960 | 1,760 | 3,200 |
| Patents | 9 - 10.5 years | 15,410 | 1,565 | 13,845 |
| Engineering Drawings | 10 years | 1,200 | 127 | 1,073 |
| Customer Relationships | 10 years | 28,600 | 2,964 | 25,636 |
| Total | | \$ 52,610 | \$ 6,936 | \$ 45,674 |

Estimated Amortization (In Thousands)

| 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter |
|----------|----------|----------|----------|----------|------------|
| \$ 6,769 | \$ 6,958 | \$ 5,846 | \$ 5,783 | \$ 5,100 | \$ 18,138 |

Amortization expense recorded for the three months ended July 1, 2006 was \$1.6 million. We perform an annual evaluation of our goodwill and intangible assets in the fourth quarter of each fiscal year for impairment as required by SFAS 142, "Goodwill and Other Intangible Assets".

8. SHARE-BASED COMPENSATION

Effective January 1, 2006 the Company adopted Statement of Financial Accounting Standards (SFAS) 123(R), *Share-Based Payment* ("SFAS 123(R)"), using the modified prospective application transition method. Before the adoption of SFAS 123(R), the Company accounted for share-based compensation in accordance with Accounting Principles Board Opinion No. 25 ("APB 25"), *Accounting for Stock Issued to Employees*. Other than for restricted stock and dividend equivalents on phantom stock plans, which has been expensed over the respective vesting periods, no share-based employee compensation cost has been reflected in net income prior to January 1, 2006.

Under APB 25, the value of the restricted stock grants was reflected as a separate component reducing Shareholders' investment equity with an offsetting increase to Paid-in Capital. Accordingly, as of December 31, 2005 the unamortized value of the restricted stock grant amounting to \$0.7 million was reflected as a separate component of Shareholder's Investment. As a result of the adoption of SFAS 123(R), the unamortized value of restricted stock grants as of April 1, 2006 in the amount of \$0.5 million has been reclassified to Paid-in Capital.

The Company is authorized to make equity-based awards under various plans approved by the Company's shareholders. The Company has not enacted any changes in the quantity or type of instruments used in share-based payment programs as a result of SFAS 123(R). Additionally, the Company did not modify any outstanding options prior to the adoption of SFAS 123(R). The Company has elected to use the Black-Scholes modified prospective method of valuing equity compensation awards, consistent with the Company's approach under APB 25. For option grants prior to 2006, the Company utilizes the same assumptions used in its Black-Scholes method used to prepare the prior required disclosure.

SFAS 123(R) requires the reporting of the tax benefit from the tax deduction that is in excess of recognized compensation costs (excess tax benefits), if any, as a financing cash flow rather than as an operating cash flow.

During the three and six months ended July 1, 2006, the Company recognized approximately \$0.9 million and \$1.7 million, respectively, in share-based compensation expense. The Company recognizes compensation expense on grants of share-based compensation awards on a straight-line basis over the vesting period of each award recipient. As of July 1, 2006, total unrecognized compensation cost related to share-based compensation awards was approximately \$7.5 million, net of estimated forfeitures, which the Company expects to recognize over a weighted average period of approximately 2.17 years. The total income tax benefit recognized relating to share-based compensation for the three and six months ended July 1, 2006 was approximately \$1.3 million and \$1.8 million, respectively.

Under the Company's 1998 and 2003 stock plans, the Company is authorized to deliver up to 2.5 million shares of common stock upon exercise of non-qualified stock options or incentive stock options, or upon grant or in payment of stock appreciation rights, performance shares, performance units and restricted stock. Approximately 0.6 million shares were available for future grant or payment under the various plans at July 1, 2006.

Stock Options

The Company has granted non-qualified and incentive stock options to purchase common stock under various incentive plans at prices equal to the fair market value of the stock on the grant dates. The exercise price for certain options granted under the plans may be paid in cash, shares of common stock or a combination of cash and shares. Stock options expire ten years from the grant date.

The per share weighted average fair value of stock options granted during the three months ended July 1, 2006 and June 29, 2005 was \$18.27 and \$9.11, respectively. The Company estimated the fair value of each stock option on the date of grant using the Black-Scholes pricing model and the following assumptions:

| | (In Thousands of Dollars) | | | |
|---------------------------------|---------------------------|---------------|------------------|---------------|
| | Three Months Ended | | Six Months Ended | |
| | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 |
| Average risk-free interest rate | 4.75% | 4.0% | 4.52% | 3.9% |
| Expected dividend yield | 1.3% | 1.98% | 1.39% | 1.63% |
| Expected volatility | 30.63% | 34% | 27.23% | 34% |
| Expected term (years) | 8.0% | 7.0% | 8.0% | 7.0% |

The average risk-free interest rate is based on the weighted average of the five-year and ten-year U.S. Treasury security rates in effect as of the grant date. The expected dividend yield is based on the projected annual dividend as a percentage of the estimated market value of our common stock as of the grant date. The Company determined expected volatility using a weighted average of daily historical volatility of our stock price over a period equal to the estimated remaining option life. The Company determined the expected term of the stock options using historical data adjusted for the estimated exercise dates of unexercised options.

A summary of stock option activity during the three and six months ended July 1, 2006 is as follows:

| | Second Quarter Ended July 1, 2006 | | | | Six Months Ended July 1, 2006 | | | |
|------------------------------------|-----------------------------------|--------------------------|--|---|-------------------------------|--------------------------|--|---|
| | Shares | Wtd. Avg. Exercise Price | Wtd. Avg. Remaining Contractual Term (years) | Aggregate Intrinsic Value (in millions) | Shares | Wtd. Avg. Exercise Price | Wtd. Avg. Remaining Contractual Term (years) | Aggregate Intrinsic Value (in millions) |
| Number of shares under option: | | | | | | | | |
| Outstanding at beginning of period | 1,908,800 | \$ 24.92 | | | 1,798,317 | \$ 23.27 | | |
| Granted | 44,202 | | | | 252,600 | | | |
| Exercised | 129,900 | | | | 214,417 | | | |
| Forfeited | 10,352 | | | | 23,750 | | | |
| Outstanding at end of period | 1,812,750 | | 6.0 | \$ 34.3 | 1,812,750 | | 6.0 | \$ 34.3 |
| Exercisable at end of period | 1,121,210 | \$ 22.47 | 4.6 | \$ 24.3 | 1,121,210 | \$ 22.47 | 4.6 | \$ 24.3 |

The table below presents stock option activity for the three-month and six-month periods ended July 1, 2006 and June 29, 2005:

| | (In Thousands of Dollars) | | | |
|---|---------------------------|---------------|------------------|---------------|
| | Second Quarter Ended | | Six Months Ended | |
| | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 |
| Total intrinsic value of stock options exercised | \$ 3,727 | \$ 272 | \$ 4,952 | \$ 418 |
| Cash received from stock option exercises | 2,876 | 878 | 4,239 | 1,146 |
| Income tax benefit from the exercise of stock options | 1,300 | 108 | 1,750 | 163 |
| Total fair value of stock options vested | 8,652 | 8,277 | 8,652 | 8,277 |

Restricted Stock

The Company also granted restricted stock awards to certain employees. The Company recorded compensation pretax expense associated with the stock grants amounting to \$0.3 million and \$0.2 million for the three months ending July 1, 2006 and June 29, 2005, respectively. The Company recorded pretax expense for the six months ended July 1, 2006 and June 29, 2005 of \$0.5 million and \$0.4 million, respectively. Restrictions generally lapse over a period of three years. The Company values restricted stock awards at the closing market value of our common stock on the date of grant.

A summary of restricted stock activity for the three and six months ended July 1, 2006 is as follows:

| | Second Quarter Ended July 1, 2006 | | | Six Months Ended July 1, 2006 | | |
|---|-----------------------------------|----------------------|---|-------------------------------|----------------------|---|
| | Shares | Wtd. Avg. Fair Value | Aggregate Intrinsic Value (in millions) | Shares | Wtd. Avg. Fair Value | Aggregate Intrinsic Value (in millions) |
| Restricted stock balance at beginning of period | 88,175 | \$ 31.51 | | 44,175 | \$ 26.68 | |
| Granted | 3,000 | 47.25 | | 47,000 | 37.06 | |
| Restrictions lapsed | - | - | | - | - | |
| Forfeited | - | - | | - | - | |
| Restricted stock balance at July 1, 2006 | <u>91,175</u> | <u>\$ 32.03</u> | <u>\$ 4.0</u> | <u>91,175</u> | <u>\$ 32.03</u> | <u>\$ 4.0</u> |

Prior Year Pro forma Expense

The following table illustrates the effect on net income and earnings per share as if the fair value-based method provided by SFAS 123(R) had been applied for all outstanding and unvested awards prior to the adoption of SFAS 123(R):

| | (In Thousands of Dollars) | |
|---|---------------------------|------------------|
| | Second Quarter Ended | Six Months Ended |
| | June 29, 2005 | June 29, 2005 |
| Net income, as reported | \$ 18,445 | \$ 30,731 |
| Add: Share-based employee compensation expense included in reported net income, net of related tax effects | 102 | 262 |
| Deduct: Total share-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects | (415) | (882) |
| Pro forma net income | \$ 18,132 | \$ 30,111 |
| Earnings per share: | | |
| Basic - as reported | \$.63 | \$ 1.06 |
| Basic - pro forma | \$.62 | \$ 1.04 |
| Diluted - as reported | \$.62 | \$ 1.03 |
| Diluted - pro forma | \$.61 | \$ 1.01 |

9. RESTRUCTURING ACTIVITIES

During the three month period ended July 1, 2006, the Company recorded restructuring costs of \$1.4 million related to the restructuring of the electric generator business and related to the rationalization of two motor product lines. The asset and inventory write-downs and severance costs were included in cost of sales. The Company expects to complete the electric generator restructuring activities by March 2007 and anticipates minimal additional restructuring expenses.

10. PENSION PLANS

The Company accounts for its defined benefit pension plans under the provisions of SFAS No. 87, "Employers' Accounting for Pensions". The Company's net periodic pension cost is comprised of the following components:

| | (In Thousands of Dollars) | | | |
|------------------------------------|---------------------------|---------------|------------------|---------------|
| | Second Quarter Ended | | Six Months Ended | |
| | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 |
| Service cost | \$ 940 | \$ 651 | \$ 1880 | \$ 1,302 |
| Interest cost | 1048 | 886 | 2188 | 1,772 |
| Expected return on plan assets | (1,225) | (1,123) | (2,450) | (2,246) |
| Amortization of prior service cost | 123 | 32 | 246 | 64 |
| Amortization of net loss | 868 | 244 | 3,170 | 488 |
| Net periodic benefit expense | \$ 1,754 | \$ 690 | \$ 5,034 | \$ 1,380 |

In the second quarter and first six months of 2006, the Company contributed \$0.25 million and \$0.38 million, respectively, to defined benefit pension plans. The Company contributed \$0.11 million in both the second quarter and first six months of 2005. The Company expects to contribute an additional \$0.97 million over the balance of 2006, for a total of \$1.35 million in 2006 contributions. The Company contributed a total of \$0.33 million in 2005. The assumptions used in the valuation of the Company's pension plans and in the target investment allocation have remained the same as those disclosed in the Company's 2005 Annual Report on Form 10-K.

11. EARNINGS PER SHARE (EPS)

The numerator for the calculation of basic and diluted earnings per share is net income. The denominator is computed as follows:

| | (In Thousands) | | | |
|---|----------------------|---------------|------------------|---------------|
| | Second Quarter Ended | | Six Months Ended | |
| | July 1, 2006 | June 29, 2005 | July 1, 2006 | June 29, 2005 |
| Denominator for basic EPS - weighted average shares | 30,816 | 29,065 | 30,759 | 29,049 |
| Effect of dilutive securities | 2,829 | 665 | 2,543 | 933 |
| Denominator for diluted EPS | 33,645 | 29,720 | 33,302 | 29,982 |

The increase from June 29, 2005 of 2.2 million dilutive securities in the quarter ended July 1, 2006, was due primarily to the effect of shares attributable to the Company's convertible senior subordinated debt. Options for common shares where the exercise price was above the market price at July 1, 2006, totaling 14,500 shares, and at June 29, 2005, totaling 376,000 shares, have been excluded from the calculation of the effect of dilutive securities as the effect of such options is anti-dilutive.

12. CONTINGENCIES

An action was filed on June 4, 2004, and amended in September 2004, against one of the Company's subsidiaries, Marathon Electric Manufacturing Corporation ("Marathon"), by Enron Wind Energy Systems, LLC, Enron Wind Contractors, LLC and Zond Minnesota Construction Company, LLC (collectively, "Enron Wind"). The action was filed in the United States Bankruptcy Court for the Southern District of New York where each of the Enron Wind entities has consolidated its Chapter 11 bankruptcy petition as part of the Enron Corporation bankruptcy proceedings. In the action against Marathon, Enron Wind has asserted various claims relating to the alleged failures and/or degradations of performance of about 564 generators sold by Marathon to Enron Wind from 1997 to 1999. In January 2001, Enron Wind and Marathon entered into a "Generator Warranty and Settlement Agreement and Release of All Claims" ("Warranty Agreement"). This Warranty Agreement resolved various issues related to past performance of the generators, provided a limited warranty related to the generators going forward, and contained a release by all parties of any claims related to the generators other than those arising out of the obligations contained in the Warranty Agreement.

Enron Wind is seeking to recover the purchase price of the generators and transportation costs totaling about \$21 million. In addition, although the Warranty Agreement contains a waiver of consequential, incidental, and punitive damages, Enron Wind claims that this limitation is unenforceable and seeks recovery of consequential, incidental and punitive damages incurred by it and by its customers, totaling an additional \$100 million. Enron Wind has asserted claims of breach of contract, breach of the implied covenant of good faith and fair dealing, promissory fraud, and intentional interference with contractual relations. Marathon has filed a motion with the court seeking to have many of Enron Wind's claims dismissed. Enron Wind has filed a motion with the court seeking a declaration that Marathon had an obligation under the Warranty Agreement to repair or replace the generators in the first instance regardless of whether an actual breach of warranty had occurred. The court has held hearings on both motions, but has not yet ruled.

[Index](#)

The Company believes that this action is without merit and that it has meritorious defenses to the action. The Company intends to defend vigorously all of the asserted claims. The litigation is in an early discovery phase and it is difficult for the Company to predict the impact the litigation may ultimately have on the Company's results of operations or financial condition, including the expenses the Company may incur to defend against the action. As of July 1, 2006, the Company continues to accrue for anticipated costs in defending against this matter and such accumulated reserves at July 1, 2006 are immaterial.

The Company is, from time to time, party to other lawsuits arising from its normal business operations. It is believed that the outcome of these lawsuits will have no material effect on the Company's financial position or its results of operations.

13. DERIVATIVE INSTRUMENTS

The Company has entered into certain commodity forward contracts and options in connection with the management of its exposure to fluctuations in certain raw material commodity pricing. These derivative instruments have been designated as cash flow hedges. The Company has also entered into foreign currency forward contracts to reduce the exposure to the risks of changes in the exchange rates of the U.S. dollar, where the Company has operations where the functional currency is the local currency.

These contracts are recorded on the balance sheet at fair value and are accounted for as cash flow hedges, with changes in fair value recorded in accumulated other comprehensive income ("AOCI") in each accounting period. An ineffective portion of a hedge's change in fair value, if any, is recorded in earnings in the period of change. The impact of ineffectiveness was immaterial in the second quarters and six months of 2006 and 2005.

In the second quarter and first six months of 2006, \$2.1 million and \$.7 million of net increased fair market value of derivative instruments, respectively, was recorded in AOCI. For the comparable periods of 2005, the net increased fair market value of derivative instruments recorded in AOCI was \$2.3 million and \$3.9 million, respectively. At July 1, 2006, the Company had a balance of \$8.5 million in assets, \$5.2 million in liabilities and a net after tax unrealized gain of \$5.5 million in AOCI. At June 29, 2005, the Company had a balance of \$4.7 million in assets and a net after tax gain of \$2.9 million in AOCI. At July 1, 2006, all \$8.5 million of the total assets, \$4.2 million of the total liabilities and \$6.5 million of AOCI gains related to commodity hedges, while \$1.0 million of the liabilities and \$1.0 million of AOCI losses related to foreign currency hedges. The Company estimates that all but \$.2 million of the net gains or losses will be reclassified from AOCI to the income statement within the next 12 months, based on valuations at July 1, 2006.

14. ACQUISITIONS AND DIVESTURES

On May 1, 2006, the Company completed the acquisition of selected assets and liabilities of Changzhou Sinya Electromotor Co. Ltd., Jiangsu Southern Sinya Electric Co. Ltd. and Changzhou Xiesheng Plastic Co. Ltd. (collectively "Sinya"). Sinya operations are located in Changzhou, China and will primarily produce electric motors for the HVAC industry. The financial results for the business will be included in the Electrical Segment. The purchase price was approximately \$13.0 million, subject to final working capital adjustments.

The preliminary allocation of the purchase price was as follows:

| | (In Millions of Dollars) |
|-------------------------------|-----------------------------|
| Cash | \$ 2.6 |
| Accounts receivable | 4.2 |
| Inventories | 9.2 |
| Plant, property and equipment | 5.7 |
| Goodwill | 1.2 |
| Intangibles | 2.9 |
| Other assets | .8 |
| Total assets | <u>\$ 26.6</u> |
| Accounts payable | \$ 7.8 |
| Accrued liabilities | 5.8 |
| Paid in capital | 13.0 |
| Total liabilities and equity | <u>\$ 26.6</u> |

On May 8, the Company announced that it had completed the sale of substantially all of the assets of the Company's Regal Cutting Tools business to YG-1 Co. Ltd. for \$7.7 million. The Company recorded a net gain of \$.2 million which was included as a reduction of operating expenses.

[Index](#)

During the second quarter, the Company disposed of real property located in New Bedford, Massachusetts. The proceeds from the sale were \$2.6 million. The Company recorded a net gain of \$1.6 million which was included as a reduction of operating expenses.

On February 7, 2005, the Company acquired 95% ownership of Changzhou Modern Technologies Co., LTD. (“CMT”). CMT is located in Changzhou, China and is producing fractional electric motors. The purchase price was \$3.23 million which the Company is paying over a three-year period. A second payment of \$565,000 was made in February 2006.

15. DEBT

The Company’s indebtedness, as of July 1, 2006 and December 31, 2005 was as follows:

| | (In Thousands of Dollars) | |
|--|---------------------------|----------------------|
| | July 1, 2006 | December 31, 2005 |
| Revolving credit facility (“Facility”) | \$ 228,500 | \$ 267,100 |
| Commercial paper | 45,000 | 25,000 |
| Industrial revenue bonds and other | 4,675 | 4,916 |
| Sub-total - Senior indebtedness | 278,175 | 297,016 |
| Convertible senior subordinated debentures (“2.75% Convertible Notes”) | 115,000 | 115,000 |
| Total debt | 393,175 | 412,016 |
| Less: current debt | (46,269) | (25,684) |
| Total long-term debt, less current maturities | \$ 346,906 | \$ 386,332 |

Borrowings under the Facility bear interest at 30-day LIBOR plus a borrowing spread of .75%. All Facility borrowings are subject to a pricing grid, which can result in increases or decreases to the borrowing spread on a quarterly basis, depending on the Company’s leverage ratios. In addition, a non-use fee is payable quarterly on the average unused credit line under the Facility. At July 1, 2006, the non-use fee was 0.15%. The Facility contains customary limits and restrictions concerning investments, sales of assets, liens on assets, interest coverage ratios, maximum leverage, and minimum net worth. As of July 1, 2006 the Company was in compliance with all debt covenants.

There were \$45.0 million of commercial paper borrowings outstanding at July 1, 2006, all of which had original maturity terms of 90 days or less and had a weighted interest rate of 5.33%. Total commercial paper outstanding cannot exceed \$50 million under the terms of the Facility. The Facility provides the liquidity backstop for outstanding commercial paper. Accordingly, the combined outstanding balances of the Facility and commercial paper cannot exceed \$475.0 million.

The Company’s \$115,000,000, 2.75% convertible subordinated notes are convertible as the closing price of the Company’s common stock exceeded the contingent conversion share price of \$33.23 for the specified amount of time. As a result, holders of the notes may surrender the notes for conversion at any time until the maturing of the bonds in March 15, 2024. Holders that exercise their right to convert the notes will receive up to the principal amount in cash, with the balance of the conversion obligation, if any, to be satisfied in shares of Company common stock or cash, at the Company’s discretion. No notes have been converted into cash or shares of common stock as of July 1, 2006.

16. RELATED PARTY TRANSACTIONS

There were no related party transactions in the period ending July 1, 2006. This compares to the quarter ended June 29, 2005 during which General Electric Company (“GE”) was a “related party.”

As part of the consideration paid for the acquisition of the HVAC Motors and Capacitors business on December 31, 2004, the Company issued to GE 4,559,048 shares of common stock (approximately 15% of the Company’s common stock issued). In connection with the GE acquisitions, the Company and GE entered into various supply, transition services, and sales agreements. Included in accounts payable on June 29, 2005 was \$13.8 million consisting of amounts payable to GE related to trade payables, transition services fees payable, and other payables of the businesses acquired from GE in 2004. The amount paid to GE during the second quarter and first six months of 2005 for these items and other liabilities arising at closing was \$28.4 million and \$85.0 million, respectively. The amount expensed in the second quarter and first half of 2005 for transition services was \$4.7 million and \$8.4 million, respectively, which was recorded in operating expenses. In 2005, GE sold all of the shares of the Company’s stock received in the HVAC Motors and Capacitors sale transaction, and, therefore, GE is no longer considered a “related party” of the Company.

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

Unless the context requires otherwise, references in this Item 2 to “we”, “us”, “our” or the “Company” refer collectively to REGAL-BELOIT Corporation and its subsidiaries.

OVERVIEW

End markets for the Company’s products continued to show strength during the second quarter of 2006. Net sales increased 18.0% to \$435.3 million from \$368.8 million in the second quarter of 2005. Net income in the second quarter of 2006 increased 80.6% to \$33.3 million as compared to \$18.4 million in the comparable period of 2005. Diluted earnings per share for the second quarter of 2006 increased 60.0% to \$.99 as compared to \$.62 for the second quarter of 2005.

The Company completed the acquisition of selected assets and liabilities of “Sinya” on May 1, 2006. (See note 14 to the notes to condensed consolidated financial statements). Results for this business are included in the Electrical Segment. The Company also completed the sale of substantially all of the assets of the Regal Cutting Tools business on May 4, 2006, the year-to-date results for which are included in results from operations.

RESULTS OF OPERATIONS**Second Quarter 2006 versus Second Quarter 2005**

Sales for the second quarter of 2006 were \$435.3 million, which was an 18.0% increase over the \$368.8 million reported for the second quarter of 2005. The divestitures in the Mechanical Segment of the Regal Cutting Tools (completed May 2006) and Illinois Gear (completed May 2005) businesses reduced sales by approximately \$4.0 million. Sinya contributed sales of \$10.2 million for the second quarter of 2006. Excluding the impact of the sales related to the acquisition and divestitures, sales increased 16.4%.

| | (In Millions of Dollars) | | |
|-------------------|---------------------------------------|--|-------|
| | Three Months Ended July 1, 2006 | Three Months Ended June 29, 2005 | % |
| Sales as Reported | \$ 435.3 | \$ 368.8 | +18.0 |
| Acquisition Sales | (10.2) | | |
| Divested Sales | 4.0 | | |
| Adjusted Sales | \$ 429.1 | \$ 368.8 | +16.4 |

The strong demand for our products that was reported in the first quarter of 2006 continued into the second quarter with all but two of our operating divisions reporting increased sales as compared to the second quarter of 2005. Electrical Segment sales increased 20.5% as compared to the second quarter of 2005. Sales for this segment showed strength in all product lines except China generator sales, which have been adversely impacted by the improving power infrastructure and reliability. Sales of Commercial and Industrial motors increased 16.0%, sales of HVAC motors and capacitors increased 25.3% including the sales attributable to Sinya and sales of generators increased 20.1%. Mechanical Segment sales increased 2.9%. The divestiture of the Cutting Tool and Illinois Gear businesses reduced segment sales by approximately \$4.0 million. All divisions across this Segment experienced sales increases except for the Richmond Gear business which has been adversely impacted by the high gasoline prices that have affected the end markets for this business.

Gross margin for the second quarter of 2006 was 23.9%, as compared to 21.6% for the prior year period. Although material costs continued to put significant pressure on margins during the quarter, new products, enhanced productivity, pricing actions and positive product mix across our entire business drove the 2.3 percentage point margin improvement. The raw material cost increases resulted primarily from increases in the costs of copper and aluminum. Also included in cost of sales was \$1.4 million of expense in the second quarter of 2006 related to restructuring actions in the Electrical Segment. The majority of this cost related to restructuring activities in the Company’s generator business.

Operating expenses were \$46.2 million (10.6% of sales) versus \$44.0 million (11.9% of sales) in second quarter of 2005. Included in operating expenses in the second quarter of 2006 was a \$1.6 million gain resulting from the sale of real property in the Mechanical Segment. Operating expenses in the second quarter of 2006 also included \$.9 million related to the expensing of equity compensation. This amount compares to \$.2 million in the prior year period resulting from the expense related to restricted stock awards. Income from operations was \$57.9 million in the second quarter of 2006 versus \$35.8 million in the comparable period of 2005, an increase of 61.7%. As a percent of sales, income from operations was 13.3% vs. 9.7% for the second quarter of 2005. This increase reflected the contribution from new products, pricing actions, enhanced productivity, and the leveraging of fixed costs.

Net interest expense was \$5.3 million in the second quarter of 2006 versus \$5.9 million in the second quarter of 2005. This decrease was driven by the lower level of debt outstanding, coupled with a resulting decrease in the Company's borrowing premium over LIBOR. The decrease in debt was primarily driven by the cash generated in the second half of 2005, including the net proceeds from our August 2005 stock offering. The impact from the lower debt level was partially offset by increases in the underlying interest rate.

The tax rate for the second quarter of 2006 was 35.9% as compared to 36.7% for the comparable period of 2005. Net income for the quarter was \$33.3 million, an increase of 80.6% versus the \$18.4 million reported in the second quarter of 2005. Fully diluted earnings per share was \$.99 which compared to the \$.62 reported in the comparable period of 2005. The average number of diluted shares during the quarter was 33,644,909 as compared to 29,720,400 for the same period last year. The increase reflects the primary shares we issued in our third quarter 2005 stock offering and the added dilutive impact of the Company's convertible senior subordinated debt resulting from the increase in the price of our stock.

Six Months Ended July 1, 2006 versus Six Months Ended June 29, 2005

Sales for the six months ended July 1, 2006 were \$833.6 million, which is an 18.0% increase over the \$706.6 million reported for the comparable period of 2005. The divestitures in the Mechanical Segment of the Regal Cutting Tools (completed May 2006) and Illinois Gear (completed May 2005) businesses reduced sales by approximately \$5.8 million. The Sinya business reported sales of \$10.2 million for the period ending July 1, 2006. Excluding the impact of the sales related to the acquisition and divestitures, sales increased 17.4%.

| | (In Millions of Dollars) | | |
|-------------------|---------------------------------------|--|-------|
| | Three Months Ended July 1, 2006 | Three Months Ended June 29, 2005 | % |
| Sales as Reported | \$ 833.6 | \$ 706.6 | +18.0 |
| Acquisition Sales | (10.2) | | |
| Divested Sales | 5.8 | | |
| Adjusted Sales | \$ 829.2 | \$ 706.6 | +17.4 |

We saw strong demand for our products throughout the first half of 2006, driven by strong end market activity, including the impact of the SEER 13 federal energy legislation enacted in January of 2006. Electrical Segment sales increased 20.0% as compared to the first six months of 2005. Sales for this segment showed strength in all product lines except China generator sales that have been adversely impacted by the improving power infrastructure and reliability in China. Included in these results are the results for the Sinya business acquired on May 1, 2006. Mechanical Segment sales increase 5.8%. The divestiture of the Regal Cutting Tool and Illinois Gear businesses reduced segment sales during the first half of 2006 by approximately \$5.8 million over the same period last year.

Gross margin for the six months ended July 1, 2006 was 23.7%, which is an improvement of 2.7 percentage points over the comparable period of 2005. Material costs had a significant impact on the first six months of 2006; however, the contribution from new products, productivity efforts, pricing actions and positive product mix across our entire business drove the margin improvement. The raw material cost increases resulted primarily from increases in the costs of copper and aluminum. Also included in cost of sales was \$1.4 million of expense recorded in the second quarter of 2006 related to restructuring actions in the Electrical Segment. The majority of this cost related to restructuring activities in the Company's generator business.

Operating expenses were \$95.8 million (11.5% of sales) versus \$86.6 million (12.3% of sales) in the comparable period of 2005. Included in operating expenses in the first half of 2006 was a second quarter \$1.6 million gain resulting from the sale of real property in the Mechanical Segment. Operating expenses for the first half of 2006 also included \$2.0 million of expense related to the REGAL-BELOIT Supplemental Executive Retirement Plan resulting from a change in assumptions associated with retirement benefits for certain key executives. Also included in operating expenses was \$1.7 million related to the expensing of equity compensation. This amount compared to \$.4 million in the prior year resulting from the expense related to restricted stock awards. Income from operations was \$101.5 million versus \$61.7 million in the comparable period of 2005, an increase of 64.5%. As a percent of sales, income from operations was 12.2% versus 8.7% for the comparable period of 2005. This increase reflected the contribution from new products, pricing actions, enhanced productivity, and the improved leveraging of fixed costs.

Net interest expense was \$10.0 million versus \$11.3 million in the comparable period of 2005. This decrease was driven by the lower level of debt outstanding, coupled with a resulting decrease in the Company's borrowing premium over LIBOR. The decrease in debt was primarily due to cash generated in the second half of 2005, including the net proceeds from our August 2005 stock offering. The impact from the lower debt level was partially offset by increases in the underlying interest rate.

[Index](#)

The tax rate for the six month period ended July 1, 2006 was 36.3% as compared to 37.0% for the comparable period of 2005. Net income was \$57.1 million, an increase of 86.0% versus the \$30.7 million reported in the comparable period of 2005. Fully diluted earnings per share was \$1.71, 66% greater than the \$1.03 reported in the comparable period of 2005. The average number of diluted shares was 33,301,719 as compared to 29,982,397 last year. The increase reflects the primary shares we issued in our third quarter 2005 stock offering and the added dilutive impact of the Company's convertible senior subordinated debt resulting from the increase in the price of our stock.

LIQUIDITY AND CAPITAL RESOURCES

Our working capital was \$283.4 million at July 1, 2006, a 5.5% increase from \$268.5 million at year-end 2005. The \$14.9 million increase was due primarily to a \$60.3 million accounts receivable increase resulting for the most part from increased sales in the first half of 2006, partially offset by a \$29.4 million increase in accounts payable and \$20.0 million of higher commercial paper borrowings. The ratio of our current assets to our current liabilities ("current ratio") was 2.0:1 at July 1, 2006, compared to 2.2:1 at year-end 2005.

Net cash provided by operating activities was \$36.2 million in the first half of 2006 as compared to \$33.6 million in 2005's first six months. During the first half of 2006, net income and depreciation and amortization more than offset the negative cash flow impact of changes in assets and liabilities excluding short-term debt. Net cash used in investing activities was \$23.6 million in the first half of 2006, above the \$17.2 million used in last year's first six months. Purchases of short-term investments and business acquisitions were the main factors in the increase, partly offset by sales of property, plant and equipment. Additions to property, plant and equipment of \$17.9 million in the first half of 2006 were up \$2.4 million from \$15.5 million in the comparable period of 2005. At July 1, 2006, we had \$15.3 million of outstanding commitments for future capital expenditures. Capital expenditures for the remainder of 2006 are expected to be \$32.0 million to \$37.0 million. Our cash flow used in financing activities was \$20.8 million during the first half of 2006 as compared to \$18.0 million in the first six months of 2005.

Our outstanding long-term debt decreased to \$346.9 million at July 1, 2006 from \$386.3 million at December 31, 2005. The decrease was due primarily to the combination of a \$20.0 million increase in commercial paper proceeds and positive cash flow. Of our total long-term debt, \$228.5 million was outstanding under our \$475 million unsecured revolving credit facility that expires on May 5, 2009 (the "Facility"). The Facility permits the Company to borrow at interest rates based upon a margin above the London Inter-Bank Offered Rate ("LIBOR"), which margin varies with the ratio of total funded debt to earnings before interest, taxes, depreciation and amortization ("EBITDA"). These interest rates also vary as LIBOR varies. We also pay a commitment fee on the unused amount of the Facility, which also varies with the ratio of our total debt to our EBITDA. At July 1, 2006, the Company's margin above LIBOR was .75% and our commitment fee rate was .15%. The Facility requires us to meet specified financial ratios and to satisfy certain financial condition tests. We were in compliance with all of these tests as of July 1, 2006.

In addition to the Facility, at July 1, 2006 we also had \$115 million of convertible senior subordinated debt outstanding at a fixed interest rate of 2.75%, \$45 million of short-term commercial paper borrowings and \$4.7 million of other senior debt. At July 1, 2006, our borrowing availability under the Facility was \$198.4 million based on the Facility's credit limit.

CRITICAL ACCOUNTING POLICIES

Revenue Recognition

The Company recognizes revenue upon transfer of title, which generally occurs upon shipment of the product to the customer. The pricing of products sold is generally supported by customer purchase orders, and accounts receivable collection is reasonably assured at the time of shipment. Estimated discounts and rebates are recorded as a reduction of sales in the same period revenue is recognized. Product returns and credits are estimated and recorded at the time of shipment based upon historical experience. Shipping and handling costs are recorded as revenue when billed to the customers.

Goodwill and Other Intangibles

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill is not amortized; however it is tested for impairment in the fourth quarter, with any resulting adjustment charged to the results of operations. Amortization continues to be recorded for other intangible assets with definite lives.

Retirement Plans

Approximately half of our domestic employees are covered by defined benefit pension plans with the remaining domestic employees covered by defined contribution plans. The large majority of our foreign employees are covered by mandated government programs. Our obligations under our domestic defined benefit plans are determined with the assistance of actuarial firms. The actuaries make certain assumptions regarding such factors as withdrawal rates and mortality rates. The actuaries also provide us with information and recommendations from which management makes further assumptions on such factors as the long-term expected rate of return on plan assets, the discount rate on benefit obligations and where applicable, the rate of annual compensation increases. Based upon the assumptions made, the investments made by the plans, overall conditions and movement in financial markets, particularly the stock market and how actual withdrawal rates, life-spans of benefit recipients and other factors differ from assumptions, annual expenses and recorded assets or liabilities of these defined benefit plans may change significantly from year to year. Based on our annual review of actuarial assumptions as well as historical rates of return on plan assets and existing long-term bond rates, we set the long-term rate of return on plan assets at 8.75% and the discount rate at 5.75% for our defined benefit plans as of December 31, 2005.

Use of Estimates and Assumptions

The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires the use of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

New Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 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. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 will be effective for us beginning in fiscal 2007. We are evaluating the interpretation to determine the effect on our financial statements and related disclosures.

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment ("SFAS 123(R))", which requires companies to expense the value of employee stock options and similar equity-based awards. This SFAS 123(R) is a revision of FASB Statement 123, "Accounting for Stock-Based Compensation". SFAS 123(R) was adopted by the Company on January 1, 2006. Prior to the adoption of SFAS 123(R) the Company accounted for equity-based awards under the intrinsic method and compensation expense was included in a proforma footnote disclosure. Operating income has been reduced by \$0.9 million of equity-based compensation in the three months ended July 1, 2006 compared to \$0.2 million in the three months ended June 29, 2005. For the six months ended July 1, 2006 and June 29, 2005, operating income was reduced by \$1.7 million and \$.4 million, respectively, for equity-based compensation. The Company expects to record pretax expense of approximately \$3.5million for the 2006 fiscal year.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk relating to the Company's operations due to changes in interest rates, foreign currency exchange rates and commodity prices of purchased raw materials. We manage the exposure to these risks through a combination of normal operating and financing activities and derivative financial instruments such as commodity cash flow hedges and foreign currency forward exchange contracts.

The Company is exposed to interest rate risk on certain of its short-term and long-term debt obligations used to finance our operations and acquisitions. At July 1, 2006, we had \$161.5 million of fixed rate debt and \$231.7 million of variable rate debt, the latter subject to interest rate risk. The variable rate debt is primarily under a credit facility with an interest rate based on a margin above LIBOR. As a result, interest rate changes impact future earnings and cash flow assuming other factors are constant. A hypothetical 10% change in our weighted average borrowing rate on outstanding variable rate debt at July 1, 2006, would result in a change in after-tax annualized earnings of approximately \$.9 million.

The Company periodically enters into commodity futures and options hedging transactions to reduce the impact of changing copper, aluminum and natural gas commodity prices. Contract terms of commodity hedge instruments generally mirror those of the hedged item, providing a high degree of risk reduction and correlation.

[Index](#)

We are also exposed to foreign currency risks that arise from normal business operations. These risks include the translation of local currency balances of foreign subsidiaries, intercompany loans with foreign subsidiaries and transactions denominated in foreign currencies. Our objective is to minimize our exposure to these risks through a combination of normal operating activities and the utilization of foreign currency contracts to manage our exposure on the transactions denominated in currencies other than the applicable functional currency. Due to our two acquisitions in August and December 2004, we have significantly increased our manufacturing operations outside the United States. In the first half of 2005, we began to enter into contracts to hedge foreign-currency denominated forecasted transactions. Contracts are executed with creditworthy banks and are denominated in currencies of major industrial countries. It is our policy not to enter into derivative financial instruments for speculative purposes. We do not hedge our exposure to the translation of reported results of foreign subsidiaries from local currency to United States dollars.

All hedges are recorded on the balance sheet at fair value and are accounted for as cash flow hedges, with changes in fair value recorded in accumulated other comprehensive income ("AOCI") in each accounting period. An ineffective portion of the hedge's change in fair value, if any, is recorded in earnings in the period of change. The impact due to ineffectiveness was immaterial for all periods included in this report.

In the second quarter and first six months of 2006, \$2.1 million and \$.7 million of net increased fair market value of derivative instruments was recorded in AOCI. At July 1, 2006, we had a balance of \$8.5 million in assets, \$5.2 million in liabilities and a net after tax unrealized gain of \$5.5 million in AOCI, representing the fair market value of cash flow commodity and foreign currency hedges. Of the total assets, liabilities and AOCI related to derivatives at July 1, 2006, -0- million, \$1.0 million and \$1.0 million, respectively, were related to currency hedges, with the balance relating to commodity hedges.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

Changes in Internal Control Over Financial Reporting. There were no changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Items 2, 3 and 5 are inapplicable and have been omitted.

ITEM 1. LEGAL PROCEEDINGS

An action was filed on June 4, 2004, and amended in September 2004, against one of the Company's subsidiaries, Marathon Electric Manufacturing Corporation ("Marathon"), by Enron Wind Energy Systems, LLC, Enron Wind Contractors, LLC and Zond Minnesota Construction Company, LLC (collectively, "Enron Wind"). The action was filed in the United States Bankruptcy Court for the Southern District of New York where each of the Enron Wind entities has consolidated its Chapter 11 bankruptcy petition as part of the Enron Corporation bankruptcy proceedings. In the action against Marathon, Enron Wind has asserted various claims relating to the alleged failures and/or degradations of performance of about 564 generators sold by Marathon to Enron Wind from 1997 to 1999. In January 2001, Enron Wind and Marathon entered into a "Generator Warranty and Settlement Agreement and Release of All Claims" ("Warranty Agreement"). This Warranty Agreement resolved various issues related to past performance of the generators, provided a limited warranty related to the generators going forward, and contained a release by all parties of any claims related to the generators other than those arising out of the obligations contained in the Warranty Agreement.

[Index](#)

Enron Wind is seeking to recover the purchase price of the generators and transportation costs totaling about \$21 million. In addition, although the Warranty Agreement contains a waiver of consequential, incidental, and punitive damages, Enron Wind claims that this limitation is unenforceable and seeks recovery of consequential, incidental and punitive damages incurred by it and by its customers, totaling an additional \$100 million. Enron Wind has asserted claims of breach of contract, breach of the implied covenant of good faith and fair dealing, promissory fraud, and intentional interference with contractual relations. Marathon has filed a motion with the court seeking to have many of Enron Wind's claims dismissed. Enron Wind has filed a motion with the court seeking a declaration that Marathon had an obligation under the Warranty Agreement to repair or replace the generators in the first instance regardless of whether an actual breach of warranty had occurred. The court has held hearings on both motions, but has not yet ruled.

The Company believes that this action is without merit and that it has meritorious defenses to the action. The Company intends to defend vigorously all of the asserted claims. The litigation is in an early discovery phase and it is difficult for the Company to predict the impact the litigation may ultimately have on the Company's results of operations or financial condition, including the expenses the Company may incur to defend against the action. As of July 1, 2006, the Company continues to accrue for anticipated costs in defending against this matter and such accumulated reserves at July 1, 2006 are immaterial.

The Company is, from time to time, party to other lawsuits arising from its normal business operations. It is believed that the outcome of these lawsuits will have no material effect on the Company's financial position or its results of operations.

ITEM 1A. RISK FACTORS

The business and financial results of the Company are subject to numerous risks and uncertainties. The risks and uncertainties have not changed materially from those reported in the 2005 Annual Report on Form 10-K.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

(a) The company held its Annual Meeting of Shareholders on April 26, 2006.

(b) The Directors elected at the meeting and those continuing after the Annual Meeting:

| Class A Directors | Class B Directors | Class C Directors |
|-------------------|----------------------|-------------------|
| Henry W. Kneuppel | James L. Packard | Stephen N. Graff |
| Dean A. Foate | G. Frederick Kasten | Thomas J. Fischer |
| | Curtis W. Stoelting | |
| | Christopher L. Doerr | |

(c) (1) The Shareholders voted for election of the following Class A Directors to serve until the 2009 Annual Meeting of Shareholders:

| | Votes For | Votes Withheld |
|-------------------|------------|----------------|
| Henry W. Kneuppel | 25,465,086 | 2,471,160 |
| Dean A. Foate | 25,718,359 | 2,217,887 |

(2) The Shareholders voted for election of the following Class B Director to serve until the 2007 Annual Meeting of Shareholders:

| | Votes For | Votes Withheld |
|------------------|------------|----------------|
| James L. Packard | 25,435,889 | 2,500,357 |

(3) The proposal to approve the Company's Shareholder Value Added (SVA) Executive Officers Incentive Compensation Plan was approved by a vote of 24,557,336 for, 2,586,008 against and 792,902 abstentions.

(4) The proposal to ratify the appointment of Deloitte & Touche LLP as the company's independent registered public accounting firm was approved by a vote of 27,151,478 for, 776,374 against and 8,394 abstentions.

ITEM 6. EXHIBITS

| Exhibit Number | Exhibit Description |
|---------------------------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certifications of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 |

SIGNATURE

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.

REGAL-BELOIT CORPORATION

(Registrant)

/s/ David A. Barta

David A. Barta

Vice President, Chief Financial Officer

(Principal Accounting and Financial Officer)

Date: August 9, 2006

INDEX TO EXHIBITS

| Exhibit Number | Exhibit Description |
|-----------------------------|---|
| <u>31.1</u> | <u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>31.2</u> | <u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.1</u> | <u>Certifications of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350</u> |