



## Item 1. Financial Statements

The accompanying interim condensed consolidated financial statements of MFRI, Inc. and subsidiaries (the "Company") are unaudited, but include all adjustments which the Company's management considers necessary to present fairly the financial position and results of operations for the periods presented. These adjustments consist of normal recurring adjustments. Certain information and footnote disclosures have been condensed or omitted pursuant to Securities and Exchange Commission rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's annual report on Form 10-K for the year ended January 31, 2007. Reclassifications have been made in prior year financial statements to conform to the current year presentation. The results of operations for the quarter ended April 30, 2007 are not necessarily indicative of the results to be expected for the full year ending January 31, 2008. One of the reasons for this is that, generally, sales of the Company's piping systems have had a tendency to be lower during the winter months, due to weather constraints over much of the northern hemisphere.

### MFRI, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share information)

	Three Months Ended April 30,	
	2007	2006
Net sales	\$ 56,954	\$ 46,932
Cost of sales	46,162	37,127
Gross profit	10,792	9,805
Operating expenses:		
Selling expenses	3,801	3,706
General and administrative expenses	5,111	4,967
Total operating expenses	8,912	8,673
Income from operations	1,880	1,132
Income from joint venture	20	83
Interest expense – net	476	556
Income before income taxes	1,424	659
Income taxes	386	508
Net income	\$ 1,038	\$ 151
Weighted average number of common shares outstanding – basic	6,537	5,281
Weighted average number of common shares outstanding - diluted	6,821	5,662
Basic earnings per share		
Net income	\$ 0.16	\$ 0.03
Diluted earnings per share		
Net income	\$ 0.15	\$ 0.03

See notes to condensed consolidated financial statements.

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### MFRI, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

<i>(In thousands)</i>	<b>April 30, 2007</b>	<b>January 31, 2007</b>
<b>Assets</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 1,125	\$ 565
Restricted cash	993	540
Trade accounts receivable, less allowance for doubtful accounts of \$360 in 2007 and \$504 in 2006	36,241	35,056
Accounts receivable – related company	356	583
Costs and estimated earnings in excess of billings on ncompleted contracts	6,823	4,974
Income taxes receivable	0	93
Inventories, net	35,370	35,155
Deferred income taxes	2,443	2,382
Prepaid expenses and other current assets	1,592	1,326
<b>Total current assets</b>	<b>84,943</b>	<b>80,674</b>
Property, plant and equipment, net	33,798	33,441
<b>Other Assets:</b>		
Patents, net of accumulated amortization	444	392
Goodwill	2,686	2,613
Other assets	4,539	4,320
<b>Total other assets</b>	<b>7,669</b>	<b>7,325</b>
<b>Total Assets</b>	<b>\$ 126,410</b>	<b>\$ 121,440</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities:</b>		
Trade accounts payable	\$ 17,940	\$ 20,919
Commissions payable	4,779	6,908
Customer deposits	4,090	5,454
Accrued compensation and payroll taxes	2,470	2,480
Other accrued liabilities	3,103	3,119
Current maturities of long-term debt	7,594	9,191
Billings in excess of costs and estimated earnings on uncompleted ontracts	694	1,270
Income taxes payable	364	0
Accounts payable – related company	400	599
<b>Total current liabilities</b>	<b>41,434</b>	<b>49,940</b>
<b>Long-Term Liabilities:</b>		
Long-term debt, less current maturities	23,264	29,844
Other	3,504	2,840
<b>Total long-term liabilities</b>	<b>26,768</b>	<b>32,684</b>
<b>Stockholders' Equity:</b>		
Common stock, \$.01 par value, authorized – 50,000 shares in April 2007 and January 2007; 6,537 issued and outstanding in April 2007 and 5,530 issued and outstanding in January 2007	65	55
Additional paid-in capital	43,738	25,327
Retained earnings	13,569	13,037
Accumulated other comprehensive income	836	397
<b>Total stockholders' equity</b>	<b>58,208</b>	<b>38,816</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 126,410</b>	<b>\$ 121,440</b>

See notes to condensed consolidated financial statements.

**MFRI, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(In thousands)

	<b>Three Months Ended</b>	
	<b>April 30,</b>	
	<u><b>2007</b></u>	<u><b>2006</b></u>
Cash Flows from Operating Activities:		
Net income	\$ 1,038	\$ 151
Adjustments, to reconcile net income to net cash flows from operating activities:		
Income from joint venture	(20)	(83)
Depreciation and amortization	1,067	868
Change in cash surrender value of deferred comp plan	(35)	6
Provision for uncollectible accounts	3	47
Deferred income taxes	(61)	73
Loss on sales of assets	4	-
Stock-based compensation expense	47	15
Changes in operating assets and liabilities:		
Accounts receivable	(949)	(8,060)
Income taxes receivable	394	19
Inventories	(1,065)	(1,589)
Prepaid expenses and other current assets	(1,072)	633
Accounts payable	26	541
Accrued compensation and payroll taxes	(2,127)	148
Other assets and liabilities	(2,630)	1,586
Net Cash Flows from Operating Activities	<u>(5,380)</u>	<u>(5,645)</u>
Cash Flows from Investing Activities:		
Purchases of property and equipment	(1,156)	(2,035)
Distributions from joint venture	286	-
Proceeds from sales of property and equipment	<u>1</u>	<u>-</u>
Net Cash Flows from Investing Activities	<u>(869)</u>	<u>(2,035)</u>

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	<u>                    </u>	<u>                    </u>
Cash Flows from Financing Activities:		
Borrowings under revolving, term and mortgage loans	4,702	37,494
Repayment of debt	(13,061)	(34,508)
Increase (decrease) in cash overdrafts	(3,343)	4,671
Issuance of stock	18,332	-
Stock options exercised	18	32
Tax benefit of stock options exercised	24	-
Payments on capitalized lease obligations	(41)	(2)
Net Cash Flows from Financing Activities	<u>6,631</u>	<u>7,687</u>
Effect of Exchange Rate Changes on Cash and Cash Equivalents	178	252
Net Increase in Cash and Cash Equivalents	<u>560</u>	<u>259</u>
Cash and Cash Equivalents – Beginning of Period	565	1,114
Cash and Cash Equivalents – End of Period	<u>\$ 1,125</u>	<u>\$ 1,373</u>
Supplemental Cash Flow Information:		
Cash paid for:		
Interest, net of capitalized amounts	\$ 547	\$ 557
Income taxes paid	28	39
See notes to condensed consolidated financial statements.		

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**MFRI, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**APRIL 30, 2007**

- The unaudited financial statements herein have been prepared by the Company in accordance with generally accepted accounting principals and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, footnote disclosures which would substantially duplicate the disclosures contained in the January 31, 2007 audited financial statements have been omitted from these interim financial statements. Interim financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's latest Annual Report on Form 10-K.

2. At April 30, 2007 the Company has equity-based compensation plans from which stock-based compensation awards can be granted to eligible employees, officers or directors.

Effective February 1, 2006, the Company adopted the fair value recognition provision of Statement of Financial Accounting Standards (“SFAS”) No. 123 (revised 2004), “Share-Based Payment” (“SFAS 123R”) using the modified-prospective-transition method. Under this transition method, compensation cost recognized includes compensation costs for all share-based payments granted prior to, but not vested as of February 1, 2006 based on the fair value at grant date estimated in accordance with SFAS 123. The Company has not awarded stock-based compensation to employees, officers or directors during the three-month period ended April 30, 2007. The stock-based compensation expense for the three months ended April 30, 2007 and 2006 was \$47,300 and \$15,000, respectively.

The fair values of the option awards granted prior to but not vested as of April 2007 and 2006 respectively, were estimated on the grant date using the Black-Scholes option pricing model and the assumptions shown in the following table:

	<b>Three Months Ended April 30, 2007</b>	<b>Three Months Ended April 30, 2006</b>
Expected volatility	46.81%-52.23%	46.81%-51.95%
Risk-free interest rate	2.93%-5.16%	2.93%-4.51%
Dividend yield	0%	0%
Expected life in years	7	7

3. ***Inventories consisted of the following:***

<i>(In thousands)</i>	<b>April 30, 2007</b>	<b>January 31, 2007</b>
Raw materials	\$ 27,231	\$ 27,982
Work in progress	4,828	3,644
Finished goods	4,544	4,803
Sub total	<u>36,603</u>	<u>36,429</u>
Less: Inventory allowance	1,233	1,274
Inventory, net	<u><u>35,370</u></u>	<u><u>35,155</u></u>

4. ***Goodwill:*** The Company reviews the carrying value of goodwill in accordance with SFAS No. 142, “Goodwill and Other Intangible Assets”, which requires that goodwill and other intangible assets with indefinite lives be analyzed for impairment on an annual basis or when there is reason to suspect that their values have been impaired. For the 2007 and 2006 evaluations, the fair value was determined using discounted cash flows and other market-related valuation models. Certain estimates and judgments are required in the application of the fair value models. Based upon the Company’s evaluations for 2007 and 2006, no impairment of goodwill was required. Goodwill was \$2,686,000 and \$2,613,000 at April 30, 2007 and January 31, 2007, respectively. As of April 30, 2007 and January 31, 2007, \$1,100,000 of goodwill was allocated to the Industrial Process Cooling Equipment segment. As of April 30, 2007 and January 31, 2007, \$1,586,000 and \$1,513,000, respectively, was allocated to the Filtration Products segment. The change in goodwill was due to foreign currency translation.
5. ***Other intangible assets with definite lives:*** Patents are capitalized and amortized on a straight-line basis over a period not to exceed the legal lives of the patents. Patents were \$2,506,000 and \$2,447,000 at April 30, 2007 and January 31, 2007, respectively. Accumulated amortization was \$2,062,000 and \$2,055,000 at April 30, 2007 and January 31, 2007,

respectively. Future amortization over the next five years ending January 31, will be 2008 - \$30,000, 2009 - \$27,000, 2010 - \$23,000, 2011 - \$21,000, 2012 - \$18,000.

6. ***Pension Plan for Hourly Rated Employees of Midwesco Filter Resources, Inc., Winchester, Virginia*** : The market-related value of plan assets at April 30, 2007 and January 31, 2007 were \$3,954,563 and \$3,869,122, respectively. Net cost recognized was as follows:

<i>(In thousands)</i>	<b>Three Months Ended April 30,</b>	
	<b>2007</b>	<b>2006</b>
Components of net periodic benefit cost:		
Service cost	\$ 28	\$ 24
Interest cost	56	49
Expected return on plan assets	(76)	(67)
Amortization of prior service cost	27	21
Recognized actuarial loss	0	6
Net periodic benefit cost	\$ 35	\$ 33

Employer contributions remaining for fiscal year ending January 31, 2008 are expected to be \$97,044.

7. ***The basic weighted average shares reconcile to diluted weighted average shares as follows:***

<i>(In thousands, except per share information)</i>	<b>Three Months Ended April 30,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 1,038	\$ 151
Basic weighted average number of common shares outstanding	6,537	5,281
Dilutive effect of stock options	284	381
Weighted average number of common shares outstanding assuming full dilution	6,821	5,662
Basic earnings per share net income	\$ 0.16	\$ 0.03
Diluted earnings per share net income	\$ 0.15	\$ 0.03

	<b>Three Months Ended April 30,</b>	
	<b>2007</b>	<b>2006</b>
Stock options not included in the computation of diluted earnings per share of common stock because the option exercise prices exceeded the average market prices of the common shares	0	75,000
Stock options with an exercise price below the average stock price	542,308	652,521

As of June 5, 2007 a total of 17,352 stock options were exercised since February 1, 2007.

8. ***The components of comprehensive income, net of tax, were as follows:***

<i>(In thousands)</i>	<b>Three Months Ended April 30,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 1,038	\$ 151
Interest rate swap	2	45
Change in foreign currency translation adjustments	554	212

OCI unrealized gain on marketable securities	(117)	-
Comprehensive income	<u>\$ 1,477</u>	<u>\$ 408</u>

Accumulated other comprehensive income presented on the accompanying condensed consolidated balance sheets consists of the following:

<i>(In thousands)</i>	<u>April 30, 2007</u>	<u>January 31, 2007</u>
Accumulated translation adjustment	\$ 1,486	\$ 932
Interest rate swap (including a tax expense \$1 at January 31, 2007)	0	(3)
Minimum pension liability adjustment (net of cumulative tax benefit of \$338)	(716)	(716)
OCI unrealized gain on marketable securities (including a Tax benefit of \$87 at January 31, 2007)	66	184
Accumulated other comprehensive income	<u>\$ 836</u>	<u>\$ 397</u>

The OCI unrealized gain on marketable securities of \$66,000 at April 30, 2007 is gross of an \$18,000 tax benefit.

9. **Business Segment Reporting:** The Company has three reportable segments under the criteria of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." The Filtration Products Business manufactures and sells a wide variety of filter elements for air filtration and particulate collection systems. The Piping Systems Business engineers, designs, manufactures and sells specialty piping systems and leak detection and location systems. The Industrial Process Cooling Equipment Business engineers, designs, manufactures and sells chillers, cooling towers, plant circulating systems and accessories for industrial process applications.

<i>(In thousands)</i>	<u>Three Months Ended April 30,</u>	
	<u>2007</u>	<u>2006</u>
Net sales:		
Filtration Products	\$ 26,437	\$ 18,565
Piping Systems	20,740	14,246
Industrial Process Cooling Equipment	9,442	11,636
Corporate and Other	335	2,485
Total net sales	<u>\$ 56,954</u>	<u>\$ 46,932</u>
Gross profit (loss):		
Filtration Products	\$ 4,143	\$ 3,302
Piping Systems	4,468	2,906
Industrial Process Cooling Equipment	2,207	3,517
Corporate and Other	(26)	80
Total gross profit	<u>\$ 10,792</u>	<u>\$ 9,805</u>
Income (loss) from operations:		
Filtration Products	\$ 1,307	\$ 682
Piping Systems	2,534	1,092

Industrial Process Cooling Equipment	(405)	904
Corporate and Other	(1,556)	(1,546)
Income from operations	<u>\$ 1,880</u>	<u>\$ 1,132</u>
Income (loss) before income taxes:		
Filtration Products	\$ 1,307	\$ 682
Piping Systems	2,554	1,175
Industrial Process Cooling Equipment	(405)	904
Corporate and Other	(2,032)	(2,102)
Income before income taxes	<u>\$ 1,424</u>	<u>\$ 659</u>

10. **Related Party Transactions:** The Company provides certain services to a company primarily owned by two principal stockholders who are also members of management of the Company.

Related company accounts receivable of \$356,000 and \$583,000 were included in the receivable balances at April 30, 2007 and January 31, 2007, respectively. Related company accounts payable of \$400,000 and \$599,000 were included in the payable balance at April 30, 2007 and January 31, 2007.

The Company recorded revenue of \$229,000 during the first quarter of 2007 and \$2,485,000 during the first quarter of 2006 pursuant to a contract wholly-subcontracted to such company.

11. **Contingencies:** The Company is subject to various unresolved legal actions, which arise in the normal course of its business. None of these matters is expected to have a material adverse effect on the Company's financial position or results of operations. However, the ultimate resolution of these matters could result in a change in the Company's estimate of its liability for these matters.

The Company issues a standard warranty with the sale of its products and sells extended warranty contracts to customers. The Company's recognition of warranty liability is based, generally, on analyses of warranty claims experiences in the operating units in the preceding years. Changes in the warranty liability in 2007 are summarized below:

<i>(in thousands)</i>	<b>Three Months Ended April 30, 2007</b>	<b>Year Ended January 31, 2007</b>
Aggregate product warranty liability at beginning of period	\$ 1,259	\$ 827
Aggregate accruals related to product warranties	483	1,996
Aggregate reductions for payments	(488)	(1,535)
Aggregate changes for pre-existing warranties	0	(29)
Aggregate product warranty liability at end of period	<u>\$ 1,254</u>	<u>\$ 1,259</u>

12. **New Accounting Pronouncements:** In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109", ("FIN 48"). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. On January 17, 2007, the FASB affirmed its previous decision to make FIN 48

effective for fiscal years beginning after December 15, 2006. FIN 48 must be applied to all existing tax positions upon initial adoption. The cumulative effect of applying Fin 48 at adoption, if any, is to be reported as an adjustment to opening retained earnings for the year of adoption. Accordingly, FIN 48 is effective for the Company on February 1, 2007.

In the first quarter of 2007, the Company adopted FIN 48. The total amount of unrecognized tax liability as of February 1, 2007 was approximately \$504,300, all of which would impact the effective tax rate if recognized. This was recorded as a decrease to retained earnings as of February 1, 2007. Included in the total unrecognized tax liability were estimated accrued interest of \$38,300 and penalties of \$31,300. The Company's policy is to exclude interest and penalties from income tax expense.

13. **Debt:** At April 30, 2007, the Company was in compliance with covenants under the Loan Agreement as defined below.

In February 2007, the Company sold 1,003,000 shares of common stock at a price of \$18.50 per share pursuant to the Company's existing shelf registration statement previously filed and declared effective by the U.S. Securities and Exchange Commission. The net proceeds of \$18,322,000 from such sale were utilized to pay down the revolving line of credit. As a result, increased revolving line of credit borrowing capacity is available to finance future general business needs.

On July 11, 2002, the Company entered into a secured loan and security agreement with a financial institution ("Loan Agreement"). The Loan Agreement was amended and restated on December 15, 2006. Under the terms of the Loan Agreement, which matures on November 13, 2010, the Company can borrow up to \$38,000,000, subject to borrowing base and other requirements, under a revolving line of credit. The Loan Agreement covenants restrict debt, liens, and investments, do not permit payment of dividends, and require attainment of certain levels of profitability and cash flows. Interest rates generally are based on options selected by the Company as follows: (a) a margin in effect plus a prime rate; or (b) a margin in effect plus the LIBOR rate for the corresponding interest period. At April 30, 2007, the prime rate was 8.25%, and the margins added to the prime rate and the LIBOR rate, which are determined each quarter based on the applicable financial statement ratio, were 0.25 and 1.75 percentage points, respectively. Monthly interest payments were made. As of April 30, 2007, the Company had borrowed \$9,341,000 and had \$12,434,000 available to it under the revolving line of credit. In addition, \$6,684,000 of availability was used under the Loan Agreement primarily to support letters of credit to guarantee amounts owed for Industrial Revenue Bond borrowings. The Loan Agreement provides that all payments by the Company's customers are deposited in a bank account from which all

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funds may only be used to pay the debt under the Loan Agreement. At April 30, 2007, the amount of restricted cash was \$993,000. Cash required for operations is provided by draw-downs on the line of credit.

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

The statements contained under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" and certain other information contained elsewhere in this report, which can be identified by the use of forward-looking terminology such as "may," "will," "expect," "continue," "remains," "intend," "aim," "should," "prospects," "could," "future," "potential," "believes," "plans," "likely," and "probable," or the negative thereof or other variations thereon or comparable terminology, constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbors created thereby. These statements should be considered as subject to the many risks and uncertainties that exist in the Company's operations and business environment. Such risks and uncertainties could cause actual results to differ materially from those projected. These uncertainties

include, but are not limited to, economic conditions, market demand and pricing, competitive and cost factors, raw material availability and prices, global interest rates, currency exchange rates, labor relations and other risk factors.

## **RESULTS OF OPERATIONS**

### **MFRI, Inc.**

MFRI, Inc. ("MFRI", the "Company" or the "Registrant") is engaged in the manufacture and sale of products in three distinct business segments: filtration products, piping systems and industrial process cooling equipment. Generally, sales of the Company's piping systems have had a tendency to be lower during the winter months, due to weather constraints over much of the northern hemisphere. The Company's other businesses do not demonstrate seasonality.

Our analysis presented below is organized to provide instructive information for understanding the business going forward. However, this discussion should be read in conjunction with the consolidated financial statements, including the notes thereto. An overview of the segment results is provided in Note 9 of the Notes to Condensed Consolidated Financial Statements (Unaudited) contained in Item 1 of this report.

*Three months ended April 30, 2007 vs. Three months ended April 30, 2006*

Net sales of \$56,954,000 for the quarter increased 21.4% from \$46,932,000 in the prior-year quarter. (See discussion of each business segment below.)

Gross profit of \$10,792,000 increased 10.1% from \$9,805,000 in the prior-year quarter, and gross margin decreased to 18.9% of net sales in the current year from 20.9 % of net sales in the prior-year. (See discussion of each business segment below.)

Selling expenses increased 2.6% to \$3,801,000 for the quarter from \$3,706,000 in the prior-year quarter due primarily to additional selling personnel. (See discussion of each business segment below.)

General and administrative expenses increased 2.9% to \$5,111,000 for the quarter from \$4,967,000 in the prior-year quarter. (See discussion of each business segment below.)

Net income rose to \$1,038,000 in the current quarter from \$151,000 in the prior-year quarter primarily for reasons summarized above and discussed in more detail below, including the favorable income tax effect of \$663,000 of United Arab Emirates ("U.A.E.") facility net income which was not taxable. Because the U.A.E. facility is located in an area with no income taxes, future earnings generated there will also be free of income taxes.

### **Filtration Products Business**

*Three months ended April 30, 2007 vs. Three months ended April 30, 2006*

Net sales for the quarter increased 42.4% to \$26,437,000 from \$18,565,000 in the prior-year quarter. This increase was primarily the result of increased sales of filter bags, pleated products and related services.

Gross profit as a percent of net sales declined to 15.7% in the current year from 17.8% in the prior-year primarily as a result of product mix and a highly competitive market place.

Selling expenses increased to \$1,872,000 from \$1,726,000 in the prior-year quarter and decreased as a percentage of sales to 7.1% from 9.3% of net sales in the prior-year quarter. The dollar increase was primarily due to additional selling personnel and inclusion of the selling expenses of the South African facility acquired in April 2006.

General and administrative expenses increased to \$964,000 in the current-year quarter from \$897,000 in the prior-year quarter and decreased as a percentage of sales to 3.7% from 4.8% of net sales in the prior-year quarter. The dollar increase was primarily the result of the inclusion of the general and administrative expenses of the South African facility acquired in April 2006.

### **Piping Systems Business**

Generally, sales of the Company's piping systems have had a tendency to be lower during the winter months, due to weather constraints over much of the northern hemisphere.

*Three months ended April 30, 2007 vs. Three months ended April 30, 2006*

Net sales increased 45.6% to \$20,740,000 in the current quarter from \$14,246,000 in the prior-year quarter. This increase was primarily due to an increase in the domestic heating and cooling business and \$3,253,000 in sales from the U.A.E. facility.

Gross profit as a percent of net sales increased to 21.5% in the current quarter from 20.4% in the prior-year quarter primarily due to higher sales margins at the U.A.E. facility.

Selling expenses increased to \$471,000 or 2.3% of net sales in the current year quarter from \$425,000 or 3.0% of net sales for the prior-year quarter. The dollar increase was primarily due to additional selling personnel at the new facility in the U.A.E.

General and administrative expenses increased to \$1,464,000 or 7.1% of net sales in the current year quarter from \$1,390,000 or 9.8% of net sales for the prior-year quarter. General administrative expenses increased primarily due to management incentive compensation earned as a result of improved profitability.

### **Industrial Process Cooling Equipment Business**

*Three months ended April 30, 2007 vs. Three months ended April 30, 2006*

Net sales of \$9,442,000 for the quarter decreased 18.9% from \$11,636,000 in the prior-year quarter. The decrease was due primarily to conditions in printing and industrial markets.

Gross profit decreased to 23.4% of net sales in the current quarter from 30.2% of net sales in the prior-year quarter, primarily due to additional post sale customer support costs and an increasing original equipment manufacturer customer sales mix.

Selling expenses decreased to \$1,459,000 or 15.5% of net sales in the current-year quarter from \$1,556,000 or 13.4% of net sales in the prior-year quarter. The dollar decrease was due to lower commissions due to decreased sales.

General and administrative expenses increased to \$1,154,000 or 12.2% of net sales from \$1,057,000 or 9.1% of net sales in the prior-year quarter. This increase was primarily due to additional recruiting expenses.

### **General Corporate and Other**

*Three months ended April 30, 2007 vs. Three months ended April 30, 2006*

During the first quarter 2006, the Company recognized \$2,485,000 in revenue pursuant to a contract wholly subcontracted to a related company, Midwesco, Inc., for installation of a heating, ventilation and air conditioning (HVAC) system for a high rise building in Chicago. During the fourth quarter 2006, the Company created a new

subsidiary, Midwesco Mechanical and Energy, Inc., that was not material to the financial statements, in which the Company intends to engage in similar activities .

The first quarter 2007, included sales of \$335,000 not related to the Company's three reportable business segments.

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General corporate expenses included interest expense and general and administrative expenses that were not allocated to the business segments.

General and administrative expenses decreased to \$1,530,000 in the current year quarter from \$1,626,000 in the prior-year quarter, and decreased as a percentage of total company net sales to 2.7% in the current year quarter from 3.5% in the prior-year quarter. The decrease was mainly due to a group insurance refund related to the prior year offset by inclusion of the new subsidiary.

Interest expense decreased to \$476,000 for the current year quarter from \$556,000 in the prior-year quarter. The decrease was due to reduced borrowings.

#### **Taxes**

Taxes on earnings reflect the estimated annual effective rates. Due to the seasonality of the Piping Systems business, the annual estimated U.S. income versus foreign income that is earned in a tax free zone differs as compared to the first quarter's actual U.S. income versus foreign income. The 27.1% effective tax rate for the first quarter 2007 is less than the statutory U.S. federal income tax rate due mainly to the favorable income tax effect of the tax free income from the U.A.E.

#### **LIQUIDITY AND CAPITAL RESOURCES**

In February 2007, the Company sold 1,003,000 shares of common stock at a price of \$18.50 per share pursuant to the Company's existing shelf registration statement previously filed and declared effective by the U.S. Securities and Exchange Commission. The net proceeds of \$18,322,000 from this sale were utilized to pay down the revolving line of credit. As a result, increased revolving line of credit borrowing capacity is available to finance future general business needs.

Cash and cash equivalents as of April 30, 2007 were \$1,125,000 as compared to \$565,000 at January 31, 2007. The Company used \$5,380,000 from operations during the first three months. Operating cash flows increased by \$265,000 from the corresponding period in the prior year. Net payments of \$8,400,000 from the Company's credit facility were made. Exercise of stock options resulted in proceeds of \$18,000.

Compared to January 31, 2007, trade receivables increased by \$949,000, inventories increased by \$1,065,000, and other operating assets and liabilities decreased by \$2,630,000.

Net cash used for investing activities for the three months ended April 30, 2007 was \$869,000. Capital expenditures decreased \$879,000 from the prior year to \$1,156,000.

Debt totaled \$30,858,000, a decrease of \$8,177,000 since the beginning of the year. Net cash inflows from financing activities were \$6,631,000. Stock option activity resulted in \$18,000 of cash inflow.

The Company's working capital was approximately \$43,509,000 at April 30, 2007 compared to approximately \$30,734,000 at January 31, 2007. The change was primarily due to the decreases in accounts payable and payment of management incentive compensation and commissions payable.

The Company's current ratio was 2.1 to 1 for April 30, 2007 and 1.6 to 1 for January 31, 2007, respectively. Debt to total capitalization at April 30, 2007 decreased to 34.7% from 50.1% in January 31, 2007.

At April 30, 2007, the Company was in compliance with covenants under the Loan Agreement as defined below.

On July 11, 2002, the Company entered into a secured loan and security agreement with a financial institution ("Loan Agreement"). The Loan Agreement was amended and restated on December 15, 2006. Under the terms of the Loan Agreement, which matures on November 13, 2010, the Company can borrow up to \$38,000,000, subject to borrowing base and other requirements, under a revolving line of credit. The Loan Agreement covenants restrict debt, liens, and investments, do not permit payment of dividends, and require attainment of certain levels of profitability and cash flows. Interest rates generally are based on options selected by the Company as follows: (a) a margin in effect plus a prime rate; or (b) a margin in effect plus the LIBOR rate for the corresponding interest period. At April 30, 2007, the prime rate was 8.25%, and the margins added to the prime rate and the LIBOR rate, which are determined each quarter based on the applicable financial statement ratio, were 0.25 and 1.75 percentage points, respectively. Monthly interest payments were made. As of April 30, 2007, the Company had borrowed \$9,341,000 and had \$12,434,000 available to it under the revolving line of credit. In addition, \$6,684,000 of availability was used under the Loan Agreement primarily to support letters of credit to guarantee amounts owed for Industrial Revenue Bond borrowings. The Loan Agreement provides that all payments by the Company's customers are deposited in a bank account from which all funds may be used to pay

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the debt under the Loan Agreement. At April 30, 2007, the amount of restricted cash was \$993,000. Cash required for operations is provided by draw-downs on the line of credit.

## **CRITICAL ACCOUNTING POLICIES**

**Reclassifications:** Reclassifications were made to prior-year financial statements to conform to the current-year presentations.

**Use of Estimates:** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company has accounting policies which it believes are important to the Company's financial condition and results of operations, and which require the Company to make estimates about matters that are inherently uncertain. These critical accounting policies include revenue recognition, realizability of inventories, collectibility of accounts receivable, depreciation of plant and equipment, and income taxes. The Company believes the above critical policies have resulted in past actual results approximating the estimated amounts in those areas.

**Revenue Recognition:** The Company recognizes revenues including shipping and handling charges billed to customers, when all the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) the seller's price to the buyer is fixed or determinable, and (iii) collectibility is reasonably assured. All subsidiaries of the Company, except the Piping Systems business, recognize revenues upon shipment or delivery of goods or services when title and risk of loss pass to customers.

**Percentage of Completion Method Revenue Recognition:** Piping Systems business recognizes revenues on contracts under the "percentage of completion" method. The percentage of completion is determined by the relationship of costs incurred to the total estimated costs of the contract. Provisions are made for estimated losses on uncompleted contracts in the period in which such losses are determined. Changes in job performance, job

conditions, and estimated profitability, including those arising from contract penalty provisions and final contract settlements may result in revisions to costs and income. Such revisions are recognized in the period in which they are determined. Claims for additional compensation due the Company are recognized in contract revenues when realization is probable and the amount can be reliably estimated.

**Inventories:** Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method for substantially all inventories.

**Goodwill and other intangible assets with indefinite lives:** The Company reviews the carrying value of goodwill in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets", which requires that goodwill and other intangible assets with indefinite lives be analyzed for impairment on an annual basis or when there is reason to suspect that their values have been impaired. For the evaluations, the fair value was determined using discounted cash flows and other market-related valuation models. Certain estimates and judgments are required in the application of the fair value models. Refer to Note 4 Goodwill in Notes to Condensed Consolidated Financial Statements.

**Stock Options:** Effective February 1, 2006, the Company adopted the fair value recognition provision of SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R") using the modified-prospective-transition method. Under this transition method, compensation cost recognized includes compensation costs for all share-based payments granted prior to, but not vested as of February 1, 2006 based on the fair value at grant date estimated in accordance with SFAS 123. In accordance with SFAS 123R, results for prior periods have not been restated.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company was subject to market risk associated with changes in foreign currency exchange rates and interest rates. Foreign currency exchange rate risk was mitigated through maintenance of local production facilities in the markets served, invoicing of customers in the same currency as the source of the products and use of foreign currency denominated debt in Denmark.

At January 31, 2007 one interest rate swap agreement was in effect with a notional value of \$15,000,000 maturing in 2011. The swap agreement exchanges the variable rate to fixed interest rate payments of 5.13% plus LIBOR margin. On February 5, 2007 the Company terminated such interest rate swap and recognized a loss of \$72,500.

A hypothetical ten percent change in market interest rates over the next year would increase interest on the Company's floating rate debt instruments by approximately \$96,000.

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Commodity price risk is the possibility of higher or lower costs due to changes in the prices of commodities, such as ferrous alloys (e.g., steel) which are used in the production of the piping systems. The Company attempted to mitigate such risks by obtaining price commitments from its commodity suppliers and, when it appeared appropriate, purchasing quantities in advance of likely price increases.

### **Item 4. Controls and Procedures**

As of April 30, 2007, the Company carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14 under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

## PART II – OTHER INFORMATION

### Item 6. Exhibits

- (31) Rule 13a – 14(a)/15d – 14(a) Certifications
  - (1) Chief Executive Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
  - (2) Chief Financial Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
  
- (32) Section 1350 Certifications
  - (1) Chief Executive Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
  - (2) Chief Financial Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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### SIGNATURES

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

MFRI, INC.

Date: June 11, 2007

/s/ David Unger

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David Unger

Chairman of the Board of Directors, and  
Chief Executive Officer  
(Principal Executive Officer)

Date: June 11, 2007

/s/ Michael D. Bennett

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Michael D. Bennett

Vice President, Secretary and Treasurer  
(Principal Financial and Accounting Officer)

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I, David Unger, certify that:

1. I have reviewed this quarterly report on Form 10-Q of MFRI, Inc.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting .

Date: June 11, 2007

/s/ David Unger

David Unger  
Director and Chairman of the Board of Directors  
and Chief Executive Officer  
(Principal Executive Officer)

I, Michael D. Bennett, certify that:

1. I have reviewed this quarterly report on Form 10-Q of MFRI, Inc.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting .

Date: June 11, 2007

/s/ Michael D. Bennett

Michael D. Bennett  
Vice President, Secretary and Treasurer  
(Principal Financial and Accounting Officer)

**Certification of Principal Executive Officer  
Pursuant to 18 U.S.C. 1350  
(Section 906 of the Sarbanes-Oxley Act of 2002)**

I, David Unger, Chief Executive Officer (principal executive officer) of MFRI, Inc. (the “Registrant”), certify that, to the best of my knowledge, based upon a review of the Quarterly Report on Form 10-Q for the period ended April 30, 2007 of the Registrant (the “Report”):

- (1) The Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ David Unger

David Unger  
Director and Chairman of the Board of Directors  
and Chief Executive Officer  
(Principal Executive Officer)  
June 11, 2007

A signed original of this written statement required by Section 906 has been provided to MFRI, Inc. and will be retained by MFRI, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

**Certification of Principal Financial Officer  
Pursuant to 18 U.S.C. 1350  
(Section 906 of the Sarbanes-Oxley Act of 2002)**

I, Michael D. Bennett, Chief Financial Officer (principal financial officer) of MFRI, Inc. (the “Registrant”), certify that, to the best of my knowledge, based upon a review of the Quarterly Report on Form 10-Q for the period ended April 30, 2007 of the Registrant (the “Report”):

- (1) The Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Michael D. Bennett

Michael D. Bennett  
Vice President, Secretary and Treasurer  
(Principal Financial and Accounting Officer)  
June 11, 2007

A signed original of this written statement required by Section 906 has been provided to MFRI, Inc. and will be retained by MFRI, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.