PROLOGIS TRUST
Form 10-Q
November 13, 2001

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 September 30, 2001
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____________ to _____________

Commission File Number 01-12846

PROLOGIS TRUST
(Exact name of registrant as specified in its charter)

Maryland (State or other jurisdiction of incorporation or organization)	74-2604728 (I.R.S. Employer Identification No.)
14100 East 35th Place, Aurora, Colorado (Address or principal executive offices)	80011 (Zip Code)

(303) 375-9292
(Registrant's telephone number, including area code)

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

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

The number of shares outstanding of the Registrant's common stock as of November 9, 2001 was 174,953,233.

ProLogis Trust

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PROLOGIS TRUST

CONSOLIDATED CONDENSED BALANCE SHEETS
(In thousands, except share data)

	September 30, 2001 (Unaudited)	De
ASSETS		
Real estate..	$ 5,005,056	$
Less accumulated depreciation..	555,690	
	4,449,366	
Investments in and advances to unconsolidated entities................	820,100	
Cash and cash equivalents..	87,310	
Accounts and notes receivable..	32,180	
Other assets...	288,911	
Total assets..	$ 5,677,867	$
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Lines of credit..	$ 287,553	$
Senior unsecured debt..	1,670,271	
Mortgage notes and other secured debt................................	531,836	
Accounts payable and accrued expenses................................	149,747	
Construction payable...	40,731	
Distributions and dividends payable..................................	729	
Other liabilities..	122,821	
Total liabilities.......................................	2,803,688	
Minority interest..	45,938	
Shareholders' equity:		
Series A Preferred Shares; $0.01 par value; 5,400,000 shares issued and outstanding at December 31, 2000; stated liquidation preference of $25.00 per share.................	--	
Series B Preferred Shares; $0.01 par value; 6,256,100 shares issued and outstanding at December 31, 2000; stated liquidation preference of $25.00 per share..	--	
Series C Preferred Shares; $0.01 par value; 2,000,000 shares issued and outstanding at September 30, 2001 and December 31, 2000; stated liquidation preference of $50.00 per share.................	100,000	
Series D Preferred Shares; $0.01 par value; 10,000,000 shares issued and outstanding at September 30, 2001 and December 31, 2000; stated liquidation preference of $25.00 per share.................	250,000	
Series E Preferred Shares; $0.01 par value; 2,000,000 shares issued and outstanding at September 30, 2001 and December 31, 2000; stated liquidation preference of $25.00 per share.................	50,000	
Common shares of beneficial interest; $0.01 par value; 174,645,388 shares issued and outstanding at September 30, 2001 and 165,287,358 shares issued and outstanding at December 31, 2000................	1,746	

Additional paid-in capital	2,933,202	
Employee share purchase notes	(17,161)	
Accumulated other comprehensive income	(53,198)	
Distributions in excess of net earnings	(436,348)	
Total shareholders' equity	2,828,241	
Total liabilities and shareholders' equity	$ 5,677,867	$

The accompanying notes are an integral part of these consolidated condensed financial statements.

PROLOGIS TRUST

CONSOLIDATED CONDENSED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME
(Unaudited)
(In thousands, except per share data)

	Three Months Ended September 30,		N
	2001	2000	20
Income:			
Rental income	$ 116,547	$ 121,519	$ 35
Other real estate income	36,326	19,479	11
Income (loss) from unconsolidated entities	(3,101)	21,336	
Interest and other income	993	1,334	
Total income	150,765	163,668	47
Expenses:			
Rental expenses, net of recoveries of $23,485 and $72,243 for the three and nine months in 2001, respectively, and $22,426 and $68,163 for the three and nine months in 2000, respectively, and including amounts paid to affiliate of $174 for the nine months in 2001 and $294 and $919 for the three and nine months in 2000, respectively	7,973	6,486	2
General and administrative, including amounts paid to affiliate of $170 for the nine months in 2001 and $252 and $719 for the three and nine months in 2000, respectively	11,312	9,652	3

Depreciation and amortization	37,170	35,448	10
Interest	37,645	43,700	11
Loss on investment	--	--	
Other	754	1,188	
Total expenses	94,854	96,474	29
Earnings from operations	55,911	67,194	18
Minority interest share in earnings	1,502	1,228	
Earnings before gain on disposition of real estate and foreign currency exchange losses	54,409	65,966	17
Gain on disposition of real estate, net	3,488	702	
Foreign currency exchange losses, net	(25)	(1,929)	(
Earnings before income taxes	57,872	64,739	17
Income taxes:			
Current income tax expense	859	465	
Deferred income tax expense (benefit)	(77)	1,535	
Total income taxes	782	2,000	
Net earnings	57,090	62,739	16
Less preferred share dividends	8,179	14,120	2
Net earnings attributable to Common Shares	48,911	48,619	13
Other comprehensive income:			
Foreign currency translation adjustments	43,200	(38,263)	(1
Comprehensive income	$ 92,111	$ 10,356	$ 11
Weighted average Common Shares outstanding - Basic	174,507	164,317	17
Weighted average Common Shares outstanding - Diluted	175,586	170,578	17
Per Common Share:			
Basic net earnings attributable to Common Shares	$ 0.28	$ 0.30	$
Diluted net earnings attributable to Common Shares	$ 0.28	$ 0.29	$
Distributions	$ 0.345	$ 0.335	$

The accompanying notes are an integral part of these consolidated condensed financial statements.

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PROLOGIS TRUST
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

Nine Months

	Septembe
	2001
Operating activities:	
Net earnings	$ 166,600
Minority interest share in earnings	4,350
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Depreciation and amortization	109,352
Gain on disposition of real estate	(863)
Straight-lined rents	(5,392)
Amortization of deferred loan costs	3,689
Stock-based compensation	5,150
Income (loss) from unconsolidated entities	5,715
Loss on investment	7,456
Deferred income tax expense	1,096
Foreign currency exchange losses, net	1,757
Increase in accounts receivable and other assets	(21,753)
Increase in accounts payable, accrued expenses and other liabilities	48,690
Net cash provided by operating activities	325,847
Investing activities:	
Real estate investments	(869,273)
Tenant improvements and lease commissions on previously leased space	(16,379)
Recurring capital expenditures	(23,401)
Proceeds from dispositions of real estate	875,541
Distributions and debt repayments received from unconsolidated entities	293,469
Investments in and advances to unconsolidated entities	(139,569)
Proceeds from repayment of note receivable	10,424
Cash balances recorded upon consolidation of Kingspark Holding S. A.	89,788
Cash balances contributed as part of ProLogis European Properties S.a.r.l.	--
Net cash provided by (used in) investing activities	220,600
Financing activities:	
Net proceeds from exercised options and dividend reinvestment and share purchase plans	48,575
Repurchase of Common Shares, net of costs	(16,000)
Redemption of Series A preferred shares	(135,000)
Redemption of Series B convertible preferred shares	(4,583)
Debt issuance and other transaction costs incurred	(1,815)
Distributions paid on Common Shares	(177,332)
Distributions paid to minority interest holders	(5,248)
Distributions paid on preferred shares	(29,130)
Principal payments on senior unsecured debt	(30,000)
Principal payments received on employee share purchase notes	1,395
Payments on the purchase of derivative financial instruments	(2,232)
Proceeds from settlement of derivative financial instruments	106
Proceeds from lines of credit	976,406
Payments on lines of credit	(1,128,675)
Regularly scheduled principal payments on mortgage notes	(5,930)
Principal prepayments on mortgage notes	(7,544)
Net cash used in financing activities	(517,007)
Net increase in cash and cash equivalents	29,440
Cash and cash equivalents, beginning of period	57,870
Cash and cash equivalents, end of period	$ 87,310

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See Note 9 for information on non-cash investing and financing activities.

The accompanying notes are an integral part of these consolidated condensed financial statements.

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PROLOGIS TRUST

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
September 30, 2001
(Unaudited)

1. General:

Business

ProLogis Trust (collectively with its consolidated subsidiaries and partnerships "ProLogis") is a publicly held real estate investment trust ("REIT") that owns and operates a network of industrial distribution facilities in North America, Europe and Asia (Japan). The ProLogis Operating System(R), comprised of the Market Services Group, the Global Services Group, the Global Development Group and the Integrated Solutions Group, utilizes ProLogis' international network of distribution facilities to meet its customers' distribution space needs globally. ProLogis has organized its business into three operating segments: property operations, corporate distribution facilities services business ("CDFS business") and temperature-controlled distribution operations. See Note 8.

Principles of Financial Presentation

The consolidated condensed financial statements of ProLogis as of September 30, 2001 and for the three and nine months ended September 30, 2001 and 2000 are unaudited and, pursuant to the rules of the Securities and Exchange Commission, certain information and footnote disclosures normally included in financial statements have been omitted. While management of ProLogis believes that the disclosures presented are adequate, these interim consolidated condensed financial statements should be read in conjunction with ProLogis' December 31, 2000 audited consolidated financial statements contained in ProLogis' 2000 Annual Report on Form 10-K.

In the opinion of management, the accompanying unaudited consolidated condensed financial statements contain all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of ProLogis' consolidated financial position and results of operations for the interim periods. The consolidated results of operations for the three and nine months ended September 30, 2001 and 2000 are not necessarily indicative of the results to be expected for the entire year. Certain of the 2000 amounts have been reclassified to conform to the 2001 financial statement presentation.

The preparation of consolidated condensed financial statements in conformity with United States generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated condensed financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

ProLogis' investment in Kingspark Holding S.A. ("Kingspark S.A."), an industrial distribution facility development company in the United Kingdom was previously accounted for under the equity method. ProLogis owned 100% of the preferred stock of Kingspark S.A. and recognized substantially all economic benefits of Kingspark S.A. and its subsidiaries through January 4, 2001. On January 5, 2001, ProLogis acquired an ownership interest in the common stock of Kingspark S.A. resulting in ProLogis having control of Kingspark S.A. Accordingly, as of January 5, 2001, the accounts of Kingspark S.A. and its subsidiaries are consolidated in ProLogis' condensed financial statements along with ProLogis' other majority-owned and controlled subsidiaries and partnerships.

As of September 30, 2001, ProLogis owned 100% of the preferred stock of ProLogis Development Services Incorporated ("ProLogis Development Services") and realizes substantially all economic benefits of this entity's activities. Because ProLogis advances mortgage loans to ProLogis Development Services to fund its acquisition, development and construction activities, ProLogis Development Services is consolidated in ProLogis' condensed financial statements along with ProLogis' other majority-owned and controlled subsidiaries and partnerships. ProLogis Development Services is not a qualified REIT subsidiary of ProLogis under the Internal Revenue Code of 1986, as amended (the "Code"). Accordingly, provisions for federal and state income taxes are recognized, as appropriate.

Recently issued Statements of Financial Accounting Standards ("SFAS") that are applicable to ProLogis' business are:

o SFAS No. 142, "Goodwill and Other Intangible Assets" provides that goodwill is no longer subject to amortization over its estimated useful life. Rather, goodwill will be subject to at least an annual assessment for impairment by applying a fair-value-based-test (the impairment guidance in existing rules for equity method goodwill will continue to apply). SFAS No. 142 also changes the rules for recognition of acquired intangible assets other than goodwill but continues to require that intangible assets be amortized over their useful lives.

o SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" establishes a single accounting model for long-lived assets to be disposed of by sale and provides implementation guidance with respect to accounting for impairment of long-lived assets. SFAS No. 144 requires that discontinued operations be measured on the same basis as other long-lived assets (the lower of its carrying amount or fair value less cost to sell) rather than at the net realizable value as previously required. Additionally, future operating losses of discontinued operations are no longer recognized before they occur.

SFAS Nos. 142 and 144 are effective for ProLogis' fiscal year ending December 31, 2002. Management is still evaluating the effects these standards will have, if any, on ProLogis' consolidated financial position, results of operations or financial statement disclosures. For the nine months ended September 30, 2001 and 2000, ProLogis recognized amortization expense related to recognized goodwill of $2.3 million and $1.8 million, respectively, as a component of "Depreciation and Amortization" in its Consolidated Condensed Statements of Earnings and Comprehensive Income.

Interest Expense

Interest expense was $115.2 million and $128.5 million for the nine months in 2001 and 2000, respectively, which is net of capitalized interest of $26.6 million and $12.8 million, respectively. Amortization of deferred loan costs included in interest expense was $3.7 million and $3.0 million for the nine months in 2001 and 2000, respectively. Total interest paid in cash on all outstanding debt was $133.2 million and $123.3 million for the nine months in 2001 and 2000, respectively.

Financial Instruments

In the normal course of business, ProLogis uses certain derivative financial instruments for the purpose of foreign currency exchange rate and interest rate risk management. All derivative financial instruments are accounted for at fair value with changes in fair value recognized immediately in accumulated other comprehensive income or income.

ProLogis adopted SFAS No. 133, "Accounting for Derivative Instruments and for Hedging Activities," as amended, on January 1, 2001. SFAS No. 133 provides comprehensive guidelines for the recognition and measurement of derivatives and hedging activities and, specifically, requires all derivatives to be recorded on the balance sheet at fair value as an asset or liability, with an offset to accumulated other comprehensive income or income. ProLogis' only derivative financial instruments in effect at September 30, 2001 were foreign currency put option contracts. Similar foreign currency put option contracts were marked to market through income in 2000 because they did not qualify for hedge accounting treatment. Under SFAS No. 133, these contracts also do not qualify for hedge accounting treatment. Consequently, ProLogis has continued to mark its foreign currency put option contracts to market through income during the nine months ended September 30, 2001. ProLogis' unconsolidated entities also adopted SFAS No. 133 on January 1, 2001. The effect to ProLogis of their adoption of SFAS No. 133 was immaterial as these entities utilize derivative financial instruments on a limited basis.

In assessing the fair value of its financial instruments, both derivative and non-derivative, ProLogis uses a variety of methods and assumptions that are based on market conditions and risks existing at each balance sheet date. Primarily, ProLogis uses quoted market prices or quotes from brokers or dealers for the same or similar instruments. These values represent a general approximation of possible value and may never actually be realized.

Foreign Currency Exchange Gains or Losses

ProLogis' consolidated subsidiaries whose functional currency is not the U.S. dollar translate their financial statements into U.S. dollars. Assets and liabilities are translated at the exchange rate in effect as of the financial statement date. Income statement accounts are translated using the average exchange rate for the period. Income statement accounts that represent significant, nonrecurring transactions are translated at the rate in effect as of the date of the transaction. Gains and losses resulting from the translation are included in accumulated other comprehensive income as a separate component of shareholders' equity.

ProLogis and its foreign subsidiaries have certain transactions denominated in currencies other than their functional currency. In these instances, nonmonetary assets and liabilities are remeasured at the historical exchange rate, monetary assets and liabilities are remeasured at the exchange rate in effect at the end of the period, and income statement accounts are remeasured at the average exchange rate for the period. Gains and losses from remeasurement are included in ProLogis' results of operations.

Gains or losses are recorded in the income statement when a transaction with a third party, denominated in a currency other than the functional currency, is settled and the functional currency cash flows realized are more or less than expected based upon the exchange rate in effect when the transaction was initiated.

The net foreign currency exchange gains and losses recognized in ProLogis' results of operations were as follows for the periods indicated (in thousands of U.S. dollars):

	Three Months Ended September 30,		Nine Months Ende September 30,	
	2001	2000	2001	2000
Gains (losses) from the remeasurement of third party debt and remeasurement and settlement of intercompany debt, net	$ 1,088	$ (2,661)	$ (3,721)	$(21,6
Mark to market gains (losses) on foreign currency put option contracts (1)	(817)	(477)	245	
Gains (losses) from the settlement of foreign currency put option contracts, net (1)	(417)	1,427	(998)	1,5
Other gains (losses), net	121	(218)	(117)	(2
Total	$ (25)	$ (1,929)	$ (4,591)	$(20,3

2. Real Estate:

Real Estate Investments

Real estate investments consisting of income producing industrial distribution facilities, facilities under development and land held for future development, at cost, are summarized as follows (in thousands):

	September 30, 2001	December 31, 2000
Operating facilities:		
Improved land	$ 657,863(1)	$ 648,950 (1)
Buildings and improvements	3,539,384(1)	3,619,543 (1)
	4,197,247	4,268,493
Facilities under development (including cost of land)	375,722(2)(3)	186,020 (2)

Land held for development	310,997(4)	187,405 (4)
Capitalized preacquisition costs	121,090(5)	47,574 (5)
Total real estate	5,005,056	4,689,492
Less accumulated depreciation	555,690	476,982
Net real estate	$ 4,449,366	$ 4,212,510

ProLogis' operating facilities, facilities under development and land held for future development are located in North America (the United States and Mexico), in ten countries in Europe and in Japan. No individual market represents more than 10% of ProLogis' real estate assets.

Operating Lease Agreements

ProLogis leases its facilities to customers under agreements, which are classified as operating leases. The leases generally provide for payment of all or a portion of utilities, property taxes and insurance by the tenant. As of September 30, 2001, minimum lease payments on leases with lease periods greater than one year are as follows (in thousands):

Remainder of 2001	$ 110,044
2002	401,552
2003	325,768
2004	240,684
2005	172,394
2006 and thereafter	352,162
	$ 1,602,604

ProLogis' largest customer (based on rental income) accounted for 0.9% of ProLogis' rental income (on an annualized basis) for the nine months ended September 30, 2001. The annualized base rent for ProLogis' 25 largest customers (based on rental income) accounted for 12.8% of ProLogis' rental income (on an annualized basis) for the nine months ended September 30, 2001.

3. Unconsolidated Entities:

Investments In and Advances To Unconsolidated Entities

Investments in and advances to unconsolidated entities are as follows (in thousands):

	September 30, 2001	December 31, 2000
Temperature-controlled distribution companies:		
CSI/Frigo LLC (1)	$ 1,994	$ --
ProLogis Logistics (2)(3)	132,257	231,053
Frigoscandia S.A. (2)(4)	185,025	191,981
	319,276	423,034

Distribution real estate entities:		
ProLogis California (5)	119,294	132,243
ProLogis North American Properties Fund I (6)	44,238	10,369
ProLogis North American Properties Fund II (7)	8,642	13,408
ProLogis North American Properties Fund III (8)	6,452	--
ProLogis North American Properties Fund IV (9)	4,315	--
ProLogis European Properties Fund (10)	226,112	147,938
ProLogis European Properties S.a.r.l. (10)	--	84,767
	409,053	388,725
Kingspark S. A. (11)	--	570,582
ProLogis Kingspark Joint Ventures (12)	31,224	--
Insight (13)	2,459	2,470
ProLogis Equipment Services (14)	1,772	450
GoProLogis (15)	56,316	56,315
ProLogis Phatpipe (16)	--	11,572
Total	$ 820,100	$ 1,453,148

Income (Loss) from Unconsolidated Entities

ProLogis recognized income (loss) from its investments in unconsolidated entities as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000
Temperature-controlled distribution companies:				
CSI/Frigo LLC (1)	$ (550)	$ --	$ (1,343)	$
ProLogis Logistics (2)	(1,036)	2,196	(3,636)	8,0
Frigoscandia S.A (2)	(8,066)	(5,755)	(18,061)	(10,8
	(9,652)	(3,559)	(23,040)	(2,7
Distribution real estate entities:				
ProLogis California (3)	3,067	3,543	10,186	9,5
ProLogis North American Properties Fund I (4)	967	1,233	3,561	1,2
ProLogis North American Properties Fund II (5)	728	307	1,634	3
ProLogis North American Properties Fund III (6)	542	--	582	
ProLogis North American Properties Fund IV (7)	(12)	--	(12)	
ProLogis European Properties Fund (8)	1,023	4,637	7,959	8,9
ProLogis European Properties S.a.r.l. (9)	--	2,811	36	7,6
	6,315	12,531	23,946	27,7
Kingspark S.A. (10)	--	11,083	--	20,4
ProLogis Kingspark Joint Ventures (11)	236	--	1,753	
Insight	--	36	(10)	
ProLogis Equipment Services	--	--	(155)	
GoProLogis (12)	--	1,171	3,043	1,1
ProLogis PhatPipe (12)	--	74	667	
	$ (3,101)	$ 21,336	$ 6,204	$ 46,7

Temperature-Controlled Distribution Companies

ProLogis' total investment in its temperature-controlled distribution companies as of September 30, 2001 consisted of (in millions of U.S. dollars):

	CSI/Frigo LLC	ProLogis Logistics (1)	Frigoscandia S.A. (2)
Equity interest	$ 0.4	$ 138.4	$ 22.6
ProLogis' share of the earnings of the entity	(1.5)	(16.4)	(95.9)
Subtotal	(1.1)	122.0	(73.3)
Other (including acquisition costs), net	--	--	1.7
Subtotal	(1.1)	122.0	(71.6)
Notes and other receivables	3.1	10.2	256.6
Total	$ 2.0	$ 132.2	$ 185.0

Distribution Real Estate Entities

ProLogis' total investment in its distribution real estate entities as of September 30, 2001 consisted of (in millions of U.S. dollars):

	ProLogis California	ProLogis North American Properties Fund I	ProLogis North American Properties Fund II	ProLogis North American Properties Fund III
Equity interest	$ 161.1	$ 52.6	$ 14.3	$ 11.8
Distributions	(35.5)	(4.6)	(1.2)	(0.4)
ProLogis' share of the earnings of the entity, excluding fees earned	20.0	2.1	0.2	--
Subtotal	145.6	50.1	13.3	11.4
Adjustments to carrying value (3)	(28.0)	(9.4)	(6.4)	(5.9)
Other (including acquisitions costs)	1.5	2.3	1.3	1.0
Subtotal	119.1	43.0	8.2	6.5
Other receivables	0.2	1.2	0.4	--
Total	$ 119.3	$ 44.2	$ 8.6	$ 6.5

Summarized Financial Information

Summarized financial information for ProLogis' unconsolidated entities as of and for the nine months ended September 30, 2001 is presented below (in millions of U.S. dollars). The information presented is for the entire entity.

	ProLogis North	ProLogis North	ProLogis North

	ProLogis Logistics (1)	Frigoscandia S.A. (1)	ProLogis California (2)	American Properties Fund I (3)	American Properties Fund II (4)	American Propertie Fund III
Total assets............	$ 379.9	$ 455.7	$ 592.0	$ 357.3	$ 236.2	$ 210.
Total liabilities (7)...	$ 257.0	$ 535.0	$ 301.0	$ 238.5	$ 168.6	$ 152.
Minority interest.......	$ --	$ 0.2	$ --	$ --	$ --	$ -
Equity..................	$ 122.9	$ (79.5)	$ 291.0	$ 118.8	$ 67.6	$ 57.
Revenues................	$ 233.4	$ 274.5	$ 50.6	$ 31.9	$ 14.8	$ 6.
Adjusted EBITDA (8).....	$ 18.2	$ 27.4	$ 41.3	$ 24.7	$ 9.8	$ 3.
Net earnings (loss)(9)..	$ (3.7)	$ (27.9)	$ 14.7	$ 4.3	$ 1.1	$ 0.

4. Borrowings:

In August 2001, the available commitment under ProLogis' unsecured credit agreement with Bank of America, N.A., Commerzbank AG and Chase Bank of Texas, National Association as Agents for a bank group that provides a revolving line of credit to ProLogis, was increased by $25.0 million to a total of $500.0 million.

In September 2001, ProLogis entered into an unsecured credit agreement that provides for a 24.5 billion yen revolving unsecured line of credit (the currency equivalent of $205.6 million as of September 30, 2001) through a group of 11 banks, on whose behalf Sumitomo Mitsui Banking Corporation acts as agent. Borrowings under the line of credit bear interest at 1.00% over the Tokyo Interbank Offering Rate (TIBOR). Borrowings outstanding as of September 30, 2001 were at a weighted average interest rate of 1.06% per annum. The credit agreement provides for an unused commitment fee of 0.25% per annum. The credit agreement matures on September 13, 2004 and may be extended for an additional year at ProLogis' option. As of September 30, 2001, the currency equivalent of approximately $46.2 million of borrowings were outstanding on the line of credit and ProLogis was in compliance with all covenants contained in the agreement.

5. Shareholders' Equity:

During the nine months ended September 30, 2001, ProLogis generated net proceeds of $48.6 million from the issuance of 2,116,000 common shares of beneficial interest, $0.01 par value ("Common Shares") under its 1999 Dividend Reinvestment and Share Purchase Plan and issued 165,000 Common Shares upon the exercise of stock options.

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On January 11, 2001, ProLogis announced a Common Share repurchase program under which it may repurchase up to $100.0 million of its Common Shares. The Common Shares will be repurchased from time to time in the open market and in privately negotiated transactions, depending on market prices and other conditions. As of September 30, 2001, 778,400 Common Shares had been repurchased at a total cost of $16.0 million.

ProLogis redeemed all of its outstanding Series B cumulative convertible redeemable preferred shares ("Series B preferred shares") as of March 20, 2001. Subsequent to the call for redemption, 5,908,971 Series B preferred shares were converted into 7,575,301 Common Shares. The remaining 183,302 Series B preferred shares outstanding on March 20, 2001 were redeemed at a price of $25.00 per share, plus $0.442 in accrued and unpaid dividends, for an aggregate redemption price of $25.442 per share.

ProLogis redeemed all of its outstanding Series A cumulative redeemable preferred shares of beneficial interest as of May 8, 2001 at the price of $25.00 per share, plus $0.2481 in accrued and unpaid dividends, for an aggregate redemption price of $25.2481 per share.

In May, 2001, ProLogis' shareholders approved the establishment of the ProLogis Trust Employee Share Purchase Plan (the "Plan"). Under the terms of the Plan, employees of ProLogis and its participating subsidiaries may purchase Common Shares, through payroll deductions only, at a discounted price of 85% of the fair market value of the Common Shares. Subject to certain provisions, the aggregate number of Common Shares which may be issued under the Plan may not exceed 5,000,000. ProLogis expects to begin issuing Common Shares under the Plan in January, 2002.

6. Distributions and Dividends:

Common Distributions

On February 23, 2001, May 25, 2001 and August 24, 2001, ProLogis paid a quarterly distribution of $0.345 per Common Share to shareholders of record on February 9, 2001, May 14, 2001 and August 10, 2001, respectively. The distribution level for 2001 was set by ProLogis' Board of Trustees in December 2000 at $1.38 per Common Share.

Preferred Dividends

The annual dividend rates on ProLogis' preferred shares are $4.27 per Series C cumulative redeemable preferred share, $1.98 per Series D cumulative redeemable preferred share and $2.1875 per Series E cumulative redeemable preferred share.

On January 31, 2001, April 30, 2001 and July 31, 2001 ProLogis paid quarterly dividends of $0.5469 per Series E cumulative redeemable preferred share. On March 30, 2001, ProLogis paid quarterly dividends of $0.5875 per Series A cumulative redeemable preferred share. On March 30, 2001, June 29, 2001 and September 28, 2001, ProLogis paid quarterly dividends of $1.0675 per Series C cumulative redeemable preferred share and $0.495 per Series D cumulative redeemable preferred share.

Pursuant to the terms of its preferred shares, ProLogis is restricted from declaring or paying any distribution with respect to the Common Shares unless all cumulative dividends with respect to the preferred shares have been paid and sufficient funds have been set aside for dividends that have been declared for the then-current dividend period with respect to the preferred shares.

7. Earnings Per Common Share:

A reconciliation of the denominator used to calculate basic earnings per Common Share to the denominator used to calculate diluted earnings per Common Share for the periods indicated (in thousands, except per share amounts) is as follows:

	Three Months Ended September 30,		Nine Months E... September 3...	
	2001	2000	2001	
Net earnings attributable to Common Shares.....	$ 48,911	$ 48,619	$ 137,470	$
Add: Minority interest share in earnings......	--	1,228	--	
Series B preferred share dividends.......	--	--	81	
Adjusted net earnings attributable to Common Shares......................................	$ 48,911	$ 49,847	$ 137,551	$
Weighted average Common Shares outstanding - Basic.....................................	174,507	164,317	171,932	
Incremental weighted average effect of common stock equivalent and contingently issuable shares......................................	1,079	1,097	948	
Weighted average convertible limited partnership units..........................	--	5,164	--	
Weighted average Series B preferred shares.....	--	--	2,065	
Adjusted weighted average Common Shares outstanding - Diluted....................	175,586	170,578	174,945	
Per share net earnings attributable to Common Shares:				
Basic....................................	$ 0.28	$ 0.30	$ 0.80	$
Diluted..................................	$ 0.28	$ 0.29	$ 0.79	$

For the periods indicated, the following weighted average convertible securities were not included in the calculation of diluted per share net earnings attributable to Common Shares as the effect, on an as-converted basis, was antidilutive (in thousands):

	Three Months Ended September 30,		Nine Months September	
	2001	2000	2001	
Series B preferred shares......................	--	8,133	--	
Limited partnership units......................	5,088	--	5,088	

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8. Business Segments:

ProLogis has three reportable business segments:

- Property operations represents the long-term ownership and leasing of industrial distribution facilities in the United States (portions of which are owned through ProLogis California, ProLogis North American Properties Fund I, ProLogis North American Properties Fund II, ProLogis North American Properties Fund III and ProLogis North American Properties Fund IV -- See Note 3), Mexico and Europe (portions of which are owned through ProLogis European Properties Fund and ProLogis European Properties S.a.r.l. -- See Note 3); each operating facility is considered to be an individual operating segment having similar economic characteristics which are combined within the reportable segment based upon geographic location;

- CDFS business operations represents the development of industrial distribution facilities by ProLogis, ProLogis Development Services or Kingspark S.A. and its subsidiaries in the United States, Mexico, Europe and Japan that are often disposed of to third parties or entities in which ProLogis has an ownership interest and the development of industrial distribution facilities by ProLogis on a fee basis for third parties in the United States, Mexico, Europe and Japan; the development activities of ProLogis, ProLogis Development Services or Kingspark S.A. and its subsidiaries are considered to be individual operating segments having similar economic characteristics which are combined within the reportable segment based upon geographic location; and

- Temperature-controlled distribution operations represents the operation of a temperature-controlled distribution and logistics network through investments in unconsolidated entities in the United States (ProLogis Logistics) and Europe (Frigoscandia S.A.); each company's operating facilities are considered to be individual operating segments having similar economic characteristics which are combined within the reportable segment based upon geographic location. See Note 3.

Reconciliations of the three reportable segments': (i) income from external customers to ProLogis' total income; (ii) net operating income from external customers to ProLogis' earnings from operations (ProLogis' chief operating decision makers rely primarily on net operating income to make decisions about allocating resources and assessing segment performance); and (iii) assets to ProLogis' total assets are as follows (in thousands):

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	Nine Months Ended September 30,	
	2001	2000
Income:		
Property operations:		
United States (1)....................	$ 350,349	$ 359,133
Mexico...............................	14,066	11,217
Europe (2)...........................	13,597	19,447
Total property operations segment..	378,012	389,797

CDFS business:		
United States (3)	66,965	56,630
Mexico	(10)	1,543
Europe (4)(5)	46,538	27,952
Total CDFS business segment	113,493	86,125
Temperature-controlled distribution operations:		
United States (6)	(3,663)	8,067
Europe (7)	(19,377)	(10,806)
Total temperature-controlled distribution operations segment	(23,040)	(2,739)
Reconciling items:		
Income (loss) from unconsolidated entities	3,545	1,279
Interest and other income	4,449	5,554
Total reconciling items	7,994	6,833
Total income	$ 476,459	$ 480,016
Net operating income:		
Property operations:		
United States (1)	$ 326,290	$ 337,742
Mexico	17,272	10,922
Europe (2)	12,795	20,516
Total property operations segment	356,357	369,180
CDFS business:		
United States (3)	64,498	53,826
Mexico	(84)	1,514
Europe (4)(5)	46,305	27,901
Total CDFS business segment	110,719	83,241
Temperature-controlled distribution operations:		
United States (6)	(3,663)	8,067
Europe (7)	(19,377)	(10,806)
Total temperature-controlled distribution operations segment	(23,040)	(2,739)
Reconciling items:		
Income (loss) from unconsolidated entities	3,545	1,279
Interest and other income	4,449	5,554
General and administrative expense	(39,441)	(32,174)
Depreciation and amortization	(109,352)	(112,513)
Interest expense	(115,199)	(128,542)
Loss on investment	(7,456)	--
Other expense	(3)	(954)
Total reconciling items	(263,457)	(267,350)
Earnings from operations	$ 180,579	$ 182,332

	September 30, 2001	December 31, 2000
Assets:		
Property operations:		
United States (8)	$ 3,737,656	$ 3,887,601
Mexico	130,903	113,538
Europe (8)(9)	383,009	308,457
Total property operations segment	4,251,568	4,309,596
CDFS business:		
United States	222,412	304,697
Mexico	31,506	26,288
Europe (9)	586,415	637,207
Japan	40,572	--
Total CDFS business segment	880,905	968,192
Temperature controlled distribution operations:		
United States (8)	133,539	231,053
Europe (8)	185,737	191,981
Total temperature controlled distribution operations segment	319,276	423,034
Reconciling items:		
Investment in and advances to unconsolidated entities	60,547	70,807
Cash	87,310	57,870
Accounts and notes receivable	10,550	43,040
Other assets	67,711	73,795
Total reconciling items	226,118	245,512
Total assets	$ 5,677,867	$ 5,946,334

9. Supplemental Cash Flow Information:

Non-cash investing and financing activities for the nine months ended September 30, 2001, and 2000 are as follows:

- In 2001, ProLogis contributed its 49.9% of the common stock of ProLogis European Properties S.a.r.l. to ProLogis European Properties Fund for an additional equity interest in ProLogis European Properties Fund of $83.0 million. In 2000, in connection with ProLogis' initial contribution of 50.1% of the common stock of ProLogis European Properties S.a.r.l. to ProLogis European Properties Fund, ProLogis received an equity interest in ProLogis European Properties Fund of approximately $78.0 million. ProLogis European Properties S.a.r.l. had total assets of $403.9 million and total liabilities of $248.1 million. ProLogis recognized its investment in the remaining 49.9% of the common stock under the equity method from January 7, 2000 through January 6, 2001. See Note 3.

- ProLogis received $30.4 million, $34.1 million, $13.7 million, $11.7 million and $8.2 million of the proceeds from its disposition of facilities to ProLogis European Properties Fund, ProLogis North American Properties Fund I, ProLogis North American Properties Fund II, ProLogis North American Properties Fund III and ProLogis North American Properties Fund IV, respectively, in the form of an equity interest in these entities during 2001. ProLogis received $5.2 million, $13.8 million, $18.6 million and $0.6 million of the proceeds from its disposition of facilities to ProLogis European Properties Fund, ProLogis California, ProLogis North American Properties Fund I and ProLogis North American Properties Fund II in the form of an equity interest during 2000.

- ProLogis received $13.2 million of the proceeds from its disposition of facilities to North American Properties Fund II in the form of notes receivable from this entity during 2000.

- ProLogis received $2.3 million and $7.4 million of the proceeds from its disposition of facilities to third parties in the form of notes receivable in 2001 and 2000, respectively.

- In connection with the acquisition of a facility, ProLogis assumed a $7.7 million mortgage note in 2001.

- In connection with the agreement for the acquisition of Kingspark S.A., ProLogis issued approximately 67,000 and 602,000 Common Shares valued at $1.5 million and $11.9 million, respectively, in 2001 and 2000, respectively.

- Series B preferred shares aggregating $151.8 million and $17.7 million were converted into Common Shares in 2001 and 2000, respectively.

- Net foreign currency translation adjustments of $(19,430,000) and $(49,613,000) were recognized in 2001 and 2000, respectively.

10. Commitments and Contingencies:

Environmental Matters

All of the facilities acquired by ProLogis have been subjected to environmental reviews by ProLogis or predecessor owners. While some of these assessments have led to further investigation and sampling, none of the environmental assessments has revealed, nor is ProLogis aware of any environmental liability (including asbestos related liability) that ProLogis believes would have a material adverse effect on ProLogis' business, financial condition or results of operations.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Trustees and Shareholders of ProLogis Trust:

We have reviewed the accompanying consolidated condensed balance sheets of ProLogis Trust and subsidiaries as of September 30, 2001, and the related consolidated condensed statements of earnings and comprehensive income for the three and nine months ended September 30, 2001 and 2000 and the consolidated condensed statements of cash flows for the nine months ended September 30, 2001 and 2000. These financial statements are the responsibility of the Trust's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States.

We have previously audited, in accordance with auditing standards generally accepted in the United States, the consolidated balance sheet of ProLogis Trust and subsidiaries as of December 31, 2000, and in our report dated March 15, 2001, we expressed an unqualified opinion on that statement. In our opinion, the information set forth in the accompanying consolidated condensed balance sheet as of December 31, 2000, is fairly stated in all material respects, in relation to the consolidated balance sheet from which it has been derived.

ARTHUR ANDERSEN LLP

Chicago, Illinois
November 9, 2001

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

The following discussion should be read in conjunction with ProLogis' Consolidated Condensed Financial Statements and the notes thereto included in Item 1 of this report. See also ProLogis' 2000 Annual Report on Form 10-K.

The statements contained in this discussion that are not historical facts are 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. These forward-looking statements are based on current expectations, estimates and projections about the industry and markets in which ProLogis operates, management's beliefs, and assumptions made by management. Words such as "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Factors which may affect outcomes and results include: (i) changes in general economic conditions in ProLogis' markets that could adversely affect demand for ProLogis' facilities and the creditworthiness of ProLogis' customers; (ii) changes in financial markets, interest rates and foreign currency exchange rates that could adversely affect ProLogis' cost of capital and its ability to meet its financial needs and obligations; (iii) increased or unanticipated competition for distribution facilities in ProLogis' target market cities; and (iv) those factors discussed in ProLogis' 2000 Annual Report on Form 10-K.

Results of Operations

Nine Months Ended September 30, 2001 and 2000

ProLogis' net earnings attributable to Common Shares were $137.5 million for the nine months ended September 30, 2001 as compared to $113.1 million for the same period in 2000. For the nine months ended September 30, 2001, basic and diluted per share net earnings attributable to Common Shares were $0.80 and $0.79 per share, respectively. Basic and diluted per share net earnings attributable to Common Shares were $0.69 per share for the same period in 2000.

The CDFS business segment provides capital for ProLogis to redeploy into its development activities in addition to generating profits that contribute to ProLogis' total income. ProLogis' net operating income from this segment increased by $27.5 million in 2001 over 2000, primarily the result of the number of dispositions of facilities developed by ProLogis to entities in which ProLogis maintains an ownership interest, such as ProLogis North American Properties Fund II, ProLogis North American Properties Fund III, ProLogis North American Properties Fund IV and ProLogis European Properties Fund, as well as to third parties. ProLogis' property operations segment net operating income was $356.4 million for 2001 and $369.2 million for 2000, a decrease of $12.8 million. This operating segment's net income includes rental income and net rental expenses from facilities directly owned by ProLogis and also its share of the income of its unconsolidated entities that engage in property operations segment activities. Losses from ProLogis' temperature-controlled distribution operations in 2001 increased from 2000 by $20.3 million. See "--Property Operations", "-- CDFS Business" and "-- Temperature-Controlled Distribution Operations".

ProLogis' investment in Kingspark S.A., an industrial distribution facility development company in the United Kingdom, was previously accounted for under the equity method. ProLogis included its share of the income from Kingspark S.A. and its subsidiaries in the CDFS business segment. ProLogis owned 100% of the preferred stock of Kingspark S.A. and recognized substantially all economic benefits of Kingspark S.A. and its subsidiaries through January 4, 2001. On January 5, 2001, ProLogis acquired an ownership interest in the common stock of Kingspark S.A resulting in ProLogis having control of Kingspark S.A. Accordingly, as of January 5, 2001, the accounts of Kingspark S.A. and its subsidiaries are consolidated in ProLogis' condensed financial statements along with ProLogis' other majority-owned and controlled subsidiaries and partnerships.

Property Operations

ProLogis owned or had ownership interests in the following operating facilities as of the dates indicated (square footage in thousands):

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	September 30,			
	2001		2000	
	Number	Square Footage	Number	Square Footage
Direct ownership (1)	1,220	122,746	1,234	123,977
ProLogis California (2)	79	13,052	77	12,395
ProLogis North American Properties Fund I (1)(3)	36	8,963	33	8,024
ProLogis North American Properties Fund II (1)(4)	27	4,477	3	440
ProLogis North American Properties Fund III (1)(5)	34	4,380	--	--
ProLogis North American Properties Fund IV (1)(6)	17	3,475	--	--
ProLogis European Properties Fund and ProLogis European Properties S.a.r.l. (7)	123	19,236	94	12,494
	1,536	176,329	1,441	157,330

ProLogis' property operations segment income consists of the: (i) net operating income from the operating facilities that are owned by ProLogis directly or through its consolidated entities, and (ii) the income recognized by ProLogis under the equity method from its investments in unconsolidated entities engaged in property operations. See Note 8 to ProLogis' Consolidated Condensed Financial Statements in Item 1. The amounts recognized under the equity method are based on the net earnings of each unconsolidated entity and include: interest income and interest expense, depreciation and amortization expenses, general and administrative expenses, income taxes and foreign currency exchange gains and losses (with respect to ProLogis European Properties Fund and ProLogis European Properties S.a.r.l.). ProLogis' net operating income from the property operations segment was as follows (in thousands):

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	Nine Months Ended September 30,	
	2001	2000
Facilities directly owned by ProLogis and its consolidated entities:		
Rental income (1)	$ 354,066	$ 362,024
Property operating expenses (2)	21,655	20,617
Net operating income (3)	332,411	341,407
Income from ProLogis California	10,186	9,597
Income from ProLogis North American Properties Fund I (4)	3,561	1,233
Income from ProLogis North American Properties Fund II (4)	1,634	308
Income from ProLogis North American Properties Fund III (5)	582	--
Income from ProLogis North American Properties Fund IV (6)	(12)	--
Income from ProLogis European Properties Fund (7)	7,959	8,949

Income from ProLogis European Properties S.a.r.l. (7)........	36	7,686
Total property operations segment......................	$ 356,357	$ 369,180

Pre-stable facilities are generally newly developed or acquired facilities that are usually underleased at the time they are completed or acquired. ProLogis, utilizing its ProLogis Operating System(R), has been successful in increasing occupancies on such facilities during their initial months of operation. ProLogis' stabilized operating facilities (facilities owned by ProLogis and its consolidated and unconsolidated entities) were 93.3% occupied and 94.2% leased as of September 30, 2001. ProLogis' stabilized occupancy levels have decreased during the first nine months of 2001 (95.4% occupied and 96.2% leased as of December 31, 2000).

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ProLogis believes that the decrease in its stabilized occupancy levels in 2001 is the result of the current economic conditions in North America which have led to a slowing in customer leasing decisions and in the absorption of new facilities in the market. ProLogis believes that occupancies may continue to decline over the next several quarters. However, ProLogis believes that its global operating platform and the ProLogis Operating System(R) will partially mitigate these occupancy decreases, as they have allowed ProLogis to build strong local market presence and strong customer relationships across many global markets. In Europe, leasing activity has remained constant throughout 2001, with 2.0 million and 6.0 million square feet of leases signed in the three and nine month periods, respectively. ProLogis believes the leasing activity in Europe is currently affected more by a shift in distribution patterns of its customers and the need to reduce distribution costs, rather than by the effects of general economic conditions.

The average increase in rental rates for both new and renewed leases on previously leased space (28.7 million square feet) for all facilities including those owned by ProLogis' consolidated and unconsolidated entities during 2001 was 17.9% (up from 15.5% for all of 2000). During the nine months ended September 30, 2001, the net operating income (rental income less net rental expenses) generated by ProLogis' "same store" portfolio of operating facilities (facilities owned by ProLogis and its consolidated and unconsolidated entities that were in operation throughout both nine month periods in 2001 and 2000) increased by 2.0% over the same period in 2000 (as compared to an increase of 6.57% during the nine months ended September 30, 2000 as compared to the same period in 1999). The decrease in the growth in same store net operating income is due to increased bad debt expense in 2001 and to lower occupancy levels in the same store portfolio in 2001 as compared to 2000. During the three months ended September 30, 2001, the same store net operating income increased by 0.7% over the same period in 2000 (as compared to an increase of 6.02% during the three months ended September 30, 2000 as compared to the same period in 1999). Although the average increase in rental rates for new and renewed leases was 18.1% for ProLogis' same store operating portfolio in 2001, only 18.2 million square feet (of a total of 144.7 million square feet) were signed during the nine months of 2001. Therefore, the rental rate growth did not have a significant effect on same store net operating income.

CDFS Business

Net operating income from ProLogis' CDFS business segment consists primarily of: (i) profits from the disposition of land parcels and facilities that were developed by ProLogis and disposed of to customers or to entities in which ProLogis has an ownership interest; (ii) development fees earned by ProLogis; (iii) income recognized under the equity method from investments in the Kingspark Joint Ventures; and (iv) income recognized under the equity method from ProLogis' investment in the Kingspark S.A. and its subsidiaries in 2000 (Kingspark S.A. and its subsidiaries are consolidated in 2001). Kingspark S.A. and its subsidiaries engage in CDFS business activities in the United Kingdom similar to those activities performed directly by ProLogis in other locations. In 2000, ProLogis recognized 95% of the net earnings of Kingspark S.A. and its subsidiaries under the equity method that includes: interest income and interest expense (net of capitalized amounts), general and administrative expense (net of capitalized amounts), income taxes and foreign currency exchange gains and losses.

The CDFS business segment income increased for the nine months in 2001 over the same period in 2000, due to an increase in sales volume. The CDFS business segment's net operating income is comprised of the following (in thousands):

	Nine Months Ended September 30, 2001	Nine Months Ended September 30, 2000
Net gains on disposition of land parcels and facilities developed (1)................	$ 102,768	$ 60,615
Development fees and other, net................	5,670	2,842
Income from Kingspark Joint Ventures...........	1,753	--
Income from Kingspark S.A. and its subsidiaries (2)............................	--	20,411
Miscellaneous income...........................	3,301	2,257
Other expenses (3).............................	(2,773)	(2,884)
	$ 110,719	$ 83,241

Temperature-Controlled Distribution Operations

ProLogis recognizes net operating income from the temperature-controlled distribution operations segment of its business under the equity method. ProLogis' share of the total income or loss of CSI/Frigo LLC, ProLogis Logistics and Frigoscandia S.A. was as follows (in thousands) (see Notes 3 and 8 to ProLogis' Consolidated Condensed Financial Statements in Item 1):

	Nine Months Ended September 30, 2001	Nine Months Ended September 30, 2000
Loss from CSI/Frigo LLC.....................	$ (1,343)	$ --
Income (loss) from ProLogis Logistics........	(3,636)	8,067
Loss from Frigoscandia S.A..................	(18,061)	(10,806)
Total temperature-controlled distribution operations segment........................	$ (23,040)	$ (2,739)

Amounts recognized under the equity method from CSI/Frigo LLC include ProLogis' share of this entity's share of the income or loss of ProLogis

Logistics and Frigoscandia S.A. Amounts recognized under the equity method for ProLogis Logistics and Frigoscandia S.A. include interest income and interest expense, depreciation and amortization expense, general and administrative expense, income taxes and foreign currency exchange gains and losses (with respect to Frigoscandia). ProLogis recognizes in excess of 99% the net earnings of each entity in 2001 as compared to 95% in 2000.

CSI's operating capacity was comparable in both nine-month periods. The decrease in ProLogis' share of ProLogis Logistics' net earnings from 2000 to 2001 of $11.7 million is attributable to: (i) higher interest expense as a result of increasing external debt of this entity by $125.0 million and using the proceeds to repay debt to ProLogis, and (ii) a decrease in operating income as a result of lower occupancy levels in certain markets in 2001.

Frigoscandia's operating capacity was 171.5 million cubic feet as of September 30, 2001 and 192.1 million cubic feet as of September 30, 2000. The decrease reflects the disposition of the directly owned facilities in Germany and the Czech Republic in May 2001 and September 2001, respectively. ProLogis' share of Frigoscandia S.A.'s net losses includes net foreign currency exchange losses of $7.9 million and net foreign currency exchange gains of $1.1 million in 2001 and 2000, respectively. Excluding these foreign currency exchange gains and losses, ProLogis recognized $1.7 million more income under the equity method in 2001 than it recognized in 2000 from its investment in Frigoscandia S.A. The increase in Frigoscandia S.A.'s net loss in 2001 from the loss recognized in 2000 is primarily attributable to lower general and administrative expense in 2001 as compared to 2000, offset by a net loss recognized on the disposal of Frigoscandia's directly owned facilities located in Germany and the Czech Republic of approximately $3.9 million. The disposition of these facilities was completed as the mix of facilities and customers no longer met ProLogis' strategic objective in this business segment, which is to concentrate on the distribution and logistics part of the supply chain rather than on storage. ProLogis is continuing to evaluate its temperature-controlled distribution operations in light of this strategic objective.

ProLogis believes that the factors that contributed to the decline in operating performance of CSI and Frigoscandia are temporary and can be partially mitigated in the short-term by reductions in general and administrative costs and other operating costs. However, there is no assurance that these factors are temporary or that some or all of these factors will not continue past 2001.

Other Income and Expense Items

Income from Unconsolidated Entities

Income from unconsolidated entities that is not directly attributable to either of ProLogis' three business segments was $3.5 million for the nine months ended September 30, 2001. See Note 8 to ProLogis' Consolidated Condensed Financial Statements in Item 1. This income is primarily fees earned for the non-exclusive use of the ProLogis Operating System(R) under license agreements with Vizional Technologies ($1.5 million recognized in each of the first and second quarters) and Phatpipe ($0.7 million, all recognized in the first quarter) offset by losses recognized under the equity method related to ProLogis's investment in ProLogis Equipment Services ($0.2 million, all recognized in the second quarter). License fee income from PhatPipe was recognized only in the first quarter of 2001 as this investment was written down to zero in the second quarter of 2001 (see "--Loss on Investment"). ProLogis recognized license fee income from Vizional Technologies only for the first six months of 2001, as ProLogis is monitoring this investment in light of the current economy's effects on the technology industry and on Vizional Technologies' business plan.

For the nine months ended September 30, 2000, ProLogis recognized fees under license agreements with Vizional Technologies of $1.2 million, all in the third quarter.

Interest Expense

Interest expense is a function of the level of borrowings outstanding and interest rates charged on borrowings, offset by interest capitalization with respect to development activities. Interest expense was $115.2 million in 2001 and $128.5 million in 2000 ($120.6 million assuming ProLogis had consolidated the financial statements of Kingspark S.A. and its subsidiaries in 2000). Assuming consolidation for 2000 reduces the total interest expense in 2000 due to the effects of interest capitalization by Kingspark S.A. and its subsidiaries.

Capitalized interest was $26.6 million in 2001 and $12.8 million in 2000 ($20.9 million assuming ProLogis had consolidated the financial statements of Kingspark S.A. and its subsidiaries in 2000). Capitalized interest levels are reflective of ProLogis' cost of funds and the level of development activity in each year.

Gain on Disposition of Real Estate

Gain on disposition of real estate represents the net gains or losses from the disposition of operating facilities that were acquired or developed within the property operations segment. Generally, ProLogis disposes of facilities in the property operations segment because such facilities are considered to be non-strategic facilities or to complement the portfolio of developed facilities that are acquired by entities in which ProLogis maintains an ownership interest. Non-strategic facilities are assets located in markets or submarkets that are no longer considered target markets as well as assets that were acquired as part of previous portfolio acquisitions that are not consistent with ProLogis' core portfolio based on the asset's size or configuration.

Property operations segment dispositions were as follows:

o 2001: 4.7 million square feet; $180.9 million of proceeds; net gain of $0.4 million (a net loss of $1.7 million was recognized in the first quarter, a net loss of $1.4 million was recognized in the second quarter and a net gain of $3.5 million was recognized in the third quarter) and a net gain of $0.5 million recognized upon the contribution of:10pt;">

Liabilities and Shareholders' Equity

Current liabilities:

Short-term borrowings
$
920,010

$
633,731

$
41,909

Accounts payable
1,975,323

1,791,552

1,221,778

Compensation and taxes withheld
417,316

508,166

296,176

Accrued taxes
113,023

79,901

158,587

Current portion of long-term debt
1,179

1,179

700,786

Other accruals
900,301

972,651

519,766

Total current liabilities
4,327,152

3,987,180

2,939,002

Long-term debt
9,891,017

9,885,745

1,211,512

Postretirement benefits other than pensions
275,735

274,675

252,031

Deferred income taxes
1,494,661

1,434,196

15,427

Other long-term liabilities
689,075

684,443

505,581

Shareholders' equity:

Common stock—$1.00 par value:

93,545,689, 93,883,645 and 93,128,304 shares outstanding

at March 31, 2018, December 31, 2017 and March 31, 2017, respectively
117,875

117,561

116,775

Other capital
2,761,207

2,723,183

2,547,621

Retained earnings
5,674,637

5,502,730

4,209,198

Treasury stock, at cost
(4,528,018
)

(4,266,416
)

(4,258,831
)
Cumulative other comprehensive loss
(335,655
)

(384,870
)

(549,413
)
Total shareholders' equity
3,690,046

3,692,188

2,065,350

Total Liabilities and Shareholders’ Equity
$
20,367,686

$
19,958,427

$
6,988,903

See notes to condensed consolidated financial statements.

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THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES
CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS (UNAUDITED)
Thousands of dollars

	Three Months Ended	
	March 31, 2018	March 31, 2017
OPERATING ACTIVITIES		
Net income	$250,127	$239,152
Adjustments to reconcile net income to net operating cash:		
Depreciation	71,591	44,595
Amortization of intangible assets	85,049	6,170
Stock-based compensation expense	14,611	17,321
Amortization of credit facility and debt issuance costs	2,749	984
Provisions for qualified exit costs	3,799	2,856
Provisions for environmental-related matters	765	519
Defined benefit pension plans net cost	1,345	5,155
Net change in postretirement liability	996	1,910
Other	3,466	(37,367)
Change in working capital accounts - net	(382,842)	(58,402)
Costs incurred for environmental-related matters	(4,069)	(3,372)
Costs incurred for qualified exit costs	(8,084)	(996)
Other	1,246	13,291
Net operating cash	40,749	231,816
INVESTING ACTIVITIES		
Capital expenditures	(42,253)	(41,479)
Proceeds from sale of assets	7,352	34,762
Increase in other investments	(5,650)	(23,194)
Net investing cash	(40,551)	(29,911)
FINANCING ACTIVITIES		
Net increase in short-term borrowings	288,866	326
Payments of long-term debt	(808)	(71)
Payments for credit facility and debt issuance costs	(113)	(7)
Payments of cash dividends	(81,028)	(79,450)
Proceeds from stock options exercised	21,595	41,762
Treasury stock purchased	(241,148)	—
Other	(14,813)	(22,702)
Net financing cash	(27,449)	(60,142)
Effect of exchange rate changes on cash	(18,349)	(13,748)
Net (decrease) increase in cash and cash equivalents	(45,600)	128,015
Cash and cash equivalents at beginning of year	204,213	889,793
Cash and cash equivalents at end of period	$158,613	$1,017,808
Income taxes paid	$27,910	$8,675
Interest paid	57,757	30,841

See notes to condensed consolidated financial statements.

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THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
Periods ended March 31, 2018 and 2017

NOTE 1—BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

There have been no significant changes in critical accounting policies since December 31, 2017, except as described in Note 2. Accounting estimates were revised as necessary during the first three months of 2018 based on new information and changes in facts and circumstances. Certain amounts in the 2017 condensed consolidated financial statements have been reclassified to conform to the 2018 presentation. See Note 2.

The Company primarily uses the last-in, first-out (LIFO) method of valuing inventory. An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management’s estimates of expected year-end inventory levels and costs are subject to the final year-end LIFO inventory valuation. In addition, interim inventory levels include management’s estimates of annual inventory losses due to shrinkage and other factors. For further information on inventory valuations and other matters, refer to the consolidated financial statements and footnotes thereto included in the Company’s Form 10-K for the year ended December 31, 2017.

The consolidated results for the three months ended March 31, 2018 are not necessarily indicative of the results to be expected for the year ending December 31, 2018.

NOTE 2—RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Adopted in 2018

Effective January 1, 2018, the Company adopted Accounting Standards Update (ASU) No. 2014-09, "Revenue from Contracts with Customers," and all the related amendments (Accounting Standards Codification (ASC) 606). ASC 606 consists of a comprehensive revenue recognition standard, which requires the recognition of revenue when promised goods or services are transferred to customers in an amount that reflects the consideration to which the entity expects to be entitled. The Company adopted the standard using the modified retrospective method and applied it to all contracts. Under the modified retrospective method, the comparative periods are not restated.

The only significant change that resulted from the new revenue standard was that certain advertising support that was previously classified as Selling, general and administrative expenses is now classified as a reduction of revenue. This reclassification had no effect on Net income, and therefore, there was no adjustment to the opening balance of retained earnings. During the three months ended March 31, 2018, this change resulted in $13.4 million within Consumer Brands Group being recorded as a reduction of Net sales rather than in Selling, general and administrative expenses. The Company does not expect the adoption of the new revenue standard to have a material impact on its Net income on an ongoing basis. Refer to Note 3 for additional information.

Effective January 1, 2018, the Company adopted ASU No. 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Costs." The standard requires the service component of pension and other postretirement benefit expense to be presented in the same income statement lines as other employee compensation costs, and the other components to be presented outside of operating income. The guidance on the presentation of components of pension and other postretirement benefit expense was adopted retrospectively, as required, and the practical expedient allowing estimates for comparative periods using the information previously disclosed in the pension and other postretirement benefit plan note was elected. The following table summarizes the impact of the standard for the three months ended March 31, 2018 and 2017.

(Thousands of dollars)

	Three Months Ended March 31, 2018		Three Months Ended March 31, 2017			
	Impact of ASU 2017-07	As Reported	As Previously Reported (Without Adoption of ASU 2017-07)	Reclass for ASU 2017-07	Reclass of Amortization to Stand-Alone Caption (Unrelated to ASU 2017-07)	As Reported in 2018
Cost of goods sold	$709	$2,278,159	$1,418,247	$ 221	$ (134)	$1,418,334
Selling, general and administrative expenses	2,835	1,214,565	1,016,211	846	(6,036)	1,011,021
Other expense (income) - net	(3,544)	(9,272)	(4,367)	(1,067)		(5,434)

Effective January 1, 2018, the Company adopted ASU No. 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities,” which amends the guidance for certain aspects of recognition, measurement and disclosure of financial instruments. As a result of this standard, changes in fair value of available-for-sale marketable securities that were previously recognized in other comprehensive income are now recognized in earnings. In addition, in accordance with the guidance, the Company reclassified its opening unrealized gains balance of $2.3 million to Retained earnings. The adoption of this standard did not have a significant impact on the Company's results of operations, financial condition or liquidity.

Not Yet Adopted

In February 2018, the FASB issued ASU No. 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." This ASU allows a reclassification from accumulated other comprehensive income to retained earnings stranded tax effects resulting from the Tax Cuts and Jobs Act. The ASU is effective for fiscal years beginning after December 15, 2018, and early adoption is permitted. The Company is evaluating the impact of the standard.

In February 2016, the FASB issued ASU No. 2016-02, “Leases,” which consists of a comprehensive lease accounting standard. Under the new standard, assets and liabilities arising from most leases will be recognized on the balance sheet. Leases will be classified as either operating or financing, and the lease classification will determine whether expense is recognized on a straight-line basis (operating leases) or based on an effective interest method (financing leases). The new standard is effective for interim and annual periods starting in 2019. A modified retrospective transition approach is required with certain practical expedients available. The Company has made significant progress with its assessment process and anticipates this standard will have a material impact on its consolidated balance sheet. While the Company continues to assess all potential impacts of the standard, it currently believes the most significant impact relates to recording lease assets and related liabilities on the balance sheet for its retail operations in The Americas Group.

NOTE 3—REVENUE

The Company manufactures and sells paint, stains, supplies, equipment and floor covering through Company-owned stores, branded and private label products through retailers, and a broad range of industrial coatings directly to global manufacturing customers through company-operated branches. A large portion of the Company’s revenue is recognized at a point in time and made to customers who are not engaged in a long-term supply agreement or any form of contract with the Company. These sales are paid for at the time of sale in cash, credit card, or may be on account with the vast majority of customers having terms between 30 and 60 days, not to exceed one year. Many customers who purchase on account take advantage of early payment discounts offered by paying within 30 days of being invoiced. The Company estimates variable consideration or performs a constraint analysis for these sales on the basis of both historical information and current trends to estimate the expected amount of discounts to which customers are likely to be entitled.

The remaining revenue is governed by long-term supply agreements and related purchase orders (“contracts”) which specify shipping terms and aspects of the transaction price including rebates, discounts and other sales incentives, such as advertising support. Contracts are at standalone pricing. The performance obligation in these contracts is determined by each of the individual purchase orders and the respective stated quantities, with revenue being recognized at a point in time when obligations under the terms of the agreement are satisfied. This generally occurs with the transfer of control of our products to the customer. Sales, value add, and other taxes we collect concurrent with revenue-producing activities are excluded from revenue.

Refer to Note 15 for the Company's disaggregation of Net sales by reportable segment. As the reportable segments are aligned by similar economic factors, trends and customers, this disaggregation best depicts how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.
The Company has made payments or credits for rebates or incentives at the beginning of a long-term contract where future revenue is expected and before satisfaction of performance obligations. Under these circumstances, the Company recognizes a contract asset and amortizes these prepayments over the expected benefit life of the long-term contract typically on a straight-line basis. Management judgment is required when estimating sales-based variable consideration, determining whether it is constrained, measuring obligations for returns, refunds, and determining amortization periods for prepayments.
The majority of variable consideration in the Company’s contracts include a form of volume rebate, discounts, and other incentives, where the customer receives a retrospective percentage rebate based on the amount of their purchases. In these situations, the rebates are accrued as a fixed percentage of sales and recorded as a reduction of net sales until paid to the customer per the terms of the supply agreement. Forms of variable consideration such as tiered rebates, whereby a customer receives a retrospective price decrease dependent on the volume of their purchases, are calculated using a forecasted percentage to determine the most likely amount to accrue. Management creates a baseline calculation using historical sales and then utilizing forecast information, estimates the anticipated sales volume each quarter to calculate the expected reduction to sales. The remainder of the transaction price is fixed as agreed upon with the customer, limiting estimation of revenues including constraints.
The Company’s accounts receivables and current and long-term contract assets and liabilities are summarized in the following table.
(Thousands of dollars)

	Accounts Receivable, Less Allowance	Contract Assets (Current)	Contract Assets (Long-Term)	Contract Liabilities (Current)	Contract Liabilities (Long-Term)
Balance at January 1, 2018	$ 2,104,555	$ 33,031	$ 135,150	$ 208,909	$ 8,745
Balance at March 31, 2018	$ 2,326,411	$ 34,316	$ 135,581	$ 153,037	$ 8,745

The difference between the opening and closing balances of the Company’s contract assets and contract liabilities primarily results from the timing difference between the Company’s performance and the customer’s payment. Provisions for estimated returns are established and the expected costs continue to be recognized as contra-revenue per ASC 606 when the products are sold. With the exception of furniture protection plan sales, the Company only offers an assurance type warranty on products sold, and there is no material service to the customer beyond fixing defects that existed at the time of sale and no warranties are sold separately. Warranty liabilities are excluded from the table above and discussed in Note 7. Amounts reclassified during the quarter from deferred liabilities to Revenue were not material. The Company records a right of return liability within each of its operations to accrue for expected customer returns. Historical actual returns are used to estimate future returns as a percentage of current sales. Obligations for returns and refunds were not material individually or in the aggregate.

NOTE 4—ACQUISITIONS

On June 1, 2017, the Company completed the acquisition of The Valspar Corporation (Valspar) at $113 per share in an all cash transaction for a total purchase price of $8.9 billion, net of divestiture proceeds of $431.0 million (Acquisition). The Acquisition expanded the Company's diversified array of brands and technologies, expanded its global platform and added new capabilities in its packaging and coil businesses. See Note 2 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017 for additional information.

The preliminary allocation of the fair value of the Acquisition is summarized in the following table. Allocations are based on the acquisition method of accounting and in-process third-party valuation appraisals. The allocation of the fair value will be finalized within the allowable measurement period. There were no material purchase accounting adjustments during the first quarter of 2018.

(Millions of dollars)

Cash	$129.1
Accounts receivable	817.5
Inventories	684.4
Indefinite-lived trademarks	775.9
Finite-lived intangible assets	5,071.8
Goodwill	5,654.4
Property, plant and equipment	841.0
All other assets	231.3
Accounts payable	(553.2)
Long-term debt	(1,603.5)
Deferred taxes	(2,015.3)
All other liabilities	(1,094.0)
Total	$8,939.4
Total, net of cash	$8,810.3

Finite-lived intangible assets include customer relationships of $3.3 billion and intellectual property and technology of $1.8 billion, which are being amortized over weighted average amortization periods ranging from 15 to 20 years. Based on the preliminary purchase accounting, goodwill of $2.3 billion, $1.9 billion and $1.5 billion was recorded in The Americas Group, Performance Coatings Group and Consumer Brands Group, respectively, and relates primarily to expected synergies.

The Company's Net sales and Net income for the three months ended March 31, 2018 included sales of $1.067 billion and a profit before tax of $80.7 million related to the Acquisition. Net income for the three months ended March 31, 2018 included Acquisition-related costs and purchase accounting amortization impacts of $119.8 million and Acquisition-related interest expense of $68.6 million. Net income for the three months ended March 31, 2017 included Acquisition-related costs and Acquisition-related interest expense of $8.0 million and $5.0 million, respectively.

The following pro forma information presents consolidated financial information as if Valspar had been acquired at the beginning of 2017. Pro forma adjustments have been made to exclude Valspar's divested North American industrial wood coatings business results and certain transaction and integration costs from all periods presented. Interest expense has been adjusted as though total debt related to the Acquisition had been outstanding at January 1, 2017. Amortization of acquired intangibles and fixed asset step-ups has been adjusted as though the amortization period started January 1, 2017. The $54.9 million amortization of inventory cost increases resulting from the preliminary purchase accounting has been included in 2017 to reflect the pro forma transaction date of January 1, 2017. The unaudited pro forma consolidated financial information does not necessarily reflect the actual results that would have occurred had the Acquisition taken place on January 1, 2017, nor is it meant to be indicative of future results of operations of the combined companies under the ownership and operation of the Company.

(Thousands of dollars except per share data)	Three Months Ended March 31,	
	2018	2017
Net sales	$3,965,006	$3,708,528
Net income	280,110	124,536
Net income per common share:		
Basic	$3.00	$1.35
Diluted	$2.93	$1.32

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NOTE 5—DIVIDENDS

Dividends paid on common stock during the first quarter of 2018 and 2017 were $.86 per common share and $.85 per common share, respectively.

NOTE 6—CHANGES IN CUMULATIVE OTHER COMPREHENSIVE LOSS

The following tables summarize the changes in Cumulative other comprehensive loss for the three months ended March 31, 2018 and 2017:

(Thousands of dollars)	Foreign Currency Translation Adjustments	Pension and Other Postretirement Benefit Adjustments	Unrealized Net Gains on Available-for-Sale Securities	Unrealized Net Gains on Cash Flow Hedges	Total Cumulative Other Comprehensive (Loss) Income
Balance at December 31, 2017	$ (353,346)	$ (84,863)	$ 2,320	$ 51,019	$ (384,870)
Amounts recognized in Other comprehensive loss	52,732				52,732
Amounts reclassified from Other comprehensive loss [1]		(209)	(2,320)	(988)	(3,517)
Net change	52,732	(209)	(2,320)	(988)	49,215
Balance at March 31, 2018	$ (300,614)	$ (85,072)	$ —	$ 50,031	$ (335,655)

[1] Net of taxes of $90 for pension and other postretirement benefit adjustments, $760 for realized gains on the sale of available-for-sale securities and $1,047 for realized gains on cash flow hedges.

(Thousands of dollars)	Foreign Currency Translation Adjustments	Pension and Other Postretirement Benefit Adjustments	Unrealized Net Gains on Available-for-Sale Securities	Unrealized Net Gains (Losses) on Cash Flow Hedges	Total Cumulative Other Comprehensive (Loss) Income
Balance at December 31, 2016	$ (501,277)	$ (125,096)	$ 1,015	$ 85,007	$ (540,351)
Amounts recognized in Other comprehensive loss [2]	20,778		630	(30,754)	(9,346)
Amounts reclassified from Other comprehensive loss [3]		279	5		284
Net change	20,778	279	635	(30,754)	(9,062)
Balance at March 31, 2017	$ (480,499)	$ (124,817)	$ 1,650	$ 54,253	$ (549,413)

[2] Net of taxes of $(389) for unrealized net gains on available-for-sale securities and $18,895 for unrealized net losses on cash flow hedges.

[3] Net of taxes of $(142) for pension and other postretirement benefit adjustments and $(3) for realized losses on the sale of available-for-sale securities.

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NOTE 7—PRODUCT WARRANTIES

Changes in the Company's accrual for product warranty claims during the first three months of 2018 and 2017, including customer satisfaction settlements, were as follows:

(Thousands of dollars)

	2018	2017
Balance at January 1	$151,425	$34,419
Charges to expense	6,437	6,076
Settlements	(4,488)	(7,508)
Balance at March 31	$153,374	$32,987

For further details on the Company's accrual for product warranty claims, see Note 1 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

NOTE 8—EXIT OR DISPOSAL ACTIVITIES

Liabilities associated with exit or disposal activities are recognized as incurred in accordance with the Exit or Disposal Cost Obligations Topic of the ASC. Qualified exit costs primarily include post-closure rent expenses, incremental post-closure costs and costs of employee terminations. Adjustments may be made to liabilities accrued for qualified exit costs if information becomes available upon which more accurate amounts can be reasonably estimated. Concurrently, property, plant and equipment is tested for impairment in accordance with the Property, Plant and Equipment Topic of the ASC, and if impairment exists, the carrying value of the related assets is reduced to estimated fair value. Additional impairment may be recorded for subsequent revisions in estimated fair value.

In the three months ended March 31, 2018, ten stores in The Americas Group and two branches in the Performance Coatings Group were closed due to lower demand or redundancy. The Company continues to evaluate all legacy operations in response to the Acquisition in order to optimize restructured operations. These Acquisition-related restructuring charges to date are recorded in the Administrative segment as presented in the table below. The following table summarizes the activity and remaining liabilities associated with qualified exit costs at March 31, 2018:

(Thousands of dollars)

Exit Plan	Balance at December 31, 2017	Provisions in Cost of Goods Sold or SG&A	Actual Expenditures Charged to Accrual	Balance at March 31, 2018
Administrative segment Acquisition-related restructuring in 2017:				
Severance and related costs	$ 6,019	$ 3,789	$ (5,883)	$ 3,925
Other qualified exit costs	5,541	—	(1,831)	3,710
Performance Coatings Group stores shutdown in 2017:				
Severance and related costs	14	—	(12)	2
Other qualified exit costs	121	—	(17)	104
Consumer Brands Group facilities shutdown in 2016:				
Severance and related costs	21	10	—	31
Performance Coatings Group stores shutdown in 2016:				
Other qualified exit costs	111	—	(21)	90
Severance and other qualified exit costs for facilities shutdown prior to 2016	1,558	—	(320)	1,238
Totals	$ 13,385	$ 3,799	$ (8,084)	$ 9,100

For further details on the Company's exit or disposal activities, see Note 5 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

NOTE 9—HEALTH CARE, PENSION AND OTHER BENEFITS

Shown below are the components of the Company’s net periodic benefit cost (credit) for domestic defined benefit pension plans, foreign defined benefit pension plans and postretirement benefits other than pensions:

(Thousands of dollars)	Domestic Defined Benefit Pension Plans		Foreign Defined Benefit Pension Plans		Postretirement Benefits Other than Pensions	
	2018	2017	2018	2017	2018	2017
Three Months Ended March 31:						
Net periodic benefit cost:						
Service cost	$4,357	$5,313	$2,016	$1,918	$498	$543
Interest cost	8,152	6,410	2,352	1,638	2,545	2,643
Expected return on assets	(14,434)	(10,309)	(2,685)	(1,764)		
Recognition of:						
Unrecognized prior service cost	379	341	—		(1,642)	(1,645)
Unrecognized actuarial loss		1,661	383	(53)	581	11
Ongoing pension (credit) cost	(1,546)	3,416	2,066	1,739	1,982	1,552
Curtailment expense	825		—			
Net pension costs (credits)	$(721)	$3,416	$2,066	$1,739	$1,982	$1,552

Service cost is recorded in Cost of goods sold and Selling, general and administrative expenses. All other components are recorded in Other income - net. See Note 2 for information on the adoption of ASU No. 2017-07.

During the first quarter of 2018, the Company's domestic defined benefit plan was split into two separate overfunded plans: one that will continue to operate (Ongoing Plan) and one that will be terminated (Terminating Plan). The Company provided notice to participants of the Terminating Plan of the intent to terminate the plan and applied for a determination letter. The Terminating Plan was frozen as of March 31, 2018, which resulted in a curtailment expense. During the second quarter of 2018, the Terminating Plan was terminated. The Company has begun the process of winding up the Terminating Plan, which will include settling plan liabilities by offering lump sum distributions to plan participants or purchasing annuity contracts for those who either do not elect lump sums or are already receiving benefit payments. The Company's settlement obligation will depend on the nature of participant settlements and the prevailing market conditions.

For further details on the Company’s health care, pension and other benefits, see Note 6 to the Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

NOTE 10—OTHER LONG-TERM LIABILITIES

The Company initially provides for estimated costs of environmental-related activities relating to its past operations and third party sites for which commitments or clean-up plans have been developed and when such costs can be reasonably estimated based on industry standards and professional judgment. These estimated costs are determined based on currently available facts regarding each site. If the best estimate of costs can only be identified as a range and no specific amount within that range can be determined more likely than any other amount within the range, the minimum of the range is provided. At March 31, 2018, the unaccrued maximum of the estimated range of possible outcomes is $98.5 million higher than the minimum.

The Company continuously assesses its potential liability for investigation and remediation-related activities and adjusts its environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Actual costs incurred may vary from these estimates due to the inherent uncertainties involved including, among others, the number and financial condition of parties involved with respect to any given site, the volumetric contribution which may be attributed to the Company relative to that attributed to other parties, the nature and magnitude of the wastes involved, the various technologies that can be used for remediation and the determination of acceptable remediation with respect to a particular site.

Included in Other long-term liabilities at March 31, 2018 and 2017 were accruals for extended environmental-related activities of $177.8 million and $161.6 million, respectively. Estimated costs of current investigation and remediation activities of $27.0 million and $20.0 million are included in Other accruals at March 31, 2018 and 2017, respectively.

Four of the Company’s currently and formerly owned manufacturing sites account for the majority of the accrual for environmental-related activities and the unaccrued maximum of the estimated range of possible outcomes at March 31, 2018. At March 31, 2018, $160.9 million, or 78.6 percent of the total accrual, related directly to these four sites. In the aggregate unaccrued maximum of $98.5 million at March 31, 2018, $77.4 million, or 78.6 percent, related to the four manufacturing sites. While environmental investigations and remedial actions are in different stages at these sites, additional investigations, remedial actions and monitoring will likely be required at each site. Management cannot presently estimate the ultimate potential loss contingencies related to these sites or other less significant sites until such time as a substantial portion of the investigation at the sites is completed and remedial action plans are developed. In the event any future loss contingency significantly exceeds the current amount accrued, the recording of the ultimate liability may result in a material impact on net income for the annual or interim period during which the additional costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its environmental-related matters will have a material adverse effect on the Company’s financial condition, liquidity, or cash flow due to the extended period of time during which environmental investigation and remediation takes place. An estimate of the potential impact on the Company’s operations cannot be made due to the aforementioned uncertainties.

Management expects these contingent environmental-related liabilities to be resolved over an extended period of time. Management is unable to provide a more specific time frame due to the indefinite amount of time to conduct investigation activities at any site, the indefinite amount of time to obtain environmental agency approval, as necessary, with respect to investigation and remediation activities, and the indefinite amount of time necessary to conduct remediation activities.

For further details on the Company’s Other long-term liabilities, see Note 8 to the Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

NOTE 11 – LITIGATION

In the course of its business, the Company is subject to a variety of claims and lawsuits, including, but not limited to, litigation relating to product liability and warranty, personal injury, environmental, intellectual property, commercial, contractual and antitrust claims that are inherently subject to many uncertainties regarding the possibility of a loss to the Company. These uncertainties will ultimately be resolved when one or more future events occur or fail to occur confirming the incurrence of a liability or the reduction of a liability. In accordance with the Contingencies Topic of the ASC, the Company accrues for these contingencies by a charge to income when it is both probable that one or more future events will occur confirming the fact of a loss and the amount of the loss can be reasonably estimated. In the event that the Company’s loss contingency is ultimately determined to be significantly higher than currently accrued, the recording of the additional liability may result in a material impact on the Company’s results of operations, liquidity or financial condition for the annual or interim period during which such additional liability is accrued. In those cases where no accrual is recorded because it is not probable that a liability has been incurred and the amount of any such loss cannot be reasonably estimated, any potential liability ultimately determined to be attributable to the Company may result in a material impact on the Company’s results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued. In those cases where no accrual is recorded or exposure to loss exists in excess of the amount accrued, the Contingencies Topic of the ASC requires disclosure of the contingency when there is a reasonable possibility that a loss or additional loss may have been incurred.

Lead pigment and lead-based paint litigation. The Company’s past operations included the manufacture and sale of lead pigments and lead-based paints. The Company, along with other companies, is and has been a defendant in a number of legal proceedings, including individual personal injury actions, purported class actions, and actions brought by various counties, cities, school districts and other government-related entities, arising from the manufacture and sale of lead pigments and lead-based paints. The plaintiffs’ claims have been based upon various legal theories, including negligence, strict liability, breach of warranty, negligent misrepresentations and omissions, fraudulent misrepresentations and omissions, concert of action, civil conspiracy, violations of unfair trade practice and consumer protection laws, enterprise liability, market share liability, public nuisance, unjust enrichment and other theories. The plaintiffs seek various damages and relief, including personal injury and property damage, costs relating to the detection and abatement of lead-based paint from buildings, costs associated with a public education campaign, medical monitoring costs and others. The Company has also been a defendant in legal proceedings arising from the manufacture and sale of non-lead-based paints that seek recovery based upon various legal theories, including the failure to adequately warn of potential exposure to lead during surface preparation when using non-lead-based paint on surfaces previously painted with lead-based paint. The Company believes that the litigation brought to date is without merit or subject to meritorious defenses and is vigorously defending such litigation. The Company has not settled any material lead pigment or lead-based paint litigation. The Company expects that additional lead pigment and lead-based paint litigation may be filed against the Company in the future asserting similar or different legal theories and seeking similar or different types of damages and relief.

Notwithstanding the Company's views on the merits, litigation is inherently subject to many uncertainties, and the Company ultimately may not prevail. Adverse court rulings or determinations of liability, among other factors, could affect the lead pigment and lead-based paint litigation against the Company and encourage an increase in the number and nature of future claims and proceedings. In addition, from time to time, various legislation and administrative regulations have been enacted, promulgated or proposed to impose obligations on present and former manufacturers of lead pigments and lead-based paints respecting asserted health concerns associated with such products or to overturn the effect of court decisions in which the Company and other manufacturers have been successful.

Due to the uncertainties involved, management is unable to predict the outcome of the lead pigment and lead-based paint litigation, the number or nature of possible future claims and proceedings or the effect that any legislation and/or administrative regulations may have on the litigation or against the Company. In addition, management cannot reasonably determine the scope or amount of the potential costs and liabilities related to such litigation, or resulting from any such legislation and regulations. The Company has not accrued any amounts for such litigation. With respect to such litigation, with the exception of the public nuisance litigation in California discussed below, the Company does not believe that it is probable that a loss has occurred, and it is not possible to estimate the range of potential losses as there is no prior history of a loss of this nature and there is no substantive information upon which an estimate could be based. In addition, any potential liability that may result from any changes to legislation and regulations cannot reasonably be estimated. In the event any significant liability is determined to be attributable to the Company relating to such litigation, the recording of the liability may result in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties associated with the amount of any such liability and/or the nature of any other remedy which may be imposed in such litigation, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition. An estimate of the potential impact on the Company's results of operations, liquidity or financial condition cannot be made due to the aforementioned uncertainties.

Public nuisance claim litigation. The Company and other companies are or were defendants in legal proceedings seeking recovery based on public nuisance liability theories, among other theories, brought by the State of Rhode Island, the City of St. Louis, Missouri, various cities and counties in the State of New Jersey, various cities in the State of Ohio and the State of Ohio, the City of Chicago, Illinois, the City of Milwaukee, Wisconsin and the County of Santa Clara, California and other public entities in the State of California. Except for the Santa Clara County, California proceeding, all of these legal proceedings have been concluded in favor of the Company and other defendants at various stages in the proceedings.

The proceedings initiated by the State of Rhode Island included two jury trials. At the conclusion of the second trial, the jury returned a verdict finding that (i) the cumulative presence of lead pigment in paints and coatings on buildings in the State of Rhode Island constitutes a public nuisance, (ii) the Company, along with two other defendants, caused or substantially contributed to the creation of the public nuisance and (iii) the Company and two other defendants should be ordered to abate the public nuisance. The Company and two other defendants appealed and, on July 1, 2008, the Rhode Island Supreme Court, among other determinations, reversed the judgment of abatement with respect to the Company and two other defendants. The Rhode Island Supreme Court's decision reversed the public nuisance liability judgment against the Company on the basis that the complaint failed to state a public nuisance claim as a matter of law.

The Santa Clara County, California proceeding was initiated in March 2000 in the Superior Court of the State of California, County of Santa Clara. In the original complaint, the plaintiffs asserted various claims including fraud and concealment, strict product liability/failure to warn, strict product liability/design defect, negligence, negligent breach of a special duty, public nuisance, private nuisance, and violations of California's Business and Professions Code. A number of the asserted claims were resolved in favor of the defendants through pre-trial proceedings. The named plaintiffs in the Fourth Amended Complaint, filed on March 16, 2011, are the Counties of Santa Clara, Alameda, Los Angeles, Monterey, San Mateo, Solano and Ventura, the Cities of Oakland and San Diego and the City and County of San Francisco. The Fourth Amended Complaint asserted a sole claim for public nuisance, alleging that the presence of lead pigments for use in paint and coatings in, on and around residences in the plaintiffs' jurisdictions constitutes a public nuisance. The plaintiffs sought the abatement of the alleged public nuisance that exists within the plaintiffs' jurisdictions. A trial commenced on July 15, 2013 and ended on August 22, 2013. The court entered final judgment on January 27, 2014, finding in favor of the plaintiffs and against the Company and two other defendants (ConAgra Grocery Products Company and NL Industries, Inc.). The final judgment held the Company jointly and severally liable with the other two defendants to pay $1.15 billion into a fund to abate the public nuisance. The Company strongly disagrees with the judgment.

On February 18, 2014, the Company filed a motion for new trial and a motion to vacate the judgment. The court denied these motions on March 24, 2014. On March 28, 2014, the Company filed a notice of appeal to the Sixth District Court of Appeal for the State of California. The filing of the notice of appeal effects an automatic stay of the judgment without the requirement to post a bond. Oral argument before the Sixth District Court of Appeal was held on August 24, 2017. On November 14, 2017, the Sixth District Court of Appeal entered its decision, which affirmed the trial court's judgment of liability with respect to residences built before 1951 and reversed and vacated the trial court's judgment with respect to residences built after 1950. The Sixth District Court of Appeal directed the trial court to: (i) recalculate the amount of the abatement fund to limit the fund to the amount necessary to cover the cost of inspecting and remediating pre-1951 residences; and (ii) hold an evidentiary hearing to appoint a suitable receiver. On November 29, 2017, the Company and the two other defendants filed separate Petitions for Rehearing, which the Sixth District Court of Appeal denied on December 6, 2017. The Sixth District Court of Appeal's decision became final on December 14, 2017. On December 22, 2017, the Company and the two other defendants submitted separate Petitions for Review to the California Supreme Court. On February 14, 2018, the California Supreme Court issued an order denying the Petitions for Review. The Company believes that the judgment conflicts with established principles of law and is unsupported by the evidence. The Company intends to file a Petition for Writ of Certiorari with the Supreme Court of the United States seeking discretionary review. The Company also may file a motion to stay the Santa Clara County, California proceeding while the Petition for Writ of Certiorari is pending.

Although the Company believes it is probable that a loss has occurred, the Company has concluded that it is not possible to reasonably estimate the range of potential loss due to the numerous possible outcomes and uncertainties, including, but not limited to, (i) the final amount of the abatement fund necessary to cover the cost of inspecting and remediating pre-1951 residences, as recalculated by the trial court, and (ii) the portion of the abatement fund for which the Company, the two other defendants and others are determined to be responsible. If the Company concludes that it is possible to reasonably estimate the range of potential loss once more definitive information becomes available, the Company will recognize the loss and disclose such information. Because of joint and several liability, it is possible the Company could ultimately be liable for the total amount of the abatement fund. In the event any significant liability is determined to be attributable to the Company relating to such litigation, the recording of any liability may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued.

Litigation seeking damages from alleged personal injury. The Company and other companies are defendants in a number of legal proceedings seeking monetary damages and other relief from alleged personal injuries. These proceedings include claims by children allegedly injured from ingestion of lead pigment or lead-containing paint and claims for damages allegedly incurred by the children's parents or guardians. These proceedings generally seek compensatory and punitive damages, and seek other relief including medical monitoring costs. These proceedings include purported claims by individuals, groups of individuals and class actions.

The plaintiff in Thomas v. Lead Industries Association, et al., initiated an action in state court against the Company, other alleged former lead pigment manufacturers and the Lead Industries Association in September 1999. The claims against the Company and the other defendants included strict liability, negligence, negligent misrepresentation and omissions, fraudulent misrepresentation and omissions, concert of action, civil conspiracy and enterprise liability. Implicit within these claims is the theory of "risk contribution" liability (Wisconsin's theory which is similar to market share liability, except that liability can be joint and several) due to the plaintiff's inability to identify the manufacturer of any product that allegedly injured the plaintiff. The case ultimately proceeded to trial and, on November 5, 2007, the jury returned a defense verdict, finding that the plaintiff had ingested white lead carbonate, but was not brain damaged or injured as a result. The plaintiff appealed and, on December 16, 2010, the Wisconsin Court of Appeals affirmed the final judgment in favor of the Company and other defendants.

Wisconsin is the only jurisdiction to date to apply a theory of liability with respect to alleged personal injury (i.e., risk contribution/market share liability) that does not require the plaintiff to identify the manufacturer of the product that allegedly injured the plaintiff in the lead pigment and lead-based paint litigation. Although the risk contribution liability theory was applied during the Thomas trial, the constitutionality of this theory as applied to the lead pigment cases has not been judicially determined by the Wisconsin state courts. However, in an unrelated action filed in the United States District Court for the Eastern District of Wisconsin, Gibson v. American Cyanamid, et al., on November 15, 2010, the District Court held that Wisconsin's risk contribution theory as applied in that case violated the defendants' right to substantive due process and is unconstitutionally retroactive. The District Court's decision in Gibson v. American Cyanamid, et al., was appealed by the plaintiff to the United States Court of Appeals for the Seventh Circuit. On July 24, 2014, the United States Court of Appeals for the Seventh Circuit reversed the judgment and remanded the case back to the District Court for further proceedings. On January 16, 2015, the defendants filed a petition for certiorari in the United States Supreme Court seeking that Court's review of the Seventh Circuit's decision, and on May 18, 2015, the United States Supreme Court denied the defendants' petition. The case is currently pending in the District Court. Three cases also are pending in the United States District Court for the Eastern District of Wisconsin (Ravon Owens v. American Cyanamid, et al., Cesar Sifuentes v. American Cyanamid, et al., and Glenn Burton, Jr. v. American Cyanamid, et al.) in which dispositive motions have been filed and are currently pending. No trial dates have been set by the District Court. In Maniya Allen, et al. v. American Cyanamid, et al., also pending in the United States District Court for the Eastern District of Wisconsin, cases involving six of the 161 plaintiffs have been selected for discovery, although no trial dates have been set by the District Court. In Dijonae Trammell, et al. v. American Cyanamid, et al., also pending in the

United States District Court for the Eastern District of Wisconsin, discovery for one of the three plaintiffs has been consolidated with the six Allen cases referenced above, although no trial date has been set by the District Court.
Insurance coverage litigation. The Company and its liability insurers, including certain underwriters at Lloyd's of London, initiated legal proceedings against each other to primarily determine, among other things, whether the costs and liabilities associated with the abatement of lead pigment are covered under certain insurance policies issued to the Company. The Company's action, filed on March 3, 2006 in the Common Pleas Court, Cuyahoga County, Ohio, is currently stayed and inactive. The liability insurers' action, which was filed on February 23, 2006 in the Supreme Court of the State of New York, County of New York, has been dismissed. An ultimate loss in the insurance coverage litigation would mean that insurance proceeds could be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities. The Company has not recorded any assets related to these insurance policies or otherwise assumed that proceeds from these insurance policies would be received in estimating any contingent liability accrual. Therefore, an ultimate loss in the insurance coverage litigation without a determination of liability against the Company in the lead pigment or lead-based paint litigation will have no impact on the Company's results of operation, liquidity or financial condition. As previously stated, however, the Company has not accrued any amounts for the lead pigment or lead-based paint litigation and any significant liability ultimately determined to be attributable to the Company relating to such litigation may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued.

NOTE 12—OTHER

Other general expense - net

Included in Other general expense - net were the following:

(Thousands of dollars)	Three Months Ended March 31, 2018	2017
Provisions for environmental matters - net	$765	$519
Loss (gain) on sale or disposition of assets	2,225	(243)
Total	$2,990	$276

Provisions for environmental matters - net represent site-specific increases or decreases to environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Environmental-related accruals are not recorded net of insurance proceeds in accordance with the Offsetting Subtopic of the Balance Sheet Topic of the ASC. See Note 10 for further details on the Company's environmental-related activities.

The loss (gain) on sale or disposition of assets represents net realized losses (gains) associated with the sale or disposal of fixed assets previously used in the conduct of the primary business of the Company.

Other income - net

Included in Other income - net were the following:

(Thousands of dollars)	Three Months Ended March 31, 2018	2017
Dividend and royalty income	$(1,451)	$(1,844)
Net expense from banking activities	2,236	2,472
Foreign currency transaction related gains	(2,462)	(3,586)
Miscellaneous pension income	(3,544)	(1,067)
Other income	(7,109)	(4,960)
Other expense	3,058	3,551
Total	$(9,272)	$(5,434)

Foreign currency transaction related gains represent net realized gains on U.S. dollar-denominated liabilities of foreign subsidiaries and net realized and unrealized gains from foreign currency option and forward contracts. There were no material foreign currency option and forward contracts outstanding at March 31, 2018 and 2017.
Miscellaneous pension income consists of the non-service components of net pension costs (credits). See Note 2 for information on the adoption of ASU No. 2017-07 and Note 9 for the detail of net pension costs (credits).

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Other income and Other expense included items of revenue, gains, expenses and losses that were unrelated to the primary business purpose of the Company. There were no other items within the other income or other expense caption that were individually significant.

NOTE 13—INCOME TAXES

The effective tax rate was 17.6 percent for the first quarter of 2018 compared to 22.0 percent for the first quarter of 2017. The decrease in the effective tax rate for the first quarter of 2018 compared to the first quarter of 2017 was primarily due to the overall favorable impact of the Tax Cuts and Jobs Act (Tax Act). The Company received favorable tax benefits from the reduction in the corporate domestic income tax rate from 35 percent to 21 percent and a deduction related to foreign-derived intangible income. These benefits were partially offset by the Tax Act's elimination of the domestic manufacturing deduction, a reduction in allowable foreign tax credits and a decreased benefit related to international tax rate differences.

In accordance with Staff Accounting Bulletin (SAB) No. 118, based on the information available as of December 31, 2017, the Company recorded a provisional reduction of income taxes of $607.9 million as a result of the Tax Act. The Company's deferred tax liabilities were reduced by $560.2 million due to the lower income tax rate. The remaining $47.7 million is the effects of the implementation of the territorial tax system and the remeasurement of U.S. deferred tax liabilities on unremitted foreign earnings. The final impact of the Tax Act may differ from the provisional amounts recorded at December 31, 2017, due to, among other things, changes in interpretations and assumptions the Company has made, guidance that may be issued and actions the Company may take as a result of the Tax Act. There were no significant changes to any of the balances recorded at December 31, 2017 as a result of the Tax Act during the first three months of 2018.

At December 31, 2017, the Company had $59.0 million in unrecognized tax benefits, the recognition of which would have an effect of $49.5 million on the effective tax rate. Included in the balance of unrecognized tax benefits at December 31, 2017 was $5.2 million related to tax positions for which it is reasonably possible that the total amounts could significantly change during the next twelve months. This amount represents a decrease in unrecognized tax benefits comprised primarily of items related to federal audits of partnership investments and expiring statutes in federal, foreign and state jurisdictions. The Company acquired $18.9 million of unrecognized tax benefits as a part of the preliminary opening balance sheet of Valspar and is subject to measurement period adjustments.

The Company classifies all income tax related interest and penalties as income tax expense. At December 31, 2017, the Company had accrued $14.6 million for the potential payment of income tax interest and penalties.

There were no significant changes to any of the balances of unrecognized tax benefits at December 31, 2017 during the first three months of 2018.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The IRS is currently auditing the Company's 2014 and 2015 income tax returns, as well as the 2014 and 2015 tax years of a Valspar subsidiary. No significant adjustments have been proposed by the IRS. The IRS and the Joint Committee of Taxation have approved refund claims for the 2010, 2011 and 2012 tax years. The Company will receive approximately $7.5 million of tax and interest related to the refund claims by the end of the 2018 tax year. As of March 31, 2018, the federal statute of limitations has not expired for the 2013, 2014, 2015 and 2016 tax years.

As of March 31, 2018, the Company is subject to non-U.S. income tax examinations for the tax years of 2010 through 2017. In addition, the Company is subject to state and local income tax examinations for the tax years 2005 through 2017.

NOTE 14—NET INCOME PER COMMON SHARE

Basic and diluted earnings per share are calculated using the treasury stock method.

(Thousands of dollars except per share data)	Three Months Ended March 31,	
	2018	2017
Basic		
Average common shares outstanding	93,339,564	92,550,559
Net income	$250,127	$239,152
Basic net income per common share	$2.68	$2.58
Diluted		
Average common shares outstanding	93,339,564	92,550,559
Stock options and other contingently issuable shares [(1)]	2,138,874	1,931,574
Non-vested restricted stock grants	67,714	59,726
Average common shares outstanding assuming dilution	95,546,152	94,541,859
Net income	$250,127	$239,152
Diluted net income per common share	$2.62	$2.53

(1) Stock options and other contingently issuable shares for the three months ended March 31, 2017 excludes 40,074 shares due to their anti-dilutive effect. There were no stock options and other contingently issuable shares excluded due to their anti-dilutive effect for the three months ended March 31, 2018.

NOTE 15—REPORTABLE SEGMENT INFORMATION

The Company reports its segment information in the same way that management internally organizes its business for assessing performance and making decisions regarding allocation of resources in accordance with the Segment Reporting Topic of the ASC. The Company has determined that it has three reportable operating segments: The Americas Group, Consumer Brands Group and Performance Coatings Group (individually, a Reportable Segment and collectively, the Reportable Segments).

(Thousands of dollars)	Three Months Ended March 31, 2018				
	The Americas Group	Consumer Brands Group	Performance Coatings Group	Administrative	Consolidated Totals
Net external sales	$2,080,415	$656,379	$1,227,775	$437	$3,965,006
Intersegment transfers	53	766,063	5,844	(771,960)	
Total net sales and intersegment transfers	$2,080,468	$1,422,442	$1,233,619	$(771,523)	$3,965,006
Segment profit	$337,392	$74,228	$90,766		$502,386
Interest expense				$(91,547)	(91,547)
Administrative expenses and other				(107,253)	(107,253)
Income before income taxes	$337,392	$74,228	$90,766	$(198,800)	$303,586

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	Three Months Ended March 31, 2017				
	The Americas Group	Consumer Brands Group	Performance Coatings Group	Administrative	Consolidated Totals
Net external sales	$1,951,746	$323,366	$ 484,454	$ 1,821	$2,761,387
Intersegment transfers	2,340	695,838	3,799	(701,977)	
Total net sales and intersegment transfers	$1,954,086	$1,019,204	$ 488,253	$ (700,156)	$2,761,387
Segment profit	$305,224	$55,914	$ 57,112		$418,250
Interest expense				$ (25,695)	(25,695)
Administrative expenses and other				(85,950)	(85,950)
Income before income taxes	$305,224	$55,914	$ 57,112	$ (111,645)	$306,605

In the reportable segment financial information, Segment profit was total net sales and intersegment transfers less operating costs and expenses. Domestic intersegment transfers were accounted for at the approximate fully absorbed manufactured cost, based on normal capacity volumes, plus customary distribution costs. International intersegment transfers were accounted for at values comparable to normal unaffiliated customer sales. The Administrative segment includes the administrative expenses of the Company’s corporate headquarters site. Also included in the Administrative segment was interest expense, interest and investment income, certain expenses related to closed facilities and environmental-related matters, and other expenses which were not directly associated with the reportable segments. The Administrative segment did not include any significant foreign operations. Also included in the Administrative segment was a real estate management unit that is responsible for the ownership, management and leasing of non-retail properties held primarily for use by the Company, including the Company’s headquarters site, and disposal of idle facilities. Sales of this segment represented external leasing revenue of excess headquarters space or leasing of facilities no longer used by the Company in its primary businesses. Gains and losses from the sale of property were not a significant operating factor in determining the performance of the Administrative segment.

Net external sales of all consolidated foreign subsidiaries were $919.7 million and $419.0 million for the first quarter of 2018 and 2017, respectively. Long-lived assets of these subsidiaries totaled $3.722 billion and $497.1 million at March 31, 2018 and March 31, 2017, respectively. The increase in net external sales and long-lived assets is primarily due to the Acquisition. Domestic operations accounted for the remaining net external sales, segment profits and long-lived assets. No single geographic area outside the United States was significant relative to consolidated net external sales, income before taxes, or consolidated long-lived assets.

Export sales and sales to any individual customer were each less than 10 percent of consolidated sales during all periods presented.

For further details on the Company's Reportable Segments, see Note 18 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

NOTE 16—FAIR VALUE MEASUREMENTS

The Fair Value Measurements and Disclosures Topic of the ASC applies to the Company's financial and non-financial assets and liabilities. The guidance applies when other standards require or permit the fair value measurement of assets and liabilities. The Company did not have any fair value measurements unrelated to purchase accounting for its non-financial assets and liabilities during the first quarter. The following table presents the Company's financial assets and liabilities that are measured at fair value on a recurring basis, categorized using the fair value hierarchy:

(Thousands of dollars)

	Fair Value at March 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Deferred compensation plan assets [1]	$61,256	$34,806	$ 26,450	
Liabilities:				
Deferred compensation plan liabilities [2]	$70,200	$70,200		

[1] The deferred compensation plan assets consist of the investment funds maintained for the future payments under the Company's executive deferred compensation plans, which are structured as rabbi trusts. The investments are marketable securities accounted for under the Debt and Equity Securities Topic of the ASC. The level 1 investments are valued using quoted market prices multiplied by the number of shares. The level 2 investments are valued based on vendor or broker models. The cost basis of the investment funds is $57,537.

[2] The deferred compensation plan liabilities are the Company's liabilities under its deferred compensation plans. The liabilities represent the fair value of the participant shadow accounts, and the value is based on quoted market prices in active markets for identical assets.

NOTE 17—DEBT

The table below summarizes the carrying amount and fair value of the Company's publicly traded debt and non-publicly traded debt in accordance with the Fair Value Measurements and Disclosures Topic of the ASC. The fair values of the Company's publicly traded debt are based on quoted market prices. The fair values of the Company's non-publicly traded debt are estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements. The Company's publicly traded debt and non-publicly traded debt are classified as level 1 and level 2, respectively, in the fair value hierarchy.

(Thousands of dollars)

	March 31, 2018		March 31, 2017	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Publicly traded debt	$8,739,950	$8,670,864	$1,908,209	$1,925,031
Non-publicly traded debt	1,152,246	1,082,658	4,089	3,770

On February 27, 2018, the Company amended the five-year credit agreement entered into in May 2016 to increase it by $250.0 million up to an aggregate availability of $750.0 million.

NOTE 18—NON-TRADED INVESTMENTS

The Company has invested in the U.S. affordable housing and historic renovation real estate markets. These non-traded investments have been identified as variable interest entities. However, because the Company does not have the power to direct the day-to-day operations of the investments and the risk of loss is limited to the amount of contributed capital, the Company is not considered the primary beneficiary. In accordance with the Consolidation Topic of the ASC, the investments are not consolidated. For affordable housing investments entered into prior to the January 1, 2015 adoption of ASU No. 2014-01, the Company uses the effective yield method to determine the carrying value of the investments. Under the effective yield method, the initial cost of the investments is amortized to income tax expense over the period that the tax credits are recognized. For affordable housing investments entered into on or after the January 1, 2015 adoption of ASU No. 2014-01, the Company uses the proportional amortization method. Under the proportional amortization method, the initial cost of the investments is amortized to income tax expense in proportion to the tax credits and other tax benefits received. The carrying amount of the affordable housing and historic renovation investments, included in Other assets, was $189.5 million and $197.6 million at March 31, 2018 and 2017, respectively. The liability for estimated future capital contributions to the investments was $167.0 million and $166.0 million at March 31, 2018 and 2017, respectively.

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

SUMMARY

The Sherwin-Williams Company, founded in 1866, and its consolidated wholly owned subsidiaries (collectively, the "Company") are engaged in the development, manufacture, distribution and sale of paints, coatings and related products to professional, industrial, commercial and retail customers primarily in North and South America with additional operations in the Caribbean region, Europe, Asia and Australia. The Company is structured into three reportable segments—The Americas Group, Consumer Brands Group and Performance Coatings Group (collectively, the "Reportable Segments")—and an Administrative segment in the same way it is internally organized for assessing performance and making decisions regarding allocation of resources. See Note 15 for more information.

The Company's financial condition, liquidity and cash flow continued to be strong through the first three months of 2018, but was impacted by a decrease in net working capital of $377.9 million at March 31, 2018 compared to the end of the first quarter of 2017 due to a significant increase in current liabilities partially offset by a significant increase in current assets primarily due to the acquisition of The Valspar Corporation (Valspar or the Acquisition) (see Note 4). Cash and cash equivalents decreased $859.2 million while current portion of long-term debt decreased $699.6 million resulting from 1.35% senior notes becoming due in 2017. The Company has been able to arrange sufficient short-term borrowing capacity at reasonable rates, and the Company continues to have sufficient total available borrowing capacity to fund its current operating needs. Net operating cash for the three months ended March 31, 2018 was a cash source of $40.7 million compared to a cash source of $231.8 million for the same period in 2017.

Consolidated net sales increased 43.6 percent in the first quarter of 2018 to $3.965 billion from $2.761 billion in the first quarter of 2017. The increase was due primarily to the Acquisition, which increased sales 38.6 percent in the first quarter, as well as selling price increases and higher paint sales volume in The Americas Group. Consolidated gross profit as a percent of consolidated net sales decreased in the first quarter of 2018 to 42.5 percent compared to 48.6 percent in the first quarter of 2017 due primarily to the higher raw material costs partially offset by increased paint volume and favorable currency impacts. Selling, general and administrative expenses (SG&A) decreased as a percent of consolidated net sales to 30.6 percent from 36.6 percent in the first quarter of 2017 primarily due to realized administrative synergies from Valspar operations. Amortization expense increased $78.9 million in the first quarter of 2018 versus 2017 due to the Acquisition and related purchase accounting fair value adjustments.

Interest expense increased $65.9 million in the first quarter of 2018 versus 2017 primarily due to increased debt levels to fund the Acquisition. The effective tax rate was 17.6 percent for the first quarter of 2018 compared to 22.0 percent for the first quarter of 2017. Excluding the impact of share-based payments, the effective tax rate was 22.2 percent for the first quarter of 2018 compared to 32.8 percent for the first quarter of 2017. Diluted net income per common share in the quarter increased to $2.62 per share from $2.53 per share in 2017. First quarter 2018 diluted net income per common share included a $.95 per share charge from Acquisition-related costs, purchase accounting impacts and increased amortization of intangibles. First quarter 2017 diluted net income per common share included an $.08 per share charge from Acquisition-related costs.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation and fair presentation of the consolidated unaudited interim financial statements and accompanying notes included in this report are the responsibility of management. The financial statements and footnotes have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements and contain certain amounts that were based upon management's best estimates, judgments and assumptions that were believed to be reasonable under the circumstances. Management considered the impact of the uncertain economic environment and utilized certain outside sources of economic information when developing the basis for their estimates and assumptions. The impact of the global economic conditions on the estimates and assumptions used by management was believed to be reasonable under the circumstances. Management used assumptions based on historical results, considering the current economic trends, and other assumptions to form the basis for determining appropriate carrying values of assets and liabilities that were not readily available from other sources. Actual results could differ from those estimates. Also, materially different amounts may result under materially different conditions, materially different economic trends or from using materially different assumptions. However, management believes that any materially different amounts resulting from materially different conditions or material changes in facts or circumstances are unlikely to significantly impact the current valuation of assets and liabilities that were not readily available from other sources.

A comprehensive discussion of the Company’s critical accounting policies and management estimates and significant accounting policies followed in the preparation of the financial statements is included in Management’s Discussion and

Analysis of Financial Condition and Results of Operations and in Note 1, on pages 46 through 50, in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. There have been no significant changes in critical accounting policies, management estimates or accounting policies followed since the year ended December 31, 2017. See Note 7 for accounting policy information regarding warranties and deferred revenue related to furniture protection plans for the Acquisition.

FINANCIAL CONDITION, LIQUIDITY AND CASH FLOW

Overview

On June 1, 2017, the Company completed the Acquisition for a total purchase price of $8.9 billion. On May 16, 2017, the Company issued $6.0 billion of senior notes (collectively, the "New Notes") in a public offering. The net proceeds from the issuance of the New Notes were used to fund the Acquisition. The Company continues to maintain sufficient short-term borrowing capacity at reasonable rates, and the Company has sufficient cash on hand and total available borrowing capacity to fund its current operating needs.

The Acquisition significantly affected the Company's financial condition, liquidity and cash flow. See Note 4 for a table detailing the preliminary opening balance sheet. Net working capital decreased $377.9 million at March 31, 2018 compared to the end of the first quarter of 2017 due to a significant increase in current liabilities partially offset by a significant increase in current assets primarily due to the Acquisition. Cash and cash equivalents decreased $859.2 million while current portion of long-term debt decreased $699.6 million resulting from 1.35% senior notes becoming due in 2017. In the first three months of 2018, accounts receivable increased $221.9 million, inventories increased $200.3 million and other current assets increased $44.6 million when normal seasonal trends typically require significant growth in these categories. Cash and cash equivalents decreased $45.6 million during the first quarter of 2018, accounts payable increased $183.8 million and short-term borrowings increased $286.3 million due to normal operations. Accrued taxes increased $33.1 million, compensation and taxes withheld liabilities decreased $90.9 million and other accruals decreased $72.4 million, all primarily due to timing of payments. Total debt at March 31, 2018 increased $8.858 billion to $10.812 billion from $1.954 billion at March 31, 2017 and increased as a percentage of total capitalization to 74.6 percent from 48.6 percent at the end of the first quarter last year. Total debt increased $291.6 million from December 31, 2017 and increased as a percentage of total capitalization from 74.0 percent to 74.6 percent. At March 31, 2018, the Company had remaining short-term borrowing ability of $1.715 billion. Net operating cash decreased $191.1 million in the first three months of 2018 to a cash source of $40.7 million from a cash source of $231.8 million in 2017. In the twelve month period from April 1, 2017 through March 31, 2018, the Company generated net operating cash of $1.693 billion.

Net Working Capital, Debt and Other Long-Term Assets and Liabilities

Cash and cash equivalents decreased $45.6 million during the first three months of 2018. Cash and cash equivalents on hand funded cash requirements for increased sales and normal seasonal increases in working capital, capital expenditures of $42.3 million and payments of cash dividends of $81.0 million. At March 31, 2018, the Company's current ratio was 1.13 compared to 1.12 at December 31, 2017 and 1.32 a year ago.

Goodwill and intangible assets decreased $40.4 million from December 31, 2017 and increased $11.394 billion from March 31, 2017. The net decrease during the first three months of 2018 was primarily due to amortization of $85.0 million and purchase accounting adjustments of $20.8 million, partially offset by foreign currency translation of $65.2 million. The net increase over the twelve month period from March 31, 2017 was primarily due to acquired goodwill and intangible assets of $11.506 billion, capitalized software additions of $12.9 million and foreign currency translation of $163.1 million, partially offset by amortization of $285.6 million and impairments of $2.0 million. Based on the preliminary purchase accounting, goodwill of $2.3 billion, $1.5 billion and $1.9 billion was recognized in The Americas Group, Consumer Brands Group and Performance Coatings Group, respectively. See Note 4, on pages 51 and 52, in the Company's Annual Report on Form 10-K for the year ended December 31, 2017 for more information concerning goodwill and intangible assets.

Deferred pension assets increased $1.7 million during the first three months of 2018 and increased $74.2 million from March 31, 2017. The increase in the last twelve months was due to an increase in the fair value of plan assets plans partially offset by increased pension benefit obligations primarily due to changes in actuarial assumptions and acquired Valspar plans. See Note 6, on pages 55 through 60, in the Company's Annual Report on Form 10-K for the

year ended December 31, 2017 for more information concerning the Company’s benefit plan assets.
Other assets at March 31, 2018 increased $64.0 million in the first three months of 2018 and increased $123.8 million from a year ago primarily due to changes in deferred tax assets.
Net property, plant and equipment decreased $37.1 million in the first three months of 2018 and increased $776.9 million in the twelve months since March 31, 2017. The decrease in the first three months was primarily due to depreciation expense of $71.6

million, sale or disposition of fixed assets of $9.6 million and changes in currency translation rates of $6.1 million, partially offset by capital expenditures of $42.3 million and purchase accounting adjustments of $8.0 million. Since March 31, 2017, increases from the Acquisition of $841.0 million, capital expenditures of $222.9 million and changes in currency translation rates of $52.7 million were partially offset by depreciation expense of $312.0 million and sale or disposition of fixed assets of $27.7 million. Capital expenditures primarily represented expenditures associated with improvements and normal equipment replacement in manufacturing and distribution facilities in the Consumer Brands Group, normal equipment replacement in The Americas and Performance Coatings Groups, and information systems hardware in the Administrative Segment.

On June 2, 2017, the Company closed its previously announced exchange offers and consent solicitations (collectively, the "Exchange Offer") for the outstanding senior notes of Valspar. Pursuant to the Exchange Offer, the Company issued an aggregate principal amount of approximately $1.478 billion. On May 16, 2017, the Company issued $6.0 billion of senior notes (collectively the "New Notes") in a public offering. The net proceeds from the issuance of the New Notes were used to fund the Acquisition. As previously disclosed, the interest rate locks entered into in 2016 settled in March 2017 resulting in a pretax gain of $87.6 million recognized in Cumulative other comprehensive loss. This gain is being amortized from Cumulative other comprehensive loss to a reduction of interest expense over the terms of the New Notes. For the three months ended March 31, 2018, the amortization of the unrealized gain reduced interest expense by $2.0 million. The Company expects to amortize unrealized gains of $8.3 million from Cumulative other comprehensive loss to Interest expense during the next twelve months. In April 2016, the Company entered into agreements for a $7.3 billion Bridge Loan and a $2.0 billion Term Loan as committed financing for the Acquisition. On June 1, 2017, the Company terminated the agreement for the Bridge Loan and borrowed the full $2.0 billion on the Term Loan. As of March 31, 2018, the term loan had an outstanding balance of $850.0 million.

On February 27, 2018, the Company amended the five-year credit agreement entered into in May 2016 to increase the aggregate availability to $750.0 million. In September 2017, the Company entered into a five-year letter of credit agreement, subsequently amended, with an aggregate availability of $500.0 million. The credit agreements are being used for general corporate purposes. At March 31, 2018, there was $450.0 million borrowings outstanding under these credit agreements. See Note 7, on pages 61 and 62, in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 for more information concerning the Company’s debt.

At March 31, 2018, the Company had outstanding borrowings of $435.3 million with a weighted average interest rate of 2.5 percent under its commercial paper program. The Company had unused capacity under the global credit agreement of $914.7 million at March 31, 2018. Short-term borrowings under various other foreign programs were $34.7 million with a weighted average interest rate of 7.2 percent.

Long-term liabilities for postretirement benefits other than pensions did not change significantly from December 31, 2017 and March 31, 2017. See Note 6, on pages 55 through 60, in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 for more information concerning the Company’s benefit plan obligations.

Deferred income taxes at March 31, 2018 increased $60.5 million in the first three months of 2018 and increased $1.479 billion from a year ago primarily due to increased deferred tax liabilities as a result of the Acquisition.

Environmental-Related Liabilities

The operations of the Company, like those of other companies in the same industry, are subject to various federal, state and local environmental laws and regulations. These laws and regulations not only govern current operations and products, but also impose potential liability on the Company for past operations. Management expects environmental laws and regulations to impose increasingly stringent requirements upon the Company and the industry in the future. Management believes that the Company conducts its operations in compliance with applicable environmental laws and regulations and has implemented various programs designed to protect the environment and promote continued compliance.

Depreciation of capital expenditures and other expenses related to ongoing environmental compliance measures were included in the normal operating expenses of conducting business. The Company’s capital expenditures, depreciation and other expenses related to ongoing environmental compliance measures were not material to the Company’s financial condition, liquidity, cash flow or results of operations during the first three months of 2018. Management does not expect that such capital expenditures, depreciation and other expenses will be material to the Company's financial condition, liquidity, cash flow or results of operations in 2018. See Note 10 for further information on environmental-related long-term liabilities.

Contractual Obligations, Commercial Commitments and Warranties

Short-term borrowings increased $286.3 million to $920.0 million at March 31, 2018 from $633.7 million at December 31, 2017. Total long-term debt increased $5.3 million to $9.892 billion at March 31, 2018 from $9.887 billion at December 31, 2017, and increased $7.980 billion from $1.912 billion at March 31, 2017. There have been no other significant changes to the

Company's contractual obligations and commercial commitments in the first quarter of 2018 as summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

See Note 7 for changes to the Company's accrual for product warranty claims in the first three months of 2018.

Litigation

See Note 11 for information concerning litigation.

Shareholders' Equity

Shareholders' equity decreased $2.1 million to $3.690 billion at March 31, 2018 from $3.692 billion at December 31, 2017 and increased $1.625 billion from $2.065 billion at March 31, 2017. The decrease in Shareholders' equity for the first three months of 2018 resulted primarily from treasury stock purchases of $241.1 million and cash dividends paid on common stock of $81.0 million partially offset by net income of $250.1 million and increases in Cumulative other comprehensive loss and Other capital. The increase in Shareholders' equity since March 31, 2017 resulted primarily from net income of $1.783 billion, an increase in Other capital of $213.6 million and a decrease in Cumulative other comprehensive loss of $213.8 million partially offset by cash dividends paid on common stock of $1.6 million and and treasury stock purchases.

During the first three months of 2018, the Company purchased 600,000 shares of its common stock for treasury purposes through open market purchases. The Company acquires its common stock for general corporate purposes, and depending on its cash position and market conditions, it may acquire additional shares in the future. The Company had remaining authorization at March 31, 2018 to purchase 11.05 million shares of its common stock. In February 2018, the Board of Directors increased the quarterly cash dividend from $.85 per common share to $.86 per common share. This quarterly dividend will result in an annual dividend for 2018 of $3.44 per common share or a 18.4 percent payout of 2017 diluted net income per common share.

Cash Flow

Net operating cash for the three months ended March 31, 2018 was a cash source of $40.7 million compared to a cash source of $231.8 million for the same period in 2017. The decrease in net operating cash was primarily due to cash requirements for working capital. Net investing cash usage increased $10.6 million in the first three months of 2018 to a usage of $40.6 million from a usage of $29.9 million in 2017 primarily due to decreased proceeds from sale of assets. Net financing cash usage decreased $32.7 million to a usage of $27.4 million in the first three months of 2018 from a usage of $60.1 million in 2017 primarily due to proceeds from short-term debt partially offset by treasury stock purchases. In the twelve month period from April 1, 2017 through March 31, 2018, the Company generated net operating cash of $1.693 billion, used $9.058 billion in investing activities and generated $6.547 billion in financing activities.

Market Risk

The Company is exposed to market risk associated with interest rate, foreign currency and commodity fluctuations. The Company occasionally utilizes derivative instruments as part of its overall financial risk management policy, but does not use derivative instruments for speculative or trading purposes. The Company believes it may be exposed to continuing market risk from foreign currency exchange rate and commodity price fluctuations. However, the Company does not expect that foreign currency exchange rate and commodity price fluctuations or hedging contract losses will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

Financial Covenant

Certain borrowings contain a consolidated leverage covenant. The covenant states that upon close of the Acquisition, the Company's leverage ratio is not to exceed 5.25 to 1.00. The leverage ratio is defined as the ratio of total indebtedness (the sum of Short-term borrowings, Current portion of long-term debt and Long-term debt) at the reporting date to consolidated pro forma "Earnings Before Interest, Taxes, Depreciation, and Amortization" (EBITDA) for the combined companies for the twelve month period ended on the same date. Refer to the "Results of Operations" caption below for a reconciliation of EBITDA to Net income. At March 31, 2018, the Company was in compliance with the covenant. The Company's Notes, Debentures and revolving credit agreements contain various default and cross-default provisions. In the event of default under any one of these arrangements, acceleration of the maturity of any one or more of these borrowings may result. See Note 7, on pages 61 and 62, in the Company's Annual Report on

Form 10-K for the year ended December 31, 2017 for more information concerning the Company's debt and related covenant.

RESULTS OF OPERATIONS

Shown below are net sales and income before taxes by segment for the first quarter:

(Thousands of dollars)	Three Months Ended March 31,		
	2018	2017	Change
Net Sales:			
The Americas Group	$2,080,415	$1,951,746	6.6 %
Consumer Brands Group	656,379	323,366	103.0 %
Performance Coatings Group	1,227,775	484,454	153.4 %
Administrative	437	1,821	-76.0 %
Total	$3,965,006	$2,761,387	43.6 %

(Thousands of dollars)	Three Months Ended March 31,		
	2018	2017	Change
Income Before Income Taxes:			
The Americas Group	$337,392	$305,224	10.5 %
Consumer Brands Group	74,228	55,914	32.8 %
Performance Coatings Group	90,766	57,112	58.9 %
Administrative	(198,800)	(111,645)	-78.1 %
Total	$303,586	$306,605	-1.0 %

Consolidated net sales increased in the first quarter of 2018 due primarily to the addition of Valspar sales, selling price increases and higher paint sales volume in The Americas Group. Currency translation rate changes provided a favorable impact on consolidated net sales in the quarter for the Performance Coatings Group and the Consumer Brands Group.

Net sales of all consolidated foreign subsidiaries were up 119.5 percent to $919.7 million in the quarter compared to $419.0 million in the same period last year. The increase in net sales for all consolidated foreign subsidiaries in the quarter was due primarily to the addition of Valspar sales. Net sales of all operations other than consolidated foreign subsidiaries were up 30.0 percent to $3.045 billion in the quarter as compared to $2.342 billion in the same period last year.

Net sales in The Americas Group increased in the first quarter due primarily to higher architectural paint sales volume across most end market segments and selling price increases. Net sales from stores open for more than twelve calendar months in the U.S. and Canada increased 5.2 percent in the quarter compared to last year’s comparable period. Sales of non-paint products increased by 6.9 percent over last year's first quarter. A discussion of changes in volume versus pricing for sales of products other than paint is not pertinent due to the wide assortment of general merchandise sold.

Net sales of the Consumer Brands Group increased in the first quarter primarily due to the inclusion of Valspar sales and selling price increases, partially offset by lower volume sales to some of the Group's retail customers. Valspar sales increased the Consumer Brands Group's Net sales by 108.3% in the quarter. Net sales in the Performance Coatings Group stated in U.S. dollars increased in the first quarter due primarily to the inclusion of Valspar sales and selling price increases. Valspar sales increased the Performance Coatings Group's Net sales by 148.1% in the quarter.

Net sales in the Administrative segment, which primarily consist of external leasing revenue of excess headquarters space and leasing of facilities no longer used by the Company in its primary business, were essentially flat in the first quarter.

Consolidated gross profit increased $343.8 million in the first quarter of 2018 compared to the same period in 2017 primarily due to Valspar sales and increased paint sales volume partially offset by higher raw material costs. Consolidated gross profit as a percent of consolidated net sales decreased in the first quarter of 2018 to 42.5 percent compared to 2017 at 48.6 percent due primarily to higher raw material costs and unfavorable product sales mix.

The Americas Group’s gross profit was higher than last year by $61.7 million in the first quarter due to higher paint sales volume and selling price increases, partially offset by increased raw material costs. The Americas Group’s gross profit as a percent of sales was essentially flat in the quarter due to increased raw material costs, offset by increased paint sales volume and selling price increases. The Consumer Brands Group’s gross profit increased by $102.7 million in the quarter compared to the same period last year primarily from the inclusion of Valspar sales, partially offset by increased raw material costs, and lower volume sales to some of the Group’s retail and commercial customers. The Consumer Brands Group’s gross profit as a percent of sales was down in the quarter compared to the same period last year due to increased raw material costs and lower sales volumes, only partially offset by the inclusion of Valspar sales. The Performance Coatings Group's gross profit increased $183.2 million in the first quarter compared to the same period last year, when stated in U.S. dollars, primarily due to the inclusion of Valspar sales, selling price increases and higher sales volume partially offset by higher raw material costs. The Performance Coatings Group's gross profit as a percent of sales was down in the quarter compared to the same period last year primarily due to higher raw material costs, only partially offset by the inclusion of Valspar sales, selling price increases and higher sales volume. The Administrative segment's gross profit decreased by $3.8 million in the first quarter compared to the same period last year.

Selling, general and administrative expenses (SG&A) increased $203.5 million in the first quarter of 2018 versus last year due primarily to the inclusion of Valspar, increased expenses to support higher sales levels and net new store openings. In the first quarter of 2018, expenses associated with the Acquisition were $194.0 million compared to $5.0 million in 2017. As a percent of sales, consolidated SG&A decreased to 30.6 percent in the first quarter of 2018 from 36.6 percent in the first quarter of 2017 primarily due to realized administrative synergies from the Acquisition.

The Americas Group's SG&A increased $30.4 million in the first quarter due primarily to net new store openings and general comparable store expenses to support higher sales levels. The Consumer Brands Group's SG&A increased $61.3 million in the quarter compared to the same period last year primarily due to the impact from Valspar operations partially offset by good expense control. The Performance Coatings Group's SG&A increased $95.9 million in the quarter primarily due to the impact from Valspar operations and foreign currency exchange rates, partially offset by improved expense control. The Administrative segment's SG&A increased $15.9 million in the first quarter primarily due to increased costs associated with the Acquisition.

Amortization expense increased $78.9 million in the first quarter of 2018 versus 2017 primarily due to amortization of acquired intangibles. In the first quarter of 2018, amortization of acquired intangibles was $54.3 million and $23.2 million for the Performance Coatings and Consumer Brands Groups, respectively.

Interest expense increased $65.9 million in the first quarter of 2018 versus 2017 due to the Acquisition-related debt incurred.

Other general expense—net increased $2.7 million in the first quarter of 2018 versus 2017 primarily due to net losses associated with the sale or disposition of assets in the Administrative segment.

Other expense (income)—net improved $3.8 million in the first quarter as compared to 2017 primarily due to an increase in miscellaneous pension income.

Consolidated income before income taxes decreased $3.0 million in the first quarter of 2018 versus last year, primarily due to Acquisition-related interest costs, and increased amortization of intangibles, partially offset higher segment profits in The Americas Group.

The effective tax rate was 17.6 percent for the first quarter of 2018 compared to 22.0 percent for the first quarter of 2017. Excluding the impact of share-based payments, the effective tax rate was 22.2 percent for the first quarter of 2018 compared to 32.8 percent for the first quarter of 2017. The decrease in the effective tax rate for the first quarter of 2018 compared to the first quarter of 2017 was primarily due to the overall favorable impact of the Tax Cuts and Jobs Act (Tax Act). The Company received favorable tax benefits from the reduction in the corporate domestic income tax rate from 35 percent to 21 percent and a deduction related to foreign-derived intangible income. These benefits were partially offset by the Tax Act's elimination of the domestic manufacturing deduction, a reduction in allowable foreign tax credits as well as a decreased benefit related to international tax rate differences.

Diluted net income per common share in the quarter increased to $2.62 per share from $2.53 per share in 2017. First quarter 2018 diluted net income per common share included a $.95 per share charge from Acquisition-related costs and increased amortization of intangibles. First quarter 2017 diluted net income per common share included a $.08 per share charge from Acquisition-related costs. Currency translation rate changes did not have a significant impact on diluted net income per common share in the quarter.

Management considers a measurement that is not in accordance with U.S. generally accepted accounting principles a useful measurement of the operational profitability of the Company. Some investment professionals also utilize such a measurement as an indicator of the value of profits and cash that are generated strictly from operating activities, putting aside working capital and certain other balance sheet changes. For this measurement, management increases net income for significant non-operating and non-cash expense items to arrive at an amount known as "Earnings Before

Interest, Taxes, Depreciation and Amortization" (EBITDA). The reader is cautioned that the following value for EBITDA should not be compared to other entities unknowingly. EBITDA should not be considered an alternative to net income or cash flows from operating activities as an indicator of operating performance or as a measure of liquidity. The reader should refer to the determination of net income and cash flows from operating activities in accordance with U.S. generally accepted accounting principles disclosed in the Statements of Consolidated Income and Comprehensive Income and Statements of Consolidated Cash Flows. EBITDA as used by management is calculated as follows:

(Thousands of dollars)	Three Months Ended March 31,	
	2018	2017
Net income	$250,127	$239,152
Interest expense	91,547	25,695
Income taxes	53,459	67,453
Depreciation	71,591	44,595
Amortization	85,049	6,170
EBITDA	551,773	383,065
Valspar EBITDA *	137,922	(7,457)
EBITDA without Valspar	$413,851	$390,522

* Valspar EBITDA for 2018 includes Valspar operations, purchase accounting items and Acquisition costs. Valspar EBITDA for 2017 includes Acquisition costs only.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Certain statements contained in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this report constitute “forward-looking statements” within the meaning of the federal securities laws. These forward-looking statements are based upon management’s current expectations, estimates, assumptions and beliefs concerning future events and conditions and may discuss, among other things, anticipated future performance (including sales and earnings), expected growth, future business plans and the costs and potential liability for environmental-related matters and the lead pigment and lead-based paint litigation. Any statement that is not historical in nature is a forward-looking statement and may be identified by the use of words and phrases such as "believe," "expect," "may," "will," "should," "project," "could," "plan," "goal," "potential," "seek," "intend" or "anticipate" or the negative thereof or comparable terminology.

Readers are cautioned not to place undue reliance on any forward-looking statements. Forward-looking statements are necessarily subject to risks, uncertainties and other factors, many of which are outside our control that could cause actual results to differ materially from such statements and from our historical results and experience. These risks, uncertainties and other factors include such things as:

- general business conditions, strengths of retail and manufacturing economies and the growth in the coatings industry;
- changes in general domestic economic conditions such as inflation rates, interest rates, tax rates, unemployment rates, higher labor and healthcare costs, recessions, and changing government policies, laws and regulations;
- changes in raw material and energy supplies and pricing;
- changes in our relationships with customers and suppliers;
- our ability to successfully integrate past and future acquisitions into our existing operations, including Valspar, as well as the performance of the businesses acquired;
- risks inherent in the achievement of anticipated cost synergies resulting from the acquisition of Valspar and the timing thereof ;
- competitive factors, including pricing pressures and product innovation and quality;
- our ability to attain cost savings from productivity initiatives;
- risks and uncertainties associated with our expansion into and our operations in Asia, Europe, South America and other foreign markets, including general economic conditions, inflation rates, recessions, foreign currency exchange rates, foreign investment and repatriation restrictions, legal and regulatory constraints, civil unrest and other external economic and political factors;
- the achievement of growth in foreign markets, such as Asia, Europe and South America;
- increasingly stringent domestic and foreign governmental regulations, including those affecting health, safety and the environment;
- inherent uncertainties involved in assessing our potential liability for environmental-related activities;
- other changes in governmental policies, laws and regulations, including changes in accounting policies and standards and taxation requirements (such as new tax laws and new or revised tax law interpretations);
- the nature, cost, quantity and outcome of pending and future litigation and other claims, including the lead pigment and lead-based paint litigation, and the effect of any legislation and administrative regulations relating thereto; and
- adverse weather conditions and natural disasters.

Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list. Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as otherwise required by law.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk associated with interest rate, foreign currency and commodity fluctuations. The Company occasionally utilizes derivative instruments as part of its overall financial risk management policy, but does not use derivative instruments for speculative or trading purposes. The Company enters into option and forward currency exchange contracts and commodity swaps to hedge against value changes in foreign currency and commodities. The Company believes it may experience continuing losses from foreign currency translation and commodity price fluctuations. However, the Company does not expect currency translation, transaction, commodity price fluctuations or hedging contract losses to have a material adverse effect on the Company's financial condition, results of operations or cash flows. There were no material changes in the Company's exposure to market risk since the disclosure included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Item 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chairman, President and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 and Rule 15d-15 of the Securities Exchange Act of 1934, as amended (“Exchange Act”). Based upon that evaluation, our Chairman, President and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer concluded that as of the end of the period covered by this report our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and accumulated and communicated to our management including our Chairman, President and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer, to allow timely decisions regarding required disclosure. We acquired The Valspar Corporation, or Valspar, on June 1, 2017 and have not yet included Valspar in our assessment of the effectiveness of our internal control over financial reporting. For the first quarter 2018, Valspar accounted for $1.1 billion of our total net sales and as of March 31, 2018 had total assets of $4.1 billion. Valspar will be included in our assessment of the effectiveness of our internal control over financial reporting as of December 31, 2018.

Except as described in the preceding paragraph, there were no changes in our internal control over financial reporting identified in connection with the evaluation that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For information with respect to certain environmental-related matters and legal proceedings, see the information included under the captions entitled “Environmental-Related Liabilities” and “Litigation” of “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and Notes 10 and 11 of the “Notes to Condensed Consolidated Financial Statements,” which is incorporated herein by reference.

Item 1A. Risk Factors

We face a number of risks that could materially and adversely affect our business, results of operations, cash flow, liquidity or financial condition. A discussion of our risk factors can be found in Item 1A, Risk Factors, in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017. During the first quarter ended March 31, 2018, there were no material changes to our previously disclosed risk factors.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

A summary of the repurchase activity for the Company's first quarter is as follows:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Number of Shares Purchased as Part of a Publicly Announced Plan	Number of Shares That May Yet Be Purchased Under the Plan
January 1 - January 31				
Share repurchase program [1]				11,650,000
Employee transactions [2]	1,000	$422.14		N/A
February 1 - February 28				
Share repurchase program [1]	161,820	$399.59	161,820	11,488,180
Employee transactions [2]	50,769	$401.09		N/A
March 1 - March 31				
Share repurchase program [1]	438,180	$402.77	438,180	11,050,000
Employee transactions [2]	587	$394.47		N/A
Total				
Share repurchase program [1]	600,000	$401.91	600,000	11,050,000
Employee transactions [2]	52,356	$401.42		NA

(1) All shares were purchased through the Company's publicly announced share repurchase program. There is no expiration date specified for the program. The Company had remaining authorization at March 31, 2018 to purchase 11,050,000 shares.

(2) All shares were delivered to satisfy the exercise price and/or tax withholding obligations by employees who exercised stock options or had shares of restricted stock vest.

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Item 5. Other Information.

During the three months ended March 31, 2018, the Audit Committee of the Board of Directors of the Company approved permitted non-audit services to be performed by Ernst & Young LLP, the Company’s independent registered public accounting firm. These non-audit services were approved within categories related to domestic tax advisory, tax compliance and other advisory services.

Item 6. Exhibits.

4.1	Amendment No. 9 to the Credit Agreement, dated as of February 27, 2018, by and among The Sherwin-Williams Company, Citicorp USA, Inc., as administrative agent and issuing bank, and the lenders party thereto, filed as Exhibit 4.1 to the Company’s Current Report on Form 8-K dated February 27, 2018, and incorporated herein by reference.
10.1*	Schedule of Executive Officers who are Parties to the Amended and Restated Severance Agreements in the forms filed as Exhibit 10(e) to the Company’s Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2010 (filed herewith).
31(a)	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (filed herewith).
31(b)	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (filed herewith).
32(a)	Section 1350 Certification of Chief Executive Officer (furnished herewith).
32(b)	Section 1350 Certification of Chief Financial Officer (furnished herewith).
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

* Management contract or compensatory plan or arrangement.

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.

THE SHERWIN-WILLIAMS COMPANY

April 25, 2018	By:	/s/ Jane M. Cronin Jane M. Cronin Senior Vice President - Corporate Controller
April 25, 2018	By:	/s/ Allen J. Mistysyn Allen J. Mistysyn Senior Vice President - Finance and Chief Financial Officer