WATERS CORP /DE/
Form 10-Q
October 31, 2008

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended September 27, 2008

or

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

Commission File Number: 01-14010

Waters Corporation

(Exact name of registrant as specified in its charter)

Delaware	**13-3668640**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

34 Maple Street
Milford, Massachusetts 01757

(Address, including zip code, of principal executive offices)

(508) 478-2000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer þ Accelerated filer o

Non-accelerated filer (Do not check if a smaller reporting company) o Smaller reporting company o

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

Indicate the number of shares outstanding of the registrant s common stock as of October 24, 2008: 98,311,425

WATERS CORPORATION AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
INDEX

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	September 27, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 892,600	$ 597,333
Short-term investments		95,681
Accounts receivable, less allowances for doubtful accounts and sales returns of $9,018 and $9,634 at September 27, 2008 and December 31, 2007, respectively	289,271	317,792
Inventories	206,231	175,888
Other current assets	45,940	50,368
Total current assets	1,434,042	1,237,062
Property, plant and equipment, net	166,569	160,856
Intangible assets, net	148,716	141,759
Goodwill	272,077	272,626
Other assets	82,378	68,752
Total assets	$ 2,103,782	$ 1,881,055
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and debt	$ 377,488	$ 384,176
Accounts payable	55,011	47,451
Accrued employee compensation	45,507	58,771
Deferred revenue and customer advances	101,203	87,348
Accrued income taxes	14,663	994
Accrued warranty	11,706	13,119
Other current liabilities	60,620	66,575
Total current liabilities	666,198	658,434
Long-term liabilities:		
Long-term debt	650,000	500,000
Long-term portion of retirement benefits	46,714	52,353
Long-term income tax liability	78,815	70,079
Other long-term liabilities	16,972	14,113
Total long-term liabilities	792,501	636,545
Total liabilities	1,458,699	1,294,979
Commitments and contingencies (Notes 6, 7 and 11)		

Stockholders equity:				
Preferred stock, par value $0.01 per share, 5,000 shares authorized, none issued at September 27, 2008 and December 31, 2007				
Common stock, par value $0.01 per share, 400,000 shares authorized, 147,821 and 147,061 shares issued, 98,279 and 100,975 shares outstanding at September 27, 2008 and December 31, 2007, respectively		1,478		1,471
Additional paid-in capital		746,155		691,746
Retained earnings		1,814,050		1,590,924
Treasury stock, at cost, 49,542 and 46,086 shares at September 27, 2008 and December 31, 2007, respectively		(1,975,351)		(1,764,297)
Accumulated other comprehensive income		58,751		66,232
Total stockholders equity		645,083		586,076
Total liabilities and stockholders equity	$	2,103,782	$	1,881,055

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

3

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	Three Months Ended	
	September 27, 2008	September 29, 2007
Product sales	$ 277,717	$ 258,469
Service sales	108,593	94,169
Total net sales	386,310	352,638
Cost of product sales	109,278	106,316
Cost of service sales	49,242	47,363
Total cost of sales	158,520	153,679
Gross profit	227,790	198,959
Selling and administrative expenses	107,463	105,577
Research and development expenses	19,946	21,974
Purchased intangibles amortization	2,349	2,176
Operating income	98,032	69,232
Interest expense	(10,570)	(14,783)
Interest income	6,028	8,061
Income from operations before income taxes	93,490	62,510
Provision for income tax expense	21,987	9,227
Net income	$ 71,503	$ 53,283
Net income per basic common share	$ 0.72	$ 0.53
Weighted-average number of basic common shares	98,891	99,821
Net income per diluted common share	$ 0.71	$ 0.52

Weighted-average number of diluted common shares and equivalents	100,566	101,712

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

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	Nine Months Ended	
	September 27, 2008	September 29, 2007
Product sales	$ 835,303	$ 759,173
Service sales	321,490	276,872
Total net sales	1,156,793	1,036,045
Cost of product sales	336,874	309,553
Cost of service sales	152,329	139,577
Total cost of sales	489,203	449,130
Gross profit	667,590	586,915
Selling and administrative expenses	325,235	301,707
Research and development expenses	61,960	59,811
Purchased intangibles amortization	6,973	6,434
Operating income	273,422	218,963
Interest expense	(31,534)	(41,306)
Interest income	17,893	21,353
Income from operations before income taxes	259,781	199,010
Provision for income taxes	36,655	29,881
Net income	$ 223,126	$ 169,129
Net income per basic common share	$ 2.24	$ 1.68
Weighted-average number of basic common shares	99,611	100,457
Net income per diluted common share	$ 2.21	$ 1.65

Weighted-average number of diluted common shares and equivalents	101,150	102,352

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

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(unaudited)

	Nine Months Ended	
	September 27, 2008	**September 29, 2007**
Cash flows from operating activities:		
Net income	$ 223,126	$ 169,129
Adjustments to reconcile net income to net cash provided by operating activities:		
Provisions for doubtful accounts on accounts receivable	2,671	825
Provisions on inventory	7,757	5,283
Stock-based compensation	23,181	20,902
Deferred income taxes	(14,313)	(2,199)
Depreciation	22,052	20,508
Amortization of intangibles	30,413	19,177
Change in operating assets and liabilities, net of acquisitions:		
Decrease in accounts receivable	28,255	14,863
Increase in inventories	(42,506)	(22,473)
Decrease in other current assets	3,973	3,498
Increase in other assets	(2,275)	(12,283)
Increase in accounts payable and other current liabilities	459	37,359
Increase in deferred revenue and customer advances	14,135	10,759
Increase in other liabilities	9,102	1,545
Net cash provided by operating activities	306,030	266,893
Cash flows from investing activities:		
Additions to property, plant, equipment and software capitalization	(49,078)	(45,023)
Business acquisitions, net of cash acquired	(2,982)	(7,105)
Investment in unaffiliated company		(3,532)
Purchase of short-term investments	(19,738)	(304,740)
Maturity of short-term investments	115,419	197,441
Cash received from escrow related to business acquisition		724
Net cash provided by (used in) investing activities	43,621	(162,235)
Cash flows from financing activities:		
Proceeds from debt issuances	468,429	1,100,549
Payments on debt	(325,117)	(1,093,495)
Payments of debt issuance costs	(501)	(1,081)
Proceeds from stock plans	23,122	51,225
Purchase of treasury shares	(211,054)	(180,749)
Excess tax benefit related to stock option plans	7,787	18,656
Payments of debt swaps and other derivatives contracts	(3,706)	(2,310)
Net cash used in financing activities	(41,040)	(107,205)
Effect of exchange rate changes on cash and cash equivalents	(13,344)	7,547

Increase in cash and cash equivalents	295,267	5,000
Cash and cash equivalents at beginning of period	597,333	514,166
Cash and cash equivalents at end of period	$ 892,600	$ 519,166

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

WATERS CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 Basis of Presentation and Significant Accounting Policies

Waters Corporation (Waters or the Company), an analytical instrument manufacturer, designs, manufactures, sells and services, through its Waters Division, high performance liquid chromatography (HPLC), ultra performance liquid chromatography® (UPLC and together with HPLC, herein referred to as LC) and mass spectrometry (MS) instrumen systems and support products, including chromatography columns, other consumable products and comprehensive post-warranty service plans. These systems are complementary products that can be integrated together and used along with other analytical instruments. LC is a standard technique and is utilized in a broad range of industries to detect, identify, monitor and measure the chemical, physical and biological composition of materials, and to purify a full range of compounds. MS instruments are used in drug discovery and development, including clinical trial testing, the analysis of proteins in disease processes (known as proteomics) and environmental testing. LC is often combined with MS to create LC-MS instruments that include a liquid phase sample introduction and separation system with mass spectrometric compound identification and quantification. Through its TA Division (TA), the Company designs, manufactures, sells and services thermal analysis, rheometry and calorimetry instruments which are used in predicting the suitability of polymers and viscous liquids for various industrial, consumer goods and healthcare products. The Company is also a developer and supplier of software-based products that interface with the Company s instruments and are typically purchased by customers as part of the instrument system.

The Company s interim fiscal quarter typically ends on the thirteenth Saturday of each quarter. Since the Company s fiscal year end is December 31, the first and fourth fiscal quarters may not consist of thirteen complete weeks. The Company s third fiscal quarters for 2008 and 2007 ended on September 27, 2008 and September 29, 2007, respectively.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and note disclosures required by generally accepted accounting principles (GAAP) in the United States of America. The consolidated financial statements include the accounts of the Company and its subsidiaries, most of which are wholly owned. All material inter-company balances and transactions have been eliminated.

The preparation of consolidated financial statements in conformity with GAAP requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities at the dates of the financial statements. Actual amounts may differ from these estimates under different assumptions or conditions.

It is management s opinion that the accompanying interim consolidated financial statements reflect all adjustments (which are normal and recurring) that are necessary for a fair statement of the results for the interim periods. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company s annual report on Form 10-K for the year ended December 31, 2007, as filed with the Securities and Exchange Commission (SEC) on February 29, 2008.

Reclassifications

Certain amounts from the prior year have been reclassified in the accompanying financial statements in order to be consistent with the current year s classifications.

Short-term Investments

Short-term investments primarily represent highly liquid investments, with original maturities generally greater than 90 days, in commercial paper rated A1 or A1+ by Standard & Poor s and P1 by Moody s Investors Service; bank deposits; repurchase agreements; U.S. Government Treasury and Agency Debt and AAA rated money market funds which are convertible to a known amount of cash and carry an insignificant risk of change in market value. The cost of the short-term investments approximates fair value.

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Value Measurements

Fair values of cash, cash equivalents, accounts receivable, accounts payable and debt approximate cost.

Effective January 1, 2008, the Company adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements . This standard addresses how companies should measure fair value when they are required to use a fair-value measure for recognition or disclosure purposes under GAAP. The adoption of this standard did not have a material effect on the Company s financial position, results of operations or cash flows. Relative to SFAS No. 157, the FASB issued Financial Statement of Position (FSP) Nos. 157-1, 157-2 and 157-3. FSP No. 157-1 amends SFAS No. 157 to exclude SFAS No. 13, Accounting for Leases , and its related interpretive accounting pronouncements that address leasing transactions, while FSP No. 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for those that are recognized or disclosed at fair value in the financial statements on a recurring basis. As is permitted by FSP No. 157-2, the Company has elected to defer implementation of this standard as it relates to the Company s non-financial assets and non-financial liabilities that are recognized and disclosed at fair value in the financial statements on a non-recurring basis until January 1, 2009. The Company is in the process of evaluating whether the adoption of FSP No. 157-2 will have a material effect on its financial position, results of operations or cash flows. FSP No. 157-3 clarifies the application of SFAS No. 157 as it relates to the valuation of financial assets in a market that is not active for those financial assets. This FSP is effective immediately and includes those periods for which financial statements have not been issued. As of September 27, 2008, the Company currently does not have any financial assets that are valued using inactive markets, and as such are not currently impacted by the issuance of this FSP.

SFAS No. 157 establishes a three-level value hierarchy for disclosure of fair-value measurements. The valuation hierarchy is based on the transparency of the inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Inputs to the valuation methodology are quoted prices for similar assets and liabilities in active markets, quoted prices in markets that are not active or inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 Unobservable inputs (e.g. a reporting entity s own data).

In accordance with methodology prescribed by SFAS No. 157, the Company has measured and disclosed the fair value of the following financial instrument assets and liabilities as of September 27, 2008 (in thousands):

	Total September 27, 2008	Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents	$ 742,981	$	$ 742,981	$
Waters Retirement Restoration Plan assets	15,761		15,761	
Foreign currency exchange contract agreements	59		59	
Total	$ 758,801	$	$ 758,801	$

Liabilities:				
Interest rate swap agreements	2,151		2,151	
Total	$ 2,151	$	$ 2,151	$

The fair values of the Company s cash equivalents, plan assets and derivative instruments are determined through market, observable and corroborated sources.

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stockholders Equity

In February 2007, the Company s Board of Directors authorized the Company to repurchase up to $500 million of its outstanding common stock over a two-year period. During the nine months ended September 27, 2008 and September 29, 2007, the Company repurchased 3.4 million and 2.5 million shares at a cost of $209 million and $146 million, respectively, under this program. As of September 27, 2008, the Company repurchased an aggregate of 6.2 million shares for an aggregate of $375 million under this program.

In October 2005, the Company s Board of Directors authorized the Company to repurchase up to $500 million of its outstanding common stock over a two-year period. During the three months ended March 31, 2007, the Company repurchased 0.6 million shares at a cost of $35 million under this program. As of March 31, 2007, the Company repurchased an aggregate of 11.9 million shares of its common stock under the October 2005 program for an aggregate of $500 million, effectively completing this program.

Hedge Transactions

Cash Flow Hedges

The Company uses interest rate swap agreements to hedge the risk to earnings associated with fluctuations in interest rates related to outstanding U.S. dollar floating rate debt. In August 2007, the Company entered into two floating-to-fixed-rate interest rate swaps, each with a notional amount of $50 million and maturity dates of April 2009 and October 2009, to hedge floating rate debt related to the term loan facility of its outstanding debt.

Other

The Company enters into forward foreign exchange contracts, principally to hedge the impact of currency fluctuations on certain inter-company balances. Principal hedged currencies include the Euro, Japanese Yen, British Pound and Singapore Dollar. The periods of these forward contracts typically range from one to three months and have varying notional amounts which are intended to be consistent with changes in inter-company balances. Gains and losses on these forward contracts are recorded in selling and administrative expenses in the consolidated statements of operations. At September 27, 2008 and December 31, 2007, the Company held forward foreign exchange contracts with notional amounts totaling $114 million and $101 million, respectively.

Product Warranty Costs

The Company accrues estimated product warranty costs at the time of sale which are included in cost of sales in the consolidated statements of operations. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component supplies, the Company s warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. The amount of the accrued warranty liability is based on historical information, such as past experience, product failure rates, number of units repaired and estimated costs of material and labor. The liability is reviewed for reasonableness at least quarterly.

The following is a summary of the activity of the Company s accrued warranty liability for the nine months ended September 27, 2008 and September 29, 2007 (in thousands):

	Balance at Beginning of Period	Accruals for Warranties	Settlements Made	Balance at End of Period
Accrued warranty liability:				
September 27, 2008	$ 13,119	$ 7,376	$ (8,789)	$ 11,706
September 29, 2007	$ 12,619	$ 8,866	$ (8,744)	$ 12,741

2 Out-of-Period Adjustments

During the second quarter of 2008, the Company identified errors originating in periods prior to the three months ended June 28, 2008. The errors primarily related to (i) an overstatement of the Company s income tax expense of $16 million as a result of errors in recording its income tax provision during the period from 2000 to March 29, 2008 and (ii) an understatement of amortization expense of $9 million for certain capitalized software. The Company incorrectly calculated its provision for income taxes by tax-effecting its tax liability utilizing a U.S. tax rate of 35% instead of an Irish tax rate of 10%. In addition, the Company incorrectly accounted for Irish-based capitalized

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

software and the related amortization expense as U.S. Dollar-denominated instead of Euro-denominated, resulting in an understatement of amortization expense and cumulative translation adjustment.

The Company identified and corrected the errors in the three months ended June 28, 2008, which had the effect of increasing cost of sales by $9 million; reducing gross profit and income from operations before income tax by $9 million; reducing the provision for income taxes by $16 million and increasing net income by $8 million. For the nine months ended September 27, 2008, the errors had the effect of reducing the Company s effective tax rate by 5.6 percentage points. In addition, as of June 28, 2008, the out-of-period adjustments increased the gross carrying value of capitalized software by $46 million; increased accumulated amortization for capitalized software by $36 million; reduced deferred tax liabilities by $14 million and increased accumulated other comprehensive income by $17 million.

The Company does not believe that the prior period errors, individually or in the aggregate, are material to any previously issued annual or quarterly financial statements. In addition, the Company does not believe that the adjustments described above to correct the cumulative effect of the errors in the three months ended June 28, 2008 are material to the three months ended June 28, 2008 or to the estimate of the full year results for 2008. As a result, the Company has not restated its previously issued annual financial statements or interim financial data.

3 Inventories

Inventories are classified as follows (in thousands):

	September 27, 2008	December 31, 2007
Raw materials	$ 66,294	$ 51,426
Work in progress	17,274	16,970
Finished goods	122,663	107,492
Total inventories	$ 206,231	$ 175,888

4 Acquisitions

In July 2008, the Company acquired the net assets of VTI Corporation (VTI), a manufacturer of sorption analysis and thermogravimetric analysis instruments, for $3 million in cash. This acquisition was accounted for under the purchase method of accounting and the results of VTI have been included in the consolidated results of the Company from the acquisition date. The purchase price of the acquisition was allocated to tangible and intangible assets and assumed liabilities based on their estimated fair values. The Company has allocated $1 million of the purchase price to intangible assets comprised of a non-compete agreement and acquired technology. These intangible assets are being amortized over a weighted-average period of nine years. The excess purchase price of $2 million after this allocation has been accounted for as goodwill. The goodwill is deductible for tax purposes.

In August 2007, the Company acquired all of the outstanding capital stock of Calorimetry Sciences Corporation (CSC), a privately held company that designs, develops and manufactures highly sensitive calorimeters, for $7 million in cash, including the assumption of $1 million of liabilities. This acquisition was accounted for under the purchase method of accounting and the results of operations of CSC have been included in the consolidated results of the Company from the acquisition date. The purchase price of the acquisition was allocated to tangible and intangible assets and assumed liabilities based on their estimated fair values. The Company has allocated $3 million of the purchase price to intangible assets comprised of customer relationships, non-compete agreements and acquired technology. These intangible assets are being amortized over a weighted-average period of nine years. The excess purchase price of $5 million after this allocation has been accounted for as goodwill. The goodwill is deductible for tax purposes.

The pro forma effect of the CSC and VTI acquisitions are immaterial.

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5 Goodwill and Other Intangibles

The carrying amount of goodwill was $272 million and $273 million at September 27, 2008 and December 31, 2007, respectively. The decrease is primarily due to currency translation adjustments of $3 million offset by the Company s acquisition of VTI which increased goodwill by $2 million.

The Company s intangible assets included in the consolidated balance sheets are detailed as follows (in thousands):

	September 27, 2008			December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period
Purchased intangibles	$ 111,883	$ 49,956	10 years	$ 111,207	$ 43,180	10 years
Capitalized software	183,383	110,804	4 years	133,215	74,298	4 years
Licenses	9,902	7,319	9 years	10,522	7,011	9 years
Patents and other intangibles	21,164	9,537	8 years	19,182	7,878	8 years
Total						