WATERS CORP /DE/
Form 10-Q
November 05, 2010

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 October 2, 2010

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). þ Yes o No

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 o (Do not check if smaller reporting company)	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 29, 2010: 91,330,030

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)

	October 2, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 262,792	$ 341,111
Short-term investments	574,306	289,146
Accounts receivable, less allowances for doubtful accounts and sales returns of $7,230 and $6,723 at October 2, 2010 and December 31, 2009, respectively	337,562	314,247
Inventories	208,339	178,666
Other current assets	55,328	49,206
Total current assets	1,438,327	1,172,376
Property, plant and equipment, net	214,773	210,926
Intangible assets, net	183,182	182,165
Goodwill	292,424	293,077
Other assets	76,940	49,387
Total assets	$ 2,205,646	$ 1,907,931
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and debt	$ 92,243	$ 131,772
Accounts payable	63,332	49,573
Accrued employee compensation	38,475	37,050
Deferred revenue and customer advances	120,850	94,680
Accrued income taxes	29,896	13,267
Accrued warranty	10,767	10,109
Other current liabilities	61,847	58,117
Total current liabilities	417,410	394,568
Long-term liabilities:		
Long-term debt	700,000	500,000
Long-term portion of retirement benefits	67,574	69,044
Long-term income tax liability	75,639	72,604
Other long-term liabilities	21,761	22,766
Total long-term liabilities	864,974	664,414
Total liabilities	1,282,384	1,058,982
Commitments and contingencies (Notes 5, 6, 7 and 11)		

Stockholders equity:				
Preferred stock, par value $0.01 per share, 5,000 shares authorized, none issued at October 2, 2010 and December 31, 2009				
Common stock, par value $0.01 per share, 400,000 shares authorized, 149,750 and 148,831 shares issued, 91,210 and 94,118 shares outstanding at October 2, 2010 and December 31, 2009, respectively		1,497		1,488
Additional paid-in capital		884,435		808,345
Retained earnings		2,491,875		2,236,716
Treasury stock, at cost, 58,540 and 54,713 shares at October 2, 2010 and December 31, 2009, respectively		(2,458,067)		(2,213,174)
Accumulated other comprehensive income		3,522		15,574
Total stockholders equity		923,262		848,949
Total liabilities and stockholders equity	$	2,205,646	$	1,907,931

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

1

Table of Contents

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

	Three Months Ended	
	October 2, 2010	October 3, 2009
Product sales	$ 282,934	$ 259,532
Service sales	118,104	114,431
Total net sales	401,038	373,963
Cost of product sales	113,345	104,038
Cost of service sales	49,640	49,105
Total cost of sales	162,985	153,143
Gross profit	238,053	220,820
Selling and administrative expenses	111,306	102,675
Research and development expenses	20,524	19,310
Purchased intangibles amortization	2,408	2,723
Operating income	103,815	96,112
Interest expense	(3,810)	(2,864)
Interest income	516	785
Income from operations before income taxes	100,521	94,033
Provision for income taxes	5,802	18,097
Net income	$ 94,719	$ 75,936
Net income per basic common share	$ 1.03	$ 0.80
Weighted-average number of basic common shares	91,714	95,235
Net income per diluted common share	$ 1.02	$ 0.79

Weighted-average number of diluted common shares and equivalents	93,286	96,513

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	
	October 2, 2010	**October 3, 2009**
Product sales	$ 811,401	$ 740,501
Service sales	348,392	329,351
Total net sales	1,159,793	1,069,852
Cost of product sales	317,640	285,946
Cost of service sales	146,410	138,805
Total cost of sales	464,050	424,751
Gross profit	695,743	645,101
Selling and administrative expenses	324,938	311,417
Research and development expenses	61,407	57,364
Purchased intangibles amortization	7,642	8,022
Operating income	301,756	268,298
Interest expense	(10,045)	(8,643)
Interest income	1,293	2,288
Income from operations before income taxes	293,004	261,943
Provision for income taxes	37,845	42,753
Net income	$ 255,159	$ 219,190
Net income per basic common share	$ 2.75	$ 2.28
Weighted-average number of basic common shares	92,647	96,215
Net income per diluted common share	$ 2.71	$ 2.26

Weighted-average number of diluted common shares and equivalents	94,271	97,027

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	
	October 2, 2010	**October 3, 2009**
Cash flows from operating activities:		
Net income	$ 255,159	$ 219,190
Adjustments to reconcile net income to net cash provided by operating activities:		
Provisions for doubtful accounts on accounts receivable	1,414	844
Provisions on inventory	7,309	5,577
Stock-based compensation	18,558	21,757
Deferred income taxes	(4,669)	1,696
Depreciation	25,897	23,782
Amortization of intangibles	19,621	18,790
Change in operating assets and liabilities, net of acquisitions:		
(Increase) decrease in accounts receivable	(20,713)	12,070
Increase in inventories	(35,771)	(18,619)
(Increase) decrease in other current assets	(1,325)	3,652
Increase in other assets	(1,256)	(1,584)
Increase in accounts payable and other current liabilities	36,311	906
Increase in deferred revenue and customer advances	23,335	14,245
Decrease in other liabilities	(101)	(3,902)
Net cash provided by operating activities	323,769	298,404
Cash flows from investing activities:		
Additions to property, plant, equipment and software capitalization	(47,277)	(80,399)
Business acquisitions, net of cash acquired		(36,086)
Purchase of short-term investments	(924,727)	(317,342)
Maturity of short-term investments	639,567	129,611
Net cash used in investing activities	(332,437)	(304,216)
Cash flows from financing activities:		
Proceeds from debt issuances	315,116	169,024
Payments on debt	(154,645)	(64,393)
Payments of debt issuance costs	(1,498)	
Proceeds from stock plans	26,850	8,159
Purchase of treasury shares	(244,893)	(157,212)
Excess tax benefit related to stock option plans	5,149	
(Payments for) proceeds from debt swaps and other derivative contracts	(4,968)	4,495
Net cash used in financing activities	(58,889)	(39,927)
Effect of exchange rate changes on cash and cash equivalents	(10,762)	7,634
Decrease in cash and cash equivalents	(78,319)	(38,105)
Cash and cash equivalents at beginning of period	341,111	428,522

Cash and cash equivalents at end of period	$ 262,792	$ 390,417

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

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 Basis of Presentation and Summary of Significant Accounting Policies

Waters Corporation (Waters or the Company), an analytical instrument manufacturer, primarily designs, manufactures, sells and services, through its Waters Division, high performance liquid chromatography (HPLC), ultra performance liquid chromatography (UPLC® and together with HPLC, referred to as LC) and mass spectrometry (MS) instrument 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), food safety analysis 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 primarily designs, manufactures, sells and services thermal analysis, rheometry and calorimetry instruments, which are used in predicting the suitability of fine chemicals, polymers and viscous liquids for various industrial, consumer goods and healthcare products, as well as for life science research. 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 will not consist of thirteen complete weeks. The Company s third fiscal quarters for 2010 and 2009 ended on October 2, 2010 and October 3, 2009, 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, 2009, as filed with the Securities and Exchange Commission on February 26, 2010.

During the second quarter of 2010, the Company identified an error originating in periods prior to December 31, 2009. The error relates to an overstatement of the Company s incentive plan and other accrual balances. The Company identified and corrected the error in the three months ended July 3, 2010 which reduced selling and administrative expense. The Company does not believe that the prior period error, individually or in the aggregate, was material to the three months ended July 3, 2010, the nine months ended October 2, 2010 or any previously issued annual or quarterly financial statements.

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.

Fair Value Measurements

In accordance with the accounting standards for fair value measurements and disclosures, certain assets and liabilities are measured at fair value on a recurring basis as of October 2, 2010 and December 31, 2009. Fair values determined by Level 1 inputs utilize observable data, such as quoted prices in active markets. Fair values determined by Level 2 inputs utilize data points other than quoted prices in active markets that are observable either directly or

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

indirectly. Fair values determined by Level 3 inputs utilize unobservable data points for which there is little or no market data, which require the reporting entity to develop its own assumptions.

The following table represents the Company s assets and liabilities measured at fair value on a recurring basis at October 2, 2010 (in thousands):

	Total at October 2, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents	$ 106,273	$	$ 106,273	$
Short-term investments	574,306		574,306	
Waters Retirement Restoration Plan assets	18,771		18,771	
Foreign currency exchange contract agreements	375		375	
Total	$ 699,725	$	$ 699,725	$
Liabilities:				
Foreign currency exchange contract agreements	$ 664	$	$ 664	$
Total	$ 664	$	$ 664	$

The following table represents the Company s assets and liabilities measured at fair value on a recurring basis at December 31, 2009 (in thousands):

	Total at December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents	$ 181,925	$	$ 181,925	$
Short-term investments	289,146		289,146	
Waters Retirement Restoration Plan assets	17,955		17,955	
Foreign currency exchange contract agreements	237		237	

Total	$	489,263	$		$	489,263	$	
Liabilities:								
Foreign currency exchange contract agreements	$	400	$		$	400	$	
Total	$	400	$		$	400	$	

The Company s financial assets and liabilities have been classified as Level 2. These assets and liabilities have been initially valued at the transaction price and subsequently valued, typically utilizing third-party pricing services. The pricing services use many inputs to determine value, including reportable trades, benchmark yields, credit spreads, broker/dealer quotes, current spot rates and other industry and economic events. The Company validates the prices provided by third-party pricing services by reviewing their pricing methods and obtaining market values from other

6

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

pricing sources. The fair values of the Company s cash equivalents, short-term investments, retirement restoration plan assets and foreign currency exchange contracts are determined through market and observable sources and have been classified as Level 2. After completing these validation procedures, the Company did not adjust or override any fair value measurements provided by third-party pricing services as of October 2, 2010 and December 31, 2009.

Fair Value of Other Financial Instruments

The Company s cash, accounts receivable, accounts payable and debt are recorded at cost, which approximates fair value.

Stockholders Equity

In February 2009, 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 October 2, 2010 and October 3, 2009, the Company repurchased 3.8 million and 2.2 million shares at a cost of $241 million and $103 million, respectively, under this program.

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 October 3, 2009, the Company repurchased 1.4 million shares at a cost of $53 million under this program, which expired in February 2009.

Hedge Transactions

The Company operates on a global basis and is exposed to the risk that its earnings, cash flows and stockholders equity could be adversely impacted by fluctuations in currency exchange rates and interest rates.

The Company records its hedge transactions in accordance with the accounting standards for derivative instruments and hedging activities, which establishes the accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the consolidated balance sheets at fair value as either assets or liabilities. If the derivative is designated as a fair-value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, the effective portions of changes in the fair value of the derivative are recorded in other comprehensive income and are recognized in earnings when the hedged item affects earnings; ineffective portions of changes in fair value are recognized in earnings. In addition, disclosures required for derivative instruments and hedging activities include the Company s objectives for using derivative instruments, the level of derivative activity the Company engages in, as well as how derivative instruments and related hedged items affect the Company s financial position and performance.

The Company currently uses derivative instruments to manage exposures to foreign currency and interest rate risks. The Company s objectives for holding derivatives are to minimize foreign currency and interest rate risk using the most effective methods to eliminate or reduce the impact of foreign currency and interest rate exposures. The Company documents all relationships between hedging instruments and hedged items and links all derivatives designated as fair-value, cash flow or net investment hedges to specific assets and liabilities on the consolidated balance sheets or to specific forecasted transactions. In addition, the Company considers the impact of its counterparties credit risk on the fair value of the contracts as well as the ability of each party to execute under the contracts. The Company also assesses and documents, both at the hedges inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows associated with the hedged items.

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. At both October 2, 2010 and December 31, 2009, the Company had no outstanding interest rate swap agreements. For the three and nine months ended October 3, 2009, the Company recorded a cumulative pre-tax unrealized gain of $1 million and $2 million, respectively, in accumulated other comprehensive income on the interest rate agreements. For the three and nine months ended October 3, 2009, the Company recorded additional interest expense of less than $1 million and $2 million, respectively.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other

The Company enters into forward foreign exchange contracts, principally to hedge the impact of currency fluctuations on certain inter-company balances and short-term assets and liabilities. 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 the underlying exposures. Gains and losses on these forward contracts are recorded in selling and administrative expenses in the consolidated statements of operations. At October 2, 2010 and December 31, 2009, the Company held forward foreign exchange contracts with notional amounts totaling $152 million and $138 million, respectively. At both October 2, 2010 and December 31, 2009, the Company had assets of less than $1 million in other current assets in the consolidated balance sheets related to the foreign currency exchange contracts. At October 2, 2010 and December 31, 2009, the Company had liabilities of $1 million and less than $1 million, respectively, in other current liabilities in the consolidated balance sheets related to the foreign currency exchange contracts. For the three months ended October 2, 2010, the Company recorded cumulative net pre-tax gains of $2 million, which consists of realized gains of $2 million relating to the closed forward contracts. For the nine months ended October 2, 2010, the Company recorded cumulative net pre-tax losses of $5 million, which consists of realized losses of $5 million relating to the closed forward contracts. For the three months ended October 3, 2009, the Company recorded cumulative net pre-tax losses of $4 million, which consists of realized losses of $4 million relating to the closed forward contracts. For the nine months ended October 3, 2009, the Company recorded cumulative net pre-tax gains of $6 million, which consists of realized gains of $5 million relating to the closed forward contracts and $1 million of unrealized gains relating to the open forward contracts.

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 October 2, 2010 and October 3, 2009 (in thousands):

	Balance at Beginning of Period	Accruals for Warranties	Settlements Made	Balance at End of Period
Accrued warranty liability:				
October 2, 2010	$10,109	$4,849	$(4,191)	$10,767
October 3, 2009	$10,276	$4,485	$(4,414)	$10,347

Subsequent Events

The Company did not have any material recognizable subsequent events.

2 Inventories

Inventories are classified as follows (in thousands):

	October 2, 2010	December 31, 2009
Raw materials	$ 67,670	$ 57,223
Work in progress	19,709	15,419
Finished goods	120,960	106,024

Total inventories	$	208,339	$	178,666

8

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3 Acquisitions

In February 2009, the Company acquired all of the remaining outstanding capital stock of Thar Instruments, Inc. (Thar), a privately-held global leader in the design, development and manufacture of analytical and preparative supercritical fluid chromatography and supercritical fluid extraction (SFC) systems, for $36 million in cash, including the assumption of $4 million of debt.

The acquisition of Thar was accounted for under the accounting standards for business combinations and the results of Thar have been included in the consolidated results of the Company from the acquisition date. The pro forma effect of the results of the ongoing operations for the Company and Thar as though the acquisition of Thar had occurred at the beginning of the periods covered by this report is immaterial.

4 Goodwill and Other Intangibles

The carrying amount of goodwill was $292 million and $293 million at October 2, 2010 and December 31, 2009, respectively. Currency translation adjustments decreased goodwill by $1 million.

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

	October 2, 2010			December 31, 2009		
	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period
Purchased intangibles	$ 135,568	$ 68,776	10 years	$ 136,604	$ 61,751	10 years
Capitalized software	228,695	126,957	5 years	217,102	122,920	5 years
Licenses	9,795	8,856	7 years	9,637	8,328	8 years
Patents and other intangibles	28,203	14,490	8 years	24,185	12,364	8 years
Total	$ 402,261	$ 219,079	7 years	$ 387,528	$ 205,363	7 years

The gross carrying value of intangible assets and accumulated amortization for intangible assets decreased by $11 million and $6 million, respectively, in the nine months ended October 2, 2010 due to the effect of foreign currency translation. Amortization expense for intangible assets was $6 million for both the three months ended October 2, 2010 and October 3, 2009. Amortization expense for intangible assets was $20 million and $19 million for the nine months ended October 2, 2010 and October 3, 2009, respectively. For the next five years, amortization expense for intangible assets is estimated to be approximately $25 million per year for the next two years and is estimated to increase to approximately $33 million per year thereafter.

5 Debt

In February 2010, the Company issued and sold five-year senior unsecured notes at an interest rate of 3.75% with a face value of $100 million. This debt matures in February 2015. In March 2010, the Company issued and sold ten-year senior unsecured notes at an interest rate of 5.00% with a face value of $100 million. This debt matures in February 2020. The Company used the proceeds from the issuance of these senior unsecured notes to repay other outstanding debt and for general corporate purposes. Interest on both issuances of senior unsecured notes is payable semi-annually in February and August of each year. The Company may redeem some of the notes at any time in an amount not less than 10% of the aggregate principal amount outstanding, plus accrued and unpaid interest, plus the applicable make-whole amount. These notes require that the Company comply with an interest coverage ratio test of not less than 3.50:1 and a leverage ratio test of not more than 3.50:1 for any period of four consecutive fiscal quarters, respectively. In addition, these notes include customary negative covenants. These notes also contain certain customary representations and warranties, affirmative covenants and events of default.

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In January 2007, the Company entered into a credit agreement (the 2007 Credit Agreement) that provides for a $500 million term loan facility and $600 million in revolving facilities, which include both a letter of credit and a swingline subfacility. The 2007 Credit Agreement matures in January 2012 and requires no scheduled prepayments before that date. The outstanding portions of the revolving facilities have been classified as short-term liabilities in the consolidated balance sheets due to the fact that the Company utilizes the revolving line of credit to fund its working capital needs. It is the Company s intention to pay the outstanding revolving line of credit balance during the subsequent twelve months following the respective period end date.

The interest rates applicable to the 2007 Credit Agreement are, at the Company s option, equal to either the base rate (which is the higher of the prime rate or the federal funds rate plus 1/2%) or the applicable 1, 2, 3, 6, 9 or 12 month LIBOR rate, in each case plus a credit margin based upon the Company s leverage ratio, which can range between 33 basis points and 72.5 basis points for LIBOR rate loans and range between zero basis points and 37.5 basis points for base rate loans. The 2007 Credit Agreement requires that the Company comply with an interest coverage ratio test of not less than 3.50:1 and a leverage ratio test of not more than 3.25:1 for any period of four consecutive fiscal quarters, respectively. In addition, the 2007 Credit Agreement includes negative covenants that are customary for investment grade credit facilities. The 2007 Credit Agreement also contains certain customary representations and warranties, affirmative covenants and events of default.

As of October 2, 2010, the Company was in compliance with all debt covenants.

At October 2, 2010 and December 31, 2009, the Company had the following outstanding debt (in thousands):

	October 2, 2010	December 31, 2009
Lines of credit	$ 12,243	$ 11,772
2007 Credit Agreement, due January 2012	80,000	120,000
Total notes payable and debt	92,243	131,772
Senior unsecured notes Series A - 3.75%, due February 2015	100,000	
Senior unsecured notes Series B - 5.00%, due February 2020	100,000	
2007 Credit Agreement, due January 2012	500,000	500,000
Total long-term debt	700,000	500,000
Total debt	$ 792,243	$ 631,772

As of October 2, 2010 and December 31, 2009, the Company had a total amount available to borrow of $519 million and $479 million, respectively, after outstanding letters of credit. The weighted-average interest rates applicable to the senior notes and 2007 Credit Agreement borrowings were 1.70% and 0.78% at October 2, 2010 and December 31, 2009, respectively. The increase in the weighted-average interest rate for the Company s long-term debt is primarily due to a higher rate paid on the fixed-rate debt.

The Company and its foreign subsidiaries also had available short-term lines of credit totaling $110 million and $88 million at October 2, 2010 and December 31, 2009, respectively, for the purpose of short-term borrowing and issuance of commercial guarantees. At October 2, 2010 and December 31, 2009, the weighted-average interest rates applicable to the short-term borrowings were 2.27% and 1.97%, respectively.

6 Income Taxes

The Company accounts for its uncertain tax return reporting positions in accordance with the accounting standards for income taxes, which require financial statement reporting of the expected future tax consequences of uncertain tax reporting positions on the presumption that all concerned tax authorities possess full knowledge of the reporting positions, as well as all of the pertinent facts and circumstances, but prohibit any discounting of unrecognized tax benefits associated with uncertain reporting positions for the time value of money.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of the activity in the Company s unrecognized tax benefits for the nine months ended October 2, 2010 and October 3, 2009 (in thousands):

	October 2, 2010	October 3, 2009
Balance at the beginning of the period	$ 77,924	$ 77,295
Realization of uncertain U.K. tax benefits	(9,996)	
Realization of uncertain pre-acquisition tax benefits	(1,500)	
Realization of uncertain legal entity reorganization tax benefits		(4,555)
Increase in other uncertain tax benefits	3,469	3,395
Balance at the end of the period	$ 69,897	$ 76,135

During the three and nine months ended October 2, 2010, the Company recorded a net $8 million tax benefit in the income tax provision which represents the realization of the reserve for uncertain United Kingdom tax benefits offset by the amount of the audit settlement. Also, during the nine months ended October 2, 2010, the Company recorded $2 million of tax benefit in the income tax provision related to the resolution of a pre-acquisition tax exposure. Included in the income tax provision for the nine months ended October 3, 2009 is approximately $5 million of tax benefit in the income tax provision related to the reversal of a $5 million tax provision, which was originally recorded in 2008, relating to the reorganization of certain foreign legal entities. The recognition of this tax benefit in 2009 was a result of changes in income tax regulations promulgated by the U.S. Treasury in February 2009.

The Company s uncertain tax positions are taken with respect to income tax return reporting periods beginning after December 31, 1999, which are the periods that generally remain open to income tax audit examination by the concerned income tax authorities. The Company continuously monitors the lapsing of statutes of limitations on potential tax assessments for related changes in the measurement of unrecognized tax benefits, related net interest and penalties, and deferred tax assets and liabilities. As of October 2, 2010, the Company does not expect to record any material changes in the measurement of any other unrecognized tax benefits, related net interest and penalties or deferred tax assets and liabilities due to the settlement of tax audit examinations or to the lapsing of statutes of limitations on potential tax assessments within the next twelve months.

The Company s effective tax rates for the three months ended October 2, 2010 and October 3, 2009 were 5.8% and 19.2%, respectively. The Company s effective tax rates for the nine months ended October 2, 2010 and October 3, 2009 were 12.9% and 16.3%, respectively. Included in the income tax provision for the three and nine months ended October 2, 2010 is the aforementioned $8 million tax benefit related to the reversal of reserves for uncertain tax positions due to an audit settlement in the United Kingdom. This net tax benefit decreased the Company s effective tax rate for the three and nine months ended October 2, 2010 by 7.5 percentage points and 2.6 percentage points, respectively. Also included in the income tax provision for the nine months ended October 2, 2010 is the aforementioned $2 million of tax benefit related to the resolution of a pre-acquisition tax exposure. This tax benefit decreased the Company s effective tax rate by 0.5 percentage points in the nine months ended October 2, 2010. Included in the income tax provision for the nine months ended October 3, 2009 is the aforementioned $5 million of tax benefit related to changes in U.S. income tax regulations. This tax benefit decreased the Company s effective tax rate by 1.7 percentage points for the nine months ended October 3, 2009. The remaining differences between the effective tax rates for the three and nine months ended October 2, 2010 as compared to the three and nine months ended October 3, 2009 were primarily attributable to differences in the proportionate amounts of pre-tax income recognized in jurisdictions with different effective tax rates.

The accounting standards for income taxes require that a Company continually evaluate the necessity of establishing or changing valuation allowances for deferred tax assets, depending on whether it is more likely than not that actual benefit of those assets will be realized in future periods. Prior to the third quarter of 2010, the Company had recorded a $71 million deferred tax asset associated with its foreign tax credit carryforward and a $71 million valuation allowance against that deferred tax asset because it was more likely than not that actual tax benefit of $71 million would not be realized. Recording the valuation allowance, therefore, reduced the net carrying value of the related deferred tax asset to zero for financial reporting purposes.

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As required by the accounting standards for income taxes, the Company maintained this deferred tax asset valuation allowance until it determined, during the third quarter of 2010, that it was more likely than not that it would realize some actual tax benefit of a portion of the deferred tax asset for which a full valuation allowance had been previously provided. During the third quarter of 2010, the Company realized a benefit of $12 million and determined that it will realize an additional benefit of $14 million in the future for this deferred tax asset. As a result, in the third quarter of 2010, the Company released the $71 million valuation allowance related to the deferred tax asset associated with the foreign tax credit carryforward, reduced the deferred tax asset associated with the foreign tax credit carryforward by $57 million (reduced to $14 million), reduced accrued taxes by $12 million and increased additional paid-in capital by $26 million. The Company increased additional paid-in capital because the valuation allowance that was originally established against this deferred tax asset was originally recorded as a reduction in additional paid-in capital. The Company believes that its current projections of future taxable income support its judgment that the remaining deferred tax asset of approximately $14 million will more likely than not be realized in the future, based on the Company s review of all relevant facts and circumstances.

7 Litigation

The Company is involved in various litigation matters arising in the ordinary course of business. The Company believes the outcome of these matters will not have a material impact on the Company s financial position.

The Company has been engaged in ongoing patent litigation with Agilent Technologies GmbH in France and Germany. In January 2009, the French appeals court affirmed that the Company had infringed the Agilent Technologies GmbH patent and a judgment was issued against the Company. The Company has appealed this judgment. In 2008, the Company recorded a $7 million provision and, in the first quarter of 2009, the Company made a payment of $6 million for damages and fees estimated to be incurred in connection with the French litigation case. The accrued patent litigation expense is in other current liabilities in the consolidated balance sheets at October 2, 2010 and December 31, 2009. No provision has been made for the German patent litigation and the Company believes the outcome, if the plaintiff ultimately prevails, will not have a material impact on the Company s financial position.

8 Stock-Based Compensation

The Company maintains various shareholder-approved, stock-based compensation plans which allow for the issuance of incentive or non-qualified stock options, stock appreciation rights, restricted stock or other types of awards (e.g. restricted stock units).

The Company accounts for stock-based compensation costs in accordance with the accounting standards for stock-based compensation, which require that all share-based payments to employees be recognized in the statements of operations based on their fair values. The Company recognizes the expense using the straight-line attribution method. The stock-based compensation expense recognized in the consolidated statements of operations is based on awards that ultimately are expected to vest; therefore, the amount of expense has been reduced for estimated forfeitures. The stock-based compensation accounting standards require forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. If actual results differ significantly from these estimates, stock-based compensation expense and the Company s results of operations could be materially impacted. In addition, if the Company employs different assumptions in the application of this standard, the compensation expense that the Company records in the future periods may differ significantly from what the Company has recorded in the current period.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The consolidated statements of operations for the three and nine months ended October 2, 2010 and October 3, 2009 include the following stock-based compensation expense related to stock option awards, restricted stock, restricted stock unit awards and the employee stock purchase plan (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Cost of sales	$ 623	$ 687	$ 1,852	$ 2,122
Selling and administrative expenses	4,829	5,467	14,364	16,992
Research and development expenses	792	1,097	2,342	2,643
Total stock-based compensation	$ 6,244	$ 7,251	$ 18,558	$ 21,757

As of both October 2, 2010 and December 31, 2009, the Company has capitalized stock-based compensation costs of less than $1 million in inventory in the consolidated balance sheets. As of both October 2, 2010 and December 31, 2009, the Company has capitalized stock-based compensation costs of $3 million in capitalized software in the consolidated balance sheets. The reduction in stock-based compensation expense for the three and nine months ended October 2, 2010 as compared to the three and nine months ended October 3, 2009 is primarily a result of a shift over time in stock-based compensation grants from stock options to restricted stock units.

Stock Options

In determining the fair value of the stock options, the Company makes a variety of assumptions and estimates, including volatility measures, expected yields and expected stock option lives. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model. The Company uses implied volatility on its publicly traded options as the basis for its estimate of expected volatility. The Company believes that implied volatility is the most appropriate indicator of expected volatility because it is generally reflective of historical volatility and expectations of how future volatility will differ from historical volatility. The expected life assumption for grants is based on historical experience for the population of non-qualified stock optionees. The risk-free interest rate is the yield currently available on U.S. Treasury zero-coupon issues with a remaining term approximating the expected term used as the input to the Black-Scholes model. The relevant data used to determine the value of the stock options granted during the nine months ended October 2, 2010 and October 3, 2009 are as follows:

Options Issued and Significant Assumptions Used to Estimate Option Fair Values	**October 2, 2010**	**October 3, 2009**
Options issued in thousands	32	28
Risk-free interest rate	3.0%	2.0%
Expected life in years	6	6
Expected volatility	0.293	0.570
Expected dividends		

Weighted-Average Exercise Price and Fair Value of Options on the Date of Grant	**October 2, 2010**	**October 3, 2009**
Exercise price	$ 61.63	$ 38.09
Fair value	$ 21.40	$ 20.71

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes stock option activity for the plans for the nine months ended October 2, 2010 (in thousands, except per share data):

	Number of Shares	Price per Share	Weighted-Average Exercise Price
Outstanding at December 31, 2009	6,857	$21.05 to $80.97	$ 47.58
Granted	32	$ 61.63	$ 61.63
Exercised	(648)	$21.39 to $72.06	$ 37.61
Canceled	(26)	$49.31 to $72.06	$ 71.93
Outstanding at October 2, 2010	6,215	$21.05 to $80.97	$ 48.59

Restricted Stock

During the nine months ended October 2, 2010, the Company granted twelve thousand shares of restricted stock. The fair value of these awards on the grant date was $61.63 per share. The restrictions on these shares lapse at the end of a three-year period.

Restricted Stock Units

The following table summarizes the unvested restricted stock unit award activity for the nine months ended October 2, 2010 (in thousands, except for per share amounts):

	Shares	Weighted-Average Price
Unvested at December 31, 2009	783	$ 45.30
Granted	217	$ 62.24
Vested	(216)	$ 46.97
Forfeited	(25)	$ 47.67
Unvested at October 2, 2010	759	$ 49.59

Restricted stock units are generally granted annually in February and vest in equal annual installments over a five-year period.

9 Earnings Per Share

Basic and diluted earnings per share (EPS) calculations are detailed as follows (in thousands, except per share data):

	Three Months Ended October 2, 2010		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 94,719	91,714	$ 1.03
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			

Outstanding		1,535	
Exercised and cancellations		37	
Net income per diluted common share	$ 94,719	93,286	$ 1.02

14

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended October 3, 2009		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 75,936	95,235	$ 0.80
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			
Outstanding		1,260	
Exercised and cancellations		18	
Net income per diluted common share	$ 75,936	96,513	$ 0.79

	Nine Months Ended October 2, 2010		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 255,159	92,647	$ 2.75
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			
Outstanding		1,470	
Exercised and cancellations		154	
Net income per diluted common share	$ 255,159	94,271	$ 2.71

	Nine Months Ended October 3, 2009		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 219,190	96,215	$ 2.28
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			
Outstanding		752	
Exercised and cancellations		60	
Net income per diluted common share	$ 219,190	97,027	$ 2.26

For both the three and nine months ended October 2, 2010, the Company had 1.8 million stock options that were antidilutive due to having higher exercise prices than the Company s average stock price during the period. For the three and nine months ended October 3, 2009, the Company had 1.3 million and 3.3 million stock options that were antidilutive, respectively. These securities were not included in the computation of diluted EPS. The effect of dilutive securities was calculated using the treasury stock method.

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10 Comprehensive Income

Comprehensive income is detailed as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Net income	$ 94,719	$ 75,936	$ 255,159	$ 219,190
Foreign currency translation	39,474	9,916	(12,356)	25,872
Net appreciation and realized gains on derivative instruments		798		2,675
Income tax expense		(279)		(936)
Net appreciation and realized gains on derivative instruments, net of tax		519		1,739
Net foreign currency adjustments	39,474	10,435	(12,356)	27,611
Unrealized gains (losses) on investments before income taxes	24	12	24	(20)
Income tax (expense) benefit	(8)	(4)	(8)	7
Unrealized gains (losses) on investments, net of tax	16	8	16	(13)
Retirement liability adjustment, net of tax	175	(35)	288	306
Other comprehensive income (loss)	39,665	10,408	(12,052)	27,904
Comprehensive income	$ 134,384	$ 86,344	$ 243,107	$ 247,094

11 Retirement Plans

The Company sponsors various retirement plans. The summary of the components of net periodic pension costs for the plans for the three and nine months ended October 2, 2010 and October 3, 2009 is as follows (in thousands):

	Three Months Ended					
	October 2, 2010			October 3, 2009		
	U.S. Pension Plans	U.S. Retiree Healthcare Plan	Non-U.S. Pension Plans	U.S. Pension Plans	U.S. Retiree Healthcare Plan	Non-U.S. Pension Plans
Service cost	$ 12	$ 118	$ 424	$ 23	$ 58	$ 424
Interest cost	1,573	75	256	1,544	96	210
Expected return on plan assets	(1,777)	(60)	(79)	(1,678)	(37)	(83)
Net amortization:						
Prior service (credit) cost		(14)		37	(14)	
Net actuarial loss (gain)	286		(13)	98	3	12
Net periodic pension cost	$ 94	$ 119	$ 588	$ 24	$ 106	$ 563

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Nine Months Ended					
	October 2, 2010			October 3, 2009		
	U.S. Pension Plans	U.S. Retiree Healthcare Plan	Non-U.S. Pension Plans	U.S. Pension Plans	U.S. Retiree Healthcare Plan	Non-U.S. Pension Plans
Service cost	$ 42	$ 310	$ 1,272	$ 69	$ 174	$ 1,272
Interest cost	4,743	281	768	4,632	288	630
Expected return on plan assets	(5,347)	(166)	(237)	(5,034)	(111)	(249)
Net amortization:						
Prior service (credit) cost		(40)		111	(42)	
Net actuarial loss (gain)	810		(39)	294	9	36
Net periodic pension cost	$ 248	$ 385	$ 1,764	$ 72	$ 318	$ 1,689

For the three and nine months ended October 2, 2010, the Company contributed $4 million to the Company s U.S. pension plans. During fiscal year 2010, the Company expects to contribute a total of approximately $4 million to $5 million to the Company s defined benefit plans.

12 Business Segment Information

The Company s business activities, for which discrete financial information is available, are regularly reviewed and evaluated by the chief operating decision makers. As a result of this evaluation, the Company determined that it has two operating segments: Waters Division and TA Division.

Waters Division is primarily in the business of designing, manufacturing, distributing and servicing LC and MS instruments, columns and other chemistry consumables that can be integrated and used along with other analytical instruments. TA Division is primarily in the business of designing, manufacturing, distributing and servicing thermal analysis, rheometry and calorimetry instruments. The Company s two divisions are its operating segments and each has similar economic characteristics; product processes; products and services; types and classes of customers; methods of distribution and regulatory environments. Because of these similarities, the two segments have been aggregated into one reporting segment for financial statement purposes. Please refer to the consolidated financial statements for financial information regarding the one reportable segment of the Company.

Net sales for the Company s products and services are as follows for the three and nine months ended October 2, 2010 and October 3, 2009 (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Product net sales:				
Waters instrument systems	$ 185,526	$ 172,623	$ 526,627	$ 486,393
Chemistry	65,595	61,919	195,144	180,291
TA instrument systems	31,813	24,990	89,630	73,817
Total product sales	282,934	259,532	811,401	740,501

Service net sales: