WATERS CORP /DE/
Form 10-Q
August 04, 2006

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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 July 1, 2006

OR

o **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: 01-14010
WATERS CORPORATION
(Exact name of registrant as specified in the 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 of principal executive offices)

Registrant s telephone number, including area code: (508) 478-2000

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 and 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Number of shares outstanding of the Registrant s common stock as of August 1, 2006: 102,447,923.

WATERS CORPORATION AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
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WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	July 1, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 489,556	$ 493,588
Accounts receivable, less allowances for doubtful accounts and sales returns of $6,810 and $6,550 at July 1, 2006 and December 31, 2005, respectively	238,352	256,809
Inventories	161,843	131,554
Other current assets	35,020	31,041
Total current assets	924,771	912,992
Property, plant and equipment, net of accumulated depreciation of $160,192 and $162,146 at July 1, 2006 and December 31, 2005, respectively	144,102	141,030
Intangible assets, net	95,422	84,363
Goodwill	215,931	210,571
Other assets	89,324	79,975
Total assets	$ 1,469,550	$ 1,428,931
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and debt	$ 362,345	$ 326,286
Accounts payable	61,398	44,243
Accrued employee compensation	22,374	23,044
Deferred revenue and customer advances	91,459	71,733
Accrued retirement plan contributions	16,995	12,931
Accrued income taxes	64,955	60,710
Accrued other taxes	6,701	14,024
Accrued warranty	12,334	11,719
Accrued litigation	1,231	5,340
Accrued restructuring costs	2,644	
Other current liabilities	31,214	33,861
Total current liabilities	673,650	603,891
Long-term liabilities:		
Long-term debt	500,000	500,000
Long-term portion of retirement benefits	34,124	33,074
Other long-term liabilities	11,208	8,334
Total long-term liabilities	545,332	541,408

Total liabilities	1,218,982	1,145,299
Commitments and contingencies (Notes 7, 9, 10, 11 and 14)		
Stockholders equity:		
Preferred stock, par value $0.01 per share, 5,000 shares authorized, none issued at July 1, 2006 and December 31, 2005		
Common stock, par value $0.01 per share, 400,000 shares authorized, 143,291 and 142,287 shares issued, 102,380 and 105,336 shares outstanding at July 1, 2006 and December 31, 2005, respectively	1,433	1,423
Additional paid-in capital	508,293	467,681
Retained earnings	1,196,492	1,104,557
Treasury stock, at cost, 40,911 and 36,951 shares at July 1, 2006 and December 31, 2005, respectively	(1,484,322)	(1,314,446)
Deferred compensation		(255)
Accumulated other comprehensive income	28,672	24,672
Total stockholders equity	250,568	283,632
Total liabilities and stockholders equity	$ 1,469,550	$ 1,428,931

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

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

	Three Months Ended	
	July 1, 2006	July 2, 2005
Product sales	$ 214,491	$ 204,154
Service sales	87,408	80,476
Total net sales	301,899	284,630
Cost of product sales	83,880	77,396
Cost of service sales	42,124	39,670
Total cost of sales	126,004	117,066
Gross profit	175,895	167,564
Selling and administrative expenses	88,968	82,861
Research and development expenses	19,655	16,485
Purchased intangibles amortization	1,383	1,266
Restructuring and other charges (Note 11)	2,974	
Operating income	62,915	66,952
Interest expense	(12,477)	(5,753)
Interest income	6,205	5,290
Income from operations before income taxes	56,643	66,489
Provision for income taxes	8,863	12,424
Net income	$ 47,780	$ 54,065
Net income per basic common share	$ 0.46	$ 0.47
Weighted average number of basic common shares	103,010	116,092

Net income per diluted common share	$ 0.46	$ 0.46
Weighted average number of diluted common shares and equivalents	104,337	117,722

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

	Six Months Ended	
	July 1, 2006	**July 2, 2005**
Product sales	$ 423,056	$ 395,764
Service sales	169,061	157,171
Total net sales	592,117	552,935
Cost of product sales	165,030	150,941
Cost of service sales	81,602	77,926
Total cost of sales	246,632	228,867
Gross profit	345,485	324,068
Selling and administrative expenses	174,506	163,456
Research and development expenses	38,698	33,232
Purchased intangibles amortization	2,577	2,548
Restructuring and other unusual charges (Note 11)	7,326	
Operating income	122,378	124,832
Interest expense	(23,905)	(9,912)
Interest income	11,497	9,813
Income from operations before income taxes	109,970	124,733
Provision for income taxes	18,035	24,073
Net income	$ 91,935	$ 100,660
Net income per basic common share	$ 0.89	$ 0.86
Weighted average number of basic common shares	103,795	117,405

Net income per diluted common share	$ 0.87	$ 0.84
Weighted average number of diluted common shares and equivalents	105,192	119,456

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

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

	Six Months Ended	
	July 1, 2006	July 2, 2005
Cash flows from operating activities:		
Net income	$ 91,935	$ 100,660
Adjustments to reconcile net income to net cash provided by operating activities:		
Provisions for doubtful accounts on accounts receivable	1,682	2,227
Provisions on inventory	2,974	2,138
Stock-based compensation	14,616	668
Deferred income taxes	(4,629)	(310)
Depreciation	12,785	11,814
Amortization of intangibles	9,787	10,356
Tax benefit related to stock option exercises		2,990
Change in operating assets and liabilities, net of acquisitions:		
Decrease in accounts receivable	21,456	25,130
Increase in inventories	(29,136)	(9,130)
(Increase) decrease in other current assets	(3,332)	4,908
Increase in other assets	(6,434)	(1,636)
Increase (decrease) in accounts payable and other current liabilities	15,666	(7,189)
Increase in deferred revenue and customer advances	18,170	18,886
Decrease in accrued litigation	(4,109)	(1,616)
Increase in other liabilities	2,667	3,158
Net cash provided by operating activities	144,098	163,054
Cash flows from investing activities:		
Additions to property, plant, equipment, software capitalization and other intangibles	(24,678)	(26,651)
Business acquisition, net of cash acquired	(13,825)	
Net cash used in investing activities	(38,503)	(26,651)
Cash flows from financing activities:		
Proceeds from debt issuances	213,661	365,708
Payments on debt	(177,602)	(164,932)
Proceeds from stock plans	20,791	11,182
Purchase of treasury shares	(169,876)	(248,617)
Excess tax benefit related to stock option exercises	4,707	
Net payments from debt swaps and other dervatives contracts	(5,599)	(8,218)
Net cash used in financing activities	(113,918)	(44,877)

Effect of exchange rate changes on cash and cash equivalents	4,291	(15,369)
(Decrease) increase in cash and cash equivalents	(4,032)	76,157
Cash and cash equivalents at beginning of period	493,588	539,077
Cash and cash equivalents at end of period	$ 489,556	$ 615,234

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

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WATERS CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

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) together with HPLC, herein referred to as (LC) and mass spectrometry (MS) instrument systems and support products including chromatography columns and other consumable products. 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. Waters Division also sells and supports laboratory-to-enterprise scale software systems for managing and storing scientific information collected from a wide variety of instrument test methods. Through its TA Instruments Division (TA), the Company designs, manufactures, sells and services thermal analysis and rheometry instruments which are used in predicting the suitability of polymers and viscous liquids for various industrial, consumer goods and health care products. The Company is also a developer of and supplier of software based products which 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 second fiscal quarters for 2006 and 2005 ended on July 1, 2006 and July 2, 2005, 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 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. All material inter-company balances and transactions have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) disclosure of contingent liabilities at the dates of the financial statements and (iii) the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

It is management s opinion that the accompanying interim consolidated financial statements reflect all adjustments (which are normal and recurring) 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 filing with the Securities and Exchange Commission for the year ended December 31, 2005.

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 activity of the Company s accrued warranty liability for the six months ended July 1, 2006 and July 2, 2005 (in thousands):

	Balance at Beginning of Period	Accruals for Warranties	Settlements Made	Balance at End of Period
Accrued warranty liability				
July 1, 2006	$ 11,719	$ 8,995	$ (8,380)	$ 12,334
July 2, 2005	$ 10,565	$ 9,068	$ (8,648)	$ 10,985

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WATERS CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

Stockholders Equity:

In October 2005, the Company s Board of Directors authorized the Company to repurchase up to an additional $500.0 million of its outstanding common shares over a two-year period. During the six months ended July 1, 2006, the Company purchased 4.0 million shares of its common stock for an aggregate of $169.9 million. As of July 1, 2006, the Company repurchased an aggregate of 9.5 million shares of its common stock under this program for an aggregate of $386.0 million.

In October 2004, the Company s Board of Directors authorized the Company to repurchase up to an additional $500.0 million of its outstanding common shares over a two-year period. During the six months ended July 2, 2005, the Company purchased 5.5 million shares of its common stock for an aggregate of $248.6 million. As of July 1, 2006, the Company repurchased an aggregate of 11.1 million shares of its common stock under this program for an aggregate of $499.5 million, thus effectively completing this $500.0 million stock repurchase program.

The Company believes that the share repurchase program benefits shareholders by increasing earnings per share through reducing the number of shares outstanding and that the Company is likely to have adequate financial flexibility to fund additional share repurchases given current cash and debt levels.

2. Stock-Based Compensation

On May 6, 2003, the Company s shareholders approved the Company s 2003 Equity Incentive Plan (2003 Plan). As of July 1, 2006, the 2003 Plan has 5.9 million shares available for granting in the form of incentive or non-qualified stock options, stock appreciation rights (SARs), restricted stock or other types of awards (e.g. restricted stock units). The Company issues new shares of common stock upon exercise of stock options or restricted stock unit conversion. Under the 2003 Plan, the exercise price for stock options may not be less than the fair market value of the underlying stock at the date of grant. The 2003 Plan is scheduled to terminate on March 4, 2013. Options generally will expire no later than 10 years after the date on which they are granted and will become exercisable as directed by the Compensation Committee of the Board of Directors and generally vest ratably over a five year period. A SAR may be granted alone or in conjunction with an option or other award. Shares of restricted stock and restricted stock units may be issued under the 2003 Plan for such consideration as is determined by the Compensation Committee of the Board of Directors. No award of restricted stock may have a restriction period of less than three years except as may be recommended by the Compensation Committee of the Board of Directors, or with respect to any award of restricted stock which provides solely for a performance-based risk of forfeiture so long as such award has a restriction period of at least one year. As of July 1, 2006, the Company had stock options, restricted stock and restricted stock unit awards outstanding.

On February 26, 1996, the Company adopted its 1996 Employee Stock Purchase Plan under which eligible employees may contribute up to 15% of their earnings toward the quarterly purchase of the Company s common stock. The plan makes available 1.0 million shares of the Company s common stock commencing October 1, 1996. As of July 1, 2006, 0.7 million shares have been issued under the plan. Each plan period lasts three months beginning on January 1, April 1, July 1 and October 1 of each year. The purchase price for each share of stock is the lesser of 90% of the market price on the first day of the plan period or 100% of the market price on the last day of the plan period. Stock-based compensation expense related to this plan was $0.1 million and $0.2 million for the three months and six months ended July 1, 2006, respectively.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 123(R) Share-Based Payment , which amends SFAS No. 123 Accounting for Stock-Based Compensation , and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) 107 Share-Based Payments . These standards require that all share-based payments to employees be recognized in the statements of operations based on their fair values. The Company has used the Black-Scholes model to determine the fair value of its stock option awards at the time of grant.

The Company adopted the modified prospective transition method permitted under SFAS No. 123(R) and consequently has not adjusted results from prior years. Under the modified prospective transition method, compensation costs associated with awards for the three months and six months ended July 1, 2006 now include the quarterly expense relating to the remaining unvested awards granted prior to December 31, 2005 and the quarterly expense related to any awards issued subsequent to December 31, 2005. The Company recognizes the expense using the straight-line attribution method. The amount of stock-based compensation recognized during the period is based on the value of the portion of the award that ultimately is expected to vest. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The cumulative effect of the change in accounting for forfeitures is immaterial.

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WATERS CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

The consolidated statements of operations for the three and six months ended July 1, 2006 and July 2, 2005 include the following stock-based compensation expense related to stock option awards, restricted stock, and restricted stock unit awards and the employee stock purchase plan (in thousands):

	Three Months Ended		Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Cost of sales	$ 1,101	$	$ 2,252	$
Selling and administrative	4,813	579	9,796	668
Research and development	1,188		2,568	
Total stock-based compensation	$ 7,102	$ 579	$ 14,616	$ 668

The after-tax stock-based compensation and the impact to diluted earnings per share related to stock option awards, restricted stock, restricted stock unit awards and the employee stock purchase plan for the three and six months ended July 1, 2006 were $5.1 million and $10.7 million with a $0.05 per share and $0.10 per share reduction to diluted earnings per share, respectively. As of July 1, 2006, the Company has capitalized stock-based compensation costs of $0.3 million and $0.5 million to inventory and capitalized software, respectively, in the consolidated balance sheets. Prior to the adoption of SFAS No. 123(R), the Company used the intrinsic value method of accounting prescribed by Accounting Principles Board Opinion (APB) 25, Accounting for Stock Issued to Employees , and related interpretations, including Financial Interpretation (FIN) 44, Accounting for Certain Transactions Involving Stock Compensation , for its plans. Under this accounting method, stock-option compensation awards that are granted with the exercise price at the current fair value of the Company s common stock as of the date of the award generally did not require compensation expense to be recognized in the consolidated statement of operations. During the three and six months ended July 2, 2005, stock-based compensation expense of $0.6 million and $0.7 million was recognized for the Company s stock option awards and restricted stock awards, respectively. The 2005 stock-based compensation expense amounts were all recorded in selling and administrative expenses.

Prior to the adoption of SFAS No. 123(R), benefits of tax deductions in excess of recognized compensation costs were reported as part of cash from operating activities. Under SFAS No. 123(R), approximately $4.7 million of benefits of tax deductions in excess of recognized compensation costs were reported as cash from financing activities for the six months ended July 1, 2006.

The following table illustrates the effect on net income and earnings per share (EPS) had the Company applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation as amended by SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure an amendment of FASB Statement No. 123 , for the Company s stock-based compensation plans for the three months and six months ended July 2, 2005 (in thousands, except per share data).

Compensation Expense Fair Value Method	Three Months Ended July 2, 2005	Six Months Ended July 2, 2005
Net income, as reported	$ 54,065	$ 100,660
Deduct: total stock-based employee compensation expense, net of related tax effects	(5,938)	(11,815)

Add: stock-based compensation recognized in the consolidated statements of operations, net of related tax effects		467		538
Pro forma net income	$	48,594	$	89,383
Earnings per share:				
Basic as reported	$	0.47	$	0.86
Basic pro forma	$	0.42	$	0.76
Diluted as reported	$	0.46	$	0.84
Diluted pro forma	$	0.41	$	0.75

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WATERS CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

Stock Options:

During the six months ended July 1, 2006, the Company issued 39 thousand stock options. The fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option-pricing model. Beginning in 2005, the Company used implied volatility on its publicly traded options as the basis for its estimate of expected volatility. The expected volatility assumption of all grants issued prior to 2005 was derived from the Company s historical volatility. The expected life assumption for 2006 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 2006 stock option grants is as follows:

	Six months ended July 1, 2006
Options Issued and Significant Assumptions Used to Estimate Option Fair Values	
Options issued (in thousands)	39
Risk-free interest rate	4.3%
Expected life in years	6.0
Expected volatility	.270
Expected dividends	
Weighted Average Exercise Price and Fair Values of Options on the Date of Grant	
Exercise price	$ 42.99
Fair value	$ 14.16

The following table summarizes stock option activity for the plans as of July 1, 2006 (in thousands, except per share data):

	Number of Shares Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2005	10,939	$ 35.47		