WATTS WATER TECHNOLOGIES INC
Form 10-Q
August 07, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended July 2, 2017

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission file number 001-11499

WATTS WATER TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	04-2916536 (I.R.S. Employer Identification No.)
815 Chestnut Street, North Andover, MA (Address of Principal Executive Offices)	01845 (Zip Code)

Registrant's Telephone Number, Including Area Code: (978) 688-1811

(Former Name, Former Address and Former Fiscal year, if changed since last report.)

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

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at August 1 , 2017
Class A Common Stock, $0.10 par value	27,809,237
Class B Common Stock, $0.10 par value	6,379,290

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WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in millions, except share information)

(Unaudited)

	July 2, 2017	December 31, 2016
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 217.5	$ 338.4
Trade accounts receivable, less allowance for doubtful accounts of $15.1 million at July 2, 2017 and $14.2 million at December 31, 2016	245.5	198.0
Inventories, net		
Raw materials	81.5	81.5
Work in process	16.6	13.7
Finished goods	160.7	144.2
Total Inventories	258.8	239.4
Prepaid expenses and other assets	37.0	40.5
Assets held for sale	2.9	3.1
Total Current Assets	761.7	819.4
PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment, at cost	521.3	498.1
Accumulated depreciation	(329.7)	(308.4)
Property, plant and equipment, net	191.6	189.7
OTHER ASSETS:		
Goodwill	544.7	532.7
Intangible assets, net	194.6	202.5
Deferred income taxes	2.7	3.0
Other, net	16.6	15.9
TOTAL ASSETS	$ 1,711.9	$ 1,763.2
LIABILITIES AND STOCKHOLDERS’ EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 110.1	$ 101.1
Accrued expenses and other liabilities	122.3	136.8
Accrued compensation and benefits	45.8	48.5
Current portion of long-term debt	37.9	139.1
Total Current Liabilities	316.1	425.5

LONG-TERM DEBT, NET OF CURRENT PORTION	510.4	511.3
DEFERRED INCOME TAXES	51.2	48.6
OTHER NONCURRENT LIABILITIES	37.0	41.5
STOCKHOLDERS' EQUITY:		
Preferred Stock, $0.10 par value; 5,000,000 shares authorized; no shares issued or outstanding	—	—
Class A common stock, $0.10 par value; 80,000,000 shares authorized; 1 vote per share; issued and outstanding, 27,840,962 shares at July 2, 2017 and 27,831,013 shares at December 31, 2016	2.8	2.8
Class B common stock, $0.10 par value; 25,000,000 shares authorized; 10 votes per share; issued and outstanding, 6,379,290 shares at July 2, 2017 and December 31, 2016	0.6	0.6
Additional paid-in capital	543.7	535.2
Retained earnings	372.1	348.5
Accumulated other comprehensive loss	(122.0)	(150.8)
Total Stockholders' Equity	797.2	736.3
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 1,711.9	$ 1,763.2

See accompanying notes to consolidated financial statements.

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WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in millions, except per share information)

(Unaudited)

	Second Quarter Ended		Six Months Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Net sales	$ 378.5	$ 371.1	$ 725.7	$ 715.3
Cost of goods sold	221.8	220.4	425.2	429.4
GROSS PROFIT	156.7	150.7	300.5	285.9
Selling, general and administrative expenses	110.2	110.5	217.8	213.1
Restructuring	1.7	3.2	2.2	4.6
Gain on disposition	—	(8.7)	—	(8.7)
OPERATING INCOME	44.8	45.7	80.5	76.9
Other expense (income):				
Interest income	(0.2)	(0.3)	(0.4)	(0.5)
Interest expense	5.0	5.5	9.8	12.2
Other expense (income), net	0.2	(0.9)	0.5	(3.1)
Total other expense	5.0	4.3	9.9	8.6
INCOME BEFORE INCOME TAXES	39.8	41.4	70.6	68.3
Provision for income taxes	12.6	12.8	21.7	23.5
NET INCOME	$ 27.2	$ 28.6	$ 48.9	$ 44.8
Basic EPS				
NET INCOME PER SHARE	$ 0.79	$ 0.83	$ 1.42	$ 1.30
Weighted average number of shares	34.5	34.5	34.5	34.4
Diluted EPS				
NET INCOME PER SHARE	$ 0.79	$ 0.83	$ 1.42	$ 1.30
Weighted average number of shares	34.5	34.5	34.5	34.5
Dividends declared per share	$ 0.19	$ 0.18	$ 0.37	$ 0.35

See accompanying notes to consolidated financial statements.

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WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Amounts in millions)

(Unaudited)

	Second Quarter Ended		Six Months Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Net income	$ 27.2	$ 28.6	$ 48.9	$ 44.8
Other comprehensive income (loss):				
Foreign currency translation adjustments	21.5	(12.2)	29.4	12.2
Reversal of foreign currency translation for sale of foreign entity, net of tax	—	(6.9)	—	(6.9)
Cash flow hedges, net of tax	(0.7)	(1.7)	(0.6)	(1.9)
Other comprehensive income (loss)	20.8	(20.8)	28.8	3.4
Comprehensive income	$ 48.0	$ 7.8	$ 77.7	$ 48.2

See accompanying notes to consolidated financial statements.

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WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in millions)

(Unaudited)

	Six Months Ended	
	July 2, 2017	July 3, 2016
OPERATING ACTIVITIES		
Net income	$ 48.9	$ 44.8
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	14.6	14.7
Amortization of intangibles	11.1	10.2
Loss on disposal and impairment of property, plant and equipment and other	0.6	1.9
Gain on disposition	—	(8.3)
Gain on acquisition	—	(1.7)
Stock-based compensation	6.9	7.3
Deferred income tax	2.3	(0.4)
Changes in operating assets and liabilities, net of effects from business acquisitions and divestures:		
Accounts receivable	(41.5)	(30.6)
Inventories	(13.1)	(5.5)
Prepaid expenses and other assets	2.6	1.8
Accounts payable, accrued expenses and other liabilities	(23.4)	(26.4)
Net cash provided by operating activities	9.0	7.8
INVESTING ACTIVITIES		
Additions to property, plant and equipment	(11.0)	(19.2)
Proceeds from the sale of property, plant and equipment	0.1	—
Net proceeds from the sale of assets, and other	1.9	—
Business acquisitions, net of cash acquired	0.1	(2.1)
Net cash used in investing activities	(8.9)	(21.3)
FINANCING ACTIVITIES		
Proceeds from long-term borrowings	20.0	530.0
Payments of long-term debt	(126.3)	(500.7)
Payment of capital leases and other	(4.3)	(1.1)
Proceeds from share transactions under employee stock plans	0.5	2.7
Tax benefit of stock awards exercised	—	0.2
Payments to repurchase common stock	(9.0)	(17.6)
Debt issuance costs	—	(2.1)
Dividends	(12.8)	(12.0)
Net cash used in financing activities	(131.9)	(0.6)
Effect of exchange rate changes on cash and cash equivalents	10.9	4.6
DECREASE IN CASH AND CASH EQUIVALENTS	(120.9)	(9.5)

Cash and cash equivalents at beginning of year	338.4	296.2
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 217.5	$ 286.7
NON CASH INVESTING AND FINANCING ACTIVITIES		
Acquisition of businesses:		
Fair value of assets acquired	$ —	$ 5.7
Cash paid, net of cash acquired	—	2.1
Gain on acquisition	—	1.7
Liabilities assumed	$ —	$ 1.9
Issuance of stock under management stock purchase plan	$ 1.0	$ 0.7
CASH PAID FOR:		
Interest	$ 9.5	$ 11.7
Income taxes	$ 20.9	$ 14.6

See accompanying notes to consolidated financial statements.

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WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the Watts Water Technologies, Inc. (the Company) Consolidated Balance Sheet as of July 2, 2017, the Consolidated Statements of Operations for the second quarters and six months ended July 2, 2017 and July 3, 2016, the Consolidated Statements of Comprehensive Income for the second quarters and six months ended July 2, 2017 and July 3, 2016, and the Consolidated Statements of Cash Flows for the six months ended July 2, 2017 and July 3, 2016.

The consolidated balance sheet at December 31, 2016 has been derived from the audited consolidated financial statements at that date. The accounting policies followed by the Company are described in the Company's Annual Report on Form 10-K for the year ended December 31, 2016. The financial statements included in this report should be read in conjunction with the consolidated financial statements and notes included in the Annual Report on Form 10-K for the year ended December 31, 2016. Operating results for the interim periods presented are not necessarily indicative of the results to be expected for the year ending December 31, 2017. Certain prior year amounts have been reclassified to conform to the current year presentation. Reclassifications did not have a material impact on previously reported results of operations, financial position or cash flows.

The Company operates on a 52-week fiscal year ending on December 31. Any quarterly data contained in this Quarterly Report on Form 10-Q generally reflect the results of operations for a 13-week period.

Estimates

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

2. Accounting Policies

The significant accounting policies used in preparation of these consolidated financial statements for the three and six months ended July 2, 2017 are consistent with those discussed in Note 2 of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

Recently Adopted Accounting Standards

In January 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." ASU 2017-04 eliminates the need to determine the fair value of individual assets and liabilities of a reporting unit to measure goodwill impairment. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value. The revised guidance will be applied prospectively and is effective for calendar year-end SEC filers in 2020. Early adoption is permitted for any impairment tests performed after January 1, 2017. The Company's adoption of the new guidance effective January 1, 2017 did not have a material impact on the Company's financial statements.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting." ASU 2016 09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as equity or liabilities, forfeitures, and classification on the statement of cash

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flows. The Company adopted this standard in the first quarter of 2017. The impact of the adoption of this standard resulted in the following:

The Company elected to account for forfeitures as they occur, rather than estimate expected forfeitures over the vesting period of the respective grant. This was adopted using a modified retrospective approach with a cumulative effect adjustment of $0.5 million to retained earnings as of January 1, 2017.

The Company no longer reclassifies the excess tax benefit from operating activities to financing activities in the Consolidated Statement of Cash Flows. This change has been applied prospectively in the Statement of Cash Flows. The Company had an excess tax benefit of $0.2 million in the six months ended July 3, 2016.

The Company no longer records windfall or shortfall tax benefits to additional paid-in capital and records these tax benefits directly to operations. This change has been applied prospectively as is required by the standard and therefore the comparative period has not been adjusted. This change may create volatility in the Company’s effective tax rate on a prospective basis.

In November 2015, the FASB issued ASU 2015-17, “Income Taxes: Balance Sheet Classification of Deferred Taxes.” ASU 2015-17 requires that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. ASU 2015-17 is effective for financial statements issued for annual periods beginning after December 15, 2016 and all interim periods thereafter. The Company adopted the provision of this ASU during the first quarter of 2017 and applied it retrospectively. As of December 31, 2016, the Company had $38.6 million of current deferred tax assets, $1.5 million of noncurrent deferred tax assets, and $85.7 million of noncurrent deferred tax liabilities. The adoption of this standard resulted in a reclassification of $38.6 million of current deferred tax assets to noncurrent deferred tax liabilities and a reclassification of $1.5 million of noncurrent deferred tax liabilities to noncurrent deferred tax assets. Therefore, the restated noncurrent deferred tax asset balance and noncurrent deferred tax liability balance as of December 31, 2016 was $3.0 million and $48.6 million, respectively. Adoption of this standard did not affect results of operations, retained earnings, or cash flows in the current or previous interim and annual reporting periods.

In July 2015, the FASB issued ASU 2015-11, “Inventory: Simplifying the Measurement of Inventory.” This new standard changes inventory measurement from lower of cost or market to lower of cost and net realizable value. The standard eliminates the requirement to consider replacement cost or net realizable value less a normal profit margin when measuring inventory. ASU 2015-11 is effective in the first quarter of 2017 for public companies with calendar year ends, and should be applied prospectively with early adoption permitted. The adoption of this guidance did not have a material impact on the Company’s financial statements.

Accounting Standards Updates

In January 2017, the FASB issued ASU 2017-01 “Business Combinations (Topic 805)-Clarifying the Definition of a Business”, which clarifies the definition of a business to assist entities with evaluating whether transactions should be accounted for as acquisitions or disposals of assets or businesses. The standard introduces a screen for determining when assets acquired are not a business and clarifies that a business must include, at a minimum, an input and a substantive process that contribute to an output to be considered a business. This standard is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period. The adoption of this guidance is not expected to have a material impact on the Company’s financial statements.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." ASU 2014-09 converges revenue recognition under U.S. GAAP and International Financial Reporting Standards ("IFRS"). For U.S. GAAP, the standard generally eliminates transaction and industry-specific revenue recognition guidance. This includes current guidance on long-term construction-type contracts, software arrangements, real estate sales, telecommunication arrangements, and franchise sales. Under the new standard, revenue is recognized based on a five-step model. The FASB issued ASU 2015-14 in August 2015 which deferred the effective date of ASU 2014-09 for public companies to periods beginning after December 15, 2017, with early adoption permitted. The Company is assessing the impact of the guidance on its revenues by reviewing its contract portfolio to identify potential differences that would result from applying the new standard to its current revenue arrangements, including evaluation of potential performance obligations and variable consideration. The Company has substantially completed its contract portfolio analysis, and is evaluating the impact, if any, on changes to the Company’s financial results, business processes, systems, and controls under this new guidance. The Company is expected to use the modified retrospective approach of adoption, with a cumulative adjustment to opening retained earnings in the period of adoption. The Company will adopt the new standard effective January 1, 2018.

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Shipping and Handling

Shipping and handling costs included in selling, general and administrative expense amounted to $13.0 million and $11.5 million for the second quarters of 2017 and 2016, respectively, and were $25.0 million and $22.9 million for the first six months of 2017 and 2016, respectively.

Research and Development

Research and development costs included in selling, general, and administrative expense amounted to $7.2 million and $6.4 million for the second quarters of 2017 and 2016, respectively, and was $14.3 million and $13.0 million for the first six months of 2017 and 2016, respectively.

3. Acquisitions

PVI Industries, LLC

On November 2, 2016, the Company acquired 100% of the shares of PVI Riverside Holdings, Inc., the parent company of PVI Industries, LLC ("PVI"). The aggregate purchase price, including the final working capital adjustment, was approximately $79.1 million.

PVI is a leading manufacturer of commercial stainless steel water heating equipment, focused on the high capacity market in North America and is based in Fort Worth, Texas. PVI's water heater product offering complements AERCO's boiler products, allowing the Company to address customers' heating and hot water requirements.

The Company accounted for the transaction as a purchased business combination and the acquisition was funded partially with available cash and partially from borrowings under the Company's Credit Agreement. During the second quarter of 2017 the Company finalized the purchase price allocation related to the purchase of PVI. The acquisition resulted in the recognition of $41.1 million in goodwill and $31.0 million in intangible assets. The intangible assets acquired consist of customer relationships valued at $17.6 million, developed technology valued at $10.2 million, and the trade name valued at $3.2 million. The goodwill is attributable to the workforce of PVI and the strategic platform adjacency that will allow Watts to extend its product offerings as a result of the acquisition. Approximately $6.9 million of the goodwill is deductible for tax purposes. The following table summarizes the value of the assets and liabilities acquired (in millions):

Accounts receivable	$ 5.7
Inventory	12.7
Fixed assets	8.1
Other assets	2.8
Intangible assets	31.0
Goodwill	41.1
Accounts payable	(4.0)
Accrued expenses and other	(9.2)
Deferred tax liability	(9.1)
Purchase price	$ 79.1

Apex

On November 30, 2015, the Company completed the acquisition of 80% of the outstanding shares of Apex Valves Limited ("Apex"). Apex specializes in the design and manufacturing of control valves for low and high pressure hot water and filtration systems. Apex also produces an extensive range of float and reservoir valves for the agricultural industry. The aggregate purchase price was approximately $20.4 million and the Company recorded a long-term liability of $5.5 million as the estimate of the acquisition date fair value on the contractual call option to purchase the remaining 20% within three years of closing. The Company acquired an additional 10% ownership in the first quarter of 2017 for approximately $2.9 million and now owns 90% of the outstanding shares of Apex. The Company maintains a long-term liability of approximately $3.0 million for the estimated fair value on the remaining 10% contractual call option.

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4. Goodwill & Intangibles

The Company operates in three geographic segments: Americas, Europe, and APMEA (Asia-Pacific, Middle East, and Africa). The changes in the carrying amount of goodwill by geographic segment are as follows:

	July 2, 2017							
	Gross Balance				Accumulated Impairment Losses			Net Goodwill
	Balance January 1, 2017	Acquired During the Period (1)	Foreign Currency Translation and Other	Balance July 2, 2017	Balance January 1, 2017	Impairment Loss During the Period	Balance July 2, 2017	July 2, 2017
	(in millions)							
Americas	$ 434.7	2.0	0.3	437.0	$ (24.5)	—	(24.5)	412.5
Europe	234.9	—	8.8	243.7	(129.7)	—	(129.7)	114.0
APMEA	30.2	—	0.9	31.1	(12.9)	—	(12.9)	18.2
Total	$ 699.8	2.0	10.0	711.8	$ (167.1)	—	(167.1)	544.7

(1)Americas goodwill additions during the first half of 2017 includes purchase accounting adjustments related to the PVI acquisition discussed in Note 3 of the Notes to the Consolidated Financial Statements.