WATTS WATER TECHNOLOGIES INC
Form 10-Q
November 05, 2018
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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 September 30, 2018

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)

(978) 688-1811

(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report.)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a 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	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 October 28, 2018
Class A Common Stock, $0.10 par value	27,764,919
Class B Common Stock, $0.10 par value	6,329,290

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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)

	September 30, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 156.8	$ 280.2
Trade accounts receivable, less allowance for doubtful accounts of $15.1 million at September 30, 2018 and $14.3 million at December 31, 2017	231.3	216.1
Inventories, net		
Raw materials	93.2	81.8
Work in process	20.5	17.5
Finished goods	176.5	159.8
Total Inventories	290.2	259.1
Prepaid expenses and other current assets	31.1	26.7
Assets held for sale	1.4	1.5
Total Current Assets	710.8	783.6
PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment, at cost	536.8	525.8
Accumulated depreciation	(338.3)	(327.3)
Property, plant and equipment, net	198.5	198.5
OTHER ASSETS:		
Goodwill	547.6	550.5
Intangible assets, net	170.0	185.2
Deferred income taxes	2.0	1.6
Other, net	20.7	17.1
TOTAL ASSETS	$ 1,649.6	$ 1,736.5
LIABILITIES AND STOCKHOLDERS’ EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 115.0	$ 123.8
Accrued expenses and other liabilities	121.9	125.8
Accrued compensation and benefits	52.4	55.3
Current portion of long-term debt	28.1	22.5
Total Current Liabilities	317.4	327.4

LONG-TERM DEBT, NET OF CURRENT PORTION	350.7	474.6
DEFERRED INCOME TAXES	50.9	55.2
OTHER NONCURRENT LIABILITIES	46.4	50.3
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, 27,781,427 shares at September 30, 2018 and 27,724,192 shares at December 31, 2017	2.8	2.8
Class B common stock, $0.10 par value; 25,000,000 shares authorized; 10 votes per share; issued and outstanding, 6,329,290 shares at September 30, 2018 and 6,379,290 shares at December 31, 2017	0.6	0.6
Additional paid-in capital	564.5	551.8
Retained earnings	426.1	372.9
Accumulated other comprehensive loss	(109.8)	(99.1)
Total Stockholders' Equity	884.2	829.0
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 1,649.6	$ 1,736.5

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)

	Three Months Ended		Nine Months Ended	
	September 30, 2018	October 1, 2017	September 30, 2018	October 1, 2017
Net sales	$ 390.9	$ 364.7	$ 1,177.3	$ 1,090.4
Cost of goods sold	226.4	212.0	686.7	637.2
GROSS PROFIT	164.5	152.7	490.6	453.2
Selling, general and administrative expenses	114.2	107.0	344.2	324.8
Restructuring	3.4	1.4	3.4	3.6
OPERATING INCOME	46.9	44.3	143.0	124.8
Other (income) expense:				
Interest income	(0.1)	(0.2)	(0.6)	(0.6)
Interest expense	3.9	4.7	12.6	14.5
Other (income) expense, net	(0.9)	0.3	(2.0)	0.8
Total other expense	2.9	4.8	10.0	14.7
INCOME BEFORE INCOME TAXES	44.0	39.5	133.0	110.1
Provision for income taxes	12.5	13.0	37.3	34.7
NET INCOME	$ 31.5	$ 26.5	$ 95.7	$ 75.4
Basic EPS				
NET INCOME PER SHARE	$ 0.92	$ 0.77	$ 2.79	$ 2.19
Weighted average number of shares	34.3	34.4	34.3	34.4
Diluted EPS				
NET INCOME PER SHARE	$ 0.92	$ 0.77	$ 2.78	$ 2.19
Weighted average number of shares	34.4	34.4	34.4	34.5
Dividends declared per share	$ 0.21	$ 0.19	$ 0.61	$ 0.56

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)

	Three Months Ended		Nine Months Ended	
	September 30, 2018	October 1, 2017	September 30, 2018	October 1, 2017
Net income	$ 31.5	$ 26.5	$ 95.7	$ 75.4
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	2.5	15.4	(14.4)	44.8
Cash flow hedges	(0.1)	0.1	3.7	(0.5)
Other comprehensive income (loss)	2.4	15.5	(10.7)	44.3
Comprehensive income	$ 33.9	$ 42.0	$ 85.0	$ 119.7

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)

	Nine Months Ended	
	September 30, 2018	October 1, 2017
OPERATING ACTIVITIES		
Net income	$ 95.7	$ 75.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	21.5	21.9
Amortization of intangibles	15.2	16.8
(Gain) loss on disposal and impairment of intangibles, property, plant and equipment and other	(0.1)	1.0
Stock-based compensation	10.0	10.2
Deferred income tax	(4.0)	1.8
Changes in operating assets and liabilities, net of effects from business acquisitions and divestures:		
Accounts receivable	(17.4)	(21.9)
Inventories	(35.4)	(10.1)
Prepaid expenses and other assets	(4.9)	11.1
Accounts payable, accrued expenses and other liabilities	(14.0)	(32.8)
Net cash provided by operating activities	66.6	73.4
INVESTING ACTIVITIES		
Additions to property, plant and equipment	(24.1)	(17.1)
Proceeds from the sale of property, plant and equipment	0.1	0.4
Net proceeds from the sale of assets, and other	0.2	3.1
Business acquisitions, net of cash acquired and other	(2.2)	0.1
Net cash used in investing activities	(26.0)	(13.5)
FINANCING ACTIVITIES		
Proceeds from long-term borrowings	50.0	20.0
Payments of long-term debt	(168.9)	(151.8)
Payment of capital leases and other	(6.4)	(4.6)
Proceeds from share transactions under employee stock plans	2.1	1.0
Payments to repurchase common stock	(15.5)	(13.6)
Dividends	(21.1)	(19.4)
Net cash used in financing activities	(159.8)	(168.4)
Effect of exchange rate changes on cash and cash equivalents	(4.2)	16.7
DECREASE IN CASH AND CASH EQUIVALENTS	(123.4)	(91.8)
Cash and cash equivalents at beginning of year	280.2	338.4
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 156.8	$ 246.6
NON CASH INVESTING AND FINANCING ACTIVITIES		

Acquisition of businesses:		
Fair value of assets acquired	$ 4.1	$ —
Cash paid, net of cash acquired	1.7	—
Liabilities assumed	$ 2.4	$ —
Issuance of stock under management stock purchase plan	$ 1.5	$ 1.0
CASH PAID FOR:		
Interest	$ 13.6	$ 12.8
Income taxes	$ 49.5	$ 29.5

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 September 30, 2018, the Consolidated Statements of Operations for the three and nine months ended September 30, 2018 and October 1, 2017, the Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and October 1, 2017, and the Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and October 1, 2017.

The consolidated balance sheet at December 31, 2017 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, 2017. 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, 2017. Operating results for the interim periods presented are not necessarily indicative of the results to be expected for the year ending December 31, 2018.

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 nine months ended September 30, 2018 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, 2017, with the exception of the Company's change in its Revenue Recognition accounting policy resulting from the adoption of ASC 606 described herein.

Revenue Recognition

On January 1, 2018, the Company adopted the accounting standard ASC 606, Revenue from Contracts with Customers and all the related amendments ("new revenue standard" or "ASU 2014-09") to all contracts using the modified retrospective method. The adoption of ASU 2014-09 was not material to the Company and as such, there was no cumulative effect upon the January 1, 2018 adoption date. As the impact of the new revenue standard is not material to the Company, there is no pro-forma disclosure presented for the three and nine months ended September 30, 2018. The Company expects the impact of the adoption of the new standard to be immaterial to the Company's financial statements on an ongoing basis.

The Company recognizes revenue under the core principle to depict the transfer of control to the Company's customers in an amount reflecting the consideration the Company expects to be entitled. In order to achieve that core principle, the Company applies the following five step approach: (1) identify the contract with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, and (5) recognize revenue when a performance obligation is satisfied.

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The Company's revenue for product sales is recognized on a point in time model, at the point control transfers to the customer, which is generally when products are shipped from the Company's manufacturing or distribution facilities or when delivered to the customer's named location. Sales tax, value-added tax, or other taxes collected concurrent with revenue producing activities are excluded from revenue. Freight costs billed to customers for shipping and handling activities are included in revenue with the related cost included in selling, general and administrative expenses. See Note 3 for further disclosures and detail regarding revenue recognition.

Other Recently Adopted Accounting Standards

In February 2018, the FASB issued ASU 2018-02 "Income Statement-Reporting Comprehensive Income." ASU 2018-02 provides guidance on the reclassification of certain tax effects from the 2017 Tax Cuts and Jobs Act ("2017 Tax Act") from accumulated other comprehensive income. Current generally accepted accounting principles requires deferred tax liabilities and deferred tax assets to be adjusted for the effect of a change in tax laws or tax rates, with that effect included in income from operations in the period of enactment. This included the income tax effects of items in accumulated other comprehensive income. This guidance allows a reclassification from accumulated other comprehensive income to retained earnings for the tax effects on items in accumulated other comprehensive income related to the change in tax rates from the 2017 Tax Act. This standard is effective for all entities for fiscal years beginning after December 15, 2018, including interim periods within that reporting period. Early adoption of this standard is permitted. The Company adopted this standard in the first quarter of 2018, and it did not have a material impact on the Company's financial statements.

In October 2016, the FASB issued ASU 2016-16 "Intra-Entity Transfers of Assets Other than Inventory." ASU 2016-16 provides guidance on the timing of recognition of tax consequences of an intra-entity transfer of an asset other than inventory. The Company adopted the provision of this ASU during the first quarter of 2018, using the modified retrospective approach through a cumulative-effect adjustment to retained earnings as of the beginning of the quarter.

The adoption of this guidance did not have a material impact on the Company's financial statements.

Accounting Standards Updates

In August 2018, the FASB issued ASU 2018-15 "Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40)-Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract." ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. This guidance requires an entity in a hosting arrangement that is a service contract to follow the guidance in Subtopic 350-40 to determine which implementation costs to capitalize as an asset related to the service contract and which costs to expense. This standard is effective for fiscal years beginning after December 15, 2019, including interim periods within that reporting period. The Company is currently evaluating the impact of this guidance on the Company's financial statements, and does not expect the adoption of this guidance to have a material impact on the Company's financial statements.

In August 2018, the FASB issued ASU 2018-13 "Fair Value Measurement (Topic 820)-Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement." ASU 2018-13 modifies the disclosure requirements on fair value measurements under Topic 820. This standard is effective for fiscal years beginning after December 15, 2019, including interim periods within that reporting period. The Company is currently evaluating the impact of this guidance on the Company's disclosures; however this guidance does not impact the Company's financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)." ASU 2016 02 requires a lessee to recognize in the statement of financial position a liability to make lease payments and a right-of-use asset representing the right to use the underlying asset for the lease term for both finance and operating leases with a term longer than twelve months. Topic 842 was subsequently amended by ASU 2018-01, "Land Easement Practical Expedient for Transition to Topic 842," ASU 2018-10, "Codification Improvements to Topic 842, Leases," and ASU 2018-11 "Targeted Improvements." ASU 2016-02 is effective for financial statements issued for annual periods beginning after December 15, 2018 and all interim periods thereafter. Early adoption is permitted for all entities. The Company plans to adopt this standard effective January 1, 2019. A modified retrospective transition approach is required, applying the new standard to all leases existing at the date of initial application. The Company may choose to use either 1) the effective date of the standard or 2) the beginning of the earliest comparable period presented in the financial statements as the date of initial application. The Company expects to adopt the new standard on January 1, 2019 and use the effective date of the standard as the date

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of the Company's initial application. By electing this approach, the financial information and the disclosures required under the new standard will not be provided for dates and periods before January 1, 2019.

The new standard provides a number of optional practical expedients throughout the transition. The Company expects to elect the "package of practical expedients," which permits the Company to not reassess under the new standard the Company's prior conclusions about lease identification, lease classification, and initial direct costs. The Company does not expect to elect the use-of-hindsight or the practical expedient pertaining to land easements, the latter not being applicable to the Company.

The new standard also provides practical expedients for an entity's ongoing accounting. The Company expects to elect the short-term lease recognition exemption for all leases that qualify. This means, for those leases that qualify, the Company will not recognize right-of-use assets or lease liabilities, and this includes not recognizing right-of-use assets or lease liabilities for existing short-term leases of those assets in transition. The Company also expects to elect the practical expedient not to separate lease and non-lease components for all of the Company's leases.

The Company is continuing to evaluate the new lease standard, and is in the process of designing the necessary changes to its existing processes and configuring system requirements that will be required to implement this new standard. The Company has a variety of categories of lease arrangements, including real estate, automobiles, manufacturing equipment, facility equipment, office equipment and certain service arrangements. The Company is currently reviewing its leasing arrangements in order to evaluate the impact of this standard on the Company's financial statements. The Company does not expect a significant change in its leasing activity between now and adoption. The Company is unable to quantify the impact of adoption at this time. However, the Company expects the primary impact to its consolidated financial position upon adoption will be the recognition, on a discounted basis, of its minimum commitments under non-cancelable operating leases on its consolidated balance sheets resulting in the recording of right-of-use assets and lease obligations. The Company currently does not expect ASC 842 to have a material effect on either its consolidated statement of operations or consolidated statement of cash flow.

Shipping and Handling

Shipping and handling costs included in selling, general and administrative expenses amounted to $14.2 million and $12.8 million for the third quarters of 2018 and 2017, respectively, and were $42.1 million and $37.8 million for the first nine months of 2018 and 2017, respectively.

Research and Development

Research and development costs included in selling, general and administrative expenses amounted to $8.7 million and $7.3 million for the third quarters of 2018 and 2017, respectively, and were $25.5 million and $21.6 million for the first nine months of 2018 and 2017, respectively.

3. Revenue Recognition

The Company is a leading supplier of products that manage and conserve the flow of fluids and energy into, through and out of buildings in the residential and commercial markets of the Americas, Europe, and Asia Pacific, Middle East, and Africa (“APMEA”). For over 140 years, the Company has designed and produced valve systems that safeguard and regulate water systems, energy efficient heating and hydronic systems, drainage systems and water filtration technology that helps purify and conserve water.

The Company distributes products through four primary distribution channels: wholesale, original equipment manufacturers (OEMs), specialty, and do-it-yourself (DIY). The Company operates in three geographic segments: Americas, Europe, and APMEA. Each of these segments sells similar products, which are comprised of the following principal product lines:

- Residential & commercial flow control products—includes products typically sold into plumbing and hot water applications such as backflow preventers, water pressure regulators, temperature and pressure relief valves, and thermostatic mixing valves.
- HVAC & gas products—includes commercial high efficiency boilers, water heaters and heating solutions, hydronic and electric heating systems for under floor radiant applications, custom heat and hot water solutions,

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hydronic pump groups for boiler manufacturers and alternative energy control packages, and flexible stainless steel connectors for natural and liquid propane gas in commercial food service and residential applications. HVAC is an acronym for heating, ventilation and air conditioning.

- Drainage & water re use products—includes drainage products and engineered rain water harvesting solutions for commercial, industrial, marine and residential applications.
- Water quality products—includes point of use and point of entry water filtration, conditioning and scale prevention systems for both commercial and residential applications.

The following table disaggregates revenue, which is presented as net sales in the financial statements, for each reportable segment, by distribution channel and principal product line:

	For the three months ended September 30, 2018				For the nine months ended September 30, 2018			
	(in millions)				(in millions)			
	Americas	Europe	APMEA	Consolidated	Americas	Europe	APMEA	Consolidated
Distribution Channel								
Wholesale	$ 146.7	$ 73.5	$ 14.8	$ 235.0	$ 433.9	$ 234.7	$ 44.4	$ 713.0
OEM	19.4	37.5	0.3	57.2	58.6	114.9	1.1	174.6
Specialty	82.7	—	1.5	84.2	236.4	—	4.3	240.7
DIY	13.9	0.6	—	14.5	46.9	2.1	—	49.0
Total	$ 262.7	$ 111.6	$ 16.6	$ 390.9	$ 775.8	$ 351.7	$ 49.8	$ 1,177.3

	For the three months ended September 30, 2018				For the nine months ended September 30, 2018			
	(in millions)				(in millions)			
Principal Product Line	Americas	Europe	APMEA	Consolidated	Americas	Europe	APMEA	Consolidated
Residential & Commercial Flow Control	$ 144.4	$ 40.2	$ 11.2	$ 195.8	$ 435.3	$ 132.2	$ 33.8	$ 601.3
HVAC and Gas Products	77.1	49.4	4.3	130.8	220.2	152.7	13.6	386.5
Drainage and Water Re-use Products	19.8	21.7	0.7	42.2	55.2	65.9	1.4	