PENTAIR INC
Form 10-Q
October 21, 2008

Table of Contents

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

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

For the Quarterly Period Ended September 27, 2008

OR

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

Commission file number 000-04689

Pentair, Inc.

(Exact name of Registrant as specified in its charter)

Minnesota	**41-0907434**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification number)**
5500 Wayzata Blvd, Suite 800, Golden Valley, Minnesota	**55416**
(Address of principal executive offices)	**(Zip code)**

Registrant s telephone number, including area code: (763) 545-1730

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

On September 27, 2008, 98,629,464 shares of Registrant s common stock were outstanding.

Pentair, Inc. and Subsidiaries

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Pentair, Inc. and Subsidiaries
Condensed Consolidated Statements of Income (Unaudited)

In thousands, except per-share data	**Three months ended September 27 2008**	**Three months ended September 29 2007**	**Nine months ended September 27 2008**	**Nine months ended September 29 2007**
Net sales	$864,167	$821,215	$2,614,328	$2,513,359
Cost of goods sold	608,854	576,519	1,829,622	1,753,183
Gross profit	255,313	244,696	784,706	760,176
Selling, general and administrative	154,972	137,100	439,929	428,463
Research and development	16,691	14,446	48,871	44,204
Legal settlement			20,435	
Operating income	83,650	93,150	275,471	287,509
Other (income) expense:				
Gain on sale of interest in subsidiaries			(109,648)	
Equity losses of unconsolidated subsidiary	669	845	2,433	1,838
Loss on early extinguishment of debt	4,611		4,611	
Net interest expense	13,735	18,157	45,685	51,351
Income from continuing operations before income taxes and minority interest	64,635	74,148	332,390	234,320
Provision for income taxes	21,146	14,869	97,522	71,419
Minority Interest	2,100		2,100	
Income from continuing operations	41,389	59,279	232,768	162,901
Loss from discontinued operations, net of tax		(1,235)	(1,217)	(726)
Gain (loss) on disposal of discontinued operations, net of tax	(269)		(7,406)	207
Net income	$ 41,120	$ 58,044	$ 224,145	$ 162,382
Earnings (loss) per common share				
Basic				
Continuing operations	$ 0.42	$ 0.60	$ 2.37	$ 1.65
Discontinued operations		(0.01)	(0.08)	(0.01)
Basic earnings per common share	$ 0.42	$ 0.59	$ 2.29	$ 1.64
Diluted				
Continuing operations	$ 0.42	$ 0.59	$ 2.34	$ 1.63
Discontinued operations		(0.01)	(0.08)	(0.01)

Diluted earnings per common share	$	0.42	$	0.58	$	2.26	$	1.62
Weighted average common shares outstanding								
Basic		97,827		98,747		98,049		98,859
Diluted		99,319		100,365		99,372		100,339
Cash dividends declared per common share	$	0.17	$	0.15	$	0.51	$	0.45

3

Table of Contents

Pentair, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets (Unaudited)

In thousands, except share and per-share data	September 27 2008	December 31 2007	September 29 2007
Assets			
Current assets			
Cash and cash equivalents	$ 93,544	$ 70,795	$ 56,555
Accounts and notes receivable, net	517,240	466,675	473,496
Inventories	430,386	392,416	395,638
Deferred tax assets	50,061	50,511	52,038
Prepaid expenses and other current assets	53,504	35,908	47,746
Current assets of discontinued operations		21,716	26,868
Total current assets	1,144,735	1,038,021	1,052,341
Property, plant and equipment, net	363,352	365,990	356,594
Other assets			
Goodwill	2,134,031	2,004,720	1,989,620
Intangibles, net	539,133	491,263	492,732
Other	69,874	82,237	77,084
Non-current assets of discontinued operations		18,383	18,500
Total other assets	2,743,038	2,596,603	2,577,936
Total assets	$4,251,125	$4,000,614	$3,986,871
Liabilities and Shareholders Equity			
Current liabilities			
Short-term borrowings	$	$ 13,586	$ 4,800
Current maturities of long-term debt	3,913	5,075	4,992
Accounts payable	225,928	229,937	204,360
Employee compensation and benefits	107,163	111,475	107,271
Current pension and post-retirement benefits	8,557	8,557	7,918
Accrued product claims and warranties	43,012	49,382	47,719
Income taxes	7,806	12,919	10,862
Accrued rebates and sales incentives	35,907	36,663	36,910
Other current liabilities	101,662	90,377	111,833
Current liabilities of discontinued operations		2,935	5,431
Total current liabilities	533,948	560,906	542,096
Other liabilities			
Long-term debt	1,035,150	1,041,925	1,102,707
Pension and other retirement compensation	164,776	161,042	222,098

Post-retirement medical and other benefits	34,218	37,147	46,499
Long-term income taxes payable	25,356	21,306	18,214
Deferred tax liabilities	184,514	167,633	134,683
Other non-current liabilities	96,941	97,086	89,898
Non-current liabilities of discontinued operations		2,698	2,519
Total liabilities	2,074,903	2,089,743	2,158,714
Commitments and contingencies			
Minority interest	120,230		
Shareholders equity			
Common shares par value $0.16 2/3; 98,629,464, 99,221,831 and 99,468,474 shares issued and outstanding, respectively	16,438	16,537	16,578
Additional paid-in capital	456,144	476,242	478,396
Retained earnings	1,469,830	1,296,226	1,262,604
Accumulated other comprehensive income	113,580	121,866	70,579
Total shareholders equity	2,055,992	1,910,871	1,828,157
Total liabilities and shareholders equity	$4,251,125	$4,000,614	$3,986,871

See accompanying notes to condensed consolidated financial statements.

Table of Contents

Pentair, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Unaudited)

In thousands	Nine months ended September 27 2008	Nine months ended September 29 2007
Operating activities		
Net income	$ 224,145	$ 162,382
Adjustments to reconcile net income to net cash provided by (used for) operating activities		
Loss from discontinued operations	1,217	726
(Gain) loss on disposal of discontinued operations	7,406	(207)
Equity losses of unconsolidated subsidiary	2,433	1,838
Minority interest	2,100	
Depreciation	45,759	45,538
Amortization	20,220	18,635
Deferred income taxes	25,927	(18,883)
Stock compensation	15,948	17,071
Excess tax benefits from stock-based compensation	(1,617)	(2,706)
Gain on sale of assets	87	(2,195)
Gain on sale of interest in subsidiaries	(109,648)	
Changes in assets and liabilities, net of effects of business acquisitions and dispositions		
Accounts and notes receivable	(55,727)	(27,927)
Inventories	(26,518)	13,973
Prepaid expenses and other current assets	(15,798)	(8,681)
Accounts payable	1,343	(1,088)
Employee compensation and benefits	(7,471)	3,037
Accrued product claims and warranties	(6,483)	3,199
Income taxes	(5,792)	(4,573)
Other current liabilities	9,380	15,955
Pension and post-retirement benefits	592	7,924
Other assets and liabilities	13,146	7,396
Net cash provided by (used for) continuing operations	140,649	231,414
Net cash provided by (used for) operating activities of discontinued operations	(3,432)	(2,081)
Net cash provided by (used for) operating activities	137,217	229,333
Investing activities		
Capital expenditures	(40,107)	(45,163)
Proceeds from sale of property and equipment	4,304	5,136
Acquisitions, net of cash acquired	(1,609)	(486,264)
Divestitures	29,526	
Other	(7)	(4,044)
Net cash provided by (used for) investing activities	(7,893)	(530,335)

Financing activities		
Net short-term borrowings	(14,180)	(10,378)
Proceeds from long-term debt	479,405	1,147,132
Repayment of long-term debt	(486,492)	(770,822)
Debt issuance costs	(114)	(1,876)
Excess tax benefits from stock-based compensation	1,617	2,706
Proceeds from exercise of stock options	5,140	5,512
Repurchases of common stock	(37,342)	(27,119)
Dividends paid	(50,541)	(44,986)
Net cash provided by (used for) financing activities	(102,507)	300,169
Effect of exchange rate changes on cash and cash equivalents	(4,068)	2,568
Change in cash and cash equivalents	22,749	1,735
Cash and cash equivalents, beginning of period	70,795	54,820
Cash and cash equivalents, end of period	$ 93,544	$ 56,555

See accompanying notes to condensed consolidated financial statements.

Table of Contents

Pentair, Inc. and subsidiaries

Notes to condensed consolidated financial statements (unaudited)

1. Basis of Presentation and Responsibility for Interim Financial Statements

We prepared the unaudited condensed consolidated financial statements following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States can be condensed or omitted.

We are responsible for the unaudited financial statements included in this document. The financial statements include all normal recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results. As these are condensed financial statements, one should also read our consolidated financial statements and notes thereto, which are included in our 2007 Annual Report on Form 10-K for the year ended December 31, 2007.

Certain line items within the 2007 Condensed Consolidated Statements of Income and the Condensed Consolidated Statements of Cash Flows have been reclassified from the 2007 presentation to conform to the 2008 presentation. The reclassification reflects the presentation of *Equity losses of unconsolidated subsidiary* of $0.8 million and $1.8 million for the three and nine months ended September 29, 2007, respectively, as a separate line item below *Operating income* in the Condensed Consolidated Statements of Income rather than as a component of *Selling, general and administrative*, and as a separate line in the *Adjustments to reconcile net income to net cash provided by(used for) by operating activities* in the Condensed Consolidated Statements of Cash Flows, rather than as a component of *Other assets and liabilities.* This reclassification corrects the previous presentation and was not material to the financial statements. It did not affect *Net income* within the Condensed Consolidated Statements of Income or net cash provided by (used for) operating, investing or financing activities within the Condensed Consolidated Statements of Cash Flows.

Revenues, expenses, cash flows, assets and liabilities can and do vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be indicative of those for a full year.

Our fiscal year ends on December 31. We report our interim quarterly periods on a 13-week basis ending on a Saturday.

2. New Accounting Standards

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB statement No. 133* (SFAS 161). SFAS 161 expands the disclosure requirements in Statement 133 about an entity s derivative instruments and hedging activities. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We are currently evaluating the impact of adopting SFAS 161.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51* (SFAS 160). SFAS 160 changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, except for the presentation and disclosure requirements, which will apply retrospectively. Upon adoption, we will classify minority interest as a component of equity for all periods presented.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141. SFAS 141R retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. SFAS 141R also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will apply SFAS 141R prospectively to business combinations completed on or after that date. We do not expect adoption to have a significant impact to our current consolidated results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value (the Fair Value Option). SFAS 159 is effective for fiscal years beginning after November 15, 2007. We did not choose the Fair Value Option; therefore, the adoption of SFAS 159 did not have any impact on our consolidated results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, with the exception of the application of the statement to the determination of fair value of nonfinancial assets and liabilities that are recognized or disclosed on a nonrecurring basis, which is effective for fiscal years beginning after November 15, 2008.

Table of Contents

Pentair, Inc. and subsidiaries
Notes to condensed consolidated financial statements (unaudited)

SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based upon our own assumptions used to measure assets and liabilities at fair value. A financial asset or liability s classification within the hierarchy is determined based on the lowest level of input that is significant to the fair value measurement.

At September 27, 2008, our interest rate swaps (see note 12) are carried at fair value measured on a recurring basis. Fair values are determined through the use of models that consider various assumptions, including time value, yield curves, as well as other relevant economic measures, which are inputs that are classified as Level 2 in the valuation hierarchy.

3. Stock-based Compensation

Total stock-based compensation expense was $4.1 million and $4.4 million for the three months ended September 27, 2008 and September 29, 2007, respectively, and was $16.0 million and $17.0 million for the nine months ended September 27, 2008 and September 29, 2007, respectively.

Non-vested shares of our common stock were granted to eligible employees with a vesting period of two to five years after issuance. Non-vested share awards are valued at market value on the date of grant and are typically expensed over the vesting period. Total compensation expense for non-vested share awards was $2.0 million for the three months ended September 27, 2008 and September 29, 2007, respectively, and was $7.5 million and $7.4 million for the nine months ended September 27, 2008 and September 29, 2007, respectively.

During the first nine months of 2008, option awards were granted under the Omnibus Stock Incentive Plan, the 2008 Omnibus Stock Incentive Plan, as amended, and the Outside Directors Nonqualified Stock Option Plan (together the Plans), each with an exercise price equal to the market price of our common stock on the date of grant. Total compensation expense for stock option awards was $2.1 million and $2.4 million for the three months ended September 27, 2008 and September 29, 2007, respectively, and was $8.5 million and $9.6 million for the nine months ended September 27, 2008 and September 29, 2007, respectively.

We estimated the fair value of each stock option award on the date of grant using a Black-Scholes option pricing model, modified for dividends and using the following assumptions:

	September 27 2008	**September 29 2007**
Expected stock price volatility	27.0%	28.5%
Expected life	4.8 yrs	4.8 yrs
Risk-free interest rate	3.11%	4.46%
Dividend yield	1.90%	1.66%

The weighted-average fair value of options granted during the third quarter of 2008 and 2007 was $8.35 and $8.38 per share, respectively.

These estimates require us to make assumptions based on historical results, observance of trends in our stock price, changes in option exercise behavior, future expectations and other relevant factors. If other assumptions had been used, stock-based compensation expense, as calculated and recorded under SFAS No. 123R (revised 2004), *Share Based Payment*, (SFAS 123R) could have been affected.

We based the expected life assumption on historical experience as well as the terms and vesting periods of the options granted. For purposes of determining expected volatility, we considered a rolling average of historical volatility measured over a period approximately equal to the expected option term. The risk-free rate for periods that coincide with the expected life of the options is based on the U.S. Treasury Department yield curve in effect at the time of grant.

Table of Contents

Pentair, Inc. and subsidiaries
Notes to condensed consolidated financial statements (unaudited)

4. Earnings Per Common Share

Basic and diluted earnings per share were calculated using the following:

	Three months ended		Nine months ended	
In thousands	**September 27 2008**	**September 29 2007**	**September 27 2008**	**September 29 2007**
Weighted average common shares outstanding basic	97,827	98,747	98,049	98,859
Dilutive impact of stock options and restricted stock	1,492	1,618	1,323	1,480
Weighted average common shares outstanding diluted	99,319	100,365	99,372	100,339
Stock options excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of the common shares	3,503	2,099	4,594	2,769

In December 2007, the Board of Directors authorized the repurchase of shares of our common stock during 2008 up to a maximum dollar limit of $50 million. As of September 27, 2008, we had purchased 1,094,059 shares for $38.1 million pursuant to this authorization during 2008. This authorization expires on December 31, 2008.

5. Restructuring

During the second quarter of 2008, we announced and initiated certain business restructuring initiatives to further streamline our operations as a result of continuing deterioration in certain end markets. In relation to these initiatives, we recorded restructuring charges (reflected in *Selling, general and administrative* expense on the accompanying Condensed Consolidated Statements of Income) of $2.7 million primarily for severance benefits paid or to be paid to terminated employees.

During the third quarter of 2008, we announced and initiated additional business restructuring initiatives aimed at reducing our fixed cost structure and rationalizing our manufacturing footprint. These initiatives included the announcement of the closure of certain manufacturing facilities as well as the reduction in hourly and salaried headcount of approximately 850 employees principally within the Water Group. These actions will generally be completed by the end of 2009. Restructuring related costs included in *Selling, general and administrative* expenses on the Condensed Consolidated Statements of Income include costs for severance and related benefits, asset impairment charges and other restructuring costs.

Restructuring costs are summarized as follows:

	Three months ended		Nine months ended	
In thousands	**September 27 2008**	**September 29 2007**	**September 27 2008**	**September 29 2007**
Severance and related costs	$10,899	$	$13,583	$
Asset impairment	4,600		4,600	

Total restructuring costs	$15,499	$	$18,183	$

Restructuring accrual activity is summarized as follows:

In thousands	
Balance at March 29, 2008	$
Costs incurred	2,684
Cash payments	(723)
Balance at June 28, 2008	$ 1,961
Costs incurred	10,899
Cash Payments	(3,338)
Balance at September 27, 2008	$ 9,522

Table of Contents

Pentair, Inc. and subsidiaries
Notes to condensed consolidated financial statements (unaudited)

6. Acquisitions

On June 28, 2008, we entered into a transaction with GE Water & Process Technologies (a unit of General Electric Company) (GE) that was accounted for as an acquisition of an 80.1 percent ownership interest in GE s global water softener and residential water filtration business in exchange for a 19.9 percent interest in our global water softener and residential water filtration business (the GE Transaction). The acquisition was effected through the formation of two new entities, a U.S. entity and an international entity, into which we and GE contributed certain assets, properties, liabilities and operations representing our respective global water softener and residential water filtration businesses. We are an 80.1 percent owner of the new entities and GE is a 19.9 percent owner. The fair value of the acquisition was $228.9 million, which includes approximately $2.9 million of acquisition related costs. The acquisition and related sale of our 19.9 percent interest resulted in a gain of $109.6 million ($85.8 million after tax), representing the difference between the carrying amount and the fair value of the 19.9 percent interest sold.

With the formation of this business, we believe we will be better positioned to serve residential customers with industry-leading technical applications in the areas of water conditioning, whole house filtration, point of use water management and water sustainability and expect to accelerate revenue growth by selling GE s existing residential conditioning products through our sales channels.

The fair value of the business acquired was allocated to the assets acquired and liabilities assumed based on their estimated fair values. The excess of the fair value acquired over the identifiable assets acquired and liabilities assumed is reflected as goodwill. Goodwill recorded as part of the purchase price allocation was approximately $137.5 million. We continue to evaluate the purchase price allocation, including tangible and intangible assets, which primarily consist of trademarks, proprietary technology and customer relationships, contingent liabilities and liabilities associated with exit or disposal activities, and expect to revise the purchase price allocation in future periods as these estimates are finalized. The following table represents the preliminary purchase price allocation:

In thousands		**September 27, 2008**
Inventory	$	12,188
Property, plant & equipment		12,934
Goodwill		137,542
Identifiable intangible assets		66,483
Current liabilities		(234)
	$	228,913

On May 7, 2007, we acquired as part of our Technical Products Group the assets of Calmark Corporation (Calmark). Calmark s results of operations have been included in our condensed consolidated financial statements since the date of acquisition.

On April 30, 2007, we acquired as part of our Water Group all of the capital interests in Porous Media Corporation and Porous Media, Ltd. (together, Porous Media). Porous Media s results of operations have been included in our condensed consolidated financial statements since the date of acquisition.

On February 2, 2007, we acquired as part of our Water Group all of the outstanding shares of capital stock of Jung Pumpen GmbH (Jung Pump). Jung Pump s results of operations have been included in our condensed consolidated financial statements since the date of acquisition.

The following pro forma condensed financial results of operations are presented as if the acquisitions described above had been completed at the beginning of the period.

Table of Contents

Pentair, Inc. and subsidiaries
Notes to condensed consolidated financial statements (unaudited)

	Three months ended		Nine months ended	
In thousands, except share and per-share data	**September 27 2008**	**September 29 2007**	**September 27 2008**	**September 29 2007**
Pro forma net sales from continuing operations	$864,167	$842,740	$2,668,801	$2,601,906
Pro forma net income from continuing operations	41,389	59,279	232,768	162,714
Income (loss) from discontinued operations, net of tax	(269)	(1,235)	(8,623)	(519)
Pro forma net income	41,120	58,044	224,145	162,195
Pro forma earnings per common share continuing operations				
Basic	$ 0.42	$ 0.60	$ 2.37	$ 1.65