

SMITH A O CORP
Form 10-Q
November 06, 2012
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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 30, 2012.

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 1-475

A. O. Smith Corporation

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

incorporation or organization)

11270 West Park Place, Milwaukee, Wisconsin
(Address of principal executive office)

(414) 359-4000

39-0619790
(I.R.S. Employer Identification No.)

53224-9508
(Zip Code)

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(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Accelerated Filer

Smaller reporting company

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

Yes No

Class A Common Stock Outstanding as of October 31, 2012 6,626,068 shares

Common Stock Outstanding as of October 31, 2012 39,542,302 shares

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Table of Contents**PART I - FINANCIAL INFORMATION****ITEM 1 - FINANCIAL STATEMENTS**

A. O. SMITH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

Three and Nine Months Ended September 30, 2012 and 2011

(dollars in millions, except for per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Continuing Operations				
Net sales	\$ 462.2	\$ 412.0	\$ 1,415.0	\$ 1,234.7
Cost of products sold	305.4	293.3	948.6	877.1
Gross profit	156.8	118.7	466.4	357.6
Selling, general and administrative expenses	111.5	92.2	325.7	266.6
Contingent consideration adjustment	(6.4)	-	(6.4)	-
Settlement income	-	-	-	(11.2)
Interest expense	1.9	2.5	7.1	6.4
Other income	(2.2)	(15.8)	(32.5)	(18.7)
	52.0	39.8	172.5	114.5
Provision for income taxes	15.0	12.9	53.1	34.8
Earnings from continuing operations	37.0	26.9	119.4	79.7
Discontinued Operations				
Earnings from discontinued EPC operations, less provision for income taxes of \$0.4 and \$14.9 in 2011	-	5.1	-	43.6
Gain on sale of discontinued EPC operations less provision for income taxes of \$143.5 and \$143.5 in 2011	-	150.3	-	150.3
Net earnings	\$ 37.0	\$ 182.3	\$ 119.4	\$ 273.6
Net Earnings Per Share of Common Stock				
Continuing Operations	\$ 0.80	\$ 0.58	\$ 2.59	\$ 1.73
Discontinued Operations	-	3.36	-	4.20
Net Earnings	\$ 0.80	\$ 3.94	\$ 2.59	\$ 5.93
Diluted Net Earnings Per Share of Common Stock				
Continuing Operations	\$ 0.79	\$ 0.58	\$ 2.57	\$ 1.71
Discontinued Operations	-	3.33	-	4.16
Net Earnings	\$ 0.79	\$ 3.91	\$ 2.57	\$ 5.87

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Dividends per share of Common Stock	\$ 0.20	\$ 0.16	\$ 0.52	\$ 0.44
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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

Three and Nine Months Ended September 30, 2012 and 2011

(dollars in millions)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net earnings	\$ 37.0	\$ 182.3	\$ 119.4	\$ 273.6
Other comprehensive earnings (loss)				
Foreign currency translation adjustments	6.1	(16.0)	3.1	(9.6)
Unrealized net (loss) gain) on cash flow derivative instruments, less related income tax benefit (provision) of \$0.1 and \$(0.2) in 2012, \$2.9 and \$6.5 in 2011	(0.1)	(4.4)	0.3	(10.2)
Adjustment to additional minimum pension liability loss related income tax benefit of \$1.5 and \$1.5 in 2012	(3.4)	-	(3.4)	-
Unrealized losses on investments less related tax benefit of \$0.7 in 2012 and \$2.3 and \$2.3 in 2011	-	(3.7)	(1.2)	(3.7)
Comprehensive Earnings	\$ 39.6	\$ 158.2	\$ 118.2	\$ 250.1

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A. O. SMITH CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

September 30, 2012 and December 31, 2011

(dollars in millions)

	(unaudited)	
	September 30, 2012	December 31, 2011
Assets		
Current Assets		
Cash and cash equivalents	\$ 279.6	\$ 463.4
Marketable securities	202.6	-
Receivables	369.1	368.4
Inventories	178.2	168.4
Deferred income taxes	32.5	24.6
Investments	-	162.4
Other current assets	26.4	21.5
Total Current Assets	1,088.4	1,208.7
Property, plant and equipment	656.8	614.0
Less accumulated depreciation	325.7	298.7
Net property, plant and equipment	331.1	315.3
Goodwill	435.9	433.8
Other intangibles	342.6	352.7
Other assets	37.3	38.5
Total Assets	\$ 2,235.3	\$ 2,349.0
Liabilities		
Current Liabilities		
Trade payables	\$ 289.4	\$ 302.5
Accrued payroll and benefits	44.1	41.9
Accrued liabilities	62.5	74.1
Product warranties	43.9	43.7
Long-term debt due within one year	18.6	18.6
Current liabilities - discontinued EPC operations	4.3	31.5
Total Current Liabilities	462.8	512.3
Long-term debt	261.0	443.0
Pension liabilities	153.7	139.5
Other liabilities	157.5	159.7
Long-term liabilities - discontinued EPC operations	8.9	8.7
Total Liabilities	1,043.9	1,263.2
Stockholders Equity		

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Class A Common Stock, \$5 par value: authorized 14,000,000 shares; issued 6,659,943 and 7,250,791	33.3	36.3
Common Stock, \$1 par value: authorized 60,000,000 shares; issued 41,016,968 and 40,426,119	41.0	40.4
Capital in excess of par value	653.5	652.5
Retained earnings	825.2	729.9
Accumulated other comprehensive loss	(302.1)	(300.9)
Treasury stock at cost	(59.5)	(72.4)
Total Stockholders Equity	1,191.4	1,085.8
Total Liabilities and Stockholders Equity	\$ 2,235.3	\$ 2,349.0

See accompanying notes to unaudited condensed consolidated financial statements

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A. O. SMITH CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

Nine Months Ended September 30, 2012 and 2011

(dollars in millions)

(unaudited)

	Nine Months Ended September 30,	
	2012	2011
Operating Activities		
Net earnings	\$ 119.4	\$ 273.6
Less earnings from discontinued operations	-	(193.9)
Adjustments to reconcile earnings from continuing operations to cash provided by (used in) operating activities:		
Depreciation and amortization	40.4	33.2
Loss on disposal of assets	0.8	0.7
Gain on sale of investments	(27.2)	(20.1)
Net changes in operating assets and liabilities, net of acquisitions:		
Current assets and liabilities	(45.3)	(65.8)
Noncurrent assets and liabilities	12.6	(95.6)
Cash Provided by (Used in) Operating Activities - continuing operations	100.7	(67.9)
Cash Used in Operating Activities - discontinued operations	(27.0)	(1.5)
Cash Provided by (Used in) Operating Activities	73.7	(69.4)
Investing Activities		
Capital expenditures	(44.5)	(36.7)
Acquisition of businesses	-	(418.1)
Investments in marketable securities	(237.8)	-
Net proceeds from sale of securities	227.8	-
Cash Used in Investing Activities - continuing operations	(54.5)	(454.8)
Cash Provided by Investing Activities - discontinued operations	-	727.8
Cash (Used in) Provided by Investing Activities	(54.5)	273.0
Financing Activities		
Long-term debt (retired) incurred	(183.1)	134.3
Common stock repurchases	(9.7)	(5.7)
Net proceeds from stock option activity	13.8	9.8
Dividends paid	(24.0)	(20.3)
Cash (Used in) Provided by Financing Activities - continuing operations	(203.0)	118.1
Cash Provided by Financing Activities - discontinued operations	-	-
Cash (Used in) Provided by Financing Activities	(203.0)	118.1

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Net (decrease) increase in cash and cash equivalents	(183.8)	321.7
Cash and cash equivalents - beginning of period	463.4	118.9
Cash and Cash Equivalents - End of Period	\$ 279.6	\$ 440.6

See accompanying notes to unaudited condensed consolidated financial statements

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PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

A. O. SMITH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2012

(unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required 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. Operating results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results expected for the full year. It is suggested that the accompanying condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the company's latest Annual Report on Form 10-K filed with the SEC on February 27, 2012.

Except where otherwise indicated, amounts reflected in the financial statements or the notes thereto relate to the company's continuing operations.

Certain other prior year amounts have been reclassified to conform to the 2012 presentation.

Recent Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-08, Testing of Goodwill for Impairment (Topic 350). ASU No. 2011-08 allows companies to assess qualitative factors to determine whether the two-step quantitative goodwill impairment test needs to be performed. Under the option, an entity no longer would be required to calculate the fair value of a reporting unit unless it determines, based on that qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The ASU may change how a company tests goodwill for impairment, but should not change the timing or measurement of goodwill impairments. ASU 2011-08 will be effective for the year ending December 31, 2012. Adoption of this ASU will not have an impact on the company's consolidated financial condition, results of operations or cash flows.

In July 2012, the FASB issued ASU 2012-02, Testing Indefinite-Lived Intangible Assets for Impairment. ASU 2012-02 allows an entity to first assess qualitative factors in determining whether events and circumstances indicate that it is more-likely-than not that an indefinite-lived intangible asset is impaired. If an entity determines that it is not more-likely-than not that the indefinite-lived intangible asset is impaired, then the entity is not required to perform a quantitative impairment test. ASU 2012-02 will be effective for the year ending December 31, 2013. Adoption of this ASU will not have an impact on the company's consolidated financial condition, results of operations or cash flows.

2. Acquisition

On August 26, 2011, the company acquired 100 percent of the shares of Lochinvar Corporation (Lochinvar), a privately held manufacturer of high-efficiency boilers used in commercial and residential applications located in Lebanon, Tennessee. The addition of Lochinvar expanded the company's product offerings and gave the company access to proven

Table of Contents**2. Acquisition (continued)**

high-efficiency boiler technology. Lochinvar is included in the company's North America segment except for a relatively immaterial amount from a Lochinvar U.K. subsidiary which is included in the company's Rest of World segment.

The company paid an aggregate cash purchase price, net of \$1.5 million of cash acquired, of \$421.1 million. In addition, the company incurred acquisition costs of approximately \$5.5 million. Under the purchase agreement for the Lochinvar acquisition, the company agreed to make a contingent payment of up to an additional \$35.0 million in cash based on the amount by which Lochinvar sales between December 1, 2011 and November 30, 2012 exceed \$216.0 million. As of the acquisition date, the fair value of the contingent payment had been estimated at \$16.8 million. As of September 30, 2012, the fair value of the contingent payment was estimated at \$10.4 million which resulted in a pre-tax gain of \$6.4 million being recorded by the company during the three months ended September 30, 2012.

The following table summarizes the allocation of fair value of the assets acquired and liabilities assumed at the date of acquisition. Of the \$258.3 million of acquired intangible assets, \$103.5 million was assigned to trade names that are not subject to amortization and \$152.5 million was assigned to customer lists which are being amortized over 19 years, and the remaining \$2.3 million was assigned to non-compete agreements and patents which are being amortized over ten years.

August 26, 2011 (dollars in millions)	
Current assets, net of cash acquired	\$ 54.0
Property, plant and equipment	41.9
Intangible assets	258.3
Other assets	0.1
Goodwill	111.4
Total assets acquired	465.7
Current liabilities	24.3
Long-term liabilities	3.5
Total liabilities assumed	27.8
Net assets acquired	\$ 437.9

For income tax purposes, the transaction has been accounted for as an asset purchase, resulting in the full amount of goodwill and intangible assets, totaling \$369.7 million, being deductible for income tax purposes.

Lochinvar's results of operations have been included in the company's financial statements from August 26, 2011, the date of acquisition. Revenues and pretax earnings associated with Lochinvar included in the three months ended September 30, 2012 totaled \$63.4 million and \$15.2 million, respectively. Revenues and pretax earnings associated with Lochinvar included in the nine months ended September 30, 2012 totaled \$167.5 million and \$35.7 million, respectively. Revenues and pretax net loss associated with Lochinvar included in operations from the acquisition date through September 30, 2011 totaled \$20.8 million and \$2.0 million, respectively which included \$3.0 million of operating earnings less \$4.4 million of acquisition costs and \$0.6 million of interest expense.

Table of Contents**2. Acquisition (continued)**

The following table represents the pro forma unaudited results of operations for the company for three and the nine months ended September 30, 2011 assuming consummation of the purchase of Lochinvar as of January 1, 2011:

	(dollars in millions except per share data)	
	Three Months Ended	Nine Months Ended
	September 30, 2011	September 30, 2011
Net sales	\$ 441.1	\$ 1,358.1
Earnings from continuing operations	27.7	92.7
Earnings per common share:		
Basic	\$ 0.60	\$ 2.01
Diluted	\$ 0.59	\$ 1.99

The pro forma results have been prepared for informational purposes only and include adjustments to depreciation expense of acquired plant and equipment, amortization of intangible assets other than goodwill and trade names, increased interest expense on acquisition related debt, and certain other adjustments, together with related income tax effects of such adjustments. These pro forma results do not purport to be indicative of the results of operations that would have occurred had the purchase been made as of the beginning of the period presented or of the results of operations that may occur in the future.

3. Discontinued Operations

On August 22, 2011, the company completed the sale of its Electrical Products Company (EPC) to Regal Beloit Corporation (RBC) for \$759.9 million in cash and approximately 2.83 million of RBC shares. Included in the \$759.9 million of cash was a final working capital adjustment of \$7.4 million which was paid to the company by RBC in January 2012. The value of the RBC shares on the date of the closing of the sale was \$140.6 million. See Note 14 for further discussion regarding the company's investment in RBC stock. The company paid \$31.1 million in income taxes and \$3.3 million of other sale related expenses in the nine months ended September 30, 2012 and estimates it will pay an additional \$2.5 million of income taxes in 2012.

As a part of the sale of EPC, the company recorded an additional income tax accrual of \$56.5 million due to the company's assertion that certain foreign earnings derived from the sale of EPC were not considered permanently reinvested by the company. The accrual is included in other long term liabilities in continuing operations.

The results of EPC have been reported separately as discontinued operations of the company for all periods presented.

Table of Contents**3. Discontinued Operations (continued)**

The condensed statement of earnings of the EPC discontinued operations is:

	(dollars in millions)	
	Three Months Ended	Nine Months Ended
	September 30, 2011	September 30, 2011
Net sales	\$ 109.5	\$ 531.8
Cost of products sold	87.4	415.6
Gross profit	22.1	116.2
Selling, general and administrative expenses	16.8	61.5
Interest expense	0.4	2.2
Other income	(0.6)	(6.0)
	5.5	58.5
Provision for income taxes	0.4	14.9
Net earnings	\$ 5.1	\$ 43.6

The cash flow provided by EPC discontinued operations is as follows:

Nine months ended September 30, 2011 (dollars in millions)

Operating Activities	
Earnings	\$ 43.6
Adjustments to reconcile earnings to net cash provided by discontinued operating activities:	
Depreciation and amortization	16.5
Gain on sale of assets	(4.8)
Net changes in operating assets and liabilities	
Current assets and liabilities	(55.9)
Noncurrent assets and liabilities	0.9
Other	(1.8)
Cash Used in Discontinued Operating Activities	(1.5)
Investing Activities	
Capital expenditures	(10.6)
Proceeds from sale of assets	6.1
Proceeds from sale of operations	752.5
Payments associated with sale	(20.2)
Cash Provided by Discontinued Investing Activities	727.8
Cash Flow Provided by Discontinued Operations	\$ 726.3

4. Inventories

The following table presents the components of the company's inventory balances:

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	(dollars in millions)	
	September 30, 2012	December 31, 2011
Finished products	\$ 85.7	\$ 85.6
Work in process	11.6	10.6
Raw materials	106.0	98.9
	203.3	195.1
LIFO reserve	(25.1)	(26.7)
	\$ 178.2	\$ 168.4

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The company has a \$425 million multi-currency revolving credit agreement with eight banks. The facility expires on November 13, 2013 and has an accordion provision which allows it to be increased up to \$525 million if certain conditions (including lender approval) are satisfied. Interest rates on borrowings under the facility are determined in part based upon the company's leverage ratio.

Borrowings under bank credit lines and commercial paper borrowings are supported by the company's \$425 million revolving credit agreement. As a result of the long-term nature of this facility, the commercial paper and credit line borrowings are classified as long-term debt at September 30, 2012.

6. Product Warranties

The company offers warranties on the sales of certain of its products and records an accrual for the estimated future claims. The following table presents the company's warranty liability activity.

	(dollars in millions)	
	Nine Months Ended	
	September 30,	
	2012	2011
Balance at January 1	\$ 131.9	\$ 112.1
Lochinvar acquisition		5.8
Expense	42.7	49.6
Net increase in warranty reserve due to settlement		7.5
Claims settled	(42.0)	(42.8)
Balance at September 30	\$ 132.6	\$ 132.2

See Note 15 for discussion on the increase in warranty reserve due to settlement and the increase in warranty expense and reserve associated with component parts in Canada.

7. Earnings per Share of Common Stock

The numerator for the calculation of basic and diluted earnings per share is net earnings. The following table sets forth the computation of basic and diluted weighted-average shares used in the earnings per share calculations:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Denominator for basic earnings per share - weighted average shares	46,193,952	46,221,603	46,190,965	46,137,918
Effect of dilutive stock options	375,140	420,920	352,883	472,871
Denominator for diluted earnings per share	46,569,092	46,642,523	46,543,848	46,610,789

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The company adopted the A. O. Smith Combined Incentive Compensation Plan (the plan) effective January 1, 2007. The plan was reapproved on April 16, 2012. The plan is a continuation of the A. O. Smith Combined Executive Incentive Compensation Plan which was originally approved by stockholders in 2002. The number of shares available for granting of options, restricted stock or share units under the plan at September 30, 2012 was 1,633,604. Upon stock option exercise or share unit vesting, shares are issued from treasury stock.

Total stock based compensation cost recognized in the three months ended September 30, 2012 and 2011 was \$1.5 million and \$1.1 million, respectively. Total stock based compensation cost recognized in the nine months ended September 30, 2012 and 2011 was \$5.3 million and \$4.6 million, respectively.

Stock Options

The stock options granted in the nine months ended September 30, 2012 and 2011 have three year pro-rata vesting from the date of grant. Stock options are issued at exercise prices equal to the fair value of Common Stock on the date of grant. For active employees, all options granted in 2012 and 2011 expire ten years after date of grant. Options are expensed ratably over the three year vesting period. Stock based compensation cost attributable to stock options in the three months ended September 30, 2012 and 2011 was \$0.7 million and \$0.5 million, respectively. Stock based compensation expense attributable to stock options in the nine months ended September 30, 2012 and 2011 was \$2.5 million and \$2.3 million, respectively. Included in the stock option expense for the nine months ended September 30, 2012 and 2011 was expense associated with the accelerated vesting of stock option awards for certain employees who either are retirement eligible or become retirement eligible during the vesting period.

Changes in option awards, all of which relate to Common Stock, were as follows for the nine months ended September 30, 2012:

	Weighted-Average Per Share Exercise Price	Nine Months Ended September 30, 2012	Average Remaining Contractual Life	Aggregate Intrinsic Value (dollars in millions)
Outstanding at January 1, 2012	\$ 24.84	1,421,867		
Granted	45.97	191,000		
Exercised	23.10	(482,308)		
Forfeited	42.89	(4,083)		
Outstanding at September 30, 2012	29.10	1,126,476	7 years	\$ 32.0