FLOWSERVE CORP
Form 10-K
February 22, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2011

OR

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

Commission file number 1-13179

FLOWSERVE CORPORATION
(Exact name of registrant as specified in its charter)

New York (State or other jurisdiction of incorporation or organization)	31-0267900 (I.R.S. Employer Identification No.)
5215 N. O'Connor Boulevard Suite 2300, Irving, Texas (Address of principal executive offices)	75039 (Zip Code)

Registrant's telephone number, including area code:
(972) 443-6500

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $1.25 Par Value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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 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 the 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. Yes o No þ

The aggregate market value of the common stock held by non-affiliates of the registrant, computed by reference to the closing price of the registrant's common stock as reported on June 30, 2011 (the last business day of the registrant's most recently completed second fiscal quarter), was approximately $5,056,000,000. For purposes of the foregoing calculation only, all directors, executive officers and known 5% beneficial owners have been deemed affiliates.

Number of the registrant's common shares outstanding as of February 16, 2012 was 54,497,352.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information contained in the definitive proxy statement for the registrant's 2012 Annual Meeting of Shareholders scheduled to be held on May 17, 2012 is incorporated by reference into Part III hereof.

FLOWSERVE CORPORATION
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PART I

ITEM 1. BUSINESS

OVERVIEW

Flowserve Corporation is a world leading manufacturer and aftermarket service provider of comprehensive flow control systems. Under the name of a predecessor entity, we were incorporated in the State of New York on May 1, 1912. Flowserve Corporation as it exists today was created in 1997 through the merger of two leading fluid motion and control companies — BW/IP and Durco International. Over the years, we have evolved through organic growth and strategic acquisitions, and our 220-year history of Flowserve heritage brands serves as the foundation for the breadth and depth of our products and services today. Unless the context otherwise indicates, references to "Flowserve," "the Company" and such words as "we," "our" and "us" include Flowserve Corporation and its subsidiaries.

We develop and manufacture precision-engineered flow control equipment integral to the movement, control and protection of the flow of materials in our customers' critical processes. Our product portfolio of pumps, valves, seals, automation and aftermarket services supports global infrastructure industries, including oil and gas, chemical, power generation and water management, as well as certain general industrial markets where our products and services add value. Through our manufacturing platform and global network of Quick Response Centers ("QRCs"), we offer a broad array of aftermarket equipment services, such as installation, advanced diagnostics, repair and retrofitting.

We sell our products and services to more than 10,000 companies, including some of the world's leading engineering, procurement and construction firms, original equipment manufacturers, distributors and end users. Our products and services are used in several distinct industries having a broad geographic reach. Our bookings mix by industry in 2011 consisted of:

• oil and gas	40	%
• general industries(1)	22	%
• chemical	18	%
• power generation	16	%
• water management	4	%

(1) General industries includes mining and ore processing, pharmaceuticals, pulp and paper, food and beverage and other smaller applications, as well as sales to distributors whose end customers typically operate in the industries we primarily serve.

The breakdown of the geographic regions to which our sales were shipped in 2011 were as follows:

• North America	32	%
• Europe	23	%
• Asia Pacific	19	%
• Middle East and Africa	16	%
• Latin America	10	%

We have pursued a strategy of industry diversity and geographic breadth to mitigate the impact on our business of normal economic downturns in any one of the industries or in any particular part of the world we serve. For events that may occur and adversely impact our business, financial condition, results of operations and cash flows, refer to "Item 1A. Risk Factors" of this Annual Report on Form 10-K for the year ended December 31, 2011 ("Annual Report"). For information on our sales and long-lived assets by geographic areas, see Note 17 to our consolidated financial statements included in "Item 8. Financial Statements and Supplementary Data" ("Item 8") of this Annual Report.

As previously disclosed in our 2010 Annual Report on Form 10-K, we reorganized our divisional operations by combining the former Flowserve Pump Division ("FPD") and former Flow Solutions Division ("FSD") into the Flow Solutions Group ("FSG"), effective January 1, 2010. FSG was divided into two reportable segments: FSG Engineered Product Division and FSG Industrial Product Division. Flow Control Division was not affected. We have retrospectively adjusted prior period financial information to reflect our current reporting structure.

We conduct our operations through three business segments based on type of product and how we manage the business:

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FSG Engineered Product Division ("EPD") for long lead-time, custom and other highly-engineered pumps and pump systems, mechanical seals, auxiliary systems and replacement parts and related services;

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- FSG Industrial Product Division ("IPD") for pre-configured engineered pumps and pump systems and related products and services; and
- Flow Control Division ("FCD") for engineered and industrial valves, control valves, actuators and controls and related services.

Our business segments share a focus on industrial flow control technology and have a high number of common customers. These segments also have complementary product offerings and technologies that are often combined in applications which provide us a net competitive advantage. Our segments also benefit from our global footprint and our economies of scale in reducing administrative and overhead costs to serve customers more cost effectively.

Strategies

Our overarching objective is to grow our position as a product and integrated solutions provider in the flow control industry. This objective includes continuing to sell products by building on existing sales relationships and leveraging the power of our portfolio of products and services. It also includes delivering specific end user solutions that help customers attain their business goals by ensuring maximum reliability at a decreased cost of ownership. We seek to drive increasing enterprise value by using strategies that are well communicated throughout the company. These strategies include: disciplined profitable growth, customer intimacy, innovation and portfolio management, strategic localization, operational excellence, employee focus and sustainable business model. The key elements of these strategies are outlined below.

Disciplined Profitable Growth

Disciplined profitable growth is an important strategy focused on growing revenues profitably from our existing portfolio of products and services, as well as through the development or acquisition of new customer-driven products and services. An overarching goal is to focus on opportunities that can maximize the organic growth from existing customers and to evaluate potential new customer-partnering initiatives that maximize the capture of the product's total life cycle. We believe we are the largest major pump, valve and seal company that can offer customers a differentiated option of flow management products and services across a broad portfolio, as well as offer additional options that include any combination of products and solution support packages.

We also seek to continue to review our substantial installed pump, valve and seal base as a means to expand the aftermarket parts and services business, as customers are increasingly using third-party aftermarket parts and service providers to reduce their fixed costs and improve profitability. To date, the aftermarket business has provided us with a steady source of revenues and cash flows at higher margins than original equipment sales. Aftermarket sales in 2011 represented approximately 41% of total sales, as compared with approximately 39% of total sales for the same period in 2010. We are building on our established presence through an extensive global QRC network to provide the immediate parts, service and technical support required to effectively manage and win the aftermarket business created from our installed base.

Customer Intimacy

Customer intimacy defines our approach to being prepared to serve the needs of our current and future customers better than our competition. Through our ongoing relationships with our customers, we seek to gain a rich understanding of their business objectives and how our portfolio of offerings can help them succeed. We collaborate with our customers on the front end engineering and design work to drive flow management solutions that effectively generate the desired business outcomes. As we progress through original equipment projects, we work closely with our customers to understand and prepare for the long-term support needs for the operations with the intent of maximizing total life cycle value for our customers' investments.

We seek to capture additional aftermarket business by creating mutually beneficial opportunities for us and our customers through sourcing and maintenance alliance programs where we provide all or an agreed-upon portion of customers' parts and servicing needs. These customer alliances enable us to develop long-term professional relationships with our customers and serve as an effective platform for introducing new products and services to our customers and generating additional sales.

Innovation and Portfolio Management

The ongoing management of our portfolio of products and services is critical to our success. As part of managing our portfolio, we continue to rationalize our portfolio of products and services to ensure alignment with changing market requirements. We also continue to invest in research and development ("R&D") to expand the scope of our product offerings and our deployment of advanced technologies. The infusion of advanced technologies into new products and services continues to play a critical role in the ongoing evolution of our product portfolio. Our objective is to improve the percentage of revenue derived from new products as a function of overall sales, utilizing technological innovation to improve overall product life cycle and total cost of ownership for our customers.

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We employ a robust portfolio management and project execution process to seek out new product and technology opportunities, evaluate their potential return on investment and allocate resources to their development on a prioritized basis. Each project is reviewed on a routine basis for such performance measures as time to market, net present value, budget adherence, technical and commercial risk and compliance with customer requirements. Technical skill sets and knowledge are deployed across business unit boundaries to ensure that we bring the best capabilities to bear for each project. Collectively, the R&D portfolio is a key to our ability to differentiate our product and service offerings from other competitors in our target markets.

We are focused on exploring and commercializing new technologies. In many of our research areas, we are teaming with universities and experts in the appropriate scientific fields to accelerate the required learning and to shorten the development time in leveraging the value of applied technologies in our products and services. Our intent is to be a market leader in the application of advanced technology to improve product performance and return on investment for our customers.

Predictive diagnostics and asset management continue to be the biggest areas of effort for us across all our divisions. Building on the strength of our ValveSight and Technology Enabled Asset Management solutions introduced in late 2008, we have continued to deploy our diagnostics capabilities into more devices and expand on the number of host control systems and third party solutions with which we can achieve interoperability. These capabilities continue to provide a key source of competitive advantage in the market place and are saving our customers time and money in keeping their operations running.

We continually evaluate acquisitions, joint ventures and other strategic investment opportunities to broaden our product portfolio, service capabilities, geographic presence and operational capabilities to meet the growing needs of our customers. We evaluate all investment opportunities through a decision filtering process to ensure a good strategic, financial and cultural fit.

In 2011, our acquisition activities focused on adjacent technology and product capabilities. Effective October 28, 2011, we acquired for inclusion in EPD, 100% of Lawrence Pumps, Inc. ("LPI"), a privately-owned, United States ("U.S.") based pump manufacturer, in a share purchase for cash of $89.6 million. LPI specializes in the design, development and manufacture of engineered centrifugal slurry pumps for critical services within the petroleum refining, petrochemical, pulp and paper and energy markets. In addition, in a separate and unrelated transaction, we acquired wireless technology solutions to allow us to offer an efficient and economical means of monitoring equipment and processes in tough industrial environments such as oil and gas, chemical, power generation and related industries, which will further enhance our product capabilities.

Strategic Localization

Strategic localization describes our global growth strategy. We recognize that as a multi-national company it will take more than a few years to become truly global. Therefore, our strategy focuses on advancing our presence appropriately in geographies deemed to be critical to our future success as a company. This business strategy focuses on the following areas:

- expanding our global presence to capture business in developing geographic market areas;
- utilizing low-cost sourcing opportunities to remain competitive in the global economy; and
- attracting and retaining the global intellectual capital required to support our growth plans in new geographical areas.

We believe there are attractive opportunities in international markets, particularly in China, India, the Middle East, Russia, Africa and Latin America, and we intend to continue to utilize our global presence and strategically invest to further penetrate these markets. In the aftermarket services business, we seek to strategically add QRC sites in order to provide rapid response, fast delivery and field repair on a global scale for our customers. In 2011, we added six QRCs, expanding our ability to effectively deliver aftermarket support globally.

We believe that future success will be supported by investments made to establish indigenous operations to effectively serve the local market while taking advantage of low-cost manufacturing, competent engineering and strategic sourcing where practical. We believe that this positions us well to support our global customers from project conception through commissioning and throughout the life of their operations.

We continue to develop and increase our manufacturing, engineering and sourcing functions in lower-cost regions and emerging markets such as India, China, Mexico, Latin America, the Middle East and Eastern Europe as we drive higher value-add from our supply base of materials and components and satisfy local content requirements. In 2011, these lower-cost regions supplied our divisions with direct materials ranging from 17% to 40% of divisional spending.

Operational Excellence

The operational excellence strategy encapsulates ongoing programs that work to drive increased customer fulfillment and yield internal productivity. This initiative includes:

- driving improved customer fulfillment through metrics such as on-time delivery, cost reduction, quality, cycle time reduction and warranty cost reduction as a percentage of sales;

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- continuing to develop a culture of continuous improvement that delivers maximum productivity and cost efficiencies; and
- implementing global functional competencies to drive standardized processes.

We seek to increase our operational efficiency through our Continuous Improvement Process ("CIP") initiative, which utilizes tools such as value analysis, value engineering, six sigma methodology, lean manufacturing and capacity management to improve quality and processes, reduce product cycle times and lower costs. Recognizing that employees are our most valuable resource in achieving operational excellence goals, we have instituted CIP training tailored to maximize the impact on our business. To date, approximately 1,600 active employees are CIP-trained or certified as "Green Belts," "Black Belts" or "Master Black Belts," and are deployed on CIP projects throughout our company in operations, as well as in the front office of the business. As a result of the CIP initiative, we have developed and implemented processes to reduce our engineering and manufacturing process cycle time, improve on-time delivery and service response time, optimize inventory levels and reduce costs. We have also experienced success in sharing and applying best practices achieved in one business segment and deploying those ideas to other segments of the business.

We continue to rationalize existing Enterprise Resource Planning ("ERP") systems onto six strategic ERP systems. Going forward, these six strategic ERP systems will be maintained as core systems with standard tool sets, and will be enhanced as needed to meet the growing needs of the business in areas such as e-commerce, back office optimization and export compliance. Further investment in non-strategic ERP systems will be limited to compliance matters and conversion to strategic ERP systems.

We also seek to improve our working capital utilization, with a particular focus on management of accounts receivable and inventory. See further discussion in the "Liquidity and Capital Resources" section of "Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report.

Employee Focus

We focus on several elements in our strategic efforts to continuously enhance our organizational capability, including:

- institutionalizing our succession planning along with our leadership competencies and performance management capabilities, with a focus on key positions and critical talent pools;
- utilizing these capabilities to drive employee engagement through our training initiatives and leadership development programs and facilitate our cross-divisional and functional development assignments;
- developing talent acquisition programs such as our engineering recruitment program to address critical talent needs to support our emerging markets and global growth;
- capturing the intellectual capital in the current workforce, disseminating it throughout our company and sharing it with customers as a competitive advantage;
- creating a total compensation program that provides our associates with equitable opportunities that are competitive and linked to business and individual performance while promoting employee behavior consistent with our code of business conduct and risk tolerance; and
- building a diverse and globally inclusive organization with a strong ethical and compliance culture based on transparency and trust.

We continue to focus on training through the distribution of electronic learning packages in multiple languages for our Code of Business Conduct, workplace harassment, facility safety, anti-bribery, export compliance and other regulatory and compliance programs. We continue to drive our training and leadership development programs through the deployment of general management development, manager competencies and a series of multi-lingual "course-in-a-box" programs that focus on enhancing people management skills.

Sustainable Business Model

The sustainable business model initiative is focused on all of the areas that have the potential of adversely affecting our reputation, limiting our financial flexibility or creating unnecessary risk for any of our stakeholders. We proactively administer an enterprise risk management program with regular reviews of high-level matters with our Board of Directors. We work with our capital sourcing partners to ensure that our credit facilities and terms are appropriately aligned with our business strategy. We also train our associates on and monitor matters of a legal or ethical nature to support understanding and compliance on a global basis.

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Competition

Despite consolidation activities in past years, the markets for our products remain highly competitive, with primary competitive drivers being price, reputation, timeliness of delivery, quality, proximity to service centers and technical expertise, as well as contractual terms and previous installation history. In the pursuit of large capital projects, competitive drivers and competition vary depending on the industry and products involved. Industries experiencing slow growth generally tend to have a competitive environment more heavily influenced by price due to supply outweighing demand, and price competition tends to be more significant for original equipment orders than aftermarket services. Considering the domestic and global economic environments in 2011 and current forecasts for 2012, pricing was and may continue to be a particularly influential competitive factor. The unique competitive environments in each of our three business segments are discussed in more detail under the “Business Segments” heading below.

In the aftermarket portion of our business, we compete against large and well-established national and global competitors and, in some markets, against regional and local companies who produce low-cost replications of spare parts. In the oil and gas industry, the primary competitors for aftermarket services tend to be customers’ own in-house capabilities. In the nuclear power generation industry, we possess certain competitive advantages due to our "N Stamp" certification, which is a prerequisite to serve customers in that industry, and our considerable base of proprietary knowledge. In other industries, the competitors for aftermarket services tend to be local independent repair shops and low-cost replicators. Aftermarket competition for standardized products is aggressive due to the existence of common standards allowing for easier replacement or repair of the installed products.

In the sale of aftermarket products and services, we benefit from our large installed base of pumps, valves and seals, which continually require maintenance, repair and replacement parts due to the nature of the products and the conditions under which they operate. Timeliness of delivery, quality and the proximity of service centers are important customer considerations when selecting a provider for aftermarket products and services. In geographic regions where we are locally positioned to provide a quick response, customers have traditionally relied on us, rather than our competitors, for aftermarket products relating to our highly engineered and customized products, although we are seeing increased competition in this area.

Generally, our customers attempt to reduce the number of vendors from which they purchase, thereby reducing the size and diversity of their inventory. Although vendor reduction programs could adversely affect our business, we have been successful in establishing long-term supply agreements with a number of customers. While the majority of these agreements do not provide us with exclusive rights, they can provide us a "preferred" status with our customers and thereby increase opportunities to win future business. We also utilize our LifeCycle Advantage program to establish fee-based contracts to manage customers’ aftermarket requirements. These programs provide an opportunity to manage the customer’s installed base and expand the business relationship with the customer.

Our ability to use our portfolio of products, solutions and services to meet customer needs is a competitive strength. Our market approach is to create value for our customers throughout the life cycle of their investments in flow control management. We continue to explore and develop potential new offerings in conjunction with our customers. In the early phases of project design, we endeavor to create value in optimizing the selection of equipment for the customer’s specific application, as we are capable of providing technical expertise on product and system capabilities even outside the scope of our specific products, solutions and services. After the equipment is constructed and delivered to the customer’s site, we continue to create value through our aftermarket capabilities by optimizing the performance of the equipment over its operational life. Our skilled service personnel can provide these aftermarket services for our products, as well as many competitors’ products, within the installed base. This value is further enhanced by the global reach of our QRCs and, when combined with our other solutions for our customers’ flow control management needs, allows us to create value for our customers during all phases of the capital expenditure cycle.

New Product Development

We spent $35.0 million, $29.5 million and $29.4 million during 2011, 2010 and 2009, respectively, on R&D initiatives. Our R&D group consists of engineers involved in new product development and improvement of existing products. Additionally, we sponsor consortium programs for research with various universities and jointly conduct limited development work with certain vendors, licensees and customers. We believe current expenditures are adequate to sustain our ongoing and necessary future R&D activities. In addition, we work closely with our customers on customer-sponsored research activities to help execute their R&D initiatives in connection with our products and services. New product development in each of our three business segments is discussed in more detail under the "Business Segments" heading below.

Customers

We sell to a wide variety of customers globally including leading engineering, procurement and construction firms, original equipment manufacturers, distributors and end users in several distinct industries: oil and gas; chemical; power generation; water management; and a number of other industries that are collectively referred to as "general industries." No individual customer

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accounted for more than 10% of our consolidated 2011 revenues. Customer information relating to each of our three business segments is discussed in more detail under the "Business Segments" heading below.

We are not normally required to carry unusually high amounts of inventory to meet customer delivery requirements, although higher backlog levels and longer lead times generally require higher amounts of inventory. We receive advance cash payments from customers on longer lead time projects to help offset our investment in inventory. We have initiated programs targeted at improving our operational effectiveness to reduce our overall working capital needs. While we do provide cancellation policies through our contractual relationships, we generally do not provide rights of product return for our customers.

Selling and Distribution

We primarily distribute our products through direct sales by employees assigned to specific regions, industries or products. In addition, we use distributors and sales representatives to supplement our direct sales force in countries where it is more appropriate due to business practices or customs, or whenever the use of direct sales staff is not economically efficient. We generate a majority of our sales leads through existing relationships with vendors, customers and prospects or through referrals.

Intellectual Property

We own a number of trademarks and patents relating to the names and designs of our products. We consider our trademarks and patents to be valuable assets of our business. In addition, our pool of proprietary information, consisting of know-how and trade secrets related to the design, manufacture and operation of our products, is considered particularly valuable. Accordingly, we take proactive measures to protect such proprietary information. We generally own the rights to the products that we manufacture and sell and are unencumbered by licensing or franchise agreements. Our trademarks can typically be renewed indefinitely as long as they remain in use, whereas our existing patents generally expire 20 years from the dates they were filed, which has occurred at various times in the past. We do not believe that the expiration of any individual patent will have a material adverse impact on our business, financial condition or result of operations.

Raw Materials

The principal raw materials used in manufacturing our products are readily available and include ferrous and non-ferrous metals in the form of bar stock, machined castings, fasteners, forgings and motors, as well as silicon, carbon faces, gaskets and fluoropolymer components. A substantial volume of our raw materials are purchased from outside sources, and we have been able to develop a robust supply chain and anticipate no significant shortages of such materials in the future. We continually monitor the business conditions of our suppliers to manage competitive market conditions and to avoid potential supply disruptions. We continue to expand global sourcing to capitalize on localization in emerging markets and low-cost sources of purchased goods balanced with efficient consolidated and compliant logistics.

We are a vertically-integrated manufacturer of certain pump and valve products. Certain corrosion-resistant castings for our pumps and valves are manufactured at our foundries. Other metal castings are either manufactured at our foundries or purchased from qualified and approved foundry sources.

Concerning the products we supply to customers in the nuclear power generation industry, suppliers of raw materials for nuclear power generation markets must be qualified to meet the requirements of nuclear industry standards and governmental regulations. Supply channels for these materials are currently adequate, and we do not anticipate difficulty in obtaining such materials in the future.

Employees and Labor Relations

We have approximately 16,000 employees globally. In the U.S., a portion of the hourly employees at our pump manufacturing plant located in Vernon, California, our pump service center located in Cleveland, Ohio, our valve manufacturing plant located in Lynchburg, Virginia and our foundry located in Dayton, Ohio, are represented by unions. Additionally, some employees at select facilities in the following countries are unionized or have employee works councils: Argentina, Australia, Austria, Brazil, Canada, Finland, France, Germany, Italy, Japan, Mexico, The Netherlands, Poland, Spain, Sweden and the United Kingdom. We believe relations with our employees throughout our operations are generally satisfactory, including those employees represented by unions and employee works councils. No unionized facility accounts for more than 10% of our revenues.

Environmental Regulations and Proceedings

We are subject to environmental laws and regulations in all jurisdictions in which we have operating facilities. These requirements primarily relate to the generation and disposal of waste, air emissions and waste water discharges. We periodically make capital expenditures to enhance our compliance with environmental requirements, as well as to abate and control pollution. At present, we have no plans for any material capital expenditures for environmental control equipment at any of our facilities.

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However, we have incurred and continue to incur operating costs relating to ongoing environmental compliance matters. Based on existing and proposed environmental requirements and our anticipated production schedule, we believe that future environmental compliance expenditures will not have a material adverse effect on our financial condition, results of operations or cash flows.

We use hazardous substances and generate hazardous wastes in many of our manufacturing and foundry operations. Most of our current and former properties are or have been used for industrial purposes and some may require clean-up of historical contamination. During the due diligence phase of our acquisitions, we conduct environmental site assessments to identify potential environmental liabilities and required clean-up measures. We are currently conducting follow-up investigation and/or remediation activities at those locations where we have known environmental concerns. We have cleaned up a majority of the sites with known historical contamination and are addressing the remaining identified issues.

Over the years, we have been involved as one of many potentially responsible parties ("PRP") at former public waste disposal sites that are or were subject to investigation and remediation. We are currently involved as a PRP at seven Superfund sites. The sites are in various stages of evaluation by government authorities. Our total projected "fair share" cost allocation at these seven sites is expected to be immaterial. See "Item 3. Legal Proceedings" included in this Annual Report for more information.

We have established reserves that we currently believe to be adequate to cover our currently identified on-site and off-site environmental liabilities.

Exports

Our export sales from the U.S. to foreign unaffiliated customers were $365.8 million in 2011, $300.3 million in 2010 and $339.6 million in 2009.

Licenses are required from U.S. and other government agencies to export certain products. In particular, products with nuclear power generation and/or military applications are restricted, as are certain other pump, valve and seal products.

We voluntarily self-disclosed to applicable U.S. governmental authorities the results of an audit of our compliance with U.S. export control laws and, in September 2011, entered into settlement agreements with U.S. governmental authorities that resolved in full all matters contained in our voluntary self-disclosures. See "Item 3. Legal Proceedings" included in this Annual Report for more information.

BUSINESS SEGMENTS

In addition to the business segment information presented below, Note 17 to our consolidated financial statements in Item 8 of this Annual Report contains additional financial information about our business segments and geographic areas in which we have conducted business in 2011, 2010 and 2009.

FSG ENGINEERED PRODUCT DIVISION

Our largest business segment is EPD, through which we design, manufacture, distribute and service engineered pumps and pump systems, mechanical seals, auxiliary systems, replacement parts and related equipment. The business primarily consists of long lead-time, highly engineered, custom configured products, which require extensive test requirements and superior project management skills. EPD products and services are primarily used by companies that operate in the oil and gas, power generation, chemical, water management and general industries. We market our pump and mechanical seal products through our worldwide sales force and our regional service and repair centers or through independent distributors and sales representatives. A portion of our mechanical seal products are sold directly to original equipment manufacturers for incorporation into rotating equipment requiring mechanical seals.

Our pump products are manufactured in a wide range of metal alloys and with a variety of configurations to meet the critical operating demands of our customers. Mechanical seals are critical to the reliable operation of rotating equipment in that they prevent leakage and emissions of hazardous substances from the rotating equipment and reduce shaft wear on the equipment caused by the use of non-mechanical seals. We also manufacture a gas-lubricated mechanical seal that is used in high-speed compressors for gas pipelines and in the oil and gas production and process markets. Our products are currently manufactured at 28 plants worldwide, nine of which are located in Europe, 11 in North America, four in Asia Pacific and four in Latin America.

We also conduct business through strategic foreign joint ventures. We have six unconsolidated joint ventures that are located in China, India, Japan, Saudi Arabia, South Korea and the United Arab Emirates, where a portion of our products are manufactured, assembled or serviced in these territories. These relationships provide numerous strategic opportunities, including increased access to our current and new markets, access to additional manufacturing capacity and expansion of our operational platform to support low-cost sourcing initiatives and capacity demands for other markets.

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EPD Products

We manufacture more than 40 different active types of pumps and approximately 185 different models of mechanical seals and sealing systems. The following is a summary list of our EPD products and globally recognized brands:

EPD Product Types

Between Bearings Pumps

- Single Case — Axially Split

Overhung Pumps

- API Process

Balance at end of period		**57,950**	57,666
Preferred shares			
Balance at beginning and end of period		**20,800**	20,800
Additional paid-in capital			
Balance at beginning of period		**1,465,688**	1,441,598
Issue of common shares		**13,743**	19,437
Balance at end of period		**1,479,431**	1,461,035
Accumulated other comprehensive income			
Balance at beginning of period		**22,808**	289,250
Change in net unrealized gains or losses on investments, net of tax		**1,129**	15,227
Change in currency translation adjustment		**7,722**	57,006
Change in unfunded pension obligation, net of tax		**400**	(334)
Impact of adopting SFAS 159			(105,961)
Balance at end of period		**32,059**	255,188
Retained earnings			
Balance at beginning of period		**2,729,662**	2,753,784
Net income		**615,789**	102,996
Dividends on common shares		**(53,151)**	(49,893)
Dividends on preferred shares		**(17,263)**	(17,263)
Impact of adopting SFAS 159			105,961
Balance at end of period		**3,275,037**	2,895,585
Common shares held in treasury			
Balance at beginning of period		**(97,599)**	(241,255)
Repurchase of common shares			(39,777)
Balance at end of period		**(97,599)**	(281,032)
Total shareholders equity	**$**	**4,767,678**	$ 4,409,242

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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PartnerRe Ltd.

Unaudited Condensed Consolidated Statements of Cash Flows

(Expressed in thousands of U.S. dollars)

	For the six months ended June 30, 2009	For the six months ended June 30, 2008
Cash Flows from Operating Activities		
Net income	**$ 615,789**	$ 102,996
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of net premium on investments	**10,074**	4,650
Net realized and unrealized investment (gains) losses	**(236,417)**	271,143
Net realized gain on purchase of capital efficient notes	**(88,427)**	
Changes in:		
Reinsurance balances, net	**(286,205)**	(622,812)
Reinsurance recoverable on paid and unpaid losses, net of ceded premiums payable	**17,380**	16,134
Funds held by reinsured companies	**8,537**	166,697
Deferred acquisition costs	**(47,052)**	(88,713)
Net tax liabilities	**93,419**	(18,127)
Unpaid losses and loss expenses including life policy benefits	**(104,921)**	215,797
Unearned premiums	**460,138**	502,540
Other changes in operating assets and liabilities	**(19,341)**	(34,023)
Other, net	**4,552**	3,223
Net cash provided by operating activities	**427,526**	519,505
Cash Flows from Investing Activities		
Sales of fixed maturities	**2,502,800**	3,234,844
Redemptions of fixed maturities	**561,895**	430,734
Purchases of fixed maturities	**(3,447,701)**	(4,421,994)
Sales of short-term investments	**110,600**	114,842
Purchases of short-term investments	**(57,602)**	(124,230)
Sales of equities	**424,522**	891,536
Purchases of equities	**(377,434)**	(800,242)
Other, net	**(6,767)**	57,535
Net cash used in investing activities	**(289,687)**	(616,975)
Cash Flows from Financing Activities		
Cash dividends paid to shareholders	**(70,414)**	(67,156)
Repayment of long-term debt	**(200,000)**	(220,000)
Purchase of capital efficient notes	**(94,241)**	
Net issue (repurchase) of common shares and treasury shares	**4,975**	(32,760)
Contract fees on forward sale agreement	**(2,502)**	(5,190)
Proceeds from issuance of senior notes		250,000
Net cash used in financing activities	**(362,182)**	(75,106)
Effect of foreign exchange rate changes on cash	**2,353**	(1,970)
Decrease in cash and cash equivalents	**(221,990)**	(174,546)
Cash and cash equivalents beginning of period	**838,280**	654,895
Cash and cash equivalents end of period	**$ 616,290**	$ 480,349

Supplemental cash flow information:

Taxes paid	**$**	**41,125**	$	17,291
Interest paid	**$**	**18,157**	$	27,408

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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PartnerRe Ltd.

Notes to Unaudited Condensed Consolidated Financial Statements

1. Organization

PartnerRe Ltd. (the Company) provides reinsurance on a worldwide basis through its principal wholly owned subsidiaries, Partner Reinsurance Company Ltd. (Partner Reinsurance), Partner Reinsurance Company of the U.S. (PartnerRe U.S.) and Partner Reinsurance Europe Limited (PartnerRe Europe). Risks reinsured include, but are not limited to property, casualty, motor, agriculture, aviation/space, catastrophe, credit/surety, engineering, energy, marine, specialty property, specialty casualty, multiline and other lines, life/annuity and health and alternative risk products. The Company s alternative risk products include weather and credit protection to financial, industrial and service companies on a worldwide basis.

On July 4, 2009, the Company entered into definitive agreements to acquire PARIS RE Holdings Limited (Paris Re) a French-listed, Swiss-based diversified reinsurer and its operating subsidiaries. See Note 10.

2. Significant Accounting Policies

The Company s Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. The Condensed Consolidated Financial Statements include the accounts of the Company and its subsidiaries, including those that meet the consolidation requirements of variable interest entities. Intercompany accounts and transactions have been eliminated. To facilitate comparison of information across periods, certain reclassifications have been made to prior year amounts to conform to the current year s presentation.

The preparation of financial statements in conformity with U.S. GAAP requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. While Management believes that the amounts included in the Condensed Consolidated Financial Statements reflect its best estimates and assumptions, actual results could differ from those estimates. The Company s principal estimates include:

- Unpaid losses and loss expenses;
- Policy benefits for life and annuity contracts;
- Gross and net premiums written and net premiums earned;
- Recoverability of deferred acquisition costs;
- Recoverability of deferred tax assets;
- Valuation of goodwill; and
- Valuation of fixed maturity and equity investments that are measured using significant unobservable inputs and valuation of other invested assets, including certain derivative financial instruments.

In the opinion of Management, all adjustments (which include normal recurring adjustments) necessary for a fair presentation of results for the interim periods have been made. As the Company s reinsurance operations are exposed to low-frequency high-severity risk events, some of which are seasonal, results for certain interim periods may include unusually low loss experience, while results for other interim periods may include significant catastrophic losses. Consequently, the Company s results for interim periods are not necessarily indicative of results for the full year. These Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

The following significant accounting policies were adopted by the Company during the six months ended June 30, 2009.

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SFAS 165

In May 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 165, Subsequent Events (SFAS 165). SFAS 165 requires the Company to evaluate subsequent events through the date that the financial statements are issued, establishes the requirements for recognition of a subsequent event in its financial statements and establishes disclosure requirements about events or transactions that occurred after the balance sheet date. The adoption of SFAS 165 as of June 30, 2009 only required new disclosures to be made and did not have an impact on the Company s consolidated shareholders equity or net income.

FSP FAS 107-1 and APB 28-1

In April 2009, the FASB issued FASB Staff Position (FSP) No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1 and APB 28-1), which amends FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments and APB Opinion No. 28, Interim Financial Reporting , to require disclosures about fair value of financial instruments in interim financial statements. The adoption of FSP FAS 107-1 and APB 28-1 for the three months ended June 30, 2009 only required new disclosures to be made and did not have an impact on the Company s consolidated shareholders equity or net income.

FSP FAS 157-4

In April 2009, the FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP FAS 157-4), which provides additional guidance on fair value measurements under SFAS No. 157, Fair Value Measurements (SFAS 157) when the volume and level of activity for an asset or liability have significantly decreased. The adoption of FSP FAS 157-4 for the three months ended June 30, 2009 did not have a material impact on the Company s consolidated shareholders equity or net income.

FSP FAS 157-2

In February 2008, the FASB issued FSP FAS 157-2, Effective Date of FASB Statement No. 157 (FSP FAS 157-2), which permits a one-year deferral of the application of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of FSP FAS 157-2 on January 1, 2009 did not have a material impact on the Company s consolidated shareholders equity or net income.

SFAS 160

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160). SFAS 160 amends Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51) to establish accounting and reporting standards for a noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51 s consolidation procedures for consistency with the requirements of FASB Statement No. 141 (revised 2007), Business Combinations . The adoption of SFAS 160 on January 1, 2009 did not have a material impact on the Company s consolidated shareholders equity or net income.

EITF 07-05

In June 2008, the FASB s Emerging Issues Task Force (EITF) reached a consensus regarding EITF Issue No. 07-5, Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock (EITF 07-5). EITF 07-5 outlines a two-step approach to evaluate the instrument s contingent exercise provisions, if any, and to evaluate the instrument s settlement provisions when determining whether an equity-linked financial instrument (or embedded feature) is indexed to an entity s own stock. The adoption of EITF 07-5 on January 1, 2009 did not have a material impact on the Company s consolidated shareholders equity or net income.

3. New Accounting Pronouncements

SFAS 167

In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R) (SFAS 167). SFAS 167 amends FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46(R)). SFAS 167 requires an enterprise to perform ongoing reassessments of its variable interest entities, clarifies certain provisions of FIN 46(R) and requires enhanced disclosures of an enterprise s involvement in variable interest entities. SFAS 167 will be effective for annual and interim periods beginning after November 15, 2009, with early adoption prohibited. The Company is currently evaluating the impact of the adoption of SFAS 167 on its consolidated shareholders equity and net income.

SFAS 168

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 (SFAS 168). SFAS 168 establishes the FASB

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Accounting Standards Codification (Codification) as the source of authoritative U.S. GAAP for non-governmental entities. The Codification supersedes all then-existing non-SEC accounting and reporting standards and reorganizes existing U.S. GAAP into authoritative accounting topics and sub-topics. SFAS 168 is effective for annual and interim periods ending after September 15, 2009. Since SFAS 168 will only amend the way the Company refers to U.S. GAAP in its financial statements, its adoption will not affect the Company s consolidated shareholders equity or net income.

4. Fair value

(a) SFAS 157

The SFAS 157 fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value by maximizing the use of observable inputs and minimizing the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing an asset or liability based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s assumptions about what market participants would use in pricing the asset or liability based on the best information available in the circumstances. The level in the hierarchy within which a given fair value measurement falls is determined based on the lowest level input that is significant to the measurement.

The Company must determine the appropriate level in the hierarchy for each financial instrument that it measures at fair value. In determining fair value, the Company uses various valuation approaches, including market, income and cost approaches. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 inputs Unadjusted, quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.
The Company s financial instruments that it measures at fair value using Level 1 inputs generally include: equities listed on a major exchange and exchange traded derivatives, such as futures and options that are actively traded.

Level 2 inputs Quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in inactive markets and directly or indirectly observable inputs, other than quoted prices, used in industry accepted models.
The Company s financial instruments that it measures at fair value using Level 2 inputs generally include: U.S. Treasury bonds; U.S. Government Sponsored Entities; Organization for Economic Co-operation and Development Sovereign Treasury bonds; investment grade and high yield corporate bonds; catastrophe bonds; mortgage-backed securities; asset-backed securities (ABS); foreign exchange forward contracts and over-the-counter derivatives such as foreign currency option contracts, equity put and call options, interest rate swaps and credit default swaps.

Level 3 inputs Unobservable inputs.
The Company s financial instruments that it measures at fair value using Level 3 inputs generally include: unlisted equities including preference shares; unit trusts; private ABS; credit linked notes; loans receivable; total return swaps and weather derivatives.

At June 30, 2009 and December 31 2008, the Company s financial instruments measured at fair value were categorized between Levels 1, 2 and 3 as follows (in thousands of U.S. dollars):

June 30, 2009	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**	**Total**
Fixed maturities, trading securities	**$**	**$ 10,684,878**	**$ 71,975**	**$ 10,756,853**
Short-term investments, trading securities		**63,800**	**73**	**63,873**
Equities, trading securities	**492,349**	**217**	**34,714**	**527,280**

Other invested assets		**(8,338)**	**5,289**	**(3,049)**
Total	**$ 492,349**	**$ 10,740,557**	**$ 112,051**	**$ 11,344,957**

December 31, 2008	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**	**Total**
Fixed maturities, trading securities	$	$ 10,103,857	$ 78,138	$ 10,181,995
Short-term investments, trading securities		116,954	137	117,091
Equities, trading securities	436,627	42,638	33,547	512,812
Other invested assets		(870)	(16,136)	(17,006)
Total	$ 436,627	$ 10,262,579	$ 95,686	$ 10,794,892

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At June 30, 2009 and December 31, 2008, the aggregate carrying amounts of items included in Other invested assets that the Company did not measure at fair value were $108.9 million and $91.5 million, respectively, which primarily related to the Company s investments that are accounted for using the equity method of accounting or investment company accounting.

Substantially all of the accrued investment income in the Condensed Consolidated Balance Sheets as of June 30, 2009 and December 31, 2008 related to the Company s fixed maturities, short-term investments and equities for which the fair value option was elected.

The following tables are reconciliations of the beginning and ending balances for all financial instruments measured at fair value using Level 3 inputs for the three months ended June 30, 2009 and 2008, respectively (in thousands of U.S. dollars):

Three months ended June 30, 2009	**Fixed maturities**	**Short-term investments**	**Equities**	**Other invested assets**	**Total**
Balance at beginning of period	**$ 121,578**	**$ 93**	**$ 32,985**	**$ (8,754)**	**$ 145,902**
Realized and unrealized investment gains (losses) included in net income	**19,037**	**(20)**	**1,729**	**16,219**	**36,965**
Net purchases, sales and settlements	**(4,010)**			**(2,176)**	**(6,186)**
Net transfers out of Level 3	**(64,630)**				**(64,630)**
Balance at end of period	**$ 71,975**	**$ 73**	**$ 34,714**	**$ 5,289**	**$ 112,051**
Change in unrealized investment gains (losses) relating to assets held at end of period	**$ 18,606**	**$ (20)**	**$ 1,729**	**$ 15,575**	**$ 35,890**

The net transfers out of Level 3 for the three months ended June 30, 2009 of $64.6 million of fixed maturities was related to a single issuer which was classified as a Level 2 asset at December 31, 2008 and June 30, 2009 and valued using a broker quote based on current market activity. However, these fixed maturities were classified as Level 3 assets at March 31, 2009 and valued using an internal model due to a lack of market activity at that time.

Three months ended June 30, 2008	**Fixed maturities**	**Short-term investments**	**Equities**	**Other invested assets**	**Total**
Balance at beginning of period	$ 11,682	$	$ 38,685	$ 89	$ 50,456
Realized and unrealized investment (losses) gains included in net loss	(1,738)		480	12,302	11,044
Net purchases, sales and settlements				12,718	12,718
Balance at end of period	$ 9,944	$	$ 39,165	$ 25,109	$ 74,218
Change in unrealized investment (losses) gains relating to assets held at end of period	$ (1,738)	$	$ 480	$ 8,468	$ 7,210

The following tables are reconciliations of the beginning and ending balances for all financial instruments measured at fair value using Level 3 inputs for the six months ended June 30, 2009 and 2008, respectively (in thousands of U.S. dollars):

Six months ended June 30, 2009	**Fixed maturities**	**Short-term investments**	**Equities**	**Other invested assets**	**Total**
Balance at beginning of period	**$ 78,138**	**$ 137**	**$ 33,547**	**$ (16,136)**	**$ 95,686**
Realized and unrealized investment gains (losses) included in net income	**18,741**	**(64)**	**1,226**	**23,720**	**43,623**
Net purchases, sales and settlements	**(5,936)**		**(59)**	**(2,295)**	**(8,290)**
Net transfers out of Level 3	**(18,968)**				**(18,968)**
Balance at end of period	**$ 71,975**	**$ 73**	**$ 34,714**	**$ 5,289**	**$ 112,051**
Change in unrealized investment gains (losses) relating to assets held at end of period	**$ 18,622**	**$ (64)**	**$ 1,226**	**$ 22,792**	**$ 42,576**

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Six months ended June 30, 2008	Fixed maturities	Short-term investments	Equities	Other invested assets	Total
Balance at beginning of period	$ 15,166	$	$ 39,606	$ (14,838)	$ 39,934
Realized and unrealized investment (losses) gains included in net income	(1,764)		(441)	10,411	8,206
Net purchases, sales and settlements				29,536	29,536
Transfers out of Level 3	(3,458)				(3,458)
Balance at end of period	$ 9,944	$	$ 39,165	$ 25,109	$ 74,218
Change in unrealized investment (losses) gains relating to assets held at end of period	$ (1,764)	$	$ (441)	$ 586	$ (1,619)

Changes in the fair value of the Company s financial instruments measured at fair value, for which the fair value option was elected, during the three months and six months ended June 30, 2009 and 2008, respectively, were as follows (in thousands of U.S. dollars):

	For the three months ended June 30, 2009	For the three months ended June 30, 2008	For the six months ended June 30, 2009	For the six months ended June 30, 2008
Fixed maturities, trading securities	**$ 186,819**	$ (303,100)	**$ 138,448**	$ (229,350)
Short-term investments, trading securities	**(206)**	(193)	**(581)**	(315)
Equities, trading securities	**121,199**	14,784	**124,689**	(74,302)
Total	**$ 307,812**	$ (288,509)	**$ 262,556**	$ (303,967)

All of the above changes in fair value are included in the Condensed Consolidated Statements of Operations under the caption Net realized and unrealized investment gains (losses).

(b) Fair Value of Financial Instrument Liabilities

The methods and assumptions used by the Company in estimating the fair value of each class of financial instrument liabilities recorded in the Condensed Consolidated Balance Sheet for which the Company does not measure these instruments at fair value did not change from December 31, 2008. The carrying values and fair values of the financial instrument liabilities recorded in the Condensed Consolidated Balance Sheets as of June 30, 2009 and December 31, 2008 were as follows (in thousands of U.S. dollars):

	June 30, 2009		December 31, 2008	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Policy benefits for life and annuity contracts (1)	**$ 1,546,779**	**$ 1,546,779**	$ 1,432,015	$ 1,432,015
Long-term debt	**200,000**	**198,319**	200,000	196,103
Debt related to senior notes (2)	**250,000**	**241,520**	250,000	237,095
Debt related to capital efficient notes (3)	**63,384**	**30,185**	250,000	94,536
Current portion of long-term debt			200,000	200,000

(1) Policy benefits for life and annuity contracts included short-duration and long-duration contracts.

(2) PartnerRe Finance A LLC, the issuer of the Senior Notes, does not meet the consolidation requirements of FIN 46(R). Accordingly, the Company shows the related intercompany debt of $250.0 million at June 30, 2009 and December 31, 2008 in its Condensed Consolidated Balance Sheets.

(3)

PartnerRe Finance II, the issuer of the capital efficient notes, does not meet the consolidation requirements of FIN 46(R). Accordingly, the Company shows the related intercompany debt of $71.0 million at June 30, 2009 and $257.6 million at December 31, 2008 in its Condensed Consolidated Balance Sheets. The fair value of the capital efficient notes was based on the aggregate principal amount outstanding from PartnerRe Finance II of $63.4 million at June 30, 2009 and $250.0 million at December 31, 2008 (see Note 5).

5. Debt

On March 2, 2009, the Company announced the commencement of a cash tender offer for any and all of the 6.440% Fixed-to-Floating Rate Junior Subordinated Capital Efficient Notes (CENts) due 2066 (see Note 13 to the Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2008). Under the terms of the tender offer, Partner Re Finance II Inc. (PartnerRe Finance II), an indirect wholly-owned subsidiary of the Company, and the issuer of the CENts, paid holders $500 per $1,000 principal amount of CENts tendered. In addition, holders of the CENts were paid any accrued and unpaid interest on the purchased CENts from the last interest payment date.

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On March 13, 2009, PartnerRe Finance II purchased approximately 75% of the issue, or $186.6 million. Contemporaneously, under the terms of a cross receipt agreement, PartnerRe U.S. Holdings paid PartnerRe Finance II consideration of $93.3 million for the extinguishment of $186.6 million of the principal amount of PartnerRe U.S. Holdings 6.440% Fixed-to-Floating Rate promissory note due December 1, 2066. All other terms and conditions of the remaining CENts and promissory note remain unchanged. A pre-tax gain of $88.4 million, net of deferred issuance costs and fees was realized on the foregoing transactions. The aggregate principal amount of the CENts and promissory note outstanding at June 30, 2009 was $63.4 million and $71.0 million, respectively.

On January 8, 2009, the Company entered into a second amendment to the loan agreement, dated as of October 25, 2005, among the Company, as borrower, Citibank, N.A., as administrative agent, and Citibank, N.A., as lender, which originally evidenced a three-and-a-half year term loan agreement with Citibank, N.A. Under the terms of the second loan amendment, the Company had a right to prepay the half of the original $400.0 million loan that had a maturity of April 27, 2009. Any such prepayment under the terms of the second loan amendment will be accompanied by payment of accrued and unpaid interest on the prepayment amount. The remaining half of the loan has a maturity of July 12, 2010 and the Company does not have a right to prepay this amount. The loan was otherwise unchanged. On January 14, 2009, the Company repaid the half of the original $400.0 million loan that was due April 27, 2009. See Notes 12 and 22 to the Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

6. Net Income (Loss) per Share

The reconciliation of basic and diluted net income (loss) per share is as follows (in thousands of U.S. dollars or shares, except per share amounts):

	For the three months ended June 30, 2009	For the three months ended June 30, 2008	For the six months ended June 30, 2009	For the six months ended June 30, 2008
Numerator:				
Net income (loss)	**$ 474,269**	$ (26,024)	**$ 615,789**	$ 102,996
Less: preferred dividends	**8,631**	8,631	**17,263**	17,263
Net income (loss) available to common shareholders	**$ 465,638**	$ (34,655)	**$ 598,526**	$ 85,733
Denominator:				
Weighted average number of common shares outstanding basic	**56,609.8**	54,276.6	**56,560.8**	54,262.5
Stock options and other (1)	**859.2**		**834.1**	1,423.1
Weighted average number of common and common share equivalents outstanding diluted	**57,469.0**	54,276.6	**57,394.9**	55,685.6
Basic net income (loss) per share	**$ 8.23**	$ (0.64)	**$ 10.58**	$ 1.58
Diluted net income (loss) per share (1)	**$ 8.10**	$ (0.64)	**$ 10.43**	$ 1.54

(1) At June 30, 2009 and 2008, stock options to purchase 969.4 thousand and 377.5 thousand common shares, respectively, were excluded from the calculation of diluted weighted average number of common and common share equivalents outstanding because their exercise prices were greater than the average market price of the common shares.

7. Derivatives

In accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), the Company s derivative instruments are recorded in the Condensed Consolidated Balance Sheets at fair value, with changes in fair value recognized in either net foreign exchange gains and losses or net realized and unrealized investment gains and losses in the Condensed Consolidated Statements of Operations, depending on the nature of the derivative instrument. The Company s objectives for holding or issuing these derivatives are as follows:

Foreign Exchange Forward Contracts

The Company utilizes foreign exchange forward contracts as part of its overall currency risk management and investment strategies. The Company also utilizes foreign exchange forward contracts to hedge a portion of its net investment exposure resulting from the translation of its foreign subsidiaries and branches whose functional currency is other than the U.S. dollar.

Foreign Currency Option Contracts and Futures Contracts

The Company also utilizes foreign currency option contracts to mitigate foreign currency risk. The Company uses exchange traded treasury note futures contracts and commodity futures to manage portfolio duration or hedge certain investments, respectively.

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Credit Default Swaps

The Company purchases protection through credit default swaps to mitigate the risk associated with its underwriting operations, most notably in the credit/surety line and to manage market exposures.

The Company assumes credit risk through credit default swaps to replicate investment positions. The original term of these credit default swaps is generally five years or less and there are no recourse provisions associated with these swaps. While the Company would be required to perform under exposure assumed through credit default swaps in the event of a default on the underlying issuer, no issuer was in default at June 30, 2009. The counterparties on the Company s assumed credit default swaps are all highly rated financial institutions.

Insurance-Linked Securities

The Company has entered into various weather derivatives, a weather future and a longevity total return swap for which the underlying risks include parametric weather risks for the weather derivatives and future and longevity risk for the longevity total return swap.

Total Return and Interest Rate Swaps

The Company has entered into total return swaps referencing various project and principal finance obligations. The Company has also entered into interest rate swaps to mitigate interest rate risk on certain total return swaps.

The fair values and the related notional values of derivatives included in the Company s Condensed Consolidated Balance Sheets at June 30, 2009 and December 31, 2008 were as follows (in thousands of U.S. dollars):

	June 30, 2009		December 31, 2008	
	Fair Value	**Notional Value**	**Fair Value**	**Notional Value**
Derivatives designated as hedges				
Foreign exchange forward contracts (net investment hedge)	**$ (31,110)**	**$ 529,779**	$ (37,470)	$ 443,210
Derivatives not designated as hedges				
Foreign exchange forward contracts	**$ 17,233**	**$ 1,892,396**	$ 32,522	$ 1,196,830
Foreign currency option contracts	**3,993**	**93,300**	(8,027)	123,932
Futures contracts	**14,297**	**1,580,993**	7,991	1,122,524
Credit default swaps (protection purchased)	**3,560**	**224,141**	20,305	295,665
Credit default swaps (assumed risks)	**(16,622)**	**35,714**	(16,191)	46,130
Insurance-linked securities	**(296)**	**35,432**	(5,393)	60,000
Total return swaps	**(6,626)**	**223,443**	(24,898)	239,733
Interest rate swaps	**(9,154)**		(12,355)	
Other	**(13)**			
Total derivatives not designated as hedges	**$ 6,372**		$ (6,046)	
Total derivatives	**$ (24,738)**		$ (43,516)	

The fair value of all derivatives at June 30, 2009 and December 31, 2008 is recorded in other invested assets in the Company s Condensed Consolidated Balance Sheets.

The effective portion of net investment hedging derivatives, recognized in accumulated other comprehensive income, at June 30, 2009 and December 31, 2008 was a $50.0 million loss and a $37.5 million loss, respectively.

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The amount of gain (loss) in the Condensed Consolidated Statement of Operations for derivatives not designated as hedges for the three months and six months ended June 30, 2009 was as follows (in thousands of U.S. dollars):

	For the three months ended June 30, 2009	For the six months ended June 30, 2009
Foreign exchange forward contracts	$ 22,221	$ 2,035
Foreign currency option contracts	3,989	2,184
Total included in net foreign exchange gains and losses	**$ 26,210**	**$ 4,219**
Futures contracts	$ 39,434	$ 34,200
Credit default swaps (protection purchased)	(8,261)	(8,836)
Credit default swaps (assumed risks)	6,347	77
Insurance-linked securities	50	571
Total return swaps	12,983	19,203
Interest rate swaps	1,620	3,202
Other	213	230
Total included in net realized and unrealized investment gains and losses	**$ 52,386**	**$ 48,647**
Total derivatives not designated as hedges	**$ 78,596**	**$ 52,866**

8. Legal Proceedings

Legal proceedings at June 30, 2009 have not changed significantly since December 31, 2008. See Note 16(e) to the Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

9. Segment Information

The Company monitors the performance of its operations in three segments, Non-life, Life and Corporate & Other as described in Note 19 to the Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008. The Non-life segment is further divided into four sub-segments: U.S., Global (Non-U.S.) P&C, Global (Non-U.S.) Specialty and Catastrophe.

Because the Company does not manage its assets by segment, net investment income is not allocated to the Non-life segment. However, because of the interest-sensitive nature of some of the Company s Life products, net investment income is considered in Management s assessment of the profitability of the Life segment. The following items are not considered in evaluating the results of the Non-life and Life segments: net realized and unrealized investment gains and losses, net realized gain on purchase of CENts, interest expense, net foreign exchange gains and losses and income tax expense or benefit. Segment results are shown net of intercompany transactions.

Management measures results for the Non-life segment on the basis of the loss ratio, acquisition ratio, technical ratio, other operating expense ratio and combined ratio (defined below). Management measures results for the Non-life sub-segments on the basis of the loss ratio, acquisition ratio and technical ratio. Management measures results for the Life segment on the basis of the allocated underwriting result, which includes revenues from net premiums earned, other income or loss and allocated net investment income, and expenses from life policy benefits, acquisition costs and other operating expenses.

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The following tables provide a summary of the segment revenues and results for the three months and six months ended June 30, 2009 and 2008 (in millions of U.S. dollars, except ratios):

Segment Information

For the three months ended June 30, 2009

	U.S.	Global (Non-U.S.) P&C	Global (Non-U.S.) Specialty	Catastrophe	Total Non-life Segment	Life Segment	Corporate and Other	Total
Gross premiums written	$ 248	$ 120	$ 232	$ 125	$ 725	$ 116	$ 5	$ 846
Net premiums written	$ 249	$ 118	$ 232	$ 125	$ 724	$ 116	$ 5	$ 845
Decrease (increase) in unearned premiums	9	43		(73)	(21)	7	(5)	(19)
Net premiums earned	$ 258	$ 161	$ 232	$ 52	$ 703	$ 123	$	$ 826
Losses and loss expenses and life policy benefits	(164)	(83)	(152)	22	(377)	(85)	3	(459)
Acquisition costs	(63)	(38)	(50)	(4)	(155)	(27)		(182)
Technical result	**$ 31**	**$ 40**	**$ 30**	**$ 70**	**$ 171**	**$ 11**	**$ 3**	**$ 185**
Other income					1	&n		