

SMITH A O CORP  
Form 10-Q  
August 10, 2015

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2015.**

**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)**

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

**11270 West Park Place, Milwaukee, Wisconsin**  
**(Address of principal executive office)**  
**(414) 359-4000**

**53224-9508**  
**(Zip Code)**

**(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 ☒ Accelerated Filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company) 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 August 5, 2015 13,146,078 shares

Common Stock Outstanding as of August 5, 2015 75,732,188 shares

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### A. O. Smith Corporation

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**PART I - FINANCIAL INFORMATION****ITEM 1 - FINANCIAL STATEMENTS****A. O. SMITH CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

(dollars in millions, except per share data)

(unaudited)

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |            |
|--|--------------------------------|----------|------------------------------|------------|
|  | 2015                           | 2014     | 2015                         | 2014       |
| Net sales                                      | \$ 653.5                       | \$ 595.4 | \$ 1,272.0                   | \$ 1,147.6 |
| Cost of products sold                          | 390.2                          | 379.2    | 779.5                        | 735.5      |
| Gross profit                                   | 263.3                          | 216.2    | 492.5                        | 412.1      |
| Selling, general and administrative expenses   | 160.3                          | 137.4    | 307.5                        | 268.3      |
| Interest expense                               | 2.5                            | 1.4      | 4.4                          | 2.8        |
| Other income                                   | (2.7)                          | (1.2)    | (5.4)                        | (2.5)      |
|  | 103.2                          | 78.6     | 186.0                        | 143.5      |
| Provision for income taxes                     | 32.1                           | 21.3     | 56.5                         | 39.5       |
| Net Earnings                                   | \$ 71.1                        | \$ 57.3  | \$ 129.5                     | \$ 104.0   |
| Net Earnings Per Share of Common Stock         | \$ 0.80                        | \$ 0.63  | \$ 1.45                      | \$ 1.15    |
| Diluted Net Earnings Per Share of Common Stock | \$ 0.79                        | \$ 0.63  | \$ 1.44                      | \$ 1.14    |
| Dividends Per Share of Common Stock            | \$ 0.19                        | \$ 0.15  | \$ 0.38                      | \$ 0.30    |

**A. O. SMITH CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS**

(dollars in millions)

(unaudited)

|  | Three Months Ended<br>June 30, |      | Six Months<br>Ended<br>June 30, |      |
|--|--------------------------------|------|---------------------------------|------|
|  | 2015                           | 2014 | 2015                            | 2014 |

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|  |         |         |          |          |
|--|---------|---------|----------|----------|
| Net earnings   | \$ 71.1 | \$ 57.3 | \$ 129.5 | \$ 104.0 |
| Other comprehensive (loss) earnings  |         |         |          |          |
| Foreign currency translation adjustments   | (0.9)   | 2.7     | (10.2)   | (7.7)    |
| Unrealized net loss on cash flow derivative instruments, less related income tax benefit of \$0.8 and \$- in 2015, \$0.9 and \$0.4 in 2014 | (1.2)   | (1.5)   |          | (0.6)    |
| Adjustment to pension liability, less related income tax provision of \$(2.3) and \$(3.9) in 2015 and \$(2.0) and \$(6.6) in 2014          | 3.7     | 3.2     | 6.2      | 8.5      |
| Comprehensive Earnings   | \$ 72.7 | \$ 61.7 | \$ 125.5 | \$ 104.2 |

See accompanying notes to unaudited condensed consolidated financial statements.

**PART I - FINANCIAL INFORMATION****ITEM 1 - FINANCIAL STATEMENTS**

## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in millions, except share data)

|                                    | (unaudited)<br>June 30, 2015 | December 31, 2014 |
|------------------------------------|------------------------------|-------------------|
| <b>Assets</b>                      |                              |                   |
| <b>Current Assets</b>              |                              |                   |
| Cash and cash equivalents          | \$ 248.1                     | \$ 319.4          |
| Marketable securities              | 304.3                        | 222.5             |
| Receivables                        | 528.5                        | 475.4             |
| Inventories                        | 233.4                        | 208.3             |
| Deferred income taxes              | 41.6                         | 40.5              |
| Other current assets               | 44.1                         | 52.9              |
| <b>Total Current Assets</b>        | <b>1,400.0</b>               | <b>1,319.0</b>    |
| Property, plant and equipment      | 840.8                        | 815.9             |
| Less accumulated depreciation      | 407.4                        | 388.2             |
| Net property, plant and equipment  | 433.4                        | 427.7             |
| Goodwill                           | 425.4                        | 428.8             |
| Other intangibles                  | 299.9                        | 308.5             |
| Other assets                       | 31.1                         | 31.3              |
| <b>Total Assets</b>                | <b>\$ 2,589.8</b>            | <b>\$ 2,515.3</b> |
| <b>Liabilities</b>                 |                              |                   |
| <b>Current Liabilities</b>         |                              |                   |
| Trade payables                     | \$ 369.2                     | \$ 393.8          |
| Accrued payroll and benefits       | 62.1                         | 70.3              |
| Accrued liabilities                | 91.9                         | 85.1              |
| Product warranties                 | 42.5                         | 42.3              |
| Long-term debt due within one year | 13.4                         | 13.7              |
| <b>Total Current Liabilities</b>   | <b>579.1</b>                 | <b>605.2</b>      |
| Long-term debt                     | 266.2                        | 210.1             |
| Pension liabilities                | 122.9                        | 133.1             |
| Other liabilities                  | 185.1                        | 185.6             |
| <b>Total Liabilities</b>           | <b>1,153.3</b>               | <b>1,134.0</b>    |

|   |           |                |                   |
|---|-----------|----------------|-------------------|
| <b>Stockholders Equity</b>  |           |                |                   |
| Class A Common Stock, \$5 par value: authorized 14,000,000 shares; issued 13,211,268 and 13,220,470 |           | 66.1           | 66.1              |
| Common Stock, \$1 par value: authorized 120,000,000 shares; issued 82,142,528 and 82,133,326        |           | 82.1           | 82.1              |
| Capital in excess of par value  |           | 609.8          | 600.1             |
| Retained earnings   |           | 1,231.0        | 1,135.5           |
| Accumulated other comprehensive loss  |           | (276.0)        | (272.0)           |
| Treasury stock at cost  |           | (276.5)        | (230.5)           |
| <b>Total Stockholders Equity</b>  |           | <b>1,436.5</b> | <b>1,381.3</b>    |
| <b>Total Liabilities and Stockholders Equity</b>  | <b>\$</b> | <b>2,589.8</b> | <b>\$ 2,515.3</b> |

See accompanying notes to unaudited condensed consolidated financial statements.

**PART I - FINANCIAL INFORMATION****ITEM 1 - FINANCIAL STATEMENTS**

## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in millions)

(unaudited)

|   | Six Months Ended<br>June 30, |               |
|---|------------------------------|---------------|
|   | 2015                         | 2014          |
| <b>Operating Activities</b>   |                              |               |
| Net earnings  | \$ 129.5                     | \$ 104.0      |
| Adjustments to reconcile net earnings to cash provided by (used in) operating activities: |                              |               |
| Depreciation and amortization   | 31.6                         | 29.6          |
| Pension expense   |                              | 13.2          |
| Loss on disposal of assets  | 0.2                          | 0.4           |
| Net changes in operating assets and liabilities, net of acquisitions:                     |                              |               |
| Current assets and liabilities  | (98.5)                       | (55.1)        |
| Noncurrent assets and liabilities   | (4.0)                        | (1.2)         |
| <b>Cash Provided by Operating Activities - continuing operations</b>                      | <b>58.8</b>                  | <b>90.9</b>   |
| <b>Cash Used in Operating Activities - discontinued operations</b>                        | <b>(0.6)</b>                 | <b>(1.1)</b>  |
| <b>Cash Provided by Operating Activities</b>  | <b>58.2</b>                  | <b>89.8</b>   |
| <b>Investing Activities</b>   |                              |               |
| Capital expenditures  | (31.0)                       | (50.8)        |
| Investments in marketable securities  | (237.7)                      | (110.3)       |
| Net proceeds from sale of securities  | 156.1                        | 110.4         |
| <b>Cash Used in Investing Activities</b>  | <b>(112.6)</b>               | <b>(50.7)</b> |
| <b>Financing Activities</b>   |                              |               |
| Long-term debt incurred   | 57.2                         | 58.5          |
| Common stock repurchases  | (47.3)                       | (60.8)        |
| Net proceeds from stock option activity   | 7.2                          | 3.6           |
| Dividends paid  | (34.0)                       | (27.4)        |
| <b>Cash Used in Financing Activities</b>  | <b>(16.9)</b>                | <b>(26.1)</b> |
| Net (decrease) increase in cash and cash equivalents                                      | (71.3)                       | 13.0          |
| Cash and cash equivalents - beginning of period   | 319.4                        | 380.7         |



|  |          |          |
|--|----------|----------|
| <b>Cash and Cash Equivalents - End of Period</b> | \$ 248.1 | \$ 393.7 |
|--|----------|----------|

See accompanying notes to unaudited condensed consolidated financial statements.

**PART I - FINANCIAL INFORMATION**

**ITEM 1 - FINANCIAL STATEMENTS**

**A. O. SMITH CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2015**

**(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 six months ended June 30, 2015 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 17, 2015.

*Recent Accounting Pronouncements*

In April 2015, the Financial Accounting Standards Board (FASB) amended Accounting Standard Codification (ASC) 835-30, *Interest - Imputation of Interest* (issued under Accounting Standards No. 2015-03). This amendment to ASC 835-30 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs is not affected by this amendment. The amendment is effective for the year beginning January 1, 2016 and requires using a retrospective approach. The Company does not expect the adoption of amended ASC 835-30 will have a material impact on the Company's consolidated financial condition, results of operations or cash flows.

In May 2014, the FASB issued ASC 606-10, *Revenue from Contracts with Customers* (issued under Accounting Standards No. 2014-09). ASC 606-10 will replace all existing revenue recognition guidance when effective. On July 9, 2015, the FASB approved a one year deferral of the effective date, with application permitted as of the original effective date which is periods beginning January 1, 2017. Either full retrospective adoption or modified retrospective adoption is allowed under ASC 606-10. The Company is in the process of determining whether the adoption of ASC 606-10 will have an impact on the Company's consolidated financial condition, results of operations or cash flows.

**2. Inventories**

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

(dollars in millions)

|                           | June 30, 2015 | December 31, 2014 |
|---------------------------|---------------|-------------------|
| Finished products         | \$ 111.1      | \$ 100.2          |
| Work in process           | 11.5          | 10.7              |
| Raw materials             | 131.8         | 121.3             |
| Inventories, at FIFO cost | 254.4         | 232.2             |
| LIFO reserve              | (21.0)        | (23.9)            |
| Net inventory             | \$ 233.4      | \$ 208.3          |

**3. 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.

|                       | Three Months<br>Ended<br>June 30, |          |
|-----------------------|-----------------------------------|----------|
| (dollars in millions) | 2015                              | 2014     |
| Balance at April 1,   | \$ 137.2                          | \$ 135.9 |
| Expense               | 15.3                              | 15.7     |
| Claims settled        | (14.2)                            | (15.2)   |
| Balance at June 30,   | \$ 138.3                          | \$ 136.4 |

|                       | Six Months Ended<br>June 30, |          |
|-----------------------|------------------------------|----------|
| (dollars in millions) | 2015                         | 2014     |
| Balance at January 1, | \$ 136.2                     | \$ 136.6 |
| Expense               | 32.5                         | 32.3     |
| Claims settled        | (30.4)                       | (32.5)   |
| Balance at June 30,   | \$ 138.3                     | \$ 136.4 |

**4. Long-Term Debt**

The Company has a \$400 million multi-currency revolving credit agreement with eight banks, which expires on December 12, 2017. The facility has an accordion provision which allows it to be increased up to \$500 million if certain conditions (including lender approval) are satisfied.

Borrowings under bank credit lines and commercial paper borrowings are supported by the \$400 million revolving credit agreement. As a result of the long-term nature of this facility, the Company's commercial paper and credit line borrowings are classified as long-term debt at June 30, 2015.

On January 15, 2015, the Company issued \$75 million in term notes to an insurance company. Principal payments commence in 2020 and the notes mature in 2030. The notes have an interest rate of 3.52 percent. The proceeds of the notes were used to pay down borrowings under the Company's revolving credit facility.

**5. 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<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---|--------------------------------|------------|------------------------------|------------|
|   | 2015                           | 2014       | 2015                         | 2014       |
| Denominator for basic earnings per share<br>weighted average shares | 89,139,114                     | 90,509,155 | 89,286,984                   | 90,868,025 |
| Effect of dilutive stock options and share<br>units                 | 686,041                        | 647,158    | 708,193                      | 690,957    |
| Denominator for diluted earnings per share                          | 89,825,155                     | 91,156,313 | 89,995,177                   | 91,558,982 |

**6. Stock Based Compensation**

The Company adopted the A. O. Smith Combined Incentive Compensation Plan (the plan) effective January 1, 2007. Stockholders reapproved the plan 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 June 30, 2015 was 1,994,284. 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 June 30, 2015 and 2014 was \$1.1 million and \$2.0 million, respectively. Total stock based compensation cost recognized in the six months ended June 30, 2015 and 2014 was \$6.7 million and \$7.8 million, respectively.

*Stock Options*

The stock options granted in the six months ended June 30, 2015 and 2014 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 2015 and 2014 expire ten years after date of grant. The Company's stock options are expensed ratably over the three-year vesting period; however, included in the stock option expense for the three and six months ended June 30, 2015 and 2014 is 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. Stock based compensation cost attributable to stock options in the three months ended June 30, 2015 and 2014 was \$0.5 million and \$0.9 million, respectively. Stock based compensation expense attributable to stock options in the six months ended June 30, 2015 and 2014 was \$3.0 million and \$3.7 million, respectively.

**6. Stock Based Compensation (continued)**

Changes in option awards, all of which relate to Common Stock, were as follows for the six months ended June 30, 2015:

|                                | Weighted-Average<br>Per Share<br>Exercise Price | Six Months<br>Ended<br>June 30, 2015 | Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(dollars in<br>millions) |
|--------------------------------|---|--------------------------------------|---|---|
| Outstanding at January 1, 2015 | \$ 27.50  | 1,577,003                            |   |   |
| Granted                        | 61.53   | 242,495                              |   |   |
| Exercised                      | 21.31   | (240,760)                            |   |   |
| Forfeited                      | 34.10   | (2,265)                              |   |   |
| Outstanding at June 30, 2015   | 33.63   | 1,576,473                            | 7 years                                     | \$ 60.5   |
| Exercisable at June 30, 2015   | \$ 24.43  | 1,028,157                            | 7 years                                     | \$ 48.9   |

The weighted-average fair value per option at the date of grant during the six months ended June 30, 2015 and 2014 using the Black-Scholes option-pricing model was \$17.17 and \$16.55, respectively. Assumptions were as follows:

|                         | Six Months Ended June 30, |       |
|-------------------------|---------------------------|-------|
|                         | 2015                      | 2014  |
| Expected life (years)   | 5.9                       | 6.0   |
| Risk-free interest rate | 2.0%                      | 2.7%  |
| Dividend yield          | 1.0%                      | 1.1%  |
| Expected volatility     | 29.3%                     | 36.6% |

The expected life is based on historical exercise behavior and the projected exercise of unexercised stock options. The risk free interest rate is based on the U.S. Treasury yield curve in effect on the date of grant for the expected life of the option. The actual dividend yield is based on the actual annual dividends divided by the grant date market value of the Company's Common Stock. The expected volatility is based on the historical volatility of the Company's Common Stock.

*Stock Appreciations Rights (SARs)*

Certain non-U.S.-based employees are granted SARs. Each SAR award grants the employee the right to receive cash equal to the excess of the share price of the Common Stock on the date that a participant exercises such right over the grant date price of the stock. SARs granted in the six months ended June 30, 2015 have three year pro rata vesting from the date of grant. SARs are issued at exercise prices equal to the fair value of Common Stock on the date of grant and expire ten years from the date of grant. Compensation expense for SARs is remeasured at each reporting period based on the estimated fair value on the date of grant using the Black-Scholes option-pricing model, using assumptions similar to stock option awards. SARs are subsequently remeasured at each interim reporting period based on a revised Black-Scholes value. In the first six months of 2015, the Company granted 13,115 cash-settled SARs and no SARs were exercisable. Stock based compensation expense attributable to SARs was minimal in the three and six

months ended June 30, 2015.

**6. Stock Based Compensation (continued)***Restricted Stock and Share Units*

Participants may also be awarded shares of restricted stock or share units under the plan. The Company granted 76,035 and 100,310 share units under the plan in the six months ended June 30, 2015 and 2014, respectively. The share units were valued at \$4.7 million and \$5.1 million at the dates of issuance in 2015 and 2014, respectively, based on the Company's stock price at the dates of grant. The Company's share units are recognized as compensation expense ratably over the three year vesting period; however, included in share unit expense in the three and six months ended June 30, 2015 and 2014 is expense associated with accelerated vesting of share unit awards for certain employees who either are retirement eligible or will become retirement eligible during the vesting period. Share based compensation expense attributable to share units of \$0.6 million and \$1.1 million was recognized in the three months ended June 30, 2015 and 2014, respectively. Stock based compensation expense attributable to share units of \$3.7 million and \$4.1 million was recognized in the six months ended June 30, 2015 and 2014, respectively. Certain non-U.S.-based employees receive the cash value of vested shares at the vesting date in lieu of shares.

A summary of share unit activity under the plan for the six months ended June 30, 2015 is as follows:

|  | Number of Units | Weighted-Average<br>Grant Date<br>Value |
|--|-----------------|---|
| Issued and unvested at January 1, 2015 | 416,289         | \$ 33.06                                |
| Granted                                | 76,035          | 61.57                                   |
| Vested                                 | (154,748)       | 22.90                                   |
| Forfeited                              | (635)           | 35.44                                   |
| Issued and unvested at June 30, 2015   | 336,941         | \$ 44.16                                |

**7. Pensions**

The following table presents the components of the Company's net pension expense:

(dollars in millions)

|                                    | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |         |
|------------------------------------|--------------------------------|--------|------------------------------|---------|
|                                    | 2015                           | 2014   | 2015                         | 2014    |
| Service cost                       | \$ 0.5                         | \$ 1.8 | \$ 1.0                       | \$ 3.9  |
| Interest cost                      | 9.4                            | 11.4   | 18.8                         | 22.4    |
| Expected return on plan assets     | (14.5)                         | (15.2) | (28.8)                       | (30.2)  |
| Amortization of unrecognized loss  | 4.8                            | 8.8    | 9.5                          | 17.6    |
| Amortization of prior service cost | (0.2)                          | (0.2)  | (0.5)                        | (0.5)   |
| Defined benefit plan expense       | \$                             | \$ 6.6 | \$                           | \$ 13.2 |



The Company's pension plan sunset for the majority of its employees on December 31, 2014.

The Company did not make a contribution to its U.S. pension plan in 2014. The Company is not required to make a contribution and does not intend to make a voluntary contribution in 2015.

## 8. Operations by Segment

The Company is comprised of two reporting segments: North America and Rest of World. Both segments manufacture and market comprehensive lines of residential and commercial gas, gas tankless and electric water heaters. Both segments primarily manufacture and market in their respective regions of the world. The Rest of World segment is primarily comprised of China, Europe and India. The North America segment also manufactures and markets specialty commercial water heating equipment, condensing and non-condensing boilers and water system tanks. The Rest of World segment also manufactures and markets water treatment products and markets air purifier products, primarily in Asia.

The Company's operations by segment are as follows:

(dollars in millions)

|                              | Three Months<br>Ended<br>June 30, |          | Six Months Ended<br>June 30, |            |
|------------------------------|-----------------------------------|----------|------------------------------|------------|
|                              | 2015                              | 2014     | 2015                         | 2014       |
| Net sales                    |                                   |          |                              |            |
| North America                | \$ 442.7                          | \$ 410.1 | \$ 871.9                     | \$ 798.6   |
| Rest of World                | 221.3                             | 193.6    | 417.2                        | 366.4      |
| Inter-segment sales          | (10.5)                            | (8.3)    | (17.1)                       | (17.4)     |
|                              | \$ 653.5                          | \$ 595.4 | \$ 1,272.0                   | \$ 1,147.6 |
| Operating earnings           |                                   |          |                              |            |
| North America                | \$ 86.0                           | \$ 63.2  | \$ 157.2                     | \$ 118.5   |
| Rest of World                | 30.9                              | 29.3     | 57.1                         | 54.4       |
|                              | 116.9                             | 92.5     | 214.3                        | 172.9      |
| Corporate expense            | (11.2)                            | (12.5)   | (23.9)                       | (26.6)     |
| Interest expense             | (2.5)                             | (1.4)    | (4.4)                        | (2.8)      |
| Earnings before income taxes | 103.2                             | 78.6     | 186.0                        | 143.5      |
| Provision for income taxes   | 32.1                              | 21.3     | 56.5                         | 39.5       |
| Net earnings                 | \$ 71.1                           | \$ 57.3  | \$ 129.5                     | \$ 104.0   |

## 9. Fair Value Measurements

ASC 820, *Fair Value Measures and Disclosures*, among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring basis or nonrecurring basis. ASC 820 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and (Level 3) unobservable inputs in

which there is little or no market data, which require the reporting entity to develop its own assumptions. Assets and liabilities measured at fair value are based on the market approach which are prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

**9. Fair Value Measurements (continued)**

Assets and liabilities measured at fair value on a recurring basis are as follows:

|  |          |              |
|--|----------|--------------|
| (dollars in millions)  |          |              |
|  | June 30, | December 31, |
| Fair Value Measurement Using                                   | 2015     | 2014         |
| Quoted prices in active markets for identical assets (Level 1) | \$ 305.9 | \$ 224.1     |
| Significant other observable inputs (Level 2)                  | (0.2)    | (0.2)        |
| Total assets measured at fair value                            | \$ 305.7 | \$ 223.9     |

There were no changes in the Company's valuation techniques used to measure fair values on a recurring basis during the six months ended June 30, 2015.

**10. Derivative Instruments**

ASC 815 *Derivatives and Hedging* as amended, requires that all derivative instruments be recorded on the balance sheet at fair value and establishes criteria for designation and effectiveness of the hedging relationships. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as a part of a hedging relationship and, further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, the Company must designate the hedging instrument, based upon the exposure hedged, as a fair value hedge, cash flow hedge, or a hedge of a net investment in a foreign operation.

The Company designates that all of its hedging instruments, with the exception of its steel futures contracts, are cash flow hedges. For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive loss, net of tax, and is reclassified into earnings in the same line item associated with the forecasted transaction and in the same period or periods during which the hedged transaction affects earnings. The amount by which the cumulative change in the value of the hedge more than offsets the cumulative change in the value of the hedged item (i.e., the ineffective portion) is recorded in earnings, net of tax, in the period the ineffectiveness occurs.

The Company utilizes certain derivative instruments to enhance its ability to manage currency as well as raw materials price risk. Derivative instruments are entered into for periods consistent with the related underlying exposures and do not constitute positions independent of those exposures. The Company does not enter into contracts for speculative purposes. The contracts are executed with major financial institutions with no credit loss anticipated for failure of the counterparties to perform.

*Foreign Currency Forward Contracts*

The Company is exposed to foreign currency exchange risk as a result of transactions in currencies other than the functional currency of certain subsidiaries. The Company utilizes foreign currency forward purchase and sale contracts to manage the volatility associated with foreign currency purchases, sales and certain intercompany

transactions in the normal course of business. Currencies for which the Company utilizes foreign currency forward contracts include the British pound, Canadian dollar, Euro and Mexican peso.

**10. Derivative Instruments (continued)**

Gains and losses on these instruments are recorded in accumulated other comprehensive loss, net of tax, until the underlying transaction is recorded in earnings. When the hedged item is realized, gains or losses are reclassified from accumulated other comprehensive loss to the statement of earnings. The assessment of effectiveness for forward contracts is based on changes in the forward rates. These hedges have been determined to be effective.

The majority of the amounts in accumulated other comprehensive loss for cash flow hedges is expected to be reclassified into earnings within one year and all of the hedges will be reclassified into earnings no later than December 31, 2016.

The following table summarizes, by currency, the contractual amounts of the Company's foreign currency forward contracts:

(dollars in millions)

|                 | June 30, |         |         |         |
|-----------------|----------|---------|---------|---------|
|                 | 2015     |         | 2014    |         |
|                 | Buy      | Sell    | Buy     | Sell    |
| British pound   | \$       | \$ 0.5  | \$      | \$ 0.9  |
| Canadian dollar |          | 66.7    |         | 56.7    |
| Euro            | 18.4     | 0.5     | 7.1     | 0.8     |
| Mexican peso    | 13.6     |         | 11.5    |         |
| Total           | \$ 32.0  | \$ 67.7 | \$ 18.6 | \$ 58.4 |

*Commodity Futures Contracts*

In addition to entering into supply arrangements in the normal course of business, the Company also enters into futures contracts to fix the cost of certain raw material purchases, principally copper, with the objective of minimizing changes in cost due to market price fluctuations. The hedging strategy for achieving this objective is to purchase commodity futures contracts on the open market of the London Metals Exchange (LME) or over the counter contracts based on the LME. Additionally, steel futures contracts were purchased on the New York Metals Exchange (NYMEX).

With NYMEX, the Company is required to make cash deposits on unrealized losses on steel derivative contracts.

The minimal after-tax loss on the effective portion of the contracts as of June 30, 2015 was recorded in accumulated other comprehensive loss and will be reclassified into cost of products sold in the period in which the underlying transaction is recorded in earnings. The effective portion of the contracts will be reclassified within one year. Commodity hedges outstanding at June 30, 2015 involve a total of approximately 0.7 million pounds of copper. There were no steel futures contracts outstanding at June 30, 2015.

The impact of derivative contracts on the Company's financial statements is as follows:

**10. Derivative Instruments (continued)**

Fair value of derivatives designated as hedging instruments under ASC 815:

(dollars in millions)

|   | Balance Sheet Location | June 30,<br>2015 | December 31,<br>2014 |
|---|------------------------|------------------|----------------------|
| Foreign currency contracts                          | Other current assets   | \$ 5.5           | \$ 4.6               |
|   | Accrued liabilities    | (3.8)            | (3.0)                |
| Commodities contracts                               | Accrued liabilities    | (0.3)            | (0.2)                |
| Total derivatives designated as hedging instruments |                        | \$ 1.4           | \$ 1.4               |

The effect of derivatives designated as hedging instruments on the statement of earnings is as follows:

Three Months Ended June 30 (dollars in millions):

| Derivatives in             | Amount of gain (loss)<br>recognized in OCI<br>on<br>derivative<br>(effective<br>portion) |          | Location of<br>gain (loss)<br>reclassified<br>from<br>accumulated<br>OCI into<br>earnings<br>(effective<br>portion) | Amount of gain<br>(loss) reclassified<br>from<br>accumulated<br>OCI into<br>earnings<br>(effective<br>portion) |        | Location of<br>gain (loss)<br>recognized in<br>earnings on<br>derivative<br>(ineffective<br>portion) | Amount of<br>gain<br>(loss)<br>recognized<br>in earnings on<br>a<br>derivative<br>(ineffective<br>portion) |      |
|----------------------------|--|----------|---|--|--------|--|--|------|
|                            | 2015   | 2014     |   | 2015   | 2014   |  | 2015   | 2014 |
| Foreign currency contracts | \$ (0.8)   | \$ (1.9) | Cost of products sold   | \$ 1.2   | \$ 0.7 | N/A  | \$   | \$   |
| Commodities contracts      | (0.1)  | 0.3      | Cost of products sold   |  | 0.1    | Cost of products sold  | 0.1  |      |
|                            | \$ (0.9)   | \$ (1.6) |   | \$ 1.2   | \$ 0.8 |  | \$ 0.1   | \$   |

Six Months Ended June 30 (dollars in millions):

| Derivatives in | Amount of gain<br>(loss)<br>recognized in OCI<br>on<br>derivative<br>(effective<br>portion) |      | Location of<br>gain (loss)<br>reclassified<br>from<br>accumulated<br>OCI into<br>earnings<br>(effective<br>portion) | Amount of gain<br>(loss) reclassified<br>from<br>accumulated<br>OCI into<br>earnings<br>(effective<br>portion) |      | Location of<br>gain (loss)<br>recognized in<br>earnings on<br>derivative<br>(ineffective<br>portion) | Amount of<br>gain<br>(loss)<br>recognized<br>in earnings on<br>a<br>derivative<br>(ineffective<br>portion) |      |
|----------------|---|------|---|--|------|--|--|------|
|                | 2015  | 2014 |   | 2015   | 2014 |  | 2015   | 2014 |
| ASC 815 cash   |   |      |   |  |      |  |  |      |
| flow hedging   |   |      |   |  |      |  |  |      |
| relationships  |   |      |   |  |      |  |  |      |

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|                            |    |       |    |     |                       |    |       |    |     |                       |    |    |
|----------------------------|----|-------|----|-----|-----------------------|----|-------|----|-----|-----------------------|----|----|
| Foreign currency contracts | \$ | 2.7   | \$ | 0.8 | Cost of products sold | \$ | 2.7   | \$ | 1.8 | N/A                   | \$ | \$ |
| Commodities contracts      |    | (0.3) |    |     | Cost of products sold |    | (0.1) |    |     | Cost of products sold |    |    |
|                            | \$ | 2.4   | \$ | 0.8 |                       | \$ | 2.6   | \$ | 1.8 |                       | \$ | \$ |



**11. Income Taxes**

The effective tax rate for the three and six months ended June 30, 2015 was 31.1 percent and 30.4 percent, respectively. The Company estimates that its annual effective tax rate for the full year of 2015 will be approximately 30.5 percent. The full year effective tax rate in 2014 was 27.5 percent. The higher effective income tax rates in the second quarter and first six months of 2015 were primarily due to a change in geographic earnings mix. The 2014 effective rates were also impacted by a one-time tax benefit associated with a revised domestic manufacturers deduction from a prior year resulting in an increased income tax benefit on an amended prior year tax return filed in the second quarter of 2014.

As of June 30, 2015, the Company had \$1.6 million of unrecognized tax benefits of which \$1.2 million would affect its effective tax rate if recognized. The Company recognizes potential interest and penalties related to unrecognized tax benefits as a component of tax expense.

The U.S. federal tax returns for 2013-2014 are subject to audit. The Company is subject to state and local audits for tax years 2000-2014. The Company is also subject to non-U.S. income tax examinations for years 2006-2014.

**12. Changes in Accumulated Other Comprehensive Loss by Component**

Changes to accumulated other comprehensive loss by component are as follows:

(dollars in millions)

|  | Three Months Ended June 30, |                   |
|--|-----------------------------|-------------------|
|  | 2015                        | 2014              |
| <b>Cumulative foreign currency translation</b>   |                             |                   |
| Balance at beginning of period   | \$ (6.0)                    | \$ 9.5            |
| Other comprehensive (loss) gain before reclassifications   | (0.9)                       | 2.7               |
| Balance at end of period   | (6.9)                       | 12.2              |
| <b>Unrealized net gain on cash flow derivatives</b>  |                             |                   |
| Balance at beginning of period   | 2.1                         | 1.9               |
| Other comprehensive loss before reclassifications  | (0.5)                       | (1.1)             |
| Realized gains on derivatives reclassified to cost of products sold (net of tax provision of \$0.5 and \$0.3 in 2015 and 2014, respectively) | (0.7)                       | (0.4)             |
| Balance at end of period   | 0.9                         | 0.4               |
| <b>Pension liability</b>   |                             |                   |
| Balance at beginning of period   | (273.7)                     | (274.7)           |
| Other comprehensive loss before reclassifications  | 0.6                         | (2.1)             |
| Amounts reclassified from accumulated other comprehensive loss: <sup>(1)</sup>   | 3.1                         | 5.3               |
| Balance at end of period   | (270.0)                     | (271.5)           |
| <b>Accumulated other comprehensive loss, end of period</b>   | <b>\$ (276.0)</b>           | <b>\$ (258.9)</b> |

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(1) Amortization of pension items:

|                             |    |                      |    |                      |
|-----------------------------|----|----------------------|----|----------------------|
| Actuarial losses            | \$ | 5.3 <sup>(2)</sup>   | \$ | 8.7 <sup>(2)</sup>   |
| Prior year service cost     |    | (0.2) <sup>(2)</sup> |    | (0.2) <sup>(2)</sup> |
|                             |    | 5.1                  |    | 8.5                  |
| Tax benefit                 |    | (2.0)                |    | (3.2)                |
| Reclassification net of tax | \$ | 3.1                  | \$ | 5.3                  |

(2) These accumulated other comprehensive loss components are included in the computation of net periodic pension cost. See Note 7 - Pensions for additional details

**12. Changes in Accumulated Other Comprehensive Loss by Component (continued)**

Changes to accumulated other comprehensive loss by component are as follows:

(dollars in millions)

|  | Six Months Ended<br>June 30, |                        |
|--|------------------------------|------------------------|
|  | 2015                         | 2014                   |
| <b>Cumulative foreign currency translation</b>   |                              |                        |
| Balance at beginning of period   | \$ 3.3                       | \$ 19.9                |
| Other comprehensive loss before reclassifications  | (10.2)                       | (7.7)                  |
| Balance at end of period   | (6.9)                        | 12.2                   |
| <b>Unrealized net gain on cash flow derivatives</b>  |                              |                        |
| Balance at beginning of period   | 0.9                          | 1.0                    |
| Other comprehensive gain before reclassifications  | 1.6                          | 0.5                    |
| Realized gains on derivatives reclassified to cost of products sold (net of tax provision of \$1.0 and \$0.7 in 2015 and 2014, respectively) | (1.6)                        | (1.1)                  |
| Balance at end of period   | 0.9                          | 0.4                    |
| <b>Pension liability</b>   |                              |                        |
| Balance at beginning of period   | (276.2)                      | (280.0)                |
| Other comprehensive loss before reclassifications  | 0.7                          | (2.1)                  |
| Amounts reclassified from accumulated other comprehensive loss: <sup>(1)</sup>   | 5.5                          | 10.6                   |
| Balance at end of period   | (270.0)                      | (271.5)                |
| <b>Accumulated other comprehensive loss, end of period</b>   | <b>\$ (276.0)</b>            | <b>\$ (258.9)</b>      |
| <sup>(1)</sup> Amortization of pension items:  |                              |                        |
| Actuarial losses   | \$ 9.5 <sup>(2)</sup>        | \$ 17.6 <sup>(2)</sup> |
| Prior year service cost  | (0.5) <sup>(2)</sup>         | (0.5) <sup>(2)</sup>   |
|  | 9.0                          | 17.1                   |
| Tax benefit  | (3.5)                        | (6.5)                  |
| <b>Reclassification net of tax</b>   | <b>\$ 5.5</b>                | <b>\$ 10.6</b>         |

<sup>(2)</sup> These accumulated other comprehensive loss components are included in the computation of net periodic pension cost. See Note 7 - Pensions for additional details

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## **PART I - FINANCIAL INFORMATION**

### **ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

#### **OVERVIEW**

Our Company is comprised of two reporting segments: North America and Rest of World. Our Rest of World segment is primarily comprised of China, Europe and India. Both segments manufacture and market comprehensive lines of residential and commercial gas, gas tankless and electric water heaters. Both segments primarily manufacture and market in their respective region of the world. Our North America segment also manufactures and globally markets specialty commercial water heating equipment, condensing and non-condensing boilers and water systems tanks. Our Rest of World segment also manufactures and markets water treatment products and markets air purifier products, primarily for Asia.

Sales in our North America segment grew approximately eight percent in the second quarter of 2015 driven by a price increase effective in April for both commercial and residential water heaters in the U.S., as well as higher sales of Lochinvar-branded products. New government regulations under the National Appliance Energy Conservation Act that mandate increasing the minimum energy efficiency standards for residential water heaters in the U.S., commonly referred to as NAECA III, went into effect on April 16, 2015. Compliance with the regulations caused an increase in our cost to manufacture our products. This resulted in price increases associated with NAECA III products. Our NAECA III transition was completed in the second quarter of 2015. We expect the residential water heater industry's unit shipments to be approximately two percent higher in 2015 compared to 2014 due to an improving construction market and expanded replacement demand. We continue to see strength in U.S. commercial water heater volumes, and we expect the industry's unit shipments will be approximately four percent higher than last year. Driven by a transition in the boiler industry from non-condensing boilers to condensing boilers as well as new product introductions, we expect sales of Lochinvar-branded products to grow approximately ten percent in 2015.

Sales in our Rest of World segment grew approximately 14 percent in the second quarter of 2015, primarily as a result of 15 percent growth in sales in China. We expect sales in China to grow at a rate of approximately two times the rate of growth in China's gross domestic product (GDP) driven by expected continued overall water heater market growth, market share gains, improved product mix and water treatment product growth significantly higher than two times GDP growth.

#### **RESULTS OF OPERATIONS**

##### **SECOND QUARTER AND FIRST SIX MONTHS OF 2015 COMPARED TO 2014**

Sales for the second quarter of 2015 were \$653.5 million or approximately ten percent higher than sales of \$595.4 million in the second quarter of 2014. Sales in the first six months of 2015 increased to \$1,272.0 million from \$1,147.6 million in the same period last year. The increase in sales in both the second quarter and first six months of 2015 is primarily due to higher prices in North America, higher sales of Lochinvar-branded products and higher sales of water heaters and water treatment products in China. Sales in China grew 15 percent in both the second quarter and first six months of 2015 as compared to the same periods of 2014. The first six months of 2015 also benefitted from higher volumes of water heaters in the U.S.

Gross profit margin in the second quarter of 2015 of 40.3 percent was higher than the gross profit margin of 36.3 percent in the second quarter of 2014. Gross profit margin in the first six months of 2015 increased to 38.7 percent from 35.9 percent in the first six months of 2014. Margins in the second quarter of 2015 and first six months of 2015 benefitted from price increases in the U.S. and Canada, higher boilers sales and a reduction in pension related costs.

Margins in the second quarter of 2015 also benefitted from lower steel costs.

Selling, general and administrative (SG&A) expenses in the second quarter and first six months of 2015 increased by \$22.9 million and \$39.2 million, respectively, as compared to the same periods last year. The increase in SG&A expenses in both periods in 2015 was primarily due to higher selling, advertising and engineering costs in support of increased volumes in China and expected higher incremental enterprise resource planning (ERP) implementation costs.

Interest expense in the second quarter of 2015 was \$2.5 million compared to \$1.4 million in the same period last year. Interest expense in the first six months of 2015 was \$4.4 million compared to \$2.8 million in the same period last year. The increase in interest expense in the second quarter and first six months of 2015 was primarily related to interest rates on term debt issued in January 2015 that are higher than the interest rate on the revolving credit facility that it replaced as well as higher overall debt levels primarily related to share repurchases.

Other income was \$2.7 million in the second quarter of 2015, up from \$1.2 million in the same period last year. Other income in the first six months of 2015 was \$5.4 million, up from \$2.5 million in the first six months of 2014. The increase in other income in the second quarter and first six months of 2015 was primarily due to increased interest income as compared to the same periods last year.

Our pension costs and credits are developed from actuarial valuations. The valuations reflect key assumptions regarding, among other things, discount rates, expected return on assets, retirement ages, and years of service. We consider current market conditions including changes in interest rates in making these assumptions. Our assumption for the expected rate of return on plan assets is 7.75 percent in 2015, consistent with 2014. The discount rate used to determine net periodic pension costs decreased to 4.05 percent in 2015 from 4.85 percent in 2014. Pension expense for the first six months of 2015 was minimal compared to \$13.2 million in the first six months of 2014. The significant decrease in pension expense in the first six months of 2015 compared to the same period last year was due to the sunset of the plan for the majority of our employees on December 31, 2014. Beginning in 2015, we are making additional Company contributions to a defined contribution plan in lieu of benefits earned in our pension plan. Our pension costs are reflected in cost of products sold and SG&A expense.

Our effective tax rates for the second quarter and first six months of 2015 were 31.1 percent and 30.4 percent, respectively. Our effective tax rates for the second quarter and first six months of 2014 were 27.1 percent and 27.5 percent, respectively. The higher effective tax rates in both periods of 2015 were primarily due to a change in geographic earnings mix as compared to the same periods in the prior year. The 2014 effective tax rates were also impacted by a one-time tax benefit associated with a revised domestic manufacturers' deduction from a prior year resulting in an increased income tax benefit on an amended prior year tax return filed in the second quarter of 2014.

#### *North America*

Sales in the North America segment were \$442.7 million in the second quarter of 2015 or \$32.6 million higher than sales of \$410.1 million in the second quarter of 2014. Sales for the first six months of 2015 were \$871.9 million or \$73.3 million higher than sales of \$798.6 million in the same period last year. The increased sales in the second quarter and first six months of 2015 were primarily due to higher prices in North America as well as higher sales of Lochinvar-branded products. The increased sales in the first six months of 2015 also benefitted from higher volumes of water heaters in the U.S.

North America operating earnings were \$86.0 million in the second quarter of 2015 or approximately 36 percent higher than earnings of \$63.2 million in the same period of 2014. Operating earnings in the first six months of 2015 were \$157.2 million or approximately 33 percent higher than operating earnings of \$118.5 million in the first six months of 2014. Operating margin of 19.4 percent in the second quarter of 2015 was higher than 15.4 percent in the same period last year. Operating margin of 18.0 percent in the first six months of 2015 was higher than 14.8 percent in the same period in 2014. The higher operating earnings and operating margins in both periods of 2015 were primarily due to higher water heater prices, increased volumes of boilers in the U.S. and lower pension related costs that were partially offset by expected higher ERP implementation costs. In addition, the second quarter operating earnings and operating margins benefitted from lower steel costs.

### *Rest of World*

Sales in the Rest of World segment were \$221.3 million in the second quarter of 2015 or \$27.7 million higher than sales of \$193.6 million in the second quarter of 2014. Sales in the first six months of 2015 were \$417.2 million or \$50.8 million higher than sales of \$366.4 million in the first six months of 2014. Sales of water heaters and water treatment products in China grew 15 percent in both the second quarter and first six months of 2015 as compared to the same periods in 2014.

Rest of World operating earnings were \$30.9 million in the second quarter of 2015 or approximately five percent higher than operating earnings of \$29.3 million in the second quarter of 2014. Operating earnings in the first six months of 2015 were \$57.1 million, approximately five percent higher than operating earnings of \$54.4 million in the first six months of 2014. The higher operating earnings in the second quarter and first six months of 2015 were primarily due to higher profits in China. The 2015 second quarter operating margin of 14.0 percent was lower than the operating margin of 15.1 percent in the same period last year. Operating margin of 13.7 percent in the first six months of 2015 was lower than the operating margin of 14.8 percent in the same period last year. Operating margins in both the second quarter and first six months of 2015 were lower than the same periods last year primarily due to higher selling, advertising and engineering costs as a percentage of sales in China, including promotion related to the new air purifier products, and higher costs in India to support the launch of water treatment products.

### **Outlook**

We continue to expect improvement in residential and commercial water heater demand in the U.S. compared to last year, as well as continued lower material costs. We expect Lochinvar-branded sales to grow approximately ten percent in 2015, well ahead of GDP growth in the U.S., as we expect the Lochinvar brand to continue to benefit from a transition from lower efficiency, non-condensing boilers to high efficiency, condensing boilers. We expect sales in China to grow at twice the rate of China's GDP growth in 2015. We estimate our organic worldwide revenue growth will be approximately 11 percent in 2015. Given these factors, we have increased our guidance for 2015. We believe A. O. Smith Corporation will achieve full-year GAAP earnings of between \$3.04 and \$3.09 per share. These estimates do not include the potential impact from future acquisitions.

### **Liquidity & Capital Resources**

Working capital of \$820.9 million at June 30, 2015 was \$107.1 million higher than at December 31, 2014 primarily due to higher inventory balances, sales-related increases in accounts receivable in the U.S., and lower accounts payable balances, primarily in China. As of June 30, 2015, all of the \$552.4 million of cash, cash equivalents and marketable securities was held by our foreign subsidiaries. We would incur a cost to repatriate these funds to the U.S. and have accrued \$50.7 million for the repatriation of a portion of these funds.





Cash provided by continuing operating activities in the first six months of 2015 was \$58.8 million compared with \$90.9 million of cash provided by continuing operations during the same period last year. Higher earnings were more than offset by larger outlays for working capital in the 2015 period. For the full year 2015, we expect total cash provided by continuing operating activities to be approximately \$300 million.

Capital expenditures totaled \$31.0 million in the first six months of 2015, compared with \$50.8 million spent in the year ago period. We are projecting 2015 capital expenditures between \$100 million to \$110 million, including approximately \$20 million to support our ERP implementation and approximately \$30 million related to capacity expansion in China and in the U.S., with the U.S. portion in support of Lochinvar-branded sales. We expect full year depreciation and amortization to be approximately \$65 million.

In December 2012, we completed a \$400 million multi-currency credit facility with a group of eight banks which expires in December 2017. The facility has an accordion provision which allows it to be increased up to \$500 million if certain conditions (including lender approval) are satisfied. Borrowing rates under the facility are determined by our leverage ratio. The facility requires us to maintain two financial covenants, a leverage ratio test and an interest coverage test, and we were in compliance with the covenants as of June 30, 2015.

The facility backs up commercial paper and credit line borrowings. As a result of the long-term nature of this facility, our commercial paper and credit line borrowings, as well as drawings under the facility, are classified as long-term debt. At June 30, 2015, we had available borrowing capacity of \$226.6 million under this facility. We believe the combination of available borrowing capacity and operating cash flow will provide sufficient funds to finance our existing operations for the foreseeable future.

In January 2015, we issued \$75 million of fixed rate term notes to an insurance company. Principal payments commence in 2020 and the notes mature in 2030. The notes have an interest rate of 3.52 percent. We used proceeds of the notes to pay down borrowings under our revolving credit facility.

Our total debt increased \$55.8 million from \$223.8 million at December 31, 2014 to \$279.6 million at June 30, 2015. Our leverage, as measured by the ratio of total debt to total capitalization, was 16.3 percent at the end of the second quarter in 2015, compared with 13.9 percent at the end of last year.

Our pension plan continues to meet all funding requirements under ERISA regulations. We forecast that we will not be required to make a contribution to the plan in 2015, and we do not plan to make any voluntary contributions to the plan in 2015.

In 2014, our Board of Directors approved adding 3,500,000 shares of common stock to an existing discretionary share repurchase authority. Under the share repurchase program, our common stock may be purchased through a combination of Rule 10b5-1 automatic trading plan and discretionary purchases in accordance with applicable securities laws. The stock repurchase authorization remains effective until terminated by our Board of Directors which may occur at any time, subject to the parameters of any Rule 10b5-1 automatic trading plan that we may then have in effect. During the first six months of 2015, we repurchased 728,787 shares of our stock at a total cost of \$47.3 million. A total of 1,769,206 shares remained of the existing repurchase authority at June 30, 2015.

Depending on factors such as stock price, working capital requirements and alternative investment opportunities, we now anticipate spending approximately \$125 million on stock repurchase activity in 2015.

On July 13, 2015, our Board of Directors declared a regular cash dividend of \$.19 per share on our Common Stock and Class A common stock. The dividend is payable on August 17, 2015 to shareholders of record on July 31, 2015.

### **Critical Accounting Policies**

The preparation of our consolidated financial statements is in conformity with accounting principles generally accepted in the U.S. which requires the use of estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements. The critical accounting policies that we believe could have the most significant effect on our reported results or require complex judgment by management are contained in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of our Annual Report on Form 10-K for the year ended December 31, 2014. We believe that as of June 30, 2015 there has been no material change to this information.

### **Recent Accounting Pronouncements**

In April 2015, the Financial Accounting Standards Board (FASB) amended Accounting Standard Codification (ASC) 835-30, *Interest - Imputation of Interest* (issued under Accounting Standards No. 2015-03). This amendment to ASC 835-30 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs is not affected by this amendment. The amendment is effective for the year beginning January 1, 2016 and requires using a retrospective approach. We do not expect the adoption of amended ASC 835-30 will have a material impact on our consolidated financial condition, results of operations or cash flows.

In May 2014, the FASB issued ASC 606-10, *Revenue from Contracts with Customers* (issued under Accounting Standards No. 2014-09). ASC 606-10 will replace all existing revenue recognition guidance when effective. On July 9, 2015, the FASB approved a one year deferral of the effective date, with application permitted as of the original effective date which is periods beginning January 1, 2017. Either full retrospective adoption or modified retrospective adoption is allowed under ASC 606-10. We are in the process of determining whether the adoption of ASC 606-10 will have an impact on our consolidated financial condition, results of operations or cash flows.

### **ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As is more fully described in our Annual Report on Form 10-K for the year ended December 31, 2014, we are exposed to various types of market risks, including currency and certain commodity risks. Our quantitative and qualitative disclosures about market risk have not materially changed since that report was filed. We monitor our currency and commodity risks on a continuous basis and generally enter into forward and futures contracts to minimize these exposures. The majority of the contracts are for periods of less than one year. We do not engage in speculation in our derivative strategies. It is important to note that gains and losses from our forward and futures contract activities are offset by changes in the underlying costs of the transactions being hedged.

## **ITEM 4 - CONTROLS AND PROCEDURES**

### **Evaluation of disclosure controls and procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the principal executive officer and principal financial officer concluded that the disclosure controls and procedures were effective as of June 30, 2015 to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time period specified in the SEC rules and forms, and to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.

### **Changes in internal control over financial reporting**

In the second quarter of 2015, we completed a significant implementation phase of our global enterprise resource planning system. This multi-year initiative is being conducted in phases and includes modifications to the design and operation of controls over financial reporting. We are testing internal controls over financial reporting for design effectiveness prior to implementation of each phase, and we have monitoring controls in place over the implementation of these changes.

Except as described above, there have been no other changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities and Exchange Act) during the quarter ended June 30, 2015 that have materially affected, or are reasonable likely to materially affect, our internal control over financial reporting.

### **Forward Looking Statements**

This filing contains statements that we believe are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally can be identified by the use of words such as may, will, expect, intend, estimate, anticipate, believe, forecast, guidance or words of similar statements regarding 2015 outlook are forward-looking statements. All forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated as of the date of this filing. Important factors that could cause actual results to differ materially from these expectations include, among other things, the following: uncertain costs, savings and timeframes associated with the implementation of the new enterprise resource planning system; potential weakening in the high efficiency boiler segment in the U.S.; the ability to execute our acquisition strategy; significant volatility in raw material prices; competitive pressures on our businesses; inability to implement and maintain pricing actions; instability in our replacement markets; strength or duration of any recoveries in U.S. residential or commercial construction; a further slowdown in the growth of the Chinese economy; foreign currency fluctuations; and adverse general economic conditions and capital market deterioration in the U.S., Canada or China.

Forward-looking statements included in this filing are made only as of the date of this filing, and we are under no obligation to update these statements to reflect subsequent events or circumstances. All subsequent written and oral forward-looking statements attributed to us, or persons acting on our behalf, are qualified entirely by these cautionary statements.



**PART II - OTHER INFORMATION****ITEM 1 - LEGAL PROCEEDINGS**

There have been no material changes in the legal and environmental matters discussed in Part 1, Item 3 and Note 15 of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2014.

**ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In 2014, our board of directors approved adding 3,500,000 shares of Common Stock to an existing discretionary share repurchase authority. Under the share repurchase program, the Common Stock may be purchased through a combination of Rule 10b5-1 automatic trading plan and discretionary purchases in accordance with applicable securities laws. The number of shares purchased and the timing of the purchases will depend on a number of factors, including share price, trading volume and general market conditions, as well as working capital requirements, general business conditions and other factors, including alternative investment opportunities. The stock repurchase authorization remains effective until terminated by our Board of Directors which may occur at any time, subject to the parameters of any Rule 10b5-1 automatic trading plan that we may then have in effect. In the second quarter of 2015, we repurchased 395,754 shares at an average price of \$67.42 per share and at a total cost of \$26.7 million. As of June 30, 2015, there were 1,769,206 shares remaining on the existing repurchase authority.

**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period  |                | (a) Total<br>Number of<br>Shares<br>Purchased | (b) Average<br>Price<br>Paid<br>per Share | (c) Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced<br>Plans<br>or Programs | (d) Maximum<br>Number of Shares<br>that may yet be<br>Purchased Under the<br>Plans or<br>Programs |
|---------|----------------|---|---|---|---|
| April 1 | April 30, 2015 | 165,200                                       | \$ 65.30                                  | 165,200   | 1,999,760   |
| May 1   | May 31, 2015   | 147,700                                       | 67.64                                     | 147,700   | 1,852,060   |
| June 1  | June, 2015     | 82,854  | 71.26                                     | 82,854  | 1,769,206   |

**ITEM 5 - OTHER INFORMATION**

None.

**ITEM 6 - EXHIBITS**

Refer to the Exhibit Index on page 25 of this report.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has authorized this report to be signed on its behalf by the undersigned.

**A. O. SMITH CORPORATION**

August 10, 2015

/s/ Daniel L. Kempken  
Daniel L. Kempken  
Vice President and Controller

August 10, 2015

/s/ John J. Kita  
John J. Kita  
Executive Vice President and Chief Financial Officer

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**INDEX TO EXHIBITS**

| Exhibit<br>Number | Description   |
|-------------------|---|
| 10.1              | Summary of Directors Compensation   |
| 31.1              | Certification of Periodic Report by the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.  |
| 31.2              | Certification of Periodic Report by the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.  |
| 32.1              | Written Statement of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350   |
| 32.2              | Written Statement of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350   |
| 101               | The following materials from A. O. Smith Corporation's Quarterly Report on Form 10-Q for the six months ended June 30, 2015 are filed herewith, formatted in XBRL (Extensive Business Reporting Language): (i) the Condensed Consolidated Statements of Earnings for the three and six months ended June 30, 2015 and 2014, (ii) the Condensed Consolidated Statements of Comprehensive Earnings for the three and six months ended June 30, 2015 and 2014, (iii) the Condensed Consolidated Balance Sheets as of June 30, 2015, and December 31, 2015, (iv) the Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2015 and 2014 (v) the Notes to Condensed Consolidated Financial Statements |