WATERS CORP /DE/
Form 10-Q
August 04, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 1, 2017

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: 01-14010

Waters Corporation

(Exact name of registrant as specified in its charter)

Delaware	**13-3668640**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

34 Maple Street

Milford, Massachusetts 01757

(Address, including zip code, of principal executive offices)

(508) 478-2000

(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, smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if smaller reporting company)	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

Indicate the number of shares outstanding of the registrant s common stock as of July 28, 2017: 79,823,570

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WATERS CORPORATION AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

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WATERS CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

	July 1, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 567,255	$ 505,631
Investments	2,558,691	2,307,401
Accounts receivable, less allowances for doubtful accounts and sales returns of $9,585 and $8,657 at July 1, 2017 and December 31, 2016, respectively	462,811	489,340
Inventories	287,139	262,682
Other current assets	71,339	70,391
Total current assets	3,947,235	3,635,445
Property, plant and equipment, net	338,860	337,118
Intangible assets, net	219,092	207,055
Goodwill	357,122	352,080
Other assets	134,436	130,361
Total assets	$ 4,996,745	$ 4,662,059
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and debt	$ 225,233	$ 125,297
Accounts payable	71,055	67,740
Accrued employee compensation	34,140	57,465
Deferred revenue and customer advances	208,606	148,837
Accrued income taxes	1,405	15,244
Accrued warranty	12,864	13,391
Other current liabilities	99,986	92,347
Total current liabilities	653,289	520,321
Long-term liabilities:		
Long-term debt	1,687,233	1,701,966
Long-term portion of retirement benefits	72,381	72,568
Long-term income tax liabilities	8,682	10,458
Other long-term liabilities	56,521	54,797
Total long-term liabilities	1,824,817	1,839,789
Total liabilities	2,478,106	2,360,110

Commitments and contingencies (Notes 5, 6, 7 and 11)		
Stockholders equity:		
Preferred stock, par value $0.01 per share, 5,000 shares authorized, none issued at July 1, 2017 and December 31, 2016		
Common stock, par value $0.01 per share, 400,000 shares authorized, 159,437 and 158,634 shares issued, 79,811 and 80,023 shares outstanding at July 1, 2017 and December 31, 2016, respectively	1,594	1,586
Additional paid-in capital	1,683,873	1,607,241
Retained earnings	5,622,448	5,385,069
Treasury stock, at cost, 79,626 and 78,611 shares at July 1, 2017 and December 31, 2016, respectively	(4,641,501)	(4,475,667)
Accumulated other comprehensive loss	(147,775)	(216,280)
Total stockholders equity	2,518,639	2,301,949
Total liabilities and stockholders equity	$ 4,996,745	$ 4,662,059

The accompanying notes are an integral part of the interim consolidated financial statements.

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WATERS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

	Three Months Ended	
	July 1, 2017	July 2, 2016
Revenues:		
Product sales	$ 372,838	$ 359,687
Service sales	185,412	176,873
Total net sales	558,250	536,560
Costs and operating expenses:		
Cost of product sales	148,023	144,814
Cost of service sales	81,604	75,565
Selling and administrative expenses	130,190	129,581
Research and development expenses	32,937	32,578
Litigation provisions	10,018	
Purchased intangibles amortization	1,693	2,411
Total costs and operating expenses	404,465	384,949
Operating income	153,785	151,611
Interest expense	(14,083)	(10,983)
Interest income	8,370	4,827
Income from operations before income taxes	148,072	145,455
Provision for income taxes	16,250	17,238
Net income	$ 131,822	$ 128,217
Net income per basic common share	$ 1.65	$ 1.59
Weighted-average number of basic common shares	79,979	80,804
Net income per diluted common share	$ 1.63	$ 1.57
Weighted-average number of diluted common shares and equivalents	80,756	81,455

The accompanying notes are an integral part of the interim consolidated financial statements.

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WATERS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

	Six Months Ended	
	July 1, 2017	July 2, 2016
Revenues:		
Product sales	$ 697,134	$ 667,544
Service sales	359,085	344,262
Total net sales	1,056,219	1,011,806
Costs and operating expenses:		
Cost of product sales	281,179	274,072
Cost of service sales	159,543	147,458
Selling and administrative expenses	260,714	258,932
Research and development expenses	63,689	62,016
Litigation provisions	10,018	
Acquired in-process research and development	5,000	
Purchased intangibles amortization	3,422	5,055
Total costs and operating expenses	783,565	747,533
Operating income	272,654	264,273
Interest expense	(26,808)	(21,102)
Interest income	15,713	8,914
Income from operations before income taxes	261,559	252,085
Provision for income taxes	24,180	29,816
Net income	$ 237,379	$ 222,269
Net income per basic common share	$ 2.97	$ 2.74
Weighted-average number of basic common shares	80,029	81,043
Net income per diluted common share	$ 2.94	$ 2.72
Weighted-average number of diluted common shares and equivalents	80,769	81,663

The accompanying notes are an integral part of the interim consolidated financial statements.

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WATERS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(IN THOUSANDS)

(unaudited)

	Three Months Ended		Six Months Ended	
	July 1, 2017	**July 2, 2016**	**July 1, 2017**	**July 2, 2016**
Net income	$ 131,822	$ 128,217	$ 237,379	$ 222,269
Other comprehensive income (loss):				
Foreign currency translation	38,241	(31,485)	67,382	(15,434)
Unrealized gains on investments before income taxes	794	1,881	1,382	5,170
Income tax expense	(77)	(76)	(99)	(169)
Unrealized gains on investments, net of tax	717	1,805	1,283	5,001
Retirement liability adjustment before reclassifications	(1,075)	501	(1,531)	(499)
Amounts reclassified to selling and administrative expenses	922	810	1,758	1,620
Retirement liability adjustment before income taxes	(153)	1,311	227	1,121
Income tax expense	(43)	(613)	(387)	(891)
Retirement liability adjustment, net of tax	(196)	698	(160)	230
Other comprehensive income (loss)	38,762	(28,982)	68,505	(10,203)
Comprehensive income	$ 170,584	$ 99,235	$ 305,884	$ 212,066

The accompanying notes are an integral part of the interim consolidated financial statements.

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WATERS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

(unaudited)

	Six Months Ended	
	July 1, 2017	**July 2, 2016**
Cash flows from operating activities:		
Net income	$ 237,379	$ 222,269
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation	17,794	24,237
Deferred income taxes	5,208	637
Depreciation	30,796	26,055
Amortization of intangibles	21,609	22,022
Excess tax benefit related to stock-based compensation plans		3,517
In-process research and development charge	5,000	
Change in operating assets and liabilities:		
Decrease in accounts receivable	41,945	32,318
Increase in inventories	(19,169)	(25,003)
(Increase) decrease in other current assets	(9,253)	2,812
Increase in other assets	(1,154)	(3,517)
Decrease in accounts payable and other current liabilities	(34,802)	(41,100)
Increase in deferred revenue and customer advances	53,601	46,801
Increase in other liabilities	2,306	9,374
Net cash provided by operating activities	351,260	320,422
Cash flows from investing activities:		
Additions to property, plant, equipment and software capitalization	(35,358)	(49,696)
Investment in unaffiliated company	(7,000)	
Payments for intellectual property licenses	(5,000)	
Purchases of investments	(1,554,769)	(1,205,035)
Maturities and sales of investments	1,308,275	987,060
Net cash used in investing activities	(293,852)	(267,671)
Cash flows from financing activities:		
Proceeds from debt issuances	85,000	400,177
Payments on debt	(64)	(310,239)
Payments of debt issuance costs		(1,705)
Proceeds from stock plans	58,182	23,272
Purchases of treasury shares	(165,834)	(172,392)
Proceeds from (payments for) derivative contracts	430	(7,531)

Net cash used in financing activities	(22,286)	(68,418)
Effect of exchange rate changes on cash and cash equivalents	26,502	(8,616)
Increase (decrease) in cash and cash equivalents	61,624	(24,283)
Cash and cash equivalents at beginning of period	505,631	487,665
Cash and cash equivalents at end of period	$ 567,255	$ 463,382

The accompanying notes are an integral part of the interim consolidated financial statements.

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WATERS CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1 Basis of Presentation and Summary of Significant Accounting Policies

Waters Corporation (the Company) is a specialty measurement company that has pioneered chromatography, mass spectrometry and thermal analysis innovations serving the life, materials and food sciences for nearly 60 years. The Company primarily designs, manufactures, sells and services high performance liquid chromatography (HPLC), ultra performance liquid chromatography (UPLC® and together with HPLC, referred to as LC) and mass spectrometry (MS) technology systems and support products, including chromatography columns, other consumable products and comprehensive post-warranty service plans. These systems are complementary products that are frequently employed together (LC-MS) and sold as integrated instrument systems using a common software platform. LC is a standard technique and is utilized in a broad range of industries to detect, identify, monitor and measure the chemical, physical and biological composition of materials, and to purify a full range of compounds. MS instruments are used in drug discovery and development, including clinical trial testing, the analysis of proteins in disease processes (known as proteomics), nutritional safety analysis and environmental testing. LC-MS instruments combine a liquid phase sample introduction and separation system with mass spectrometric compound identification and quantification. In addition, the Company designs, manufactures, sells and services thermal analysis, rheometry and calorimetry instruments through its TA® product line. These instruments are used in predicting the suitability and stability of fine chemicals, pharmaceuticals, water, polymers, metals and viscous liquids for various industrial, consumer goods and healthcare products, as well as for life science research. The Company is also a developer and supplier of software-based products that interface with the Company s instruments, as well as other suppliers instruments, and are typically purchased by customers as part of the instrument system.

The Company s interim fiscal quarter typically ends on the thirteenth Saturday of each quarter. Since the Company s fiscal year end is December 31, the first and fourth fiscal quarters may have more or less than thirteen complete weeks. The Company s second fiscal quarters for 2017 and 2016 ended on July 1, 2017 and July 2, 2016, respectively.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with the instructions to the Quarterly Report on Form 10-Q and do not include all of the information and note disclosures required by generally accepted accounting principles (GAAP) in the United States of America. The consolidated financial statements include the accounts of the Company and its subsidiaries, which are wholly owned. All inter-company balances and transactions have been eliminated.

The preparation of consolidated financial statements in conformity with GAAP requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities at the dates of the financial statements. Actual amounts may differ from these estimates under different assumptions or conditions.

It is management s opinion that the accompanying interim consolidated financial statements reflect all adjustments (which are normal and recurring) that are necessary for a fair statement of the results for the interim periods. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the U.S. Securities and Exchange Commission on February 24, 2017.

Translation of Foreign Currencies

For most of the Company s foreign operations, assets and liabilities are translated into U.S. dollars at exchange rates prevailing on the balance sheet date, while revenues and expenses are translated at average exchange rates prevailing during the period. Any resulting translation gains or losses are included in accumulated other comprehensive income in the consolidated balance sheets. The functional currency of each of the Company s foreign operating subsidiaries is the local currency of that particular country, except for the Company s subsidiaries in Hong Kong, Singapore and the Cayman Islands, where the underlying transactional cash flows are denominated in currencies other than the respective local currency of domicile. The functional currency of the Hong Kong, Singapore and Cayman Islands subsidiaries is the U.S. dollar, based on the respective entity s cash flows.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

Cash, Cash Equivalents and Investments

Cash equivalents represent highly liquid investments, with original maturities of 90 days or less, while investments with longer maturities are classified as investments. The Company maintains cash balances in various operating accounts in excess of federally insured limits, and in foreign subsidiary accounts in currencies other than the U.S. dollar. As of July 1, 2017 and December 31, 2016, $3,081 million out of $3,126 million and $2,766 million out of $2,813 million, respectively, of the Company s total cash, cash equivalents and investments were held by foreign subsidiaries and may be subject to material tax effects on distribution to U.S. legal entities. In addition, $316 million out of $3,126 million and $261 million out of $2,813 million of cash, cash equivalents and investments were held in currencies other than the U.S. dollar at July 1, 2017 and December 31, 2016, respectively.

Other Investments

During the six months ended July 1, 2017, the Company made a $7 million investment in a developer of analytical system solutions used to make measurements, predict stability and accelerate product discovery in the routine analytic, process monitoring and quality control release processes for life science and biopharmaceutical markets. This investment will be accounted for under the cost method of accounting.

Fair Value Measurements

In accordance with the accounting standards for fair value measurements and disclosures, certain of the Company s assets and liabilities are measured at fair value on a recurring basis as of July 1, 2017 and December 31, 2016. Fair values determined by Level 1 inputs utilize observable data, such as quoted prices in active markets. Fair values determined by Level 2 inputs utilize data points other than quoted prices in active markets that are observable either directly or indirectly. Fair values determined by Level 3 inputs utilize unobservable data points for which there is little or no market data, which require the reporting entity to develop its own assumptions.

The following table represents the Company s assets and liabilities that are measured at fair value on a recurring basis at July 1, 2017 (in thousands):

	Total at July 1, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
U.S. Treasury securities	$ 626,587	$	$ 626,587	$
Foreign government securities	6,969		6,969	
Corporate debt securities	1,795,051		1,795,051	
Time deposits	295,845		295,845	

Equity securities	147		147	
Waters 401(k) Restoration Plan assets	32,200	32,200		
Foreign currency exchange contracts	1,418		1,418	
Total	$ 2,758,217	$ 32,200	$ 2,726,017	$
Liabilities:				
Contingent consideration	$ 3,014	$	$	$ 3,014
Foreign currency exchange contracts	11		11	
Total	$ 3,025	$	$ 11	$ 3,014

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

The following table represents the Company s assets and liabilities that are measured at fair value on a recurring basis at December 31, 2016 (in thousands):

	Total at December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
U.S. Treasury securities	$ 570,313	$	$ 570,313	$
Foreign government securities	17,991		17,991	
Corporate debt securities	1,643,838		1,643,838	
Time deposits	199,906		199,906	
Equity securities	147		147	
Waters 401(k) Restoration Plan assets	30,954	30,954		
Foreign currency exchange contracts	60		60	
Total	$ 2,463,209	$ 30,954	$ 2,432,255	$
Liabilities:				
Contingent consideration	$ 3,007	$	$	$ 3,007
Foreign currency exchange contracts	730		730	
Total	$ 3,737	$	$ 730	$ 3,007

Fair Value of 401(k) Restoration Plan Assets

The 401(k) Restoration Plan is a nonqualified defined contribution plan and the assets were held in registered mutual funds and have been classified as Level 1. The fair values of the assets in this plan are determined through market and observable sources from daily quoted prices on nationally recognized securities exchanges.

Fair Value of Cash Equivalents, Investment and Foreign Currency Exchange Contracts

The fair values of the Company s cash equivalents, investments and foreign currency exchange contracts are determined through market and observable sources and have been classified as Level 2. These assets and liabilities have been initially valued at the transaction price and subsequently valued, typically utilizing third-party pricing services. The pricing services use many inputs to determine value, including reportable trades, benchmark yields, credit spreads, broker/dealer quotes, current spot rates and other industry and economic events. The Company validates the prices provided by third-party pricing services by reviewing their pricing methods and obtaining market values from other pricing sources. After completing these validation procedures, the Company did not adjust or override any fair value measurements provided by third-party pricing services as of July 1, 2017 and December 31, 2016. There were no transfers between the levels of the fair value hierarchy during the six months ended July 1, 2017.

Fair Value of Contingent Consideration

The fair value of the Company s liability for contingent consideration relates to the July 2014 acquisition of Medimass Research, Development and Service Kft. and is determined using a probability-weighted discounted cash flow model, which uses significant unobservable inputs, and has been classified as Level 3. Subsequent changes in the fair value of the contingent consideration liability are recorded in the results of operations. The fair value of the contingent consideration liability associated with future earnout payments is based on several factors, including the estimated future results and a discount rate that reflects both the likelihood of achieving the estimated future results and the Company s creditworthiness. A change in any of these unobservable inputs can significantly change the fair value of the contingent consideration. Although there is no contractual limit, the fair value of future contingent consideration payments was estimated to be $3 million at both July 1, 2017 and December 31, 2016, based on the Company s best estimate, as the earnout is based on future sales of certain products, some of which are currently in development, through 2034. There have been no changes in significant assumptions since December 31, 2016 and the change in fair value since then is primarily due to change in time value of money.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

Fair Value of Other Financial Instruments

The Company s cash, accounts receivable, accounts payable and variable interest rate debt are recorded at cost, which approximates fair value due to their short-term nature. The carrying value of the Company s fixed interest rate debt was $610 million at both July 1, 2017 and December 31, 2016. The fair value of the Company s fixed interest rate debt was estimated using discounted cash flow models, based on estimated current rates offered for similar debt under current market conditions for the Company. The fair value of the Company s fixed interest rate debt was estimated to be $609 million and $603 million at July 1, 2017 and December 31, 2016, respectively, using Level 2 inputs.

Derivative Transactions

The Company is a global company that operates in over 35 countries and, as a result, the Company s net sales, cost of sales, operating expenses and balance sheet amounts are significantly impacted by fluctuations in foreign currency exchange rates. The Company is exposed to currency price risk on foreign currency exchange rate fluctuations when it translates its non-U.S. dollar foreign subsidiaries financial statements into U.S. dollars, and when any of the Company s subsidiaries purchase or sell products or services in a currency other than its own currency.

The Company s principal strategy in managing exposure to changes in foreign currency exchange rates is to naturally hedge the foreign-currency-denominated liabilities on the Company s balance sheet against corresponding assets of the same currency, such that any changes in liabilities due to fluctuations in foreign currency exchange rates are typically offset by corresponding changes in assets.

The Company does not specifically enter into any derivatives that hedge foreign-currency-denominated assets, liabilities or commitments on its balance sheet, other than a portion of certain third-party accounts receivable and accounts payable, and the Company s net worldwide intercompany receivables and payables, which are eliminated in consolidation. The Company periodically aggregates its net worldwide balances by currency and then enters into foreign currency exchange contracts that mature within 90 days to hedge a portion of the remaining balance to minimize some of the Company s currency price risk exposure. The foreign currency exchange contracts are not designated for hedge accounting treatment.

Principal hedged currencies include the Euro, Japanese yen, British pound, Mexican peso and Brazilian real. At July 1, 2017 and December 31, 2016, the Company held foreign currency exchange contracts with notional amounts totaling $122 million and $120 million, respectively.

The Company s foreign currency exchange contracts included in the consolidated balance sheets are classified as follows (in thousands):

	July 1, 2017	December 31, 2016
Other current assets	$ 1,418	$ 60
Other current liabilities	$ 11	$ 730

The following is a summary of the activity included in cost of sales in the statements of operations related to the foreign currency exchange contracts (in thousands):

	Three Months Ended		Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Realized gains (losses) on closed contracts	$ 1,868	$ (5,637)	$ 430	$ (7,531)
Unrealized gains (losses) on open contracts	2,209	(963)	2,077	(992)
Cumulative net pre-tax gains (losses)	$ 4,077	$ (6,600)	$ 2,507	$ (8,523)

Stockholders Equity

In May 2017, the Company s Board of Directors authorized the Company to repurchase up to $1 billion of its outstanding common stock over a three-year period. During the six months ended July 1, 2017, the Company repurchased 1.0 million shares of the Company s outstanding common stock at a cost of $159 million under the May 2014 and May 2017 authorizations. During the six months ended July 2, 2016, the Company repurchased 1.3 million shares of the Company s outstanding common stock at a cost of $166 million under the May 2014 authorization. As

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

of July 1, 2017, the Company purchased an aggregate of 5.5 million shares at a cost of $750 million under the May 2014 repurchase program, which is now completed. The Company has a total of $964 million authorized for future repurchases under the May 2017 plan. In addition, the Company repurchased $7 million and $6 million of common stock related to the vesting of restricted stock units during the six months ended July 1, 2017 and July 2, 2016, respectively. The Company believes that it has the financial flexibility to fund these share repurchases given current cash levels and debt borrowing capacity, as well as to invest in research, technology and business acquisitions to further grow the Company s sales and profits.

Product Warranty Costs

The Company accrues estimated product warranty costs at the time of sale, which are included in cost of sales in the consolidated statements of operations. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component suppliers, the Company s warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. The amount of the accrued warranty liability is based on historical information, such as past experience, product failure rates, number of units repaired and estimated costs of material and labor. The liability is reviewed for reasonableness at least quarterly.

The following is a summary of the activity of the Company s accrued warranty liability for the six months ended July 1, 2017 and July 2, 2016 (in thousands):

	Balance at Beginning of Period	Accruals for Warranties	Settlements Made	Balance at End of Period
Accrued warranty liability:				
July 1, 2017	$ 13,391	$ 3,842	$ (4,369)	$ 12,864
July 2, 2016	$ 13,349	$ 4,297	$ (4,719)	$ 12,927

Restructuring and Other Charges

During the six months ended July 1, 2017, the Company incurred $11 million of severance costs associated with the closure of a facility in Germany and costs associated with providing U.S. employees with an early retirement transition incentive. During the six months ended July 2, 2016, the Company incurred $3 million of severance costs associated with an organizational restructuring. At July 1, 2017, the Company had $5 million of severance costs accrued in other current liabilities.

Acquired In-process Research and Development

During the six months ended July 1, 2017, the Company incurred a $5 million charge for acquired in-process research and development related to a milestone payment for the licensing of certain intellectual property relating to mass spectrometry technologies yet to be commercialized and for which there was no future alternative use as of the acquisition date. This licensing arrangement is significantly related to new, biologically-focused applications, as well as other applications, and require the Company to make additional future payments of up to $7 million if certain milestones are achieved, as well as royalties on future net sales.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

2 Marketable Securities

The Company s marketable securities within cash equivalents and investments included in the consolidated balance sheets are detailed as follows (in thousands):

	July 1, 2017			
	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
U.S. Treasury securities	$ 627,443	$ 104	$ (960)	$ 626,587
Foreign government securities	6,971	1	(3)	6,969
Corporate debt securities	1,794,831	1,463	(1,243)	1,795,051
Time deposits	295,845			295,845
Equity securities	77	70		147
Total	$ 2,725,167	$ 1,638	$ (2,206)	$ 2,724,599
Amounts included in:				
Cash equivalents	$ 165,909	$	$ (1)	$ 165,908
Investments	2,559,258	1,638	(2,205)	2,558,691
Total	$ 2,725,167	$ 1,638	$ (2,206)	$ 2,724,599

	December 31, 2016			
	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
U.S. Treasury securities	$ 570,695	$ 253	$ (635)	$ 570,313
Foreign government securities	17,999		(8)	17,991
Corporate debt securities	1,645,468	496	(2,126)	1,643,838
Time deposits	199,906			199,906
Equity securities	77	70		147
Total	$ 2,434,145	$ 819	$ (2,769)	$ 2,432,195
Amounts included in:				
Cash equivalents	$ 124,793	$ 1	$	$ 124,794
Investments	2,309,352	818	(2,769)	2,307,401
Total	$ 2,434,145	$ 819	$ (2,769)	$ 2,432,195

The estimated fair value of marketable debt securities by maturity date is as follows (in thousands):

	July 1, 2017	December 31, 2016
Due in one year or less	$ 1,591,388	$ 1,388,537
Due after one year through three years	837,219	843,605
Total	$ 2,428,607	$ 2,232,142

3 Inventories

Inventories are classified as follows (in thousands):

	July 1, 2017	December 31, 2016
Raw materials	$ 95,162	$ 95,430
Work in progress	16,970	16,585
Finished goods	175,007	150,667
Total inventories	$ 287,139	$ 262,682

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

4 Goodwill and Other Intangibles

The carrying amount of goodwill was $357 million and $352 million at July 1, 2017 and December 31, 2016, respectively. During the six months ended July 1, 2017, the effect of foreign currency translation increased goodwill by $5 million.

The Company s intangible assets included in the consolidated balance sheets are detailed as follows (in thousands):

	July 1, 2017			December 31, 2016		
	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period
Capitalized software	$ 403,303	$ 257,347	5 years	$ 355,973	$ 223,572	5 years
Purchased intangibles	167,123	133,565	11 years	162,180	127,045	11 years
Trademarks and IPR&D	13,781			13,544		
Licenses	5,401	4,260	6 years	4,632	3,851	6 years
Patents and other intangibles	65,358	40,702	8 years	61,646	36,452	8 years
Total	$ 654,966	$ 435,874	7 years	$ 597,975	$ 390,920	7 years

During the six months ended July 1, 2017, the effect of foreign currency translation increased the gross carrying value of intangible assets and accumulated amortization for intangible assets by $37 million and $24 million, respectively. Amortization expense for intangible assets was $12 million and $11 million for the three months ended July 1, 2017 and July 2, 2016, respectively. Amortization expense for intangible assets was $22 million for both the six months ended July 1, 2017 and July 2, 2016. Amortization expense for intangible assets is estimated to be approximately $43 million per year for each of the next five years.

5 Debt

In June 2013, the Company entered into a credit agreement that provides for a $1.1 billion revolving facility and a $300 million term loan facility. In April 2015, Waters Corporation entered into an amendment to this agreement (the Amended Credit Agreement). The Amended Credit Agreement provides for an increase of the revolving commitments from $1.1 billion to $1.3 billion and extends the maturity of the original credit agreement from June 25, 2018 until April 23, 2020. The Company plans to use future proceeds from the revolving facility for general corporate purposes.

The interest rates applicable to the Amended Credit Agreement are, at the Company s option, equal to either the alternate base rate calculated daily (which is a rate per annum equal to the greatest of (a) the prime rate in effect on such day, (b) the federal funds effective rate in effect on such day plus 1/2% per annum, or (c) the adjusted LIBO rate on such day (or if such day is not a business day, the immediately preceding business day) for a deposit in U.S. dollars with a maturity of one month plus 1% per annum) or the applicable 1, 2, 3 or 6 month adjusted LIBO rate, in each case, plus an interest rate margin based upon the Company s leverage ratio, which can range between 0 basis points to

12.5 basis points for alternate base rate loans and between 80 basis points and 117.5 basis points for adjusted LIBO rate loans. The facility fee on the Amended Credit Agreement ranges between 7.5 basis points and 20 basis points. The Amended Credit Agreement requires that the Company comply with an interest coverage ratio test of not less than 3.50:1 as of the end of any fiscal quarter for any period of four consecutive fiscal quarters and a leverage ratio test of not more than 3.50:1 as of the end of any fiscal quarter. In addition, the Amended Credit Agreement includes negative covenants, affirmative covenants, representations and warranties and events of default that are customary for investment grade credit facilities.

At July 1, 2017, $125 million of the outstanding portion of the revolving facility was classified as short-term liabilities in the consolidated balance sheet due to the fact that the Company expects to repay this portion of the borrowing under the revolving line of credit within the next twelve months. The remaining $790 million of the outstanding portion of the revolving facility was classified as long-term liabilities in the consolidated balance sheet, as this portion is not expected to be repaid within the next twelve months.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

The Company had a total of $700 million of outstanding senior unsecured notes as of July 1, 2017 and December 31, 2016. Interest on the fixed rate senior unsecured notes is payable semi-annually each year. Interest on the floating rate senior unsecured notes is payable quarterly. The Company may prepay all or some of the senior unsecured notes at any time in an amount not less than 10% of the aggregate principal amount outstanding, plus the applicable make-whole amount or prepayment premium for Series H and J senior unsecured notes. In the event of a change in control of the Company (as defined in the note purchase agreement), the Company may be required to prepay the senior unsecured notes at a price equal to 100% of the principal amount thereof, plus accrued and unpaid interest. These senior unsecured notes require that the Company comply with an interest coverage ratio test of not less than 3.50:1 for any period of four consecutive fiscal quarters and a leverage ratio test of not more than 3.50:1 as of the end of any fiscal quarter. In addition, these senior unsecured notes include customary negative covenants, affirmative covenants, representations and warranties and events of default.

The Company had the following outstanding debt at July 1, 2017 and December 31, 2016 (in thousands):

	July 1, 2017	December 31, 2016
Foreign subsidiary lines of credit	$ 233	$ 297
Senior unsecured notes - Series D - 3.22%, due March 2018	100,000	
Credit agreements	125,000	125,000
Total notes payable and debt	225,233	125,297
Senior unsecured notes - Series B - 5.00%, due February 2020	100,000	100,000
Senior unsecured notes - Series D - 3.22%, due March 2018		100,000
Senior unsecured notes - Series E - 3.97%, due March 2021	50,000	50,000
Senior unsecured notes - Series F - 3.40%, due June 2021	100,000	100,000
Senior unsecured notes - Series G - 3.92%, due June 2024	50,000	50,000
Senior unsecured notes - Series H - floating rate*, due June 2024	50,000	50,000
Senior unsecured notes - Series I - 3.13%, due May 2023	50,000	50,000
Senior unsecured notes - Series J - floating rate**, due May 2024	40,000	40,000
Senior unsecured notes - Series K - 3.44%, due May 2026	160,000	160,000
Credit agreements	1,090,000	1,005,000

Unamortized debt issuance costs	(2,767)	(3,034)
Total long-term debt	1,687,233	1,701,966
Total debt	$ 1,912,466	$ 1,827,263

* Series H senior unsecured notes bear interest at a 3-month LIBOR for that floating rate interest period plus 1.25%.

** Series J senior unsecured notes bear interest at a 3-month LIBOR for that floating rate interest period plus 1.45%.

As of July 1, 2017 and December 31, 2016, the Company had a total amount available to borrow under existing credit agreements of $383 million and $468 million, respectively, after outstanding letters of credit. The weighted-average interest rates applicable to the senior unsecured notes and credit agreement borrowings collectively were 2.79% and 2.55% at July 1, 2017 and December 31, 2016, respectively. As of July 1, 2017, the Company was in compliance with all debt covenants.

The Company and its foreign subsidiaries also had available short-term lines of credit totaling $82 million and $79 million at July 1, 2017 and December 31, 2016, respectively, for the purpose of short-term borrowing and issuance of commercial guarantees. At July 1, 2017 and December 31, 2016, the weighted-average interest rates applicable to these short-term borrowings were 0.77% and 1.49%, respectively.

6 Income Taxes

The four principal jurisdictions in which the Company manufactures are the U.S., Ireland, the U.K. and Singapore, where the Company s marginal effective tax rates were approximately 37.5%, 12.5%, 19.25% and 0%, respectively, as of July 1, 2017. The Company has a contractual tax rate of 0% on qualifying activities in Singapore through

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

March 2021, based upon the achievement of certain contractual milestones, which the Company expects to continue to meet. The current statutory tax rate in Singapore is 17%. For the first half of 2017 and 2016, the effect of applying the contractual tax rate rather than the statutory tax rate to income from qualifying activities in Singapore increased the Company s net income by $11 million and $10 million, respectively, and increased the Company s net income per diluted share by $0.14 and $0.12, respectively.

The Company s effective tax rate for the quarter was 11.0% and 11.9% for 2017 and 2016, respectively. Year-to-date, the Company s effective tax rate was 9.2% and 11.8% for 2017 and 2016, respectively. The decrease in the effective tax rate in 2017 as compared to 2016 can be primarily attributed to the adoption of new accounting guidance related to stock-based compensation, which decreased income tax expense by $4 million and $12 million for the three and six months ended July 1, 2017, respectively, and decreased the Company s effective tax rate by 3.0 percentage points and 4.5 percentage points, respectively. See Note 13 for further information regarding the adoption of this standard. In addition, the provision for income tax for the first quarter of 2016 included a quarter-specific tax benefit associated with modifications to certain stock-based compensation awards. The remaining differences between the effective tax rate in 2017 and 2016 can be primarily attributed to differences in the proportionate amounts of pre-tax income recognized in jurisdictions with different effective tax rates.

The Company accounts for its uncertain tax return reporting positions in accordance with the accounting standards for income taxes, which require financial statement reporting of the expected future tax consequences of uncertain tax reporting positions on the presumption that all concerned tax authorities possess full knowledge of those tax reporting positions, as well as all of the pertinent facts and circumstances, but prohibit any discounting of unrecognized tax benefits associated with those reporting positions for the time value of money. The Company classifies interest and penalties related to unrecognized tax benefits as a component of the provision for income taxes.

The following is a summary of the activity of the Company s unrecognized tax benefits for the six months ended July 1, 2017 and July 2, 2016 (in thousands):

	July 1, 2017	July 2, 2016
Balance at the beginning of the period	$ 9,964	$ 14,450
Net changes in uncertain tax benefits	(1,870)	(2,563)
Balance at the end of the period	$ 8,094	$ 11,887

With limited exceptions, the Company is no longer subject to tax audit examinations in significant jurisdictions for the years ended on or before December 31, 2012. However, carryforward tax attributes that were generated in years beginning on or before January 1, 2013 may still be adjusted upon examination by tax authorities if the attributes are utilized. The Company continuously monitors the lapsing of statutes of limitations on potential tax assessments for related changes in the measurement of unrecognized tax benefits, related net interest and penalties, and deferred tax assets and liabilities. As of July 1, 2017, the Company expects to record additional reductions in the measurement of its unrecognized tax benefits and related net interest and penalties of approximately $3 million within the next twelve months due to potential tax audit settlements and the lapsing of statutes of limitations on potential tax assessments. The Company does not expect to record any other material reductions in the measurement of its unrecognized tax benefits within the next twelve months.

7 Litigation

From time to time, the Company and its subsidiaries are involved in various litigation matters arising in the ordinary course of business. The Company believes it has meritorious arguments in its current litigation matters and believes any outcome, either individually or in the aggregate, will not be material to the Company s financial position, results of operations or cash flows.

The Company has been engaged in patent litigation in Germany since 2005. In June 2017, the court issued a verdict against the Company and awarded the plaintiff damages, fees and interest. As a result of the court s judgment, the Company recorded a $10 million provision for damages and fees estimated to be incurred in connection with this litigation. The accrued patent litigation expense of $16 million and $7 million is in other current liabilities in the consolidated balance sheets at July 1, 2017 and December 31, 2016, respectively.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

8 Stock-Based Compensation

The Company maintains various shareholder-approved, stock-based compensation plans which allow for the issuance of incentive or non-qualified stock options, stock appreciation rights, restricted stock or other types of awards (e.g. restricted stock units and performance stock units). In the first quarter of 2017, the Company adopted new accounting guidance related to stock-based compensation, see Note 13 for further information regarding the adoption of this standard.

The Company accounts for stock-based compensation costs in accordance with the accounting standards for stock-based compensation, which require that all share-based payments to employees be recognized in the statements of operations based on their grant date fair values. The Company recognizes the expense using the straight-line attribution method. The stock-based compensation expense recognized in the consolidated statements of operations is based on awards that ultimately are expected to vest; therefore, the amount of expense has been reduced for estimated forfeitures. The new stock-based compensation accounting guidance offers the option of recognizing forfeitures as they occur or estimating forfeitures at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company has elected to remain consistent with prior periods and estimate forfeitures at the time of grant and, if necessary, revise in subsequent periods in which actual forfeitures differ from those estimates. Forfeitures are estimated based on historical experience. If actual results differ significantly from these estimates, stock-based compensation expense and the Company s results of operations could be materially impacted. In addition, if the Company employs different assumptions in the application of these standards, the compensation expense that the Company records in the future periods may differ significantly from what the Company has recorded in the current period.

The consolidated statements of operations for the three and six months ended July 1, 2017 and July 2, 2016 include the following stock-based compensation expense related to stock option awards, restricted stock awards, restricted stock unit awards, performance stock unit awards and the employee stock purchase plan (in thousands):

	Three Months Ended		Six Months Ended	
	July 1, 2017	**July 2, 2016**	**July 1, 2017**	**July 2, 2016**
Cost of sales	$ 787	$ 656	$ 1,525	$ 1,327
Selling and administrative expenses	7,602	6,613	14,790	20,582
Research and development expenses	750	1,127	1,479	2,328
Total stock-based compensation	$ 9,139	$ 8,396	$ 17,794	$ 24,237

During the six months ended July 2, 2016, the Company recognized $7 million of stock-based compensation expense related to the modification of certain stock awards upon the retirement of senior executives.

Stock Options

In determining the fair value of the stock options, the Company makes a variety of assumptions and estimates, including volatility measures, expected yields and expected stock option lives. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model. The Company uses implied volatility on its publicly-traded options as the basis for its estimate of expected volatility. The Company believes that implied volatility is the most appropriate indicator of expected volatility because it is generally reflective of historical volatility and expectations of how future volatility will differ from historical volatility. The expected life assumption for grants is based on historical experience for the population of non-qualified stock option exercises. The risk-free interest rate is the yield currently available on U.S. Treasury zero-coupon issues with a remaining term approximating the expected term used as the input to the Black-Scholes model. The relevant data used to determine the value of the stock options granted during the six months ended July 1, 2017 and July 2, 2016 are as follows:

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

Options Issued and Significant Assumptions Used to Estimate Option Fair Values	Six Months Ended July 1, 2017	Six Months Ended July 2, 2016
Options issued (in thousands)	207	86
Risk-free interest rate	2.2%	1.5%
Expected life in years	6	5
Expected volatility	0.232	0.286
Expected dividends		

Weighted-Average Exercise Price and Fair Value of Options on the Date of Grant	Six Months Ended July 1, 2017	Six Months Ended July 2, 2016
Exercise price	$ 149.74	$ 122.65
Fair value	$ 40.39	$ 34.63

The following table summarizes stock option activity for the plans for the six months ended July 1, 2017 (in thousands, except per share data):

	Number of Shares	Price per Share			Weighted-Average Exercise Price
Outstanding at December 31, 2016	2,697	$ 38.09	to	$ 139.51	$ 106.55
Granted	207	$ 136.43	to	$ 154.33	$ 149.74
Exercised	(619)	$ 41.20	to	$ 134.37	$ 88.36
Canceled	(44)	$ 87.06	to	$ 136.43	$ 114.38
Outstanding at July 1, 2017	2,241	$ 38.09	to	$ 154.33	$ 115.41

Restricted Stock

During the six months ended July 1, 2017, the Company granted seven thousand shares of restricted stock. The weighted-average fair value per share of these awards on the grant date was $136.43 per share.

Restricted Stock Units

The following table summarizes the unvested restricted stock unit award activity for the six months ended July 1, 2017 (in thousands, except for per share data):

	Shares	Weighted-Average Price

Unvested at December 31, 2016	453	$	110.34
Granted	106	$	154.23
Vested	(131)	$	105.18
Forfeited	(15)	$	115.34
Unvested at July 1, 2017	413	$	123.06

Restricted stock units are generally granted annually in February and vest in equal annual installments over a five-year period.

Performance Stock Units

The Company s performance stock units are equity compensation awards with a market vesting condition based on the Company s Total Shareholder Return (TSR) relative to the TSR of the components of the S&P Health Care Index. TSR is the change in value of a stock price over time, including the reinvestment of dividends. The vesting schedule ranges from 0% to 200% of the target shares awarded.

In determining the fair value of the performance stock units, the Company makes a variety of assumptions and estimates, including volatility measures, expected yields and expected terms. The fair value of each performance stock unit grant was estimated on the date of grant using the Monte Carlo simulation model. The Company uses

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

implied volatility on its publicly-traded options as the basis for its estimate of expected volatility. The Company believes that implied volatility is the most appropriate indicator of expected volatility because it is generally reflective of historical volatility and expectations of how future volatility will differ from historical volatility. The expected life assumption for grants is based on the performance period of the underlying performance stock units. The risk-free interest rate is the yield currently available on U.S. Treasury zero-coupon issues with a remaining term approximating the expected term used as the input to the Monte Carlo simulation model. The correlation coefficient is used to model the way in which each company in the S&P Health Care Index tends to move in relation to each other during the performance period. The relevant data used to determine the value of the performance stock units granted during 2017 is as follows:

Performance Stock Units Issued and Significant Assumptions Used to Estimate Fair Values	2017
Performance stock units issued in thousands	20
Risk-free interest rate	1.5%
Expected life in years	3
Expected volatility	0.232
Average volatility of peer companies	0.261
Correlation coefficient	0.385
Expected dividends	

The following table summarizes the unvested performance stock unit award activity for the three months ended July 1, 2017 (in thousands, except for per share data):

	Shares	Weighted-Average Fair Value
Unvested at December 31, 2016	27	$ 171.16
Granted	20	$ 198.78
Unvested at July 1, 2017	47	$ 184.40

9 Earnings Per Share

Basic and diluted earnings per share (EPS) calculations are detailed as follows (in thousands, except per share data):

	Three Months Ended July 1, 2017		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 131,822	79,979	$ 1.65
		777	(0.02)

Effect of dilutive stock option, restricted stock, performance stock unit and restricted stock unit securities			
Net income per diluted common share	$ 131,822	80,756	$ 1.63

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

	Three Months Ended July 2, 2016		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 128,217	80,804	$ 1.59
Effect of dilutive stock option, restricted stock and restricted stock unit securities		651	(0.02)
Net income per diluted common share	$ 128,217	81,455	$ 1.57

	Six Months Ended July 1, 2017		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 237,379	80,029	$ 2.97
Effect of dilutive stock option, restricted stock, performance stock unit and and restricted stock unit securities		740	(0.03)
Net income per diluted common share	$ 237,379	80,769	$ 2.94

	Six Months Ended July 2, 2016		
	Net Income (Numerator)	Weighted-Average Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 222,269	81,043	$ 2.74
Effect of dilutive stock option, restricted stock and restricted stock unit securities		620	(0.02)
Net income per diluted common share	$ 222,269	81,663	$ 2.72

For the three and six months ended July 1, 2017, the Company had 0.4 million and 0.5 million stock options that were antidilutive, respectively, due to having higher exercise prices than the Company s average stock price during the period. For the three and six months ended July 2, 2016, the Company had 0.8 million and 1.2 million stock options that were antidilutive, respectively. These securities were not included in the computation of diluted EPS. The effect of dilutive securities was calculated using the treasury stock method.

10 Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income are detailed as follows (in thousands):

	Currency Translation	Unrealized Gain (Loss) on Retirement Plans	Unrealized Gain (Loss) on Investments	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2016	$ (170,566)	$ (43,894)	$ (1,820)	$ (216,280)
Other comprehensive income (loss), net of tax	67,382	(160)	1,283	68,505
Balance at July 1, 2017	$ (103,184)	$ (44,054)	$ (537)	$ (147,775)

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)

11 Retirement Plans

The Company sponsors various retirement plans. The summary of the components of net periodic pension costs for the plans for the three and six months ended July 1, 2017 and July 2, 2016 is as follows (in thousands):

	Three Months Ended					
	July 1, 2017			July 2, 2016		
	U.S. Pension Plans	U.S. Retiree Healthcare Plan	Non-U.S. Pension Plans	U.S. Pension Plans	U.S. Retiree Healthcare Plan	Non-U.S. Pension Plans
Service cost	$ 124	$ 170	$ 1,240	$ 94	$ 116	$ 1,250
Interest cost	1,696	159	368	1,745	135	429
Expected return on plan assets	(2,487)	(147)	(414)	(2,417)	(130)	(406)
Net amortization:						