

WATERS CORP /DE/
Form 10-Q
November 02, 2018
Table of Contents

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 September 29, 2018

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
(State or other jurisdiction of
incorporation or organization)

13-3668640
(I.R.S. Employer
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 every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or 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. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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 October 26, 2018: 75,745,720

Table of Contents**WATERS CORPORATION AND SUBSIDIARIES****QUARTERLY REPORT ON FORM 10-Q****INDEX**

	Page
PART I	
FINANCIAL INFORMATION	
Item 1.	
<u>Financial Statements</u>	
<u>Consolidated Balance Sheets (unaudited) as of September 29, 2018 and December 31, 2017</u>	3
<u>Consolidated Statements of Operations (unaudited) for the three months ended September 29, 2018 and September 30, 2017</u>	4
<u>Consolidated Statements of Operations (unaudited) for the nine months ended September 29, 2018 and September 30, 2017</u>	5
<u>Consolidated Statements of Comprehensive Income (unaudited) for the three and nine months ended September 29, 2018 and September 30, 2017</u>	6
<u>Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 29, 2018 and September 30, 2017</u>	7
<u>Condensed Notes to Consolidated Financial Statements (unaudited)</u>	8
Item 2.	30
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	
Item 3.	41
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	
Item 4.	42
<u>Controls and Procedures</u>	
PART II	
OTHER INFORMATION	
Item 1.	42
<u>Legal Proceedings</u>	
Item 1A.	42
<u>Risk Factors</u>	
Item 2.	43
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	
Item 6.	43
<u>Exhibits</u>	
<u>Signature</u>	44

Table of Contents**Item 1: Financial Statements****WATERS CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(unaudited)**

September 29, 2018 December 31, 2017
(In thousands, except per share data)

ASSETS		
Current assets:		
Cash and cash equivalents	\$ 689,373	\$ 642,319
Investments	1,394,887	2,751,382
Accounts receivable, net	489,193	533,825
Inventories	313,614	270,294
Other current assets	83,702	72,314
Total current assets	2,970,769	4,270,134
Property, plant and equipment, net	338,472	349,278
Intangible assets, net	252,834	228,395
Goodwill	357,869	359,819
Other assets	123,114	116,728
Total assets	\$ 4,043,058	\$ 5,324,354
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable and debt	\$ 284	\$ 100,273
Accounts payable	65,810	64,537
Accrued employee compensation	39,860	69,024
Deferred revenue and customer advances	186,485	166,840
Accrued income taxes	59,304	73,008
Accrued warranty	12,193	13,026
Other current liabilities	84,189	119,449
Total current liabilities	448,125	606,157
Long-term liabilities:		
Long-term debt	1,148,061	1,897,501
Long-term portion of retirement benefits	63,696	67,334
Long-term income tax liabilities	429,611	456,949
Other long-term liabilities	77,133	62,625
Total long-term liabilities	1,718,501	2,484,409

Edgar Filing: WATERS CORP /DE/ - Form 10-Q

Total liabilities	2,166,626	3,090,566
Commitments and contingencies (Notes 6, 7 and 11)		
Stockholders' equity:		
Preferred stock, par value \$0.01 per share, 5,000 shares authorized, none issued at September 29, 2018 and December 31, 2017		
Common stock, par value \$0.01 per share, 400,000 shares authorized, 160,368 and 159,845 shares issued, 75,730 and 79,337 shares outstanding at September 29, 2018 and December 31, 2017, respectively	1,604	1,598
Additional paid-in capital	1,815,428	1,745,088
Retained earnings	5,810,053	5,405,380
Treasury stock, at cost, 84,638 and 80,509 shares at September 29, 2018 and December 31, 2017, respectively	(5,624,860)	(4,808,211)
Accumulated other comprehensive loss	(125,793)	(110,067)
Total stockholders' equity	1,876,432	2,233,788
Total liabilities and stockholders' equity	\$ 4,043,058	\$ 5,324,354

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

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended	
	September 29, 2018	September 30, 2017
	(In thousands, except per share data)	
Revenues:		
Product sales	\$ 378,522	\$ 375,550
Service sales	199,499	190,034
Total net sales	578,021	565,584
Costs and operating expenses:		
Cost of product sales	155,825	155,621
Cost of service sales	85,314	80,271
Selling and administrative expenses	126,997	135,206
Research and development expenses	35,173	33,782
Litigation provision	924	
Purchased intangibles amortization	2,114	1,682
Total costs and operating expenses	406,347	406,562
Operating income	171,674	159,022
Other (expense) income	(811)	12
Interest expense	(11,435)	(14,750)
Interest income	9,802	9,516
Income before income taxes	169,230	153,800
Provision for income taxes	28,216	17,696
Net income	\$ 141,014	\$ 136,104
Net income per basic common share	\$ 1.84	\$ 1.71
Weighted-average number of basic common shares	76,575	79,712
Net income per diluted common share	\$ 1.83	\$ 1.69
Weighted-average number of diluted common shares and equivalents	77,136	80,521

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

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Nine Months Ended	
	September 29, 2018	September 30, 2017
	(In thousands, except per share data)	
Revenues:		
Product sales	\$ 1,106,508	\$ 1,072,684
Service sales	598,402	549,119
Total net sales	1,704,910	1,621,803
Costs and operating expenses:		
Cost of product sales	456,270	436,800
Cost of service sales	249,425	239,814
Selling and administrative expenses	394,049	395,972
Research and development expenses	105,297	97,471
Litigation (settlement) provision	(748)	10,018
Purchased intangibles amortization	5,375	5,104
Acquired in-process research and development		5,000
Total costs and operating expenses	1,209,668	1,190,179
Operating income	495,242	431,624
Other (expense) income	(2,293)	64
Interest expense	(36,965)	(41,558)
Interest income	28,356	25,229
Income before income taxes	484,340	415,359
Provision for income taxes	75,698	41,876
Net income	\$ 408,642	\$ 373,483
Net income per basic common share	\$ 5.26	\$ 4.67
Weighted-average number of basic common shares	77,741	79,908
Net income per diluted common share	\$ 5.21	\$ 4.63
Weighted-average number of diluted common shares and equivalents	78,395	80,660

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

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 29, 2018	September 30, 2017	September 29, 2018	September 30, 2017
	(In thousands)		(In thousands)	
Net income	\$ 141,014	\$ 136,104	\$ 408,642	\$ 373,483
Other comprehensive income (loss):				
Foreign currency translation	5,309	26,827	(17,937)	94,209
Unrealized gains on investments before income taxes	1,631	318	108	1,700
Income tax expense	(382)	(9)	(125)	(108)
Unrealized gains (losses) on investments, net of tax	1,249	309	(17)	1,592
Retirement liability adjustment before reclassifications	(177)	(499)	107	(2,030)
Amounts reclassified to other income	904	894	2,720	2,652
Retirement liability adjustment before income taxes	727	395	2,827	622
Income tax expense	(177)	(183)	(599)	(570)
Retirement liability adjustment, net of tax	550	212	2,228	52
Other comprehensive income (loss)	7,108	27,348	(15,726)	95,853
Comprehensive income	\$ 148,122	\$ 163,452	\$ 392,916	\$ 469,336

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

Table of Contents

WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Nine Months Ended	
	September 29, 2018	September 30, 2017
	(In thousands)	
Cash flows from operating activities:		
Net income	\$ 408,642	\$ 373,483
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation	28,184	30,068
Deferred income taxes	278	3,046
Depreciation	44,710	45,454
Amortization of intangibles	38,101	32,795
In-process research and development		5,000
Change in operating assets and liabilities:		
Decrease in accounts receivable	36,893	53,358
Increase in inventories	(47,826)	(26,217)
Increase in other current assets	(21,091)	(12,944)
Increase in other assets	(235)	(2,370)
Decrease in accounts payable and other current liabilities	(84,203)	(23,066)
Increase in deferred revenue and customer advances	23,085	29,332
Decrease in other liabilities	(3,641)	(2,483)
Net cash provided by operating activities	422,897	505,456
Cash flows from investing activities:		
Additions to property, plant, equipment and software capitalization	(64,215)	(55,257)
Asset acquisitions	(31,486)	
Investment in unaffiliated companies	(7,615)	(7,000)
Payments for intellectual property licenses		(5,000)
Purchases of investments	(908,147)	(2,345,259)
Maturities and sales of investments	2,269,181	2,008,528
Net cash provided by (used in) investing activities	1,257,718	(403,988)
Cash flows from financing activities:		
Proceeds from debt issuances	10	130,190
Payments on debt	(850,000)	(64)
Proceeds from stock plans	42,377	72,821
Purchases of treasury shares	(816,649)	(245,742)
(Payments for) proceeds from derivative contracts	(2,181)	3,301
Net cash used in financing activities	(1,626,443)	(39,494)
Effect of exchange rate changes on cash and cash equivalents	(7,118)	36,202

Increase in cash and cash equivalents	47,054	98,176
Cash and cash equivalents at beginning of period	642,319	505,631
Cash and cash equivalents at end of period	\$ 689,373	\$ 603,807

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

Table of Contents**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 analytical workflow solutions involving liquid chromatography, mass spectrometry and thermal analysis innovations serving the life, materials and food sciences for 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 common software platforms. 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 technology, principally in conjunction with chromatography, is employed 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 TATM 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 advanced software-based products that interface with the Company's instruments, as well as other manufacturers' instruments.

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 third fiscal quarters for 2018 and 2017 ended on September 29, 2018 and September 30, 2017, 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 footnote disclosures required for annual financial statements prepared in accordance with 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, 2017, as filed with the U.S. Securities and Exchange Commission (SEC) on February 27, 2018.

Translation of Foreign Currencies

The functional currency of each of the Company's foreign operating subsidiaries is the local currency of its country of domicile, 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.

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 respective period. Any resulting translation gains or losses are included in accumulated other comprehensive income in the consolidated balance sheets.

Table of Contents**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 September 29, 2018 and December 31, 2017, \$942 million out of \$2,084 million and \$3,326 million out of \$3,394 million, respectively, of the Company's total cash, cash equivalents and investments were held by foreign subsidiaries. In addition, \$341 million out of \$2,084 million and \$304 million out of \$3,394 million of cash, cash equivalents and investments were held in currencies other than the U.S. dollar at September 29, 2018 and December 31, 2017, respectively.

Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The Company has very limited use of rebates and other cash considerations payable to customers and, as a result, the transaction price determination does not have any material variable consideration. The allowance for doubtful accounts is the best estimate of the amount of probable credit losses in the existing accounts receivable. The allowance is based on a number of factors, including historical experience and the customer's credit-worthiness. The allowance for doubtful accounts is reviewed on at least a quarterly basis. Past due balances over 90 days and over a specified amount are reviewed individually for collectibility. Account balances are charged against the allowance when the Company determines it is probable that the receivable will not be recovered. The Company does not have any off-balance sheet credit exposure related to its customers. Historically, the Company has not experienced significant bad debt losses.

The following is a summary of the activity of the Company's allowance for doubtful accounts for the nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	Balance at Beginning of Period	Additions	Deduction	Balance at End of Period
Allowance for Doubtful Accounts				
September 29, 2018	\$ 6,109	\$ 2,752	\$ (2,175)	\$ 6,686
September 30, 2017	\$ 5,140	\$ 2,545	\$ (1,586)	\$ 6,099

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 September 29, 2018 and December 31, 2017. 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.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The following table represents the Company's assets and liabilities measured at fair value on a recurring basis at September 29, 2018 (in thousands):

	Total at September 29, 2018	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	\$ 271,918	\$	\$ 271,918	\$
Foreign government securities	2,958		2,958	
Corporate debt securities	1,063,382		1,063,382	
Time deposits	179,271		179,271	
Waters 401(k) Restoration Plan assets	37,723	37,723		
Foreign currency exchange contracts	116		116	
Interest rate cross-currency swap agreements	767		767	
Total	\$ 1,556,135	\$ 37,723	\$ 1,518,412	\$
Liabilities:				
Contingent consideration	\$ 3,701	\$	\$	\$ 3,701
Foreign currency exchange contracts	828		828	
Total	\$ 4,529	\$	\$ 828	\$ 3,701

The following table represents the Company's assets and liabilities measured at fair value on a recurring basis at December 31, 2017 (in thousands):

	Total at December 31, 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	\$ 591,988	\$	\$ 591,988	\$
Foreign government securities	6,952		6,952	
Corporate debt securities	1,975,160		1,975,160	

Edgar Filing: WATERS CORP /DE/ - Form 10-Q

Time deposits	371,511		371,511	
Equity securities	147		147	
Waters 401(k) Restoration Plan assets	35,645	35,645		
Foreign currency exchange contracts	566		566	
Total	\$ 2,981,969	\$ 35,645	\$ 2,946,324	\$
Liabilities:				
Contingent consideration	\$ 3,247	\$	\$	\$ 3,247
Foreign currency exchange contracts	182		182	
Total	\$ 3,429	\$	\$ 182	\$ 3,247

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)***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 the plan are determined through market and observable sources from daily quoted prices on nationally recognized securities exchanges.

Fair Value of Cash Equivalents, Investments, Foreign Currency Exchange Contracts and Interest Rate Cross-Currency Swap Agreements

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.

Fair Value of Contingent Consideration

The fair value of the Company's liability for contingent consideration relates to earnout payments in connection with 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 \$4 million and \$3 million at September 29, 2018 and December 31, 2017, respectively, 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.

Fair Value of Other Financial Instruments

The Company's 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 \$510 million and \$610 million at September 29, 2018 and December 31, 2017, respectively. 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 \$495 million and \$608 million at September 29, 2018 and December 31, 2017, 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 strategies in managing exposures to changes in foreign currency exchange rates are to 1) 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 and 2) mitigate foreign exchange risk exposure of international operations by hedging the variability in the movement of foreign currency exchange rates on a portion of its Euro-denominated net asset investments. The Company presents the derivative transactions in financing activities in the statement of cash flows.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)****Foreign Currency Exchange Contracts**

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.

Interest Rate Cross-Currency Swap Agreements

In July 2018, the Company entered into a three-year interest rate cross-currency swap derivative agreement with a notional value of \$150 million to hedge the variability in the movement of foreign currency exchange rates on a portion of its Euro-denominated net asset investments. Under hedge accounting, the change in fair value of the derivative that relates to changes in the foreign currency spot rate are recorded in the currency translation adjustment in other comprehensive income and remain in accumulated comprehensive income in stockholders' equity until the sale or substantial liquidation of the foreign operation. The difference between the interest rate received and paid under the interest rate cross-currency swap derivative agreement is recorded in interest income in the statement of operations.

The Company's foreign currency exchange contracts and interest rate cross-currency swap agreements included in the consolidated balance sheets are classified as follows (in thousands):

	September 29, 2018		December 31, 2017	
	Notional Value	Fair Value	Notional Value	Fair Value
Foreign exchange contracts:				
Other current assets	\$ 37,927	\$ 116	\$ 110,759	\$ 566
Other current liabilities	\$ 105,885	\$ 828	\$ 37,104	\$ 182
Interest rate cross-currency swap agreements:				
Other assets	\$ 150,000	\$ 767	\$	\$
Accumulated other comprehensive income		\$ (767)		\$

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

	Financial Statement Classification	Three Months Ended September 29, 2018	September 30, 2017	Nine Months Ended September 29, 2018	September 30, 2017
Foreign currency exchange contracts:					

Edgar Filing: WATERS CORP /DE/ - Form 10-Q

Realized (losses) gains on closed contracts	Cost of sales	\$ (23)	\$	2,871	\$ (2,181)	\$	3,301
Unrealized (losses) gains on open contracts	Cost of sales	(5)		(1,258)	(1,097)		819
Cumulative net pre-tax (losses) gains	Cost of sales	\$ (28)	\$	1,613	\$ (3,278)	\$	4,120
Interest rate cross-currency swap agreements:							
Interest earned	Interest income	\$ 927	\$		\$ 927	\$	
Unrealized gains on open contracts	Stockholders equity	\$ 767	\$		\$ 767	\$	

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)***Stockholders' Equity*

In April 2018, the Company's Board of Directors authorized the Company to repurchase up to \$3 billion of its outstanding common stock over a three-year period. This new program adds the remaining \$526 million from the pre-existing program, allowing for the purchase of a total of \$3.5 billion of the Company's common stock over a three-year period. Upon commencement of the new authorization, the May 2017 authorization was terminated. During the nine months ended September 29, 2018 and September 30, 2017, the Company repurchased 4.1 million and 1.4 million shares of the Company's outstanding common stock at a cost of \$809 million and \$238 million, respectively, under the April 2018 authorization and other previously announced programs. As of September 29, 2018, the Company had repurchased an aggregate of 2.8 million shares at a cost of \$534 million under the April 2018 repurchase program and had a total of \$3.0 billion authorized for future repurchases. In addition, the Company repurchased \$9 million and \$8 million of common stock related to the vesting of restricted stock units during the nine months ended September 29, 2018 and September 30, 2017, 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.

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 nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	Balance at Beginning of Period	Accruals for Warranties	Settlements Made	Balance at End of Period
Accrued warranty liability:				
September 29, 2018	\$ 13,026	\$ 6,068	\$ (6,901)	\$ 12,193
September 30, 2017	\$ 13,391	\$ 6,287	\$ (6,823)	\$ 12,855

Other Commitments

In February 2018, the Company's Board of Directors approved expanding its precision chemistry consumable manufacturing operations in the U.S. The Company anticipates spending an estimated \$215 million to build and equip the new state-of-the-art manufacturing facility, which will be paid for with existing cash and investments.

2 Revenue Recognition

The Company adopted new accounting guidance regarding the recognition of revenue from contracts with customers as of January 1, 2018.

The Company recognizes revenue upon transfer of control of promised products and services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. The Company generally enters into contracts that include a combination of products and services. Revenue is allocated to distinct performance obligations and is recognized net of allowances for returns and discounts.

The Company recognizes revenue on product sales at the time control of the product transfers to the customer. In substantially all of the Company's arrangements, title of our products transfers at shipping point and, as a result, the Company determined control transfers at the point of shipment. In more limited cases, there are destination-based shipping terms and, thus, control is deemed to transfer when the products arrive at the customer site. Incremental costs of obtaining a contract are expensed as and when incurred if the expected amortization period of the asset that

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

would have been recognized is one year or less. Shipping and handling costs are included as a component of cost of sales. In situations where the control of the goods transfers prior to the completion of the Company's obligation to ship the products to its customers, the Company has elected the practical expedient to account for the shipping services as a fulfillment cost. Accordingly, such costs are recognized when control of the related goods is transferred to the customer. In more rare situations, the Company has revenue associated with products that contain specific customer acceptance criteria and the related revenue is not recognized before the customer acceptance criteria are satisfied. The Company elected to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with specific revenue-producing transactions and collected by the Company from a customer.

Generally, the Company's contracts for products include a performance obligation related to installation. The Company has determined that the installation represents a distinct performance obligation and revenue is recognized separately upon the completion of installation. The Company determines the amount of the transaction price to allocate to the installation service based on the standalone selling price of the product and the service, which requires judgment. The Company determines relative standalone selling price of installation based upon a number of factors, including hourly service billing rates and estimated installation hours. In developing these estimates, the Company considers past history, competition, billing rates of current services and other factors.

The Company has sales from standalone software, which is included in instrument systems revenue. These arrangements typically include software licenses and maintenance contracts, both of which the Company has determined are distinct performance obligations. The Company determines the amount of the transaction price to allocate to the license and maintenance contract based on the relative standalone selling price of each performance obligation. Software license revenue is recognized at the point in time when control has been transferred to the customer. The revenue allocated to the software maintenance contract is recognized on a straight-line basis over the maintenance period, which is the contractual term of the contract, as a time-based measure of progress best reflects the Company's performance in satisfying this obligation. Unspecified rights to software upgrades are typically sold as part of the maintenance contract on a when-and-if-available basis.

Payment terms and conditions vary among the Company's revenue streams, although terms generally include a requirement of payment within 30 to 60 days of product shipment. Prior to providing payment terms to customers, an evaluation of the customer's credit risk is performed. Returns and customer credits are infrequent and insignificant and are recorded as a reduction to sales. Rights of return are not included in sales arrangements and, therefore, there is minimal variable consideration included in the transaction price of our products.

Service revenue includes (i) service and software maintenance contracts and (ii) service calls (time and materials). Instrument service contracts and software maintenance contracts are typically annual contracts, which are billed at the beginning of the contract or maintenance period. The amount of the service and software maintenance contract is recognized on a straight-line basis to revenue over the maintenance service period, which is the contractual term of the contract, as a time-based measure of progress best reflects the Company's performance in satisfying this obligation. There are no deferred costs associated with the service contract, as the cost of the service is recorded when the service is performed. Service calls are recognized to revenue at the time a service is performed.

The Company's deferred revenue liabilities on the consolidated balance sheets consists of the obligation on instrument service contracts and customer payments received in advance, prior to shipment of the instrument. The Company

records deferred revenue primarily related to its service contracts, where consideration is billable at the beginning of the service period.

The following is a summary of the activity of the Company's deferred revenue and customer advances for the nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	September 29, 2018	September 30, 2017
Balance at the beginning of the period	\$ 192,590	\$ 173,780
Recognition of revenue included in balance at beginning of the period	(147,310)	(132,435)
Revenue deferred during the period, net of revenue recognized	179,571	169,337
Balance at the end of the period	\$ 224,851	\$ 210,682

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

As of September 29, 2018 and December 31, 2017, \$38 million and \$26 million of deferred revenue and customer advances were classified in other long-term liabilities, respectively.

The estimated amount of deferred revenue and customer advances equals the transaction price allocated to unfulfilled performance obligations for the period presented. Such amounts are expected to be recognized in the future as follows (in thousands):

	September 29, 2018
Deferred revenue and customer advances expected to be recognized:	
In one year or less	\$ 186,485
In 13-24 months	26,316
In 25 months and beyond	12,050
Total	\$ 224,851

3 Marketable Securities

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

	September 29, 2018			Fair Value
	Amortized Cost	Unrealized Gain	Unrealized Loss	
U.S. Treasury securities	\$ 272,812	\$	\$ (894)	\$ 271,918
Foreign government securities	2,994		(36)	2,958
Corporate debt securities	1,066,088	424	(3,130)	1,063,382
Time deposits	179,271			179,271
Total	\$ 1,521,165	\$ 424	\$ (4,060)	\$ 1,517,529
Amounts included in:				
Cash equivalents	\$ 122,645	\$	\$ (3)	\$ 122,642
Investments	1,398,520	424	(4,057)	1,394,887
Total	\$ 1,521,165	\$ 424	\$ (4,060)	\$ 1,517,529

	December 31, 2017			Fair
	Amortized	Unrealized	Unrealized	

Edgar Filing: WATERS CORP /DE/ - Form 10-Q

	Cost	Gain	Loss	Value
U.S. Treasury securities	\$ 593,599	\$ 82	\$ (1,693)	\$ 591,988
Foreign government securities	6,982		(30)	6,952
Corporate debt securities	1,977,329	897	(3,066)	1,975,160
Time deposits	371,515		(4)	371,511
Equity securities	77	70		147
Total	\$ 2,949,502	\$ 1,049	\$ (4,793)	\$ 2,945,758
Amounts included in:				
Cash equivalents	\$ 194,377	\$	\$ (1)	\$ 194,376
Investments	2,755,125	1,049	(4,792)	2,751,382
Total	\$ 2,949,502	\$ 1,049	\$ (4,793)	\$ 2,945,758

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

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

	September 29, 2018	December 31, 2017
Due in one year or less	\$ 1,043,082	\$ 1,722,553
Due after one year through three years	295,176	851,547
Total	\$ 1,338,258	\$ 2,574,100

4 Inventories

Inventories are classified as follows (in thousands):

	September 29, 2018	December 31, 2017
Raw materials	\$ 112,588	\$ 99,033
Work in progress	18,838	15,324
Finished goods	182,188	155,937
Total inventories	\$ 313,614	\$ 270,294

5 Acquisitions and Investments in Unaffiliated Companies

In July 2018, the Company acquired the sole intellectual property rights to the Desorption Electrospray Ionization (DESI) imaging technology for \$30 million in cash and a future contractual obligation to pay a minimum royalty of \$3 million over the remaining life of the patent. DESI is a mass spectrometry imaging technique that is used to develop medical therapies. The Company accounted for this transaction as an asset acquisition as it did not meet the definition of a business. The Company allocated \$33 million of fair value to a purchased intangible asset which will be amortized over the useful life of 12 years.

During the three months ended September 29, 2018, the Company made \$4 million of investments in unaffiliated companies, bringing the total investment in unaffiliated companies to \$8 million for the nine months ended September 29, 2018.

6 Goodwill and Other Intangibles

The carrying amount of goodwill was \$358 million and \$360 million at September 29, 2018 and December 31, 2017, respectively. During the nine months ended September 29, 2018, the effect of foreign currency translation decreased goodwill by \$2 million.

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

	September 29, 2018			December 31, 2017		
	Gross Carrying Amount	Accumulated Amortization	Weighted- Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Weighted- Average Amortization Period
Capitalized software	\$ 455,312	\$ 306,286	5 years	\$ 438,652	\$ 285,461	5 years
Purchased intangibles	203,170	143,009	11 years	169,870	138,750	11 years
Trademarks and IPR&D	13,827			13,923		
Licenses	5,733	4,901	6 years	5,840	4,628	6 years
Patents and other intangibles	77,175	48,187	8 years	72,815	43,866	8 years
Total	\$ 755,217	\$ 502,383	7 years	\$ 701,100	\$ 472,705	7 years

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The gross carrying value of intangible assets and accumulated amortization for intangible assets decreased by \$11 million and \$8 million, respectively, in the nine months ended September 29, 2018 due to the effects of foreign currency translation. Amortization expense for intangible assets was \$12 million and \$11 million for the three months ended September 29, 2018 and September 30, 2017, respectively. Amortization expense for intangible assets was \$38 million and \$33 million for the nine months ended September 29, 2018 and September 30, 2017, respectively. Amortization expense for intangible assets is estimated to be \$53 million per year for each of the next five years.

7 Debt

In November 2017, the Company entered into a new credit agreement (the 2017 Credit Agreement) that provides for a \$1.5 billion revolving facility and a \$300 million term loan. The revolving facility and term loan both mature on November 30, 2022 and require no scheduled prepayments before that date.

The interest rates applicable to the 2017 Credit Agreement are, at the Company's option, equal to either the alternate base rate (which is a rate per annum equal to the greatest of (a) the prime rate in effect on such day, (b) the Federal Reserve Bank of New York Rate on such day plus 1/2 of 1% per annum and (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 or EURIBO rate for Euro-denominated loans, in each case, plus an interest rate margin based upon the Company's leverage ratio, which can range between 0 and 12.5 basis points for alternate base rate loans and between 80 and 112.5 basis points for LIBO rate or EURIBO rate loans. The facility fee on the 2017 Credit Agreement ranges between 7.5 and 25 basis points per annum, based on the leverage ratio, of the amount of the revolving facility commitments and the outstanding term loan. The 2017 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 2017 Credit Agreement includes negative covenants, affirmative covenants, representations and warranties and events of default that are customary for investment grade credit facilities.

As of September 29, 2018 and December 31, 2017, the Company had a total of \$560 million and \$700 million of outstanding senior unsecured notes, respectively. 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.

In July 2018, the Company entered into a \$150 million U.S.-to-Euro interest rate cross-currency swap agreement that hedges the Company's net investment in its Euro denominated net assets. See Note 1, Basis of Presentation and Summary of Significant Accounting Policies.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The Company had the following outstanding debt at September 29, 2018 and December 31, 2017 (in thousands):

	September 29, 2018	December 31, 2017
Foreign subsidiary lines of credit	\$ 284	\$ 273
Senior unsecured notes - Series D - 3.22%, due March 2018		100,000
Total notes payable and debt, current	284	100,273
Senior unsecured notes - Series B - 5.00%, due February 2020	100,000	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
Senior unsecured notes - Series K - 3.44%, due May 2026	160,000	160,000
Credit agreement	590,000	1,300,000
Unamortized debt issuance costs	(1,939)	(2,499)
Total long-term debt	1,148,061	1,897,501
Total debt	\$ 1,148,345	\$ 1,997,774

* 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 bore interest at a 3-month LIBOR for that floating rate interest period plus 1.45%. As of September 29, 2018 and December 31, 2017, the Company had a total amount available to borrow under existing credit agreements of \$1,208 million and \$498 million, respectively, after outstanding letters of credit. During the nine months ended September 29, 2018, the Company reduced its outstanding debt by \$850 million using cash repatriated under the 2017 Tax Cuts and Jobs Act. The weighted-average interest rates applicable to the senior unsecured notes and credit agreement borrowings collectively were 3.64% and 2.98% at September 29, 2018 and

December 31, 2017, respectively. As of September 29, 2018, the Company was in compliance with all debt covenants.

The Company and its foreign subsidiaries also had available short-term lines of credit totaling \$90 million and \$91 million at September 29, 2018 and December 31, 2017, respectively, for the purpose of short-term borrowing and issuance of commercial guarantees. The weighted-average interest rate applicable to these short-term borrowings was 1.48% for both September 29, 2018 and December 31, 2017.

8 Income Taxes

In December 2017, the U.S. enacted legislation informally referred to as the Tax Cuts and Jobs Act (the 2017 Tax Act). For the year ended December 31, 2017 the Company accrued a \$550 million tax provision related to the 2017 Tax Act. The \$550 million expense consisted of \$490 million related to the federal toll charge, \$40 million for state income taxes and foreign withholding taxes and \$20 million for the revaluation of the Company's deferred tax assets and liabilities at the new federal tax rate of 21%.

During the third quarter of 2018, the Internal Revenue Service issued proposed regulations on the federal toll charge and various states issued additional guidance. The Company revised its analysis and calculation of the federal toll charge. In addition, the Company was able to conclude upon the treatment in certain state jurisdictions and expects to complete its analysis in the fourth quarter of 2018. As a result of the new guidance issued and additional work to complete the calculation of its federal toll charge, the Company reduced its provisional accrual for federal, state and foreign taxes by net \$19 million during the three months ended September 29, 2018. In addition, the Company also assessed its uncertain tax positions related to these taxes and accrued income tax reserves of \$18 million during both the three months ended and nine months ended September 29, 2018. The Company will continue to analyze any new guidance from the tax authorities, as well as any new information, and expects to finalize its analysis of the toll charge and related liabilities, including uncertain tax positions, in the fourth quarter of 2018 pursuant to SEC Staff Accounting Bulletin No. 118.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

As part of the 2017 Tax Act, there is a provision for the taxation of certain off-shore earnings referred to as the Global Intangible Low-Taxed Income (GILTI) provision. This new provision taxes off-shore earnings at a rate of 10.5%, partially offset with foreign tax credits. In connection with this new provision, the Company has adopted an accounting policy to treat this new tax as a current period cost.

The four principal jurisdictions in which the Company manufactures are the U.S., Ireland, the U.K. and Singapore, where the statutory tax rates are 21%, 12.5%, 19% and 17%, respectively, as of September 29, 2018. The Company has a contractual tax rate of 0% on qualifying activities in Singapore through March 2021, based upon the achievement of certain contractual milestones, which the Company expects to continue to meet. 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 for the nine months ended September 29, 2018 and September 30, 2017 by \$21 million and \$18 million, respectively, and increased the Company's net income per diluted share by \$0.26 and \$0.23, respectively.

The Company's effective tax rate for the three months ended September 29, 2018 and September 30, 2017 was 16.7% and 11.5%, respectively. The Company's effective tax rate for the nine months ended September 29, 2018 and September 30, 2017 was 15.6% and 10.1%, respectively. The increase in the effective tax rate of 5.2 percentage points and 5.5 percentage points for the three and nine months ended September 29, 2018, respectively, can be primarily attributed to the following:

The impact of the change in foreign currency exchange rates on the earnings taxed in December 2017 under the toll charge of the 2017 Tax Act and other related matters, which increased our effective tax rate by 1.4 percentage points (or \$2 million) and 1.3 percentage points (or \$6 million) for the three and nine months ended September 29, 2018, respectively, as compared to the previous periods in 2017.

The impact of the reduction in tax benefit related to stock-based compensation, which increased the effective tax rate by 1.6 percentage points (or \$2 million) and 1.8 percentage points (\$6 million) for the three and nine months ended September 29, 2018, respectively, as compared to the previous periods in 2017.

The impact of the increase in income tax reserves for uncertain tax positions and settlement of audits in 2018 as compared with the release of income tax reserves in 2017, which resulted in an increase in the Company's effective tax rate of .7 percentage points for both the three and nine months ended September 29, 2018. The 2018 increase in the tax reserve for uncertain tax positions and settlement of audits added \$2 million of tax expense to 2018. During the same period during 2017, there was a \$3 million release of reserves due to the lapsing of the statutes of limitation. This movement in income tax reserves is without regard to the change for U.S. Tax Reform items noted above.

The most significant ongoing changes applicable to the Company under the 2017 Tax Act are the reduction in the U.S. federal income tax rate from 35% to 21% and the new GILTI provision described above. The impact of the GILTI provision is an increase of approximately 2.4 percentage points to the Company's

effective tax rates for both the three and nine months ended September 29, 2018. This detriment is significantly offset by the overall federal rate reduction, for no net impact in comparison to the same periods in the prior year.

The remaining differences between the effective tax rates can primarily be 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 continues to classify interest and penalties related to unrecognized tax benefits as a component of the provision for income taxes.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The following is a summary of the activity of the Company's uncertain tax positions for the nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	September 29, 2018	September 30, 2017
Balance at the beginning of the period	\$ 5,843	\$ 9,964
Net changes in uncertain tax positions	19,097	(2,953)
Balance at the end of the period	\$ 24,940	\$ 7,011

As noted above, during the quarter and nine months ended September 29, 2018, the Company increased its income tax reserves for uncertain tax positions by \$18 million related to the 2017 federal toll charge. 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, 2013. However, carryforward tax attributes that were generated in years beginning on or before January 1, 2014 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 September 29, 2018, the Company expects to record additional reductions in the measurement of its unrecognized tax benefits and related net interest and penalties of less than \$1 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.

The Company adopted new accounting guidance which eliminates the deferral of tax effects on intra-entity transfers other than inventory and requires an entity to recognize the income tax consequences when the transfer occurs. The Company adopted this standard as of January 1, 2018 with a \$4 million charge to beginning retained earnings in the consolidated balance sheet.

9 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).

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. 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.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The consolidated statements of operations for the three and nine months ended September 29, 2018 and September 30, 2017 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		Nine Months Ended	
	September 29, 2018	September 30, 2017	September 29, 2018	September 30, 2017
Cost of sales	\$ 488	\$ 726	\$ 1,696	\$ 2,251
Selling and administrative expenses	6,731	10,768	22,855	25,558
Research and development expenses	1,994	780	3,633	2,259
Total stock-based compensation	\$9,213	\$ 12,274	\$ 28,184	\$ 30,068

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 nine months ended September 29, 2018 and September 30, 2017 are as follows:

Options Issued and Significant Assumptions Used to Estimate	Nine Months Ended	
	September 29, 2018	September 30, 2017
Option Fair Values		
Options issued in thousands	147	217
Risk-free interest rate	2.7%	2.2%
Expected life in years	6	6
Expected volatility	23.2%	23.0%
Expected dividends		

	Nine Months Ended	
Weighted-Average Exercise Price and Fair Value of Options on		

the Date of Grant	September 30, 2018	September 30, 2017
Exercise price	\$ 205.37	\$ 151.24
Fair value	\$ 57.99	\$ 40.49

The following table summarizes stock option activity for the plans for the nine months ended September 29, 2018 (in thousands, except per share data):

	Number of Shares	Exercise Price per Share			Weighted-Average Exercise Price per Share
Outstanding at December 31, 2017	2,039	\$ 38.09	to	\$ 194.26	\$ 124.41
Granted	147	\$ 188.26	to	\$ 208.47	\$ 205.37
Exercised	(357)	\$ 38.09	to	\$ 154.33	\$ 102.44
Canceled	(137)	\$ 98.21	to	\$ 154.33	\$ 126.13
Outstanding at September 29, 2018	1,692	\$ 38.09	to	\$ 208.47	\$ 135.94

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)***Restricted Stock*

During the nine months ended September 29, 2018, the Company granted five thousand shares of restricted stock. The weighted-average fair value per share of these awards on the grant date was \$194.73.

Restricted Stock Units

The following table summarizes the unvested restricted stock unit award activity for the nine months ended September 29, 2018 (in thousands, except per share data):

	Shares	Weighted-Average Fair Value per Share
Unvested at December 31, 2017	374	\$ 124.81
Granted	91	\$ 207.85
Vested	(123)	\$ 117.68
Forfeited	(18)	\$ 126.43
Unvested at September 29, 2018	324	\$ 150.75

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 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 the nine months ended September 29, 2018 and September 30, 2017 are as follows:

Performance Stock Units Issued and Significant Assumptions Used to Estimate Fair Values	Nine Months Ended	
	September 30, 2018	September 30, 2017
Performance stock units issued (in thousands)	16	20
Risk-free interest rate	2.0%	1.5%
Expected life in years	2.8	3.0
Expected volatility	23.4%	23.2%
Average volatility of peer companies	25.8%	26.1%
Correlation coefficient	37.2%	38.5%
Expected dividends		

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

The following table summarizes the unvested performance stock unit award activity for the nine months ended September 29, 2018 (in thousands, except per share data):

	Shares	Weighted-Average Fair Value per Share
Unvested at December 31, 2017	64	\$ 196.29
Granted	16	\$ 253.44
Forfeited	(5)	\$ 188.45
Unvested at September 29, 2018	75	\$ 209.00

10 Earnings Per Share

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

	Three Months Ended September 29, 2018 Net Income (Numerator)	Weighted- Average Shares (Denominator)	Per Share Amount
Net income per basic common share	\$ 141,014	76,575	\$ 1.84
Effect of dilutive stock option, restricted stock, performance stock unit and restricted stock unit securities		561	(0.01)
Net income per diluted common share	\$ 141,014	77,136	\$ 1.83

	Three Months Ended September 30, 2017 Net Income (Numerator)	Weighted- Average Shares (Denominator)	Per Share Amount
Net income per basic common share	\$ 136,104	79,712	\$ 1.71
Effect of dilutive stock option, restricted stock, performance stock unit and restricted stock unit securities		809	(0.02)
Net income per diluted common share	\$ 136,104	80,521	\$ 1.69

	Nine Months Ended September 29, 2018		
	Net Income (Numerator)	Weighted- Average Shares (Denominator)	Per Share Amount
Net income per basic common share	\$ 408,642	77,741	\$ 5.26
Effect of dilutive stock option, restricted stock, performance stock unit and restricted stock unit securities		654	(0.05)
Net income per diluted common share	\$ 408,642	78,395	\$ 5.21

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

	Nine Months Ended September 30, 2017		
	Net Income (Numerator)	Weighted- Average Shares (Denominator)	Per Share Amount
Net income per basic common share	\$ 373,483	79,908	\$ 4.67
Effect of dilutive stock option, restricted stock, performance stock unit and restricted stock unit securities		752	(0.04)
Net income per diluted common share	\$ 373,483	80,660	\$ 4.63

For the three and nine months ended September 29, 2018, the Company had 0.3 million and 0.1 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 nine months ended September 30, 2017, the Company had 0.4 million and 0.5 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.

11 Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income (loss) 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, 2017	\$ (69,418)	\$ (37,103)	\$ (3,546)	\$ (110,067)
Other comprehensive (loss) income, net of tax	(17,937)	2,228	(17)	(15,726)
Balance at September 29, 2018	\$ (87,355)	\$ (34,875)	\$ (3,563)	\$ (125,793)

12 Retirement Plans

The Company sponsors various retirement plans. The Company adopted new accounting guidance which requires that an employer disaggregate the service cost component from other components of net benefit cost. As a result of the adoption of this standard, the components of net periodic benefit cost other than the service cost component are included in other income in the consolidated statements of operations and all previous periods have been adjusted accordingly. The summary of the components of net periodic pension costs for the plans for the three and nine months ended September 29, 2018 and September 30, 2017 is as follows (in thousands):

	Three Months Ended					
	September 29, 2018			September 30, 2017		
	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	\$ 142	\$ 142	\$ 1,311	\$ 113	\$ 137	\$ 1,311
Interest cost	1,622	159	406	1,707	155	386
Expected return on plan assets	(1,708)	(177)	(486)	(2,574)	(146)	(434)
Net amortization:						
Prior service credit		(4)	(30)			(47)
Net actuarial loss	771		167	693		248
Net periodic pension cost (benefit)	\$ 827	\$ 120	\$ 1,368	\$ (61)	\$ 146	\$ 1,464

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

	Nine Months Ended					
	September 29, 2018			September 30, 2017		
	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	\$ 426	\$ 425	\$ 4,024	\$ 338	\$ 410	\$ 3,802
Interest cost	4,868	477	1,250	5,122	464	1,112
Expected return on plan assets	(5,123)	(530)	(1,442)	(7,724)	(440)	(1,250)
Net amortization:						
Prior service credit		(14)	(93)			(140)
Net actuarial loss	2,312		515	2,078		714
Net periodic pension cost (benefit)	\$ 2,483	\$ 358	\$ 4,254	\$ (186)	\$ 434	\$ 4,238

In 2018, the Company's board of directors approved the termination of its frozen U.S. defined benefit pension plans. The Company anticipates that it will take three to six months to settle all of these plans' obligations and, during this timeframe, the Company may incur pension accounting charges in connection with the termination of these plans.

During the three and nine months ended September 29, 2018, the Company contributed \$5 million to the non-U.S. pension plans. During fiscal year 2018, the Company expects to contribute a total of approximately \$5 million to \$10 million to the Company's defined benefit plans for all plans, excluding its U.S. defined benefit pension plans.

13 Business Segment Information

The Company's business activities, for which discrete financial information is available, are regularly reviewed and evaluated by the chief operating decision maker. As a result of this evaluation, the Company determined that it has two operating segments: WatersTM and TATM.

The Waters operating segment is primarily in the business of designing, manufacturing, distributing and servicing LC and MS instruments, columns and other precision chemistry consumables that can be integrated and used along with other analytical instruments. The TA operating segment is primarily in the business of designing, manufacturing, distributing and servicing thermal analysis, rheometry and calorimetry instruments. The Company's two operating segments have similar economic characteristics; product processes; products and services; types and classes of customers; methods of distribution; and regulatory environments. Because of these similarities, the two segments have been aggregated into one reporting segment for financial statement purposes. Please refer to the consolidated financial statements for financial information regarding the one reportable segment of the Company.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

Net sales for the Company's products and services are as follows for the three and nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2018	September 30, 2017	September 29, 2018	September 30, 2017
Product net sales:				
Waters instrument systems	\$ 238,986	\$ 238,431	\$ 677,017	\$ 674,768
Chemistry consumables	95,979	92,879	293,818	271,606
TA instrument systems	43,557	44,240	135,673	126,310
Total product sales	378,522	375,550	1,106,508	1,072,684
Service net sales:				
Waters service	180,830	172,594	543,411	498,736
TA service	18,669	17,440	54,991	50,383
Total service sales	199,499	190,034	598,402	549,119
Total net sales	\$ 578,021	\$ 565,584	\$ 1,704,910	\$ 1,621,803

Geographic sales information is presented below for the three and nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2018	September 30, 2017	September 29, 2018	September 30, 2017
Net Sales:				
Asia:				
China	\$ 109,713	\$ 96,141	\$ 313,250	\$ 275,367
Japan	43,549	42,202	129,497	125,058
Asia Other	68,934	70,996	216,634	219,723
Total Asia	222,196	209,339	659,381	620,148
Americas:				
United States	170,766	171,053	479,072	474,661
Americas Other	36,037	31,960	107,567	99,588
Total Americas	206,803	203,013	586,639	574,249
Europe	149,022	153,232	458,890	427,406

Edgar Filing: WATERS CORP /DE/ - Form 10-Q

Total net sales \$ 578,021 \$ 565,584 \$ 1,704,910 \$ 1,621,803

Net sales by customer class are as follows for the three and nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29,	September 30,	September 29,	September 30,
	2018	2017	2018	2017
Pharmaceutical	\$ 325,166	\$ 321,963	\$ 968,848	\$ 921,423
Industrial	171,985	168,349	517,979	504,183
Governmental and academic	80,870	75,272	218,083	196,197
Total net sales	\$ 578,021	\$ 565,584	\$ 1,704,910	\$ 1,621,803

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

Net sales for the Company recognized at a point in time versus over time are as follows for the three and nine months ended September 29, 2018 and September 30, 2017 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2018	September 30, 2017	September 29, 2018	September 30, 2017
Net sales recognized at a point in time:				
Instrument systems	\$ 282,543	\$ 282,671	\$ 812,690	\$ 801,078
Chemistry consumables	95,979	92,879	293,818	271,606
Service sales recognized at a point in time (time & materials)	75,769	72,221	228,685	212,660
Total net sales recognized at a point in time	454,291	447,771	1,335,193	1,285,344
Net sales recognized over time:				
Service and software sales recognized over time (contracts)	123,730	117,813	369,717	336,459
Total net sales	\$ 578,021	\$ 565,584	\$ 1,704,910	\$ 1,621,803

14 Recent Accounting Standard Changes and Developments*Recently Adopted Accounting Standards*

In May 2014, amended accounting guidance was issued regarding the recognition of revenue from contracts with customers. The objective of this guidance is to significantly enhance comparability and clarify principles of revenue recognition practices across entities, industries, jurisdictions and capital markets. This guidance was originally effective for annual and interim reporting periods beginning after December 15, 2016; however, the Financial Accounting Standards Board (FASB) amended the standard in August 2015 to delay the effective period date by one year to annual and interim periods beginning after December 15, 2017. Adoption prior to December 15, 2016 was not permitted. In March 2016, the FASB clarified the implementation guidance on principal versus agent considerations and, in April 2016, clarification was made regarding certain aspects of identifying performance obligations and licensing implementation guidance. In May 2016, additional guidance was issued related to disclosure of remaining performance obligations, as well as other amendments to guidance on collectibility, non-cash consideration and the presentation of sales and other similar taxes collected from customers. The Company adopted this standard as of January 1, 2018 and applied the modified-retrospective method. The Company elected the practical expedient and only evaluated the contracts that were considered incomplete as of January 1, 2018 when quantifying the cumulative effect adjustment under the modified retrospective method. The adoption of this standard did not have a material impact on the Company's financial position, results of operations or cash flows and, as such, did not require any adjustments to information reported in the prior year.

In January 2016, accounting guidance was issued which primarily affects the classification and measurement of certain financial instruments, principally equity investments and certain financial liabilities. Under the new guidance, there will no longer be an available-for-sale classification for equity securities with readily determinable fair values. Changes to the fair value of equity investments will be recognized through earnings. Equity investments carried at cost should be adjusted for changes in observable prices, as applicable, and qualitatively assessed for impairment annually. Changes to the fair value of financial liabilities under the fair value option due to instrument specific credit risk will be recognized separately in other comprehensive income. The new guidance also requires financial assets and financial liabilities to be presented separately and grouped by measurement category in the notes to the financial statements. The Company adopted this standard as of January 1, 2018 and the adoption of this standard did not have a material impact on the Company's financial position, results of operations and cash flows.

In August 2016, accounting guidance was issued that clarifies the classification of certain cash flows. The new guidance addresses eight specific areas where current accounting guidance is either unclear or does not specifically address classification issues. This guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The Company adopted this standard as of January 1, 2018 and the adoption of this standard did not have a material impact on the Company's cash flows.

Table of Contents**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (Continued)**

In October 2016, accounting guidance was issued regarding intra-entity transfers of assets other than inventory. The new guidance eliminates the deferral of tax effects on intra-entity transfers other than inventory and requires an entity to recognize the income tax consequences when the transfer occurs. The Company adopted this standard as of January 1, 2018 with a \$4 million charge to beginning retained earnings in the consolidated balance sheet. Please see Note 8, *Income Taxes*, for additional information.

In January 2017, accounting guidance was issued that clarifies the definition of a business. The new guidance provides a more robust framework to use in determining when a set of assets and activities is a business, thus narrowing the definition and the amount of transactions accounted for as business combinations. The Company adopted this standard as of January 1, 2018 and will apply this guidance prospectively to any business combination transactions that take place in the future.

In March 2017, accounting guidance was issued regarding the presentation of net periodic pension cost and net periodic postretirement benefit cost. The new guidance requires that an employer disaggregate the service cost component from other components of net benefit cost, with service cost reported in the same line items as other compensation costs and the other components of net benefit costs presented outside income from operations. The Company adopted this standard as of January 1, 2018 and has reported the components of net periodic benefit cost other than the service cost component in other income on the consolidated statements of operations for all periods presented. Please see Note 12, *Retirement Plans*, for additional information.

In May 2017, accounting guidance was issued that clarifies the accounting for a change to the terms or conditions of a share-based payment award. The standard provides more specific guidance for determining when a change to an award requires modification accounting and when it should be deemed purely administrative in nature. The Company adopted this standard as of January 1, 2018 and the adoption of this standard did not have a material impact on the Company's financial position, results of operations and cash flows.

In August 2017, accounting guidance was issued which simplifies the application of hedge accounting and enables companies to better portray the economics of their risk management activities in their financial statements. The Company adopted this standard in the second quarter of 2018, and this adoption did not have a material impact on the Company's financial position, results of operations and cash flows.

Recently Issued Accounting Standards

In February 2016, accounting guidance was issued regarding the accounting for leases. This new comprehensive lease standard amends various aspects of existing accounting guidance for leases. The core principle of the new guidance will require lessees to present the assets and liabilities that arise from leases on their balance sheets. This guidance is effective for annual and interim reporting periods beginning after December 15, 2018 and early adoption is permitted. The Company will apply the prospective method of adoption and expects that the adoption of this standard will have a material effect on the Company's balance sheet; however, it is not expected to have an overall material impact on the Company's results of operations and cash flows.

In June 2016, accounting guidance was issued that modifies the recognition of credit losses related to financial assets, such as debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, and other financial assets that have the contractual right to receive cash. Current guidance requires the recognition of a credit

loss when it is considered probable that a loss event has occurred. The new guidance requires the measurement of expected credit losses to be based upon relevant information, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the asset. As such, expected credit losses may be recognized sooner under the new guidance due to the broader range of information that will be required to determine credit loss estimates. The new guidance also amends the current other-than-temporary impairment model used for debt securities classified as available-for-sale. When the fair value of an available-for-sale debt security is below its amortized cost, the new guidance requires the total unrealized loss to be bifurcated into its credit and non-credit components. Any expected credit losses or subsequent recoveries will be recognized in earnings and any changes not considered credit related will continue to be recognized within other comprehensive income. This guidance is effective for annual and interim periods beginning after December 15, 2019. The Company currently does not expect that the adoption of this standard will have a material effect on the Company's financial position, results of operations and cash flows.

Table of Contents

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

In January 2017, accounting guidance was issued that simplifies the accounting for goodwill impairment. The guidance eliminates step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. This guidance is effective for annual and interim periods beginning after December 15, 2019 and early adoption is permitted. The Company currently does not expect that the adoption of this standard will have a material effect on the Company's financial position, results of operations and cash flows.

In March 2017, accounting guidance was issued to amend the amortization period for certain purchased callable debt securities held at a premium. Specifically, the amortization period for certain callable debt securities will be shortened to end at the earliest call date. This guidance is effective for annual and interim periods beginning after December 15, 2018 and early adoption is permitted. The Company currently does not believe that the adoption of this standard will have a material impact on the Company's financial position, results of operations and cash flows.

In February 2018, accounting guidance was issued to address the impact of the 2017 Tax Cuts and Jobs Act on items recorded in accumulated other comprehensive income. Current accounting guidance requires deferred tax liabilities and assets to be adjusted for the effect of a change in tax laws or rates with the effect recorded in income from continuing operations, even if the related tax effects were originally recognized in other comprehensive income, the new guidance allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the 2017 Tax Act. This guidance is effective for annual and interim periods beginning after December 15, 2018 and early adoption is permitted. The Company is currently evaluating the potential impact that the adoption of this standard will have on the Company's financial position, results of operations and cash flows.

Table of Contents**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations****Business and Financial Overview**

The Company has two operating segments: Waters™ and TA™. Waters products and services primarily consist of high performance liquid chromatography (HPLC), ultra performance liquid chromatography (UPLC and together with HPLC, referred to as LC), mass spectrometry (MS) and precision chemistry consumable products and related services. TA products and services primarily consist of thermal analysis, rheometry and calorimetry instrument systems and service sales. The Company's products are used by pharmaceutical, biochemical, industrial, nutritional safety, environmental, academic and governmental customers. These customers use the Company's products to detect, identify, monitor and measure the chemical, physical and biological composition of materials and to predict the suitability and stability of fine chemicals, pharmaceuticals, water, polymers, metals and viscous liquids in various industrial, consumer goods and healthcare products.

The Company's operating results are as follows for the three and nine months ended September 29, 2018 and September 30, 2017 (dollars in thousands, except per share data):

	Three Months Ended			Nine Months Ended		
	September 29, 2018	September 30, 2017	% change	September 29, 2018	September 30, 2017	% change
Revenues:						
Product sales	\$ 378,522	\$ 375,550	1%	\$ 1,106,508	\$ 1,072,684	3%
Service sales	199,499	190,034	5%	598,402	549,119	9%
Total net sales	578,021	565,584	2%	1,704,910	1,621,803	5%
Costs and operating expenses:						
Cost of sales	241,139	235,892	2%	705,695	676,614	4%
Selling and administrative expenses	126,997	135,206	(6%)	394,049	395,972	
Research and development expenses	35,173	33,782	4%	105,297	97,471	8%
Litigation provision (settlement)	924		**	(748)	10,018	**
Purchased intangibles amortization	2,114	1,682	26%	5,375	5,104	5%
Acquired in-process research and development					5,000	(100%)
Operating income	171,674	159,022	8%	495,242	431,624	15%
Operating income as a % of sales	29.7%	28.1%		29.0%	26.6%	
Other (expense) income	(811)	12	**	(2,293)	64	**
Interest expense, net	(1,633)	(5,234)	(69%)	(8,609)	(16,329)	(47%)
Income before income taxes	169,230	153,800	10%	484,340	415,359	17%

Edgar Filing: WATERS CORP /DE/ - Form 10-Q

Provision for income taxes	28,216	17,696	59%	75,698	41,876	81%
Net income	\$ 141,014	\$ 136,104	4%	\$ 408,642	\$ 373,483	9%
Net income per diluted common share	\$ 1.83	\$ 1.69	8%	\$ 5.21	\$ 4.63	13%

** Percentage not meaningful

The Company's sales increased 2% and 5% for the third quarter and year-to-date in 2018, respectively, as compared to the third quarter and year-to-date in 2017, with foreign currency translation decreasing sales growth by 1% in the third quarter of 2018 and contributing 2% to the sales growth year-to-date in 2018. Recent acquisitions did not have an impact on sales growth in either the third quarter or year-to-date in 2018. Unless otherwise noted, sales growth or decline percentages are presented as compared with the same period in the prior year.

Instrument system sales were flat in the quarter and increased 1% year-to-date, as strong instrument system sales growth in China and Latin America was offset by weaker customer demand for our LC and MS instrument systems in the U.S., Europe and India. Recurring revenues (combined sales of precision chemistry consumables and services) increased 4% and 9% in the quarter and year-to-date, respectively, as a result of a larger installed base of customers and higher billing demand for service sales and despite there being one less calendar day in the first nine months of 2018 as compared to the first nine months of 2017.

Table of Contents

In the third quarter of 2018, the Company's sales increased 6% in Asia and 2% in the Americas, while sales decreased 3% in Europe. Year-to-date, the Company's sales increased 7% in Europe, 6% in Asia and 2% in the Americas. Sales growth in Asia was a result of the double-digit sales growth in China, which was broad-based across all product lines and driven by sales to pharmaceutical, governmental and academic customers, partially offset by a 7% and 6% decline in sales in India for the third quarter and year-to-date, respectively, on weaker customer demand for our LC and MS instrument systems. In addition, foreign currency translation reduced India's sales growth by 8% and 3% in the quarter and year-to-date, respectively. Sales for the quarter in Europe were impacted by weaker customer demand for our LC and MS instrument systems, while Europe benefited year-to-date from the effect of foreign currency translation, which added 5% to the sales growth rate. Sales growth in the Americas for the quarter was impacted by flat sales in the U.S., while U.S. sales increased 1% year-to-date.

Net sales by customer class are presented below for the three and nine months ended September 29, 2018 and September 30, 2017 (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	September 29, 2018	September 30, 2017	% change	September 29, 2018	September 30, 2017	% change
Pharmaceutical	\$ 325,166	\$ 321,963	1%	\$ 968,848	\$ 921,423	5%
Industrial	171,985	168,349	2%	517,979	504,183	3%
Governmental and academic	80,870	75,272	7%	218,083	196,197	11%
Total net sales	\$ 578,021	\$ 565,584	2%	\$ 1,704,910	\$ 1,621,803	5%

Sales to pharmaceutical customers increased 1% and 5% for the quarter and year-to-date, respectively. These increases were driven by the increasing need for global access to prescription drugs and the testing of newer and more complex biologic drugs. Geographically, sales growth within our pharmaceutical market was driven by double-digit sales growth in China and Latin America, and was partially offset by weakness in India and Europe.

Combined sales to industrial customers, which include customers in materials characterization, food, environmental and fine chemical markets, grew 2% and 3% for the quarter and year-to-date, respectively. Industrial sales were negatively impacted by a decline in sales to environmental customers during 2018 as compared to 2017.

Combined sales to governmental and academic customers increased 7% and 11% for the quarter and year-to-date, respectively. The increase in sales to governmental and academic customers was broad-based across all product categories, with strong year-to-date growth in all regions, except Japan. Sales to governmental and academic customers are highly dependent on when institutions receive funding to purchase our instrument systems and, as such, sales can vary significantly from period to period.

Operating income increased 8% and 15% for the quarter and year-to-date, respectively. This increase was primarily a result of the effect of higher sales volume achieved in 2018 and the impact of the certain expenses incurred in 2017 that did not occur again in 2018. These expenses include \$10 million of litigation settlement provisions and related costs for the first nine months of 2017; \$1 million and \$12 million in the third quarter and year-to-date, respectively, of severance costs primarily associated with the closure of a facility in Germany and costs associated with providing U.S. employees with an early retirement transition incentive; a \$5 million year-to-date charge relating to a milestone payment for the licensing of certain intellectual property relating to mass spectrometry technologies yet to be commercialized; and a \$4 million charge related to the acceleration of certain stock awards in the third quarter of

2017.

The Company generated \$423 million and \$505 million of net cash flows from operations in the first nine months of 2018 and 2017, respectively. This decrease in operating cash flow was primarily a result of \$83 million in income tax payments made in the U.S. relating to the Company's estimated 2017 tax reform liability and 2018 estimated tax payments, a \$15 million litigation settlement payment and \$5 million of contributions to certain international defined benefit pension plans. Over the next four years, the Company is required to make annual U.S. federal tax payments of approximately \$40 million to tax authorities in connection with the Company's estimated tax liabilities of \$480 million under the legislation informally referred to as the Tax Cuts and Jobs Act (2017 Tax Act). The remaining 60% of this liability is required to be paid over a three-year period beginning in 2023.

Table of Contents

Cash flows used in investing activities included capital expenditures related to property, plant, equipment and software capitalization of \$64 million and \$55 million in the third quarter of 2018 and 2017, respectively. In February 2018, the Company's Board of Directors approved expanding its precision chemistry consumable manufacturing operations in the U.S. The Company anticipates spending an estimated \$215 million to build and equip this new state-of-the-art manufacturing facility, which will be paid for with existing cash and investments and the Company does not expect to issue any debt in relation to this expansion. In July 2018, the Company acquired the sole intellectual property rights to the Desorption Electrospray Ionization (DESI) imaging technology for \$30 million in cash and a future contractual obligation to pay a minimum royalty of \$3 million over the remaining life of the patent. DESI is a mass spectrometry imaging technique that is used to develop medical therapies. During the third quarter of 2018, the Company made \$4 million of investments in unaffiliated companies, bringing the total investment in unaffiliated companies to \$8 million for the first nine months ended of 2018.

In April 2018, the Company's Board of Directors authorized the Company to repurchase up to \$3 billion of its outstanding common stock over a three-year period. This new program adds the remaining \$526 million from the pre-existing program, allowing for the purchase of a total of \$3.5 billion of the Company's common stock over a three-year period. Upon commencement of the new authorization, the May 2017 authorization was terminated. During the first nine months of 2018 and 2017, the Company repurchased \$809 million and \$238 million of the Company's outstanding common stock, respectively, under authorized share repurchase programs. The Company believes that it has the financial flexibility to fund these share repurchases given current cash and investment 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.

In July 2018, the Company entered into a \$150 million U.S.-to-Euro interest rate cross-currency swap agreement that hedges the Company's net investment in its Euro denominated net assets.

Results of Operations*Sales by Geography*

Geographic sales information is presented below for the three and nine months ended September 29, 2018 and September 30, 2017 (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	September 29, 2018	September 30, 2017	% change	September 29, 2018	September 30, 2017	% change
Net Sales:						
Asia:						
China	\$ 109,713	\$ 96,141	14%	\$ 313,250	\$ 275,367	14%
Japan	43,549	42,202	3%	129,497	125,058	4%
Asia Other	68,934	70,996	(3%)	216,634	219,723	(1%)
Total Asia	222,196	209,339	6%	659,381	620,148	6%
Americas:						
United States	170,766	171,053		479,072	474,661	1%
Americas Other	36,037	31,960	13%	107,567	99,588	8%

Edgar Filing: WATERS CORP /DE/ - Form 10-Q

Total Americas	206,803	203,013	2%	586,639	574,249	2%
Europe	149,022	153,232	(3%)	458,890	427,406	7%
Total net sales	\$ 578,021	\$ 565,584	2%	\$ 1,704,910	\$ 1,621,803	5%

Sales in China increased across all product lines and were driven by double-digit increases in sales to pharmaceutical, governmental and academic customers. The effect of foreign currency translation decreased sales in Japan by 1% in the quarter and increased sales in Japan by 2% year-to-date. In the third quarter of 2018, the sales decline in the rest of Asia was driven by weaker demand for our TA instrument systems, while the year-to-date sales decline in the rest of Asia was also impacted by weaker sales to environmental customers in the first quarter of 2018.

Table of Contents

Sales in the U.S. in the third quarter of 2018 were flat, primarily due to weaker demand for MS instrument systems and lower sales of TA instrument systems, offset by strength in recurring revenues. Sales growth in the U.S. year-to-date was driven by recurring revenues and TA instruments, and sales to pharmaceutical and industrial customers. Sales in the rest of the Americas had double-digit sales growth for instrument systems and double-digit sales growth to pharmaceutical, governmental and academic customers, which was offset by a decline in sales to industrial customers.

In the third quarter of 2018, sales in Europe were negatively impacted by weaker demand for LC and MS instrument systems to pharmaceutical, governmental and academic customers. Year-to-date, sales growth in Europe was driven by TA s products and services and recurring revenues to industrial, governmental and academic customers. In addition, the effect of foreign currency translation decreased sales in Europe by 1% for the quarter and increased sales in Europe by 5% year-to-date.

Waters Products and Services Net Sales

Net sales for Waters products and services are as follows for the three and nine months ended September 29, 2018 and September 30, 2017 (dollars in thousands):

	Three Months Ended				
	September 29, 2018	% of Total	September 30, 2017	% of Total	% change
Waters instrument systems	\$ 238,986	46%	\$ 238,431	47%	
Chemistry consumables	95,979	19%	92,879	19%	3%
Total Waters product sales	334,965	65%	331,310	66%	1%
Waters service	180,830	35%	172,594	34%	5%
Total Waters net sales	\$ 515,795	100%	\$ 503,904	100%	2%

	Nine Months Ended				
	September 29, 2018	% of Total	September 30, 2017	% of Total	% change
Waters instrument systems	\$ 677,017	45%	\$ 674,768	47%	
Chemistry consumables	293,818	19%	271,606	18%	8%
Total Waters product sales	970,835	64%	946,374	65%	3%
Waters service	543,411	36%	498,736	35%	9%
Total Waters net sales	\$ 1,514,246	100%	\$ 1,445,110	100%	5%

Precision chemistry consumables sales increased on the uptake in columns and application-specific testing kits and were driven by double-digit growth in China. Waters service sales benefited from increased sales of service plans and higher service demand billings to a higher installed base of customers and were broad-based across all geographies and customer classes. The effect of foreign currency translation decreased Waters sales by 1% for the third quarter and

increased sales by 2% year-to-date. Waters instrument systems sales were flat for both the quarter and year-to-date as strong sales growth in Asia and Latin America was offset by weak customer demand in the U.S., Europe and India.

In the third quarter of 2018, Waters sales increased 8% in Asia and 2% in the Americas and decreased 4% in Europe. Year-to-date, Waters sales increased 7% in Europe, 6% in Asia and 2% in the Americas. The effect of foreign currency translation decreased sales in Europe by 2% in the quarter and increased sales in Europe by 5% year-to-date. Within Asia for the quarter and year-to-date, Waters sales increased in China 16% and 14%, respectively, and increased in Japan 2% and 5%, respectively. Sales in the rest of Asia decreased 1% and 2% for the quarter and year-to-date, respectively.

Table of Contents*TA Product and Services Net Sales*

Net sales for TA products and services are as follows for the three and nine months ended September 29, 2018 and September 30, 2017 (dollars in thousands):

	Three Months Ended				
	September 29, 2018	% of Total	September 30, 2017	% of Total	% change
TA instrument systems	\$ 43,557	70%	\$ 44,240	72%	(2%)
TA service	18,669	30%	17,440	28%	7%
Total TA net sales	\$ 62,226	100%	\$ 61,680	100%	1%

	Nine Months Ended				
	September 29, 2018	% of Total	September 30, 2017	% of Total	% change
TA instrument systems	\$ 135,673	71%	\$ 126,310	71%	7%
TA service	54,991	29%	50,383	29%	9%
Total TA net sales	\$ 190,664	100%	\$ 176,693	100%	8%

TA instrument system sales grew year-to-date on strong customer demand for thermal, microcalorimetry and mechanical testing instrument systems; however, due to delays in the timing of shipments in certain parts of the world, TA's third quarter sales declined by 2%. TA service sales increased due to sales of service plans and billings to a higher installed base of customers. The effect of foreign currency translation decreased TA sales 1% in the quarter and increased TA sales 2% year-to-date.

In the third quarter of 2018, TA sales increased 14% in Europe and 1% in the Americas, but decreased 6% in Asia. Year-to-date, TA sales increased 14% in Europe and 6% in both Asia and the Americas. TA sales in Europe benefited from the effect of foreign currency translation, which increased sales 1% and 6% in the quarter and year-to-date, respectively. Within Asia, TA experienced double-digit sales growth in India and Japan in the quarter, which were offset by declines in the rest of Asia. Year-to-date, TA experienced double-digit sales growth in China and India, which was offset by declines in Japan. TA's sales in the U.S. decreased 2% in the quarter and increased 6% year-to-date.

Cost of Sales

The increase in cost of sales for the third quarter of 2018 was consistent with the increase in sales volume. Cost of sales is affected by many factors, including, but not limited to, foreign currency translation, product mix, product costs of instrument systems and amortization of software platforms. At current foreign currency exchange rates, the Company expects foreign currency translation to negatively impact gross profit for the remainder of 2018.

Selling and Administrative Expenses

Selling and administrative expenses decreased 6% for the quarter and were flat year-to-date. In 2018, the effect of foreign currency translation decreased selling and administrative expenses by 1% for the quarter and increased selling and administrative expenses by 1% year-to-date. In addition, selling and administrative expenses were impacted by headcount additions and higher merit compensation costs. In 2017, the Company incurred \$1 million and \$12 million of severance costs in connection with the closure of a facility in Germany and an early retirement transition incentive program in the quarter and year-to-date, respectively. In addition, selling and administrative expenses in the third quarter of 2017 included a \$4 million charge related to the acceleration of certain stock awards.

As a percentage of net sales, selling and administrative expenses were 22.0% and 23.1% for the 2018 quarter and year-to-date, respectively, and 23.9% and 24.4% for the 2017 quarter and year-to-date, respectively.

Table of Contents

Research and Development Expenses

Research and development expenses increased 4% and 8% in 2018 quarter and year-to-date, respectively, primarily as a result of additional headcount, merit compensation and costs associated with new products and the development of new technology initiatives. In addition, the effect of foreign currency translation decreased research and development expenses by 3% in the third quarter of 2018 and increased research and development expenses by 1% in the first nine months of 2018.

Acquired In-Process Research and Development

During the first nine months of 2017, the Company incurred charges of \$5 million for acquired in-process research and development related to milestone payments associated with a licensing arrangement for 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. These licensing arrangements are 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. These future payments may be significant and occur over multiple years.

Litigation Settlement

In the second quarter of 2017, the Company incurred a \$10 million litigation provision related to the issuance of a verdict in a patent litigation case. In the first quarter of 2018, the Company resolved the case with a final settlement that resulted in a gain of \$2 million.

Interest Expense, Net

The decrease in net interest expense in the third quarter of 2018 was primarily attributable to the Company using cash, cash equivalents and investment balances recently repatriated into the U.S. to reduce its debt by \$850 million during the 2018, as well as higher yields on investments.

In July 2018, the Company entered into a three-year U.S.-to-Euro interest rate cross-currency swap agreement with a notional value of \$150 million that hedges the Company's net investment in its Euro denominated net assets. The difference between the interest rate received and paid under the interest rate cross-currency swap agreement is recorded as interest income. During both the third quarter and year-to-date in 2018, the Company recorded \$1 million of interest income related to these agreements. This interest rate cross-currency swap agreement is estimated to generate \$5 million of interest income annually over a three-year period.

Provision for Income Taxes

In December 2017, the U.S. enacted legislation informally referred to as the Tax Cuts and Jobs Act (the 2017 Tax Act). For the year ended December 31, 2017 the Company accrued a \$550 million tax provision related to the 2017 Tax Act. The \$550 million expense consisted of \$490 million related to the federal toll charge, \$40 million for state income taxes and foreign withholding taxes and \$20 million for the revaluation of the Company's deferred tax assets and liabilities at the new federal tax rate of 21%.

During the third quarter of 2018, the Internal Revenue Service issued proposed regulations on the federal toll charge and various states issued additional guidance. The Company revised its analysis and calculation of the federal toll charge. In addition, the Company was able to conclude upon the treatment in certain state jurisdictions and expects to

complete its analysis in the fourth quarter of 2018. As a result of the new guidance issued and additional work to complete the calculation of its federal toll charge, the Company reduced its provisional accrual for federal, state and foreign taxes by net \$19 million during the third quarter of 2018. In addition, the Company also assessed its uncertain tax positions related to these taxes and accrued income tax reserves of \$18 million during the third quarter of 2018. The Company will continue to analyze any new guidance from the tax authorities, as well as any new information, and expects to finalize its analysis of the toll charge and related liabilities, including uncertain tax positions, in the fourth quarter of 2018 pursuant to U.S. Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 118.

Table of Contents

The four principal jurisdictions in which the Company manufactures are the U.S., Ireland, the U.K. and Singapore, where the statutory tax rates are 21%, 12.5%, 19% and 17%, respectively, as of September 29, 2018. The Company has a contractual tax rate in Singapore of 0% on qualifying activities in Singapore through March 2021, based upon the achievement of certain contractual milestones, which the Company expects to continue to meet. 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 year-to-date in 2018 and 2017 by \$21 million and \$18 million, respectively, and increased the Company's net income per diluted share by \$0.26 and \$0.23, respectively.

The Company's effective tax rate for the three months ended September 29, 2018 and September 30, 2017 was 16.7% and 11.5%, respectively. The Company's effective tax rate for the nine months ended September 29, 2018 and September 30, 2017 was 15.6% and 10.1%, respectively. The increase in the effective tax rate of 5.1 percentage points and 5.5 percentage points for the third quarter of September 29, 2018 and year-to-date, respectively, can be primarily attributed to the following:

The impact of the change in foreign currency exchange rates on the earnings taxed in December 2017 under the toll charge of the 2017 Tax Act and other related matters, which increased our effective tax rate by 1.4 percentage points (or \$2 million) and 1.3 percentage points (or \$6 million) for the three and nine months ended September 29, 2018, respectively, as compared to the previous periods in 2017.

The impact of the reduction in tax benefit related to stock-based compensation, which increased the effective tax rate by 1.6 percentage points (or \$2 million) and 1.8 percentage points (\$6 million) for the three and nine months ended September 29, 2018, respectively, as compared to the previous periods in 2017.

The impact of the increase in income tax reserves for uncertain tax positions and settlement of audits in 2018 as compared with the release of income tax reserves in 2017, which resulted in an increase in the Company's effective tax rate of .7 percentage points for both the three and nine months ended September 29, 2018. The 2018 increase in the tax reserve for uncertain tax positions and settlement of audits added \$2 million of tax expense to 2018. During the same period during 2017, there was a \$3 million release of reserves due to the lapsing of the statutes of limitation. This movement in income tax reserves is without regard to the change for U.S. Tax Reform items noted above.

The most significant ongoing changes applicable to the Company under the 2017 Tax Act are the reduction in the U.S. federal income tax rate from 35% to 21% and the new GILTI provision described above. The impact of the GILTI provision is an increase of approximately 2.4 percentage points to the Company's effective tax rates for both the three and nine months ended September 29, 2018. This detriment is significantly offset by the overall federal rate reduction, for no net impact in comparison to the same periods in the prior year.

The remaining differences between the effective tax rates can primarily be attributed to differences in the proportionate amounts of pre-tax income recognized in jurisdictions with different effective tax rates. The Company's effective tax rate is influenced by many significant factors, including, but not limited to, the wide range of income tax rates in jurisdictions in which the Company operates; sales volumes and profit levels in each tax

jurisdiction; changes in tax laws, tax rates and policies; the outcome of various ongoing tax audit examinations; and the impact of foreign currency transactions and translation. As a result of variability in these factors, the Company's effective tax rates in the future may not be similar to the effective tax rates for the current or prior years.

Table of Contents**Liquidity and Capital Resources*****Condensed Consolidated Statements of Cash Flows (in thousands):***

	Nine Months Ended	
	September 29, 2018	September 30, 2017
Net income	\$ 408,642	\$ 373,483
Depreciation and amortization	82,811	78,249
Stock-based compensation	28,184	30,068
Deferred income taxes	278	3,046
In-process research and development		5,000
Change in accounts receivable	36,893	53,358
Change in inventories	(47,826)	(26,217)
Change in accounts payable and other current liabilities	(84,203)	(23,066)
Change in deferred revenue and customer advances	23,085	29,332
Other changes	(24,967)	(17,797)
Net cash provided by operating activities	422,897	505,456
Net cash provided by (used in) investing activities	1,257,718	(403,988)
Net cash used in financing activities	(1,626,443)	(39,494)
Effect of exchange rate changes on cash and cash equivalents	(7,118)	36,202
Increase in cash and cash equivalents	\$ 47,054	\$ 98,176

Cash Flow from Operating Activities

Net cash provided by operating activities was \$423 million and \$505 million during the nine months ended September 29, 2018 and September 30, 2017, respectively. The changes within net cash provided by operating activities include the following significant changes in the sources and uses of net cash provided by operating activities, aside from the changes in net income:

The changes in accounts receivable were primarily attributable to timing of payments made by customers and timing of sales. Days sales outstanding increased to 77 days at September 29, 2018 as compared to 73 days at September 30, 2017.

The changes in inventory were primarily attributable to anticipated annual increases in sales volumes, as well as new product launches.

The changes in accounts payable and other current liabilities were a result of \$83 million in income tax payments made in the U.S. relating to the Company's estimated 2017 tax reform liability and 2018 estimated income tax payments, a \$15 million litigation settlement payment, \$5 million in contributions to certain international defined benefit pension plans, as well as the timing of payments to vendors.

Net cash provided from deferred revenue and customer advances results from annual increases in new service contracts as a higher installed base of customers renew annual service contracts.

Other changes were attributable to variation in the timing of various provisions, expenditures, prepaid income taxes and accruals in other current assets, other assets and other liabilities.

In May 2018, the Company's board of directors approved the termination of the frozen U.S. defined benefit pension plans. The Company anticipates it will take six months to a year to settle all of these plans obligations and, during this timeframe, the Company may incur pension accounting charges in connection with these plan terminations. The Company currently has \$35 million of pre-tax net actuarial losses in accumulated comprehensive income in stockholders equity that will be charged to the consolidated statement of operations as the plans are settled. These pension plans are currently in a net overfunded status for GAAP purposes; however, the Company may incur additional costs and have to make additional cash contributions into the plans to purchase third party annuity contracts to settle the individual pension obligations. The ultimate cost and cash requirement to fund the plan terminations will not be known until all employees choose whether to receive an annuity or a lump sum payment.

Table of Contents**Cash Flow from Investing Activities**

Net cash provided by investing activities totaled \$1,258 million in the nine months ended September 29, 2018 compared to net cash used in investing activities that totaled \$404 million in the nine months ended September 30, 2017. Additions to fixed assets and capitalized software were \$64 million and \$55 million in the first nine months of 2018 and 2017, respectively. In February 2018, the Company's Board of Directors approved expanding its precision chemistry consumable manufacturing operations in the U.S. The Company anticipates spending an estimated \$215 million to build and equip this new state-of-the-art manufacturing facility, which will be paid for with existing cash and investments. The Company does not expect to issue any debt in relation to this expansion. The Company has incurred \$5 million of costs associated with the construction of this facility during the first nine months of 2018.

During the nine months ended September 29, 2018 and September 30, 2017, the Company purchased \$908 million and \$2,345 million of investments, respectively, while \$2,269 million and \$2,009 million of investments matured, respectively, and were used for financing activities described below.

In July 2018, the Company acquired the sole intellectual property rights to the DESI imaging technology for \$30 million. DESI is a mass spectrometry imaging technique that is used to develop medical therapies.

During the first quarter of 2018, the Company made a \$3 million investment in a developer of laboratory solutions to increase productivity and reproducibility for use in any industry. During the third quarter of 2018, the Company made a \$3 million investment in a developer of optical instruments and consumables for the label-free analysis of molecular interactions for life science research and the drug discovery industry. During the third quarter of 2018, the Company made an additional \$1 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.

During the first nine months of 2017, the Company made payments of \$7 million for an 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. In addition, the Company made a \$5 million milestone payment in 2017 for acquired in-process research and development for the licensing of certain intellectual property relating to mass spectrometry technologies yet to be commercialized.

Cash Flow from Financing Activities

During the nine months ended September 29, 2018 and September 30, 2017, the Company's net debt borrowings decreased by \$850 million and increased by \$130 million, respectively. During the nine months ended September 29, 2018, the Company reduced its outstanding debt using cash repatriated under the 2017 Tax Cuts and Jobs Act. As of September 29, 2018, the Company had a total of \$1,148 million in outstanding debt, which consisted of \$560 million in outstanding senior unsecured notes, \$300 million borrowed under a term loan and \$290 million borrowed under a revolving credit facility, with both the term loan and revolving credit facilities under the credit agreement dated November 2017 (2017 Credit Agreement). As of September 29, 2018, the Company had a total amount available to borrow under the 2017 Credit Agreement of \$1,208 million after outstanding letters of credit. As of September 29, 2018, the Company was in compliance with all debt covenants. In July 2018, the Company entered into a \$150 million U.S.-to-Euro interest rate cross-currency swap agreement that hedges the Company's net investment in its Euro denominated net assets. As a result of entering into this agreement, the Company anticipates lowering net interest expense by approximately \$5 million annually over the next three years.

In April 2018, the Company's Board of Directors authorized the Company to repurchase up to \$3 billion of its outstanding common stock over a three-year period. This new program adds the remaining \$526 million from the pre-existing program, allowing for the purchase of a total of \$3.5 billion of the Company's common stock over a three-year period. Upon commencement of the new authorization, the May 2017 authorization was terminated. During the first nine months of 2018 and 2017, the Company repurchased \$809 million and \$238 million, respectively, of the Company's outstanding common stock under authorized share repurchase programs. In addition, the Company repurchased \$9 million and \$8 million of common stock related to the vesting of restricted stock units during the nine months ended September 29, 2018 and September 30, 2017, respectively. The Company expects to increase its share repurchase activity in 2019 as compared to 2018 and intends to use existing cash and investments, cash flows from operations and, as needed, borrowings under its existing credit facilities to fund its repurchases under its share repurchase program.

Table of Contents

The Company received \$42 million and \$73 million of proceeds from the exercise of stock options and the purchase of shares pursuant to the Company's employee stock purchase plan during the nine months ended September 29, 2018 and September 30, 2017, respectively.

The Company had cash, cash equivalents and investments of \$2,084 million as of September 29, 2018. The majority of the Company's cash, cash equivalents and investments are generated from foreign operations, with \$942 million held by foreign subsidiaries at September 29, 2018, of which \$341 million was held in currencies other than U.S. dollars. The Company believes it has sufficient levels of cash flow and access to its existing cash, cash equivalents and investments to fund operations and capital expenditures, service debt interest, finance potential acquisitions and continue the authorized stock repurchase program in the U.S. These cash requirements are managed by the Company's cash flow from operations, its existing cash, cash equivalents and investments, and the use of the Company's revolving credit facility.

Management believes, as of the date of this report, that the Company's financial position, along with expected future cash flows from earnings based on historical trends and the ability to raise funds from external sources and the borrowing capacity from existing, committed credit facilities, will be sufficient to service debt and fund working capital and capital spending requirements, authorized share repurchase amounts and potential acquisitions for at least the next twelve months. Other than the Company gaining tax efficient access to its offshore cash, cash equivalents and investments as a result of the 2017 Tax Act, there have been no recent significant changes to the Company's financial position, nor are there any anticipated changes, to warrant a material adjustment related to indefinitely reinvested foreign earnings.

Contractual Obligations, Commercial Commitments, Contingent Liabilities and Dividends

A summary of the Company's contractual obligations and commercial commitments is included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 27, 2018. The Company reviewed its contractual obligations and commercial commitments as of September 29, 2018 and determined that there were no material changes outside the ordinary course of business from the information set forth in the Annual Report on Form 10-K.

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 that it has meritorious arguments in its current litigation matters and that any outcome, either individually or in the aggregate, will not be material to the Company's financial position or results of operations.

During the three and nine months ended September 29, 2018, the Company contributed \$5 million to its non-U.S. pension plans. During fiscal year 2018, the Company expects to contribute a total of approximately \$5 million to \$10 million to its defined benefit plans, excluding the U.S. defined benefit pension plans.

The Company has not paid any dividends and has no plans, at this time, to pay any dividends in the future.

Off-Balance Sheet Arrangements

The Company has not created, and is not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating parts of its business that are not consolidated (to the extent of the Company's ownership interest therein) into the consolidated financial statements. The Company has not entered into any transactions with unconsolidated entities whereby it has subordinated retained interests, derivative instruments or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities or any

other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company.

The Company enters into standard indemnification agreements in its ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company's business partners or customers, in connection with patent, copyright or other intellectual property infringement claims by any third party with respect

Table of Contents

to its current products, as well as claims relating to property damage or personal injury resulting from the performance of services by the Company or its subcontractors. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. Historically, the Company's costs to defend lawsuits or settle claims relating to such indemnity agreements have been minimal and management accordingly believes the estimated fair value of these agreements is immaterial.

Critical Accounting Policies and Estimates

In the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 27, 2018, the Company's most critical accounting policies and estimates upon which its financial status depends were identified as those relating to revenue recognition, loss provisions on accounts receivable and inventory, valuation of long-lived assets, intangible assets and goodwill, income taxes, uncertain tax positions, warranty, litigation, pension and other postretirement benefit obligations, stock-based compensation, business combinations and asset acquisitions and valuation of contingent consideration. The Company reviewed its policies and determined that those policies remain the Company's most critical accounting policies for the nine months ended September 29, 2018. Except for the adoption of the new revenue recognition accounting standard, the Company did not make any changes in those policies during the nine months ended September 29, 2018. Please refer to Note 2, Revenue Recognition, for further information regarding the new revenue recognition accounting policy.

New Accounting Pronouncements

Please refer to Note 14, Recent Accounting Standard Changes and Developments, in the Condensed Notes to Consolidated Financial Statements.

Special Note Regarding Forward-Looking Statements

Certain of the statements in this Quarterly Report on Form 10-Q, including the information incorporated by reference herein, may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), with respect to future results and events, including any statements regarding, among other items, anticipated trends or growth in the Company's business, including, but not limited to, the impact of new or proposed tariff or trade regulations; the impact of foreign currency translation on financial results; development of products by acquired businesses; the growth rate of sales and research and development expenses; the impact of costs associated with developing new technologies and bringing these new technologies to market; the impact of new product launches and the associated costs, such as the amortization expense related to software platforms; geographic sales mix of business; development of products by acquired businesses and the amount of contingent payments to the sellers of an acquired business; anticipated expenses, including interest expense, capitalized software costs and effective tax rates; the impact of the 2017 Tax Act in the U.S.; the impact and outcome of the Company's various ongoing tax audit examinations; the achievement of contractual milestones to preserve foreign tax rates; the impact and outcome of litigation matters; the impact of the loss of intellectual property protection; the impact of new accounting standards and pronouncements; the adequacy of the Company's supply chain and manufacturing capabilities and facilities; the impact of regulatory compliance; the Company's expected cash flow, borrowing capacity, debt repayment and refinancing; the Company's ability to fund working capital, capital expenditures, service debt, repay outstanding lines of credit, make authorized share repurchases, fund potential acquisitions and pay any adverse litigation or tax audit liabilities, particularly in the U.S.; future impairment charges; the Company's contributions to defined benefit plans; the Company's expectations regarding changes to its financial position; compliance with applicable environmental laws; and the impact of recent acquisitions on sales and earnings.

Many of these statements appear, in particular, under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations in Part I, Item 2 of this Quarterly Report on Form 10-Q. Statements that are not statements of historical fact may be deemed forward-looking statements. You can identify these forward-looking statements by the use of the words feels, believes, anticipates, plans, expects, may, will, would, intend, appears, estimates, projects, should and similar expressions, whether in the negative or affirmative. These statements are subject to various risks and uncertainties, many of which are outside the control of the Company, including, and without limitation:

Table of Contents

Foreign currency exchange rate fluctuations that could adversely affect translation of the Company's future sales, financial operating results and the condition of its non-U.S. operations, especially when a currency weakens against the U.S. dollar.

Current global economic, sovereign and political conditions and uncertainties, particularly regarding the effect of new or proposed tariff or trade regulations; the U.K. voting to exit the European Union as well as the Chinese government's ongoing tightening of restrictions on procurement by government-funded customers; the Company's ability to access capital and maintain liquidity in volatile market conditions; changes in timing and demand for the Company's products among the Company's customers and various market sectors, particularly if they should reduce capital expenditures or are unable to obtain funding, as in the cases of governmental, academic and research institutions; the effect of mergers and acquisitions on customer demand for the Company's products; and the Company's ability to sustain and enhance service.

Negative industry trends; changes in the competitive landscape as a result of changes in ownership, mergers and continued consolidation among the Company's competitors; introduction of competing products by other companies and loss of market share; pressures on prices from customers or resulting from competition; regulatory, economic and competitive obstacles to new product introductions; lack of acceptance of new products; expansion of our business in developing markets; spending by certain end-markets; ability to obtain alternative sources for components and modules; and the possibility that future sales of new products related to acquisitions, which trigger contingent purchase payments, may exceed the Company's expectations.

Increased regulatory burdens as the Company's business evolves, especially with respect to the United States Food and Drug Administration and the United States Environmental Protection Agency, among others, as well as regulatory, environmental and logistical obstacles affecting the distribution of the Company's products, completion of purchase order documentation by our customers and ability of customers to obtain letters of credit or other financing alternatives.

Risks associated with lawsuits, particularly involving claims for infringement of patents and other intellectual property rights.

The impact and costs incurred from changes in accounting principles and practices; the impact and costs of changes in statutory or contractual tax rates in jurisdictions in which the Company operates, specifically as it relates to the newly enacted tax reform legislation in the U.S.; shifts in taxable income among jurisdictions with different effective tax rates; and the outcome of and costs associated with ongoing and future tax audit examinations or changes in respective country legislation affecting the Company's effective rates.

Certain of these and other factors are discussed under the heading "Risk Factors" under Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 27, 2018. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements, whether because of these factors or for other reasons. All forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q and are expressly qualified in their entirety by the cautionary statements included in this report. Except as required by law, the Company does not assume any obligation to update any forward-looking statements.

Item 3: *Quantitative and Qualitative Disclosures About Market Risk*

In July 2018, the Company entered into a \$150 million U.S.-to-Euro interest rate cross-currency swap agreement that hedges the Company's net investment in its Euro denominated net assets. The difference between the interest rate received and paid under the interest rate cross-currency swap agreement is recorded as interest income. During both the three and nine months ended September 29, 2018, the Company recorded \$1 million of interest income related to these agreements.

Assuming a hypothetical adverse change of 10% in year-end exchange rates (a strengthening of the U.S. dollar), the fair market value of the interest rate cross-currency swap agreements outstanding as of September 29, 2018 would increase by approximately \$15 million and would be recorded to foreign currency translation in other comprehensive income within stockholders' equity. The related impact on interest income would not have a material effect on pre-tax earnings.

Table of Contents

The Company is exposed to the risk of interest rate fluctuations from the investments of cash generated from operations. Investments with maturities greater than 90 days are classified as investments, and are held primarily in U.S. dollar-denominated treasury bills and commercial paper, bank deposits and corporate debt securities. As of September 29, 2018, the Company estimates that a hypothetical adverse change of 100 basis points across all maturities would not have a material effect on the fair market value of its portfolio.

The Company is also exposed to the risk of exchange rate fluctuations. 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 September 29, 2018 and December 31, 2017, \$942 million out of \$2,084 million and \$3,326 million out of \$3,394 million, respectively, of the Company's total cash, cash equivalents and investments were held by foreign subsidiaries. In addition, \$341 million out of \$2,084 million and \$304 million out of \$3,394 million of cash, cash equivalents and investments were held in currencies other than the U.S. dollar at September 29, 2018 and December 31, 2017, respectively. As of September 29, 2018, the Company has no holdings in auction rate securities or commercial paper issued by structured investment vehicles.

Assuming a hypothetical adverse change of 10% in year-end exchange rates (a strengthening of the U.S. dollar), the fair market value of the Company's cash, cash equivalents and investments held in currencies other than the U.S. dollar as of September 29, 2018 would decrease by approximately \$34 million, of which the majority would be recorded to foreign currency translation in other comprehensive income within stockholders' equity.

There have been no other material changes in the Company's market risk during the nine months ended September 29, 2018. For information regarding the Company's market risk, refer to Item 7A of Part II of the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 27, 2018.

Item 4: Controls and Procedures*Evaluation of Disclosure Controls and Procedures*

The Company's chief executive officer and chief financial officer (principal executive officer and principal financial officer), with the participation of management, evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures were effective as of September 29, 2018 (1) to ensure that information required to be disclosed by the Company, including its consolidated subsidiaries, in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its chief executive officer and chief financial officer, to allow timely decisions regarding the required disclosure and (2) to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in Internal Controls Over Financial Reporting

No change was identified in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 29, 2018 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II: Other Information

Item 1: *Legal Proceedings*

There have been no material changes in the Company's legal proceedings during the three months ended September 29, 2018 as described in Item 3 of Part 1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 27, 2018.

Item 1A: *Risk Factors*

Information regarding risk factors of the Company is set forth under the heading "Risk Factors" under Part I, Item 1A in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 27, 2018. The Company reviewed its risk factors as of September 29, 2018 and determined that there were no material changes from the ones set forth in the Form 10-K. Note, however, the discussion under the subheading "Special Note Regarding Forward-Looking Statements" in Part I, Item 2 of this Quarterly Report on Form 10-Q. These risks are not the only ones facing the Company. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and operating results.

Table of Contents**Item 2: Unregistered Sales of Equity Securities and Use of Proceeds***Purchases of Equity Securities by the Issuer*

The following table provides information about purchases by the Company during the three months ended September 29, 2018 of equity securities registered by the Company under the Exchange Act (in thousands, except per share data):

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs (2)	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Programs (2)
July 1 to July 28, 2018		\$		\$ 3,254,966
July 29 to August 25, 2018	615	\$ 191.91	615	\$ 3,136,978
August 26 to September 29, 2018	757	\$ 192.18	754	\$ 2,992,082
Total	1,372	\$ 192.06	1,369	\$ 2,992,082

- (1) The Company repurchased 3 thousand shares of common stock at a cost of less than \$1 million related to the vesting of restricted stock units during the three months ended September 29, 2018.
- (2) In April 2018, the Company's Board of Directors authorized the repurchase of up to \$3 billion of its outstanding common stock in open market transactions over a three-year period.

Item 6: Exhibits

Exhibit Number	Description of Document
31.1	<u>Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
31.2	<u>Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
32.1	<u>Chief Executive Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(*).</u>
32.2	<u>Chief Financial Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(*).</u>
101	The following materials from Waters Corporation's Quarterly Report on Form 10-Q for the quarter ended September 29, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets (unaudited), (ii) the Consolidated Statements of Operations (unaudited),

(iii) the Consolidated Statements of Comprehensive Income (unaudited), (iv) the Consolidated Statements of Cash Flows (unaudited) and (vi) Condensed Notes to Consolidated Financial Statements (unaudited).

(**) This exhibit shall not be deemed filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, whether made before or after the date hereof and irrespective of any general incorporation language in any filing, except to the extent the Company specifically incorporates it by reference.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WATERS CORPORATION

/s/ Sherry L. Buck
Sherry L. Buck
*Senior Vice President and
Chief Financial Officer*

Date: November 2, 2018