WATTS WATER TECHNOLOGIES INC
Form 10-K
February 27, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2008

Or

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

Commission file number 001-11499

WATTS WATER TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	**04-2916536** (I.R.S. Employer Identification No.)
815 Chestnut Street, North Andover, MA (Address of Principal Executive Offices)	**01845** (Zip Code)

Registrant's telephone number, including area code: **(978) 688-1811**

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

Title of Each Class	Name of Each Exchange on Which Registered
Class A Common Stock, par value $0.10 per share	**New York Stock Exchange**

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

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

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

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 ý No o

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

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

Large accelerated filer ý	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

(Do not check if a smaller reporting company)

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

As of June 29, 2008, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was approximately $708,165,326 based on the closing sale price as reported on the New York Stock Exchange.

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at February 20, 2009
Class A Common Stock, $0.10 par value per share	29,407,648 shares
Class B Common Stock, $0.10 par value per share	7,193,880 shares

DOCUMENTS INCOPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for its Annual Meeting of Stockholders to be held on May 13, 2009, are incorporated by reference into Part III of this Annual Report on Form 10-K.

PART I

Item 1. *BUSINESS.*

This Annual Report on Form 10-K contains statements which are not historical facts and are considered forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements contain projections of our future results of operations or our financial position or state other forward-looking information. In some cases you can identify these forward-looking statements by words such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "should," "will" and "would" or similar words. You should not rely on forward-looking statements because they involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. These risks, uncertainties and other factors may cause our actual results, performance or achievements to differ materially from the anticipated future results, performance or achievements expressed or implied by the forward-looking statements. Some of the factors that might cause these differences are described under Item 1A "Risk Factors." You should carefully review all of these factors, and you should be aware that there may be other factors that could cause these differences. These forward-looking statements were based on information, plans and estimates at the date of this report, and, except as required by law, we undertake no obligation to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.

In this Annual Report on Form 10-K, references to "the Company," "Watts," "we," "us" or "our" refer to Watts Water Technologies, Inc. and its consolidated subsidiaries.

Overview

Watts Regulator Co. was founded by Joseph E. Watts in 1874 in Lawrence, Massachusetts. Watts Regulator Co. started as a small machine shop supplying parts to the New England textile mills of the 19th century and grew into a global manufacturer of products and systems focused on the control, conservation and quality of water and the comfort and safety of the people using it. Watts Water Technologies, Inc. was incorporated in Delaware in 1985 and became the parent Company of Watts Regulator Co.

Our "Water by Watts" strategy is to be the leading provider of water quality, water conservation, water safety and water flow control products for the residential and commercial markets in North America and Europe and to expand our presence in Asia. Our primary objective is to grow earnings by increasing sales within existing markets, expanding into new markets, leveraging our distribution channels and customer base, making selected acquisitions, reducing manufacturing costs and advocating for the development and enforcement of industry standards.

We intend to continue to introduce products in existing markets by enhancing our preferred brands, developing new complementary products, promoting plumbing code development to drive sales of safety and water quality products and continually improving merchandising in both the do-it-yourself (DIY) and wholesale distribution channels. We continually target selected new product and geographic markets based on growth potential, including our ability to leverage our existing distribution channels. Additionally, we continually leverage our distribution channels through the introduction of new products, as well as the integration of products of our acquired companies.

We intend to continue to generate growth by targeting selected acquisitions, both in our core markets as well as new complementary markets. We have completed 32 acquisitions since divesting our industrial and oil and gas business in 1999, including one acquisition in each of 2008 and 2007 and five acquisitions in 2006. Our acquisition strategy focuses on businesses that manufacture preferred brand name products that address our themes of water quality, water safety, water conservation, water flow control and related complementary markets. We target businesses that will provide us with one or more of the following: an entry into new markets, an increase in shelf space with existing customers, strong brand names, a new or improved technology or an expansion of the breadth of our Water by Watts offerings.

We are committed to reducing our manufacturing and operating costs through a combination of manufacturing in lower-cost countries, using Lean Six Sigma to drive continuous improvement across all key processes, and consolidating our diverse manufacturing operations in North America, Europe and China. We have acquired a number of manufacturing facilities in lower-cost regions such as China, Bulgaria and Tunisia. In 2007, we announced a global restructuring plan to reduce our manufacturing footprint in order to reduce our costs and to realize additional operating efficiencies. In February 2009, we announced an additional plan to consolidate manufacturing in North America and China. See Recent Developments in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for more details.

Our products are sold to wholesale distributors and dealers, major DIY chains and original equipment manufacturers (OEMs). Most of our sales are for products that have been approved under regulatory standards incorporated into state and municipal plumbing, heating, building and fire protection codes in North America and Europe. We have consistently advocated the development and enforcement of plumbing codes and are committed to providing products to meet these standards, particularly for safety and control valve products. These codes serve as a competitive barrier to entry by requiring that products sold in select jurisdictions meet stringent criteria.

Additionally, a majority of our manufacturing facilities are ISO 9000, 9001 or 9002 certified by the International Organization for Standardization.

Our business is reported in three geographic segments: North America, Europe and China. The contributions of each segment to net sales, operating income and the presentation of certain other financial information by segment are reported in Note 17 of the Notes to Consolidated Financial Statements and in Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report.

Recent Acquisitions and Disposition

On May 30, 2008, we purchased all of the outstanding share capital of Blücher Metal A/S (Blücher) located in Vildbjerg, Denmark, for approximately $183.5 million, which includes the assumption of $13.4 million of debt, net of cash acquired. Blücher is a leading provider of stainless steel drainage systems in Europe to the residential, commercial and industrial marketplaces and is a worldwide leader in providing stainless steel drainage products to the marine industry. Blücher's main products include push-fit stainless steel pipes and related fittings, light-duty drains for residential, commercial and marine applications, and drains for heavy-duty industrial applications including brewery and pharmaceutical applications.

During the second quarter of 2008, we completed the acquisition of the remaining 40% ownership of our Tianjin Tanggu Watts Valve Company Ltd. joint venture in China, known as TWT, for $3.3 million in cash. TWT manufactured products to support the U.S. operations as well as to sell into the local China market. In the third quarter of 2008, we relocated the business supporting the U.S. from TWT into an existing operation in China. We then entered into an agreement to sell TWT. Under this agreement, we determined that the risks and rewards of ownership of TWT were effectively transferred to the buyer as of October 18, 2008. We further determined that we were no longer the primary beneficiary of the operating results of TWT and therefore had deconsolidated TWT as of the agreement date. As the equity transfer from us to the buyer has not yet been approved by local authorities, we deferred a $1.1 million gain from the sale. We expect to recognize the gain during 2009, upon final approval of the transfer by Chinese government authorities. The deferred gain has been recorded as a current liability in the accompanying Consolidated Balance Sheet.

On November 9, 2007, we acquired the assets and business of Topway Global Inc. (Topway) located in Brea, California for approximately $18.4 million. Topway manufactures a wide variety of water softeners, point of entry filter units, and point of use drinking water systems for residential, commercial and industrial applications.

Products

We believe that we have the broadest range of products in terms of design distinction, size and configuration in a majority of our principal product lines. In 2008 and 2007, water quality products accounted for approximately 17% and 18%, respectively, of our total sales. Our principal product lines include:

- water quality products, including backflow preventers and check valves for preventing reverse flow within water lines and fire protection systems and point-of-use water filtration and reverse osmosis systems for both commercial and residential applications;
- a wide range of water pressure regulators for both commercial and residential applications;
- drainage products for industrial, commercial, marine and residential applications;
- water supply products for commercial and residential applications;
- temperature and pressure relief valves for water heaters, boilers and associated systems;
- thermostatic mixing valves for tempering water in commercial and residential applications;
- systems for under-floor radiant applications and hydraulic pump groups for gas boiler manufacturers and renewable energy applications, including solar and heat pump control packages;
- flexible stainless steel connectors for natural and liquid propane gas in commercial food service and residential applications; and
- large diameter butterfly valves for use in China's water infrastructure.

Customers and Markets

We sell our products to plumbing, heating and mechanical wholesale distributors, major DIY chains and OEMs.

Wholesalers. Approximately 65% of our sales in both 2008 and 2007 were to wholesale distributors for both commercial and residential applications. We rely on commissioned manufacturers' representatives, some of which maintain a consigned inventory of our products, to market our product lines. Additionally, various water quality products are sold to independent dealers throughout North America.

DIY. Approximately 13% and 15% of our sales in 2008 and 2007, respectively, were to DIY customers. Our DIY customers demand less technical products, but are highly receptive to innovative designs and new product ideas.

OEMs. Approximately 22% and 20% of our sales in 2008 and 2007, respectively, were to OEMs. In North America, our typical OEM customers are water heater manufacturers, equipment manufacturers needing flow control devices and water systems manufacturers needing backflow preventers. Our sales to OEMs in Europe are primarily to boiler manufacturers, and radiant systems manufacturers. Our sales to OEMs in China are primarily to boiler and bath manufacturers including manufacturers of faucet and shower products.

In both 2008 and 2007, no customer accounted for more than 10% of our total net sales. Our top ten customers accounted for approximately $293.9 million, or 20%, of our total net sales in 2008 and $304.3 million, or 22%, of our total net sales in 2007. Thousands of other customers constituted the remaining 80% of our net sales in 2008 and 78% of our net sales in 2007.

Marketing and Sales

We rely primarily on commissioned manufacturers' representatives, some of which maintain a consigned inventory of our products. These representatives sell primarily to plumbing and heating wholesalers or service DIY store locations in North America. We also sell products for the residential construction and home repair and remodeling industries through DIY plumbing retailers, national catalog distribution companies, hardware stores, building material outlets and retail home center chains and through plumbing and heating wholesalers. In addition, we sell products directly to certain large OEMs and private label accounts.

Manufacturing

We have integrated and automated manufacturing capabilities, including a bronze foundry, machining, plastic extrusion and injection molding and assembly operations. Our foundry operations include metal pouring systems, automatic core making, yellow brass forging and brass and bronze die-castings. Our machining operations feature computer-controlled machine tools, high-speed chucking machines with robotics and automatic screw machines for machining bronze, brass and steel components. We have invested heavily in recent years to expand our manufacturing capabilities and to ensure the availability of the most efficient and productive equipment. We are committed to maintaining our manufacturing equipment at a level consistent with current technology in order to maintain high levels of quality and manufacturing efficiencies.

Capital expenditures and depreciation for each of the last three years were as follows:

	Years Ended December 31,		
	2008	**2007**	**2006**
		(in millions)	
Capital expenditures	$26.6	$37.8	$44.7
Depreciation	$31.8	$28.9	$26.7

The Company's 2006 capital expenditures included approximately $18.0 million related to the purchase and subsequent sale-leaseback of a building in Italy.

Raw Materials

We require substantial amounts of raw materials to produce our products, including bronze, brass, cast iron, steel and plastic, and substantially all of the raw materials we require are purchased from outside sources. We had experienced increases in the costs of certain raw materials, particularly copper. Bronze and brass are copper-based alloys. Through July 3, 2008, copper prices rose significantly from demands in the worldwide marketplace. The spot price of copper, which was $4.08 at July 3, 2008, had increased approximately 186% from December 2005. In response, we implemented price increases for some of our products that had become more expensive to manufacture due to the increases in raw material costs. During 2007 and 2006, cost increases in raw materials were not completely recovered by increased selling prices or other product cost reductions. During the latter half of 2008, commodity prices, including copper, decreased significantly as most industrialized and emerging economies began experiencing economic recessions. The spot price of copper at December 31, 2008 was $1.32. We are not able to predict whether commodity costs, including copper, will significantly increase or decrease in the future. If commodity costs increase in the future and we are not able to reduce or eliminate the effect of the cost increases by reducing production costs or implementing price increases, our profit margins could decrease. If commodity costs continue to decline, we may experience pressures from customers to reduce our selling prices. The timing of any price reductions and decreases in commodity costs may not align. Therefore, our near-term margins in 2009 could decline.

Code Compliance

Products representing a majority of our sales are subject to regulatory standards and code enforcement which typically require that these products meet stringent performance criteria. Standards are established by such industry test and certification organizations as the American Society of Mechanical Engineers (A.S.M.E.), the Canadian Standards Association (C.S.A.), the American Society of Sanitary Engineers (A.S.S.E.), the University of Southern California Foundation for Cross-Connection Control (USC FCC), the International Association of Plumbing and Mechanical Officials (I.A.P.M.O.), Factory Mutual (F.M.), the National Sanitation Foundation (N.S.F.) and Underwriters Laboratory (U.L.). Many of these standards are incorporated into state and municipal plumbing and heating, building and fire protection codes.

National regulatory standards in Europe vary by country. The major standards and/or guidelines which our products must meet are AFNOR (France), DVGW (Germany), UNI/ICIN (Italy), KIWA (Netherlands), SVGW (Switzerland), SITAC (Sweden) and WRAS (United Kingdom). Further, there are local regulatory standards requiring compliance as well.

Together with our commissioned manufacturers' representatives, we have consistently advocated for the development and enforcement of plumbing codes. We maintain stringent quality control and testing procedures at each of our manufacturing facilities in order to manufacture products in compliance with code requirements.

We believe that product-testing capability and investment in plant and equipment is needed to manufacture products in compliance with code requirements. Additionally, a majority of our manufacturing facilities are ISO 9000, 9001 or 9002 certified by the International Organization for Standardization.

New Product Development and Engineering

We maintain our own product development staff, design teams, and testing laboratories in North America, Europe and China that work to enhance our existing products and develop new products. We maintain sophisticated product development and testing laboratories. Research and development costs included in selling, general, and administrative expense amounted to $17.5 million, $15.1 million and $12.7 million for the years ended December 31, 2008, 2007 and 2006, respectively.

California and Vermont recently enacted laws that will require beginning on January 1, 2010 that all pipes, pipe and plumbing fittings and plumbing fixtures sold in those states that convey or dispense water for human consumption contain virtually no lead content. Other states, including Maryland, are currently considering similar legislation and we expect that similar laws will be adopted in other states in the future. We have invested considerable resources over the past several years to develop lead free versions of our plumbing products to comply with these new laws. We expect that our lead free product offerings will be available for sale by the fourth quarter of 2009, which should allow our customers in California and Vermont time to manage their inventories of our products to prepare for the January 1, 2010 implementation date of the new lead free standards.

Competition

The domestic and international markets for water safety and flow control devices are intensely competitive and require us to compete against some companies possessing greater financial, marketing and other resources than ours. Due to the breadth of our product offerings, the number and identities of our competitors vary by product line and market. We consider brand preference, engineering specifications, plumbing code requirements, price, technological expertise, delivery times and breadth of product offerings to be the primary competitive factors. We believe that new product development and product engineering are also important to success in the water industry and that our position in the industry is attributable in part to our ability to develop new and innovative products quickly and to adapt and enhance existing products. We continue to develop new and innovative products to enhance market position and are continuing to implement manufacturing and design programs to reduce costs. We cannot be certain that our efforts to develop new products will be successful or that our customers will accept our new products. Although we own certain patents and trademarks that we consider to be of importance, we do not believe that our business and competitiveness as a whole are dependent on any one of our patents or trademarks or on patent or trademark protection generally.

Backlog

Backlog was approximately $94.8 million at February 13, 2009 and was approximately $116.8 million at February 15, 2008. We do not believe that our backlog at any point in time is indicative of future operating results.

Employees

As of December 31, 2008, our wholly-owned domestic and foreign operations employed approximately 6,300 people. None of our employees in North America or China are covered by collective bargaining agreements. In some European countries our employees are subject to traditional national collective bargaining agreements. We believe that our employee relations are good.

Available Information

We maintain a website with the address *www.wattswater.com*. The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own internet access charges, we make available free of charge through our website our Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we have electronically filed such material with, or furnished such material to, the Securities and Exchange Commission.

Certifications

Our Chief Executive Officer and Chief Financial Officer have provided the certifications required by rule 13a-14(a) under the Securities Exchange Act of 1934, copies of which are filed as exhibits to this Annual Report on Form 10-K. In addition, an annual chief executive officer certification was submitted by our Chief Executive Officer to the New York Stock Exchange on May 19, 2008 in accordance with the New York Stock Exchange listing requirements.

Executive Officers and Directors

Set forth below are the names of our executive officers and directors, their respective ages and positions with our Company and a brief summary of their business experience for at least the past five years:

Name	Age	Position
Patrick S. O'Keefe	56	Chief Executive Officer, President and Director
William C. McCartney	54	Chief Financial Officer and Treasurer
J. Dennis Cawte	58	Group Managing Director, Europe
David J. Coghlan	49	President of North America and Asia
Ernest E. Elliott	57	Executive Vice President of Marketing
Michael P. Flanders	50	Executive Vice President of Manufacturing Operations, North America and Asia
Josh C. Fu	52	President, Asia
Kenneth R. Lepage	38	General Counsel and Secretary
Gregory J. Michaud	47	Executive Vice President of Human Resources
Taylor K. Robinson	45	Executive Vice President of Supply Chain Management
Douglas T. White	64	Group Vice President
Robert L. Ayers(1)(3)	63	Director
Kennett F. Burnes(1)(3)	66	Director
Richard J. Carthcart(2)	64	Director
Timothy P. Horne	70	Director
Ralph E. Jackson Jr.(2)(3)	67	Director
Kenneth J. McAvoy(1)(3)	68	Director
John K. McGillicuddy(1)	65	Director
Gordon W. Moran(2)(3)	70	Non-Executive Chairman of the Board and Director
Daniel J. Murphy, III(2)(3)	67	Director

(1) Member of the Audit Committee

(2) Member of the Compensation Committee

(3) Member of the Nominating and Corporate Governance Committee

Patrick S. O'Keefe joined our Company in 2002. Prior to joining our Company, he served as President, Chief Executive Officer and Director of Industrial Distribution Group, a supplier of maintenance, repair, operating and production products, from 1999 to 2001. He was Chief Executive Officer of Zep Manufacturing, a unit of National Service Industries and a manufacturer of specialty chemicals throughout North America, Europe and Australia, from 1997 to 1999. He also held various senior management positions with Crane Co. from 1994 to 1997.

William C. McCartney joined our Company in 1985 as Controller. He was appointed our Vice President of Finance in 1994 and served as our Corporate Controller from 1988 to 1999. He was appointed Chief Financial Officer and Treasurer in 2000. He served as Secretary of the Company from January 2000 to November 2005.

J. Dennis Cawte joined our Company in 2001 and was appointed Group Managing Director Europe. Prior to joining our Company, he was European President of PCC Valve and Controls, a division of Precision Castparts Corp., a manufacturer of components and castings to the aeronautical industry, from 1999 to 2001. He had also worked for approximately 20 years for Keystone Valve International, a manufacturer and distributor of industrial valves, where his most recent position was the Managing Director Northern Europe, Middle East, Africa and India.

David J. Coghlan joined our Company in June 2008 as President of North America and Asia. Prior to joining our Company, Mr. Coghlan served as Vice President, Global Parts of Trane Inc., a global manufacturer of commercial and residential heating, ventilation and air conditioning equipment, from April 2004 through May 2008. He also held several management positions within the Climate Control Technologies segment of Ingersoll-Rand Company Limited, a manufacturer of transport temperature control units and refrigerated display merchandisers, from 1995 to December 2003. Before joining Ingersoll-Rand, Mr. Coghlan worked for several years with the management consulting firm of McKinsey & Co. in both the United Kingdom and United States.

Ernest E. Elliott joined our Company in 1986 and has served in a variety of sales and marketing roles. He was appointed Vice President of Sales in 1991, served as Executive Vice President of Wholesale Sales and Marketing from 1996 to March 2003, Executive Vice President of Wholesale Marketing from March 2003 to February 2006 and as Executive Vice President of Marketing since February 2006. Mr. Elliott temporarily assumed responsibilities of our former Chief Operating Officer and President of North American and Asian Operations in September 2007. Prior to joining our Company, he was Vice President of BTR Inc.'s Valve Group, a diversified manufacturer of industrial and commercial valve products.

Michael P. Flanders joined our Company in October 2007 as Executive Vice President of Manufacturing Operations, North America and Asia. From August 2005 to July 2007, he served as President and Chief Operating Officer of Aavid Thermalloy, LLC, an international manufacturing company providing thermal management solutions to the computer and electronics industries. From July 2003 to April 2005, he was Vice President and General Manager of Waukesha Bearings Corporation, a manufacturer of hydrodynamic and active magnetic bearings and a subsidiary of Dover Corporation. From November 1998 to July 2003, he was General Manager of the LCN Division of Ingersoll-Rand Company Limited, which manufactured mechanical and electronic door control products.

Josh C. Fu joined our Company in January 2008 as President, Asia. From January 2007 to December 2007, he served as President and Chief Executive Officer of Reradiant International Co. Ltd., a consulting firm focused on the energy and industrial goods industries. From August 2004 to December 2006, he served as President of the China operations of Flowserve Corporation, a global manufacturer of flow control equipment, including valves, pumps, and seals. From July 2003 to August 2004, he was Executive Vice President, Product Development and Merchandise Sourcing for Intercon Merchandise Sourcing, an importer of consumer goods from China. From 2000 to 2003, he held various senior management positions with the China operations of BP p.l.c., a worldwide petroleum and petrochemicals company.

Kenneth R. Lepage was appointed General Counsel and Secretary of the Company in August 2008. Mr. Lepage originally joined our Company in September 2003 as Assistant General Counsel and Assistant Secretary. Prior to joining our Company, he was a junior partner at the law firm of Hale and Dorr LLP (now Wilmer Cutler Pickering Hale and Dorr LLP).

Gregory J. Michaud joined our Company in April 2006 as Executive Vice President of Human Resources. Prior to joining our Company, he served as Vice President, Human Resources of the

Compact Equipment division of Ingersoll-Rand Company Limited, a diversified industrial company, from June 2003 through March 2006. He served as Vice President, Human Resources of the Productivity Solutions division of Ingersoll-Rand from January 2003 to June 2003 and as Director, Human Resources & Corporate Organizational Planning of Ingersoll-Rand from June 2000 to December 2002.

Taylor K. Robinson joined our Company in September 2007 as Executive Vice President of Supply Chain Management. From January 2007 to August 2007, he owned and operated a consulting company named Global Supply Chain Solutions, which provided advice to international clients to improve their global supply chain methods and operations. From February 2004 to April 2006, he was Chief Procurement Officer for H.J. Heinz Company, an international manufacturer and marketer of processed foods. From January 1999 to January 2004, he served in various positions for Honeywell International Inc., a diversified technology and manufacturing company, including Global Supply Chain Director, Aviation Aftermarket Services, Director of Global Sourcing, Aerospace Electronic Systems and Corporate Director of Global Commodity Management Electronics.

Douglas T. White joined our Company in 2001 as Group Vice President. Prior to joining our Company he was employed by Honeywell International, Inc., a diversified technology and manufacturing company, as Vice President of Marketing Consumer Products Group from 1998 to 2001.

Robert L. Ayers has served as a director of our Company since October 2006. He was Senior Vice President of ITT Industries and President of ITT Industries' Fluid Technology from October 1999 until September 2005. Mr. Ayers continued to be employed by ITT Industries from September 2005 until his retirement in September 2006, during which time he focused on special projects for the company. Mr. Ayers joined ITT Industries in 1998 as President of ITT Industries' Industrial Pump Group. Before joining ITT Industries, he was President of Sulzer Industrial USA and Chief Executive Officer of Sulzer Bingham, a pump manufacturer. He is a director of T-3 Energy Services, Inc.

Kennett F. Burnes became a director of our Company in February 2009. Mr. Burnes is the retired Chairman, President and Chief Executive Officer of Cabot Corporation, a global specialty chemicals company. He was Chairman from 2001 to March 2008, President from 1995 to January 2008 and Chief Executive Officer from 2001 to January 2008. Prior to joining Cabot Corporation in 1987, Mr. Burnes was a partner at the Boston-based law firm of Choate, Hall & Stewart, where he specialized in corporate and business law for nearly 20 years. He is a director of State Street Corporation, a member of the Dana Farber Cancer Institute's Board of Trustees and a board member of the New England Conservatory. Mr. Burnes is also Chairman of the Board of Trustees of the Schepens Eye Research Institute.

Richard J. Cathcart has served as a director of our Company since October 2007. He was Vice Chairman and a member of the Board of Directors of Pentair, Inc. from February 2005 until his retirement in September 2007. Pentair is a diversified manufacturing company consisting of two operating segments: Water Technologies and Technical Products. He was appointed President and Chief Operating Officer of Pentair's Water Technologies Group in January 2001 and served in that capacity until his appointment as Vice Chairman in February 2005. He began his career at Pentair in March 1995 as Executive Vice President, Corporate Development, where he identified water as a strategic area of growth. In February 1996, he was named Executive Vice President and President of Pentair's Water Technologies Group. Prior to joining Pentair, he held several management and business development positions during his 20-year career with Honeywell International Inc. He is a director of Fluidra S.A.

Timothy P. Horne has served as a director of our Company since 1962. He became an employee of our Company in 1959 and served as our President from 1976 to 1978, from 1994 to 1997 and from 1999 to 2002. He served as our Chief Executive Officer from 1978 to 2002, and he served as Chairman of our Board of Directors from 1986 to 2002. He retired as an employee of our Company on December 31, 2002. Since his retirement, he has continued to serve our Company as a consultant.

Ralph E. Jackson, Jr. has served as a director of our Company since 2004. He worked for Cooper Industries, Inc., a manufacturer of electrical products, from 1985 until his retirement in December 2003. Prior to joining Cooper Industries, he worked for the Bussmann and Air Comfort divisions of McGraw-Edison from 1976 until McGraw-Edison was acquired by Cooper Industries in 1985. While with Cooper Industries, he served as Chief Operating Officer from 2000 to December 2003, Executive Vice President, Electrical Operations from 1992 to 2000, and President, Bussmann Division from the time McGraw-Edison was acquired by Cooper Industries to 1992. He served as a member of the Board of Directors of Cooper Industries from 2000 to December 2003.

Kenneth J. McAvoy has served as a director of our Company since 1994. He was Controller of our Company from 1981 to 1985 and Chief Financial Officer and Treasurer from 1986 to 1999. He also served as Vice President of Finance from 1984 to 1994; Executive Vice President of European Operations from 1994 to 1996; and Secretary from 1985 to 1999. He retired from our Company on December 31, 1999.

John K. McGillicuddy has served as a director of our Company since 2003. He was employed by KPMG LLP, a public accounting firm, from 1965 until his retirement in 2000. He was elected into the Partnership at KPMG LLP in June 1975 where he served as Audit Partner, SEC Reviewing Partner, Partner-in-Charge of Professional Practice, Partner-in-Charge of College Recruiting and Partner-in-Charge of Staff Scheduling. He is a director of Brooks Automation, Inc. and Cabot Corporation.

Gordon W. Moran has served as a director of our Company since 1990. He has been the Chairman of Hollingsworth & Vose Company, a paper manufacturer, since 1997, and served as its President and Chief Executive Officer from 1983 to 1998.

Daniel J. Murphy, III has served as a director of our Company since 1986. He has been the Chairman of Northmark Bank, a commercial bank he founded, since 1987. Prior to forming Northmark Bank in 1987, he was a Managing Director of Knightsbridge Partners, a venture capital firm, from January to August 1987, and President and a director of Arltru Bancorporation, a bank holding company, and its wholly-owned subsidiary, Arlington Trust Company, from 1980 to 1986.

Product Liability, Environmental and Other Litigation Matters

We are subject to a variety of potential liabilities connected with our business operations, including potential liabilities and expenses associated with possible product defects or failures and compliance with environmental laws. We maintain product liability and other insurance coverage, which we believe to be generally in accordance with industry practices. Nonetheless, such insurance coverage may not be adequate to protect us fully against substantial damage claims.

Contingencies

James Jones Litigation

On June 25, 1997, Nora Armenta (the Relator) filed a civil action in the California Superior Court for Los Angeles County (the Armenta case) against James Jones Company (James Jones), Mueller Co., Tyco International (U.S.), and the Company. We formerly owned James Jones. The Relator filed under the qui tam provision of the California state False Claims Act, Cal. Govt. Code § 12650 et seq. (California False Claims Act) and generally alleged that James Jones and the other defendants violated this statute by delivering some "defective" or "non-conforming" waterworks parts to municipal water systems in the State of California. The Relator filed a First Amended Complaint in November 1998 and a Second Amended Complaint in December 2000, which brought the total number of plaintiffs to 161. The Complaint further alleges that purchased non-conforming James Jones waterworks parts may leach into public drinking water elevated amounts of lead that may create a public health risk because they were made out of '81 bronze alloy (UNS No. C8440) and contain more lead than the specified and advertised '85 bronze alloy (UNS No. C83600). This contention is based on the average difference of about 2% lead content between '81 bronze (6% to 8% lead) and '85 bronze (4% to 6% lead) and the assumption that this would mean increased consumable lead in public drinking water that could cause a public health concern. We believe the evidence and discovery available to date indicates that this is not the case. In addition, '81 bronze is used extensively in municipal and home plumbing systems and is approved by municipal, local and national codes. The Federal Environmental Protection Agency also defines metal for pipe fittings with no more than 8% lead as "lead free" under Section 1417 of the Federal Safe Drinking Water Act.

In this case, the Relator seeks three times an unspecified amount of actual damages and alleges that the municipalities have suffered hundreds of millions of dollars in damages. She also seeks civil penalties of $10,000 for each false claim and alleges that defendants are responsible for tens of thousands of false claims. Finally, the Relator requests an award of costs of this action, including attorneys' fees.

In December 1998, the Los Angeles Department of Water and Power (LADWP) intervened in this case and filed a complaint. We settled with the city of Los Angeles, by far the most significant city, for $7.3 million plus attorneys' fees. Co-defendants contributed $2.0 million toward this settlement.

In August 2003, an additional settlement payment was made for $13.0 million ($11.0 million from us and $2.0 million from James Jones), which settled the claims of the three Phase I cities (Santa Monica, San Francisco and East Bay Municipal Utility District) chosen by the Relator as having the strongest claims to be tried first. In addition to this $13.0 million payment, we are obligated to pay the Relator's attorney's fees.

On June 22, 2005, the Court dismissed the claims of the Phase II cities selected for a second trial phase (Contra Costa, Corona, Santa Cruz and Vallejo). The Court ruled that the Relator and these cities were required to show that the cities had received out of specification parts which were related to specific invoices and that this showing had not been made. Although each city's claim is unique, this ruling is significant for the claims of the remaining cities, and the Relator appealed. On June 29, 2007, the appellate court dismissed this appeal. However, this judgment can be appealed again at the conclusion of the entire case. The trial court has scheduled a trial on October 6, 2009 for six Phase III cities. Litigation is inherently uncertain, and we are unable to predict the outcome of this case.

On September 15, 2004, the Relator's attorneys filed a lawsuit in the California Superior Court for the City of Banning and 42 other cities and water districts against James Jones, Watts and Mueller Co. based on the same transactions alleged in the Armenta case alleging common law fraud. In October 2008, the Court dismissed the claims of 11 cities as time-barred. A first phase trial of selected cities is scheduled for April 13, 2010. Litigation is inherently uncertain, and we are unable to predict the outcome of this case.

On February 14, 2001, after our insurers had denied coverage for the claims in the Armenta case, we filed a complaint for coverage against our insurers in the California Superior Court (the coverage case). James Jones filed a similar complaint, the cases were consolidated, and the trial court made summary adjudication rulings that Zurich must pay all reasonable defense costs incurred by us and James Jones in the Armenta case since April 23, 1998 as well as such defense costs in the future until the end of the Armenta case. In August 2004, the California Court of Appeal affirmed these rulings, and, on December 1, 2004, the California Supreme Court denied Zurich's appeal of this decision. This denial permanently established Zurich's obligation to pay Armenta defense costs for both us and James Jones, and Zurich is currently making payments of incurred Armenta defense costs. However, as noted below, Zurich asserts that the defense costs paid by it are subject to reimbursement.

On November 22, 2002, the trial court entered a summary adjudication order that Zurich must indemnify and pay us and James Jones for amounts paid to settle with the City of Los Angeles. On August 6, 2004, the trial court made another summary adjudication ruling that Zurich must indemnify and pay us and James Jones for the $13.0 million paid to settle the claims of the Phase I cities described above. Zurich will be able to appeal these orders at the end of the coverage case. Zurich has now made all of the payments required by these indemnity orders.

On February 8, 2006, Zurich filed a motion to set aside as void the November 22, 2002 and August 6, 2004 summary adjudication indemnity payment orders. After this motion was denied, Zurich's appeal was also denied and the California Supreme Court denied Zurich's petition for review. We are currently unable to predict the finality of these indemnity payment orders since Zurich can also appeal them at the end of the coverage case.

Zurich has asserted that all amounts paid by it to us and James Jones are subject to reimbursement under Deductible Agreements related to the insurance policies between Zurich and Watts. We believe that the agreements are unenforceable, that the Armenta case should be viewed as one occurrence, and that the deductible amount should be $0.5 million per occurrence if the agreements are enforceable.

On January 31, 2006, the federal district court in Chicago, Illinois determined that there are disputes under all Deductible Agreements in effect during the period in which Zurich issued primary policies and that the arbitrator could decide which agreements would control reimbursement claims. We appealed this ruling. On October 20, 2006, the United States Court of Appeals for the Seventh Circuit affirmed that an arbitration panel could decide which deductible agreements between Zurich and us would control Zurich's reimbursement claim.

Based on management's assessment, we do not believe that the ultimate outcome of the James Jones Litigation will have a material adverse effect on our liquidity, financial condition or results of operations. While this assessment is based on the facts currently known by us, litigation is inherently uncertain, the actual liability to us to resolve this litigation fully cannot be predicted with any certainty and there exists a reasonable possibility that we may ultimately incur losses in the James Jones Litigation in excess of the amount accrued. We intend to continue to contest vigorously all aspects of the James Jones Litigation.

Environmental Remediation

We have been named as a potentially responsible party with respect to a limited number of identified contaminated sites. The levels of contamination vary significantly from site to site as do the related levels of remediation efforts. Environmental liabilities are recorded based on the most probable cost, if known, or on the estimated minimum cost of remediation. We accrue estimated environmental liabilities based on assumptions, which are subject to a number of factors and uncertainties. Circumstances which can affect the reliability and precision of these estimates include identification of additional sites, environmental regulations, level of cleanup required, technologies available, number and financial condition of other contributors to remediation and the time period over which remediation may occur. We recognize changes in estimates as new remediation requirements are defined or as new information becomes available.

Based on the facts currently known to us, we do not believe that the ultimate outcome of these matters will have a material adverse effect on our liquidity, financial condition or results of operations. Some of our environmental matters are inherently uncertain and there exists a possibility that we may ultimately incur losses from these matters in excess of the amount accrued. However, we cannot currently estimate the amount of any such additional losses.

Asbestos Litigation

We are defending approximately 105 lawsuits in different jurisdictions, with the greatest number filed in Mississippi and California state courts, alleging injury or death as a result of exposure to asbestos. The complaints in these cases typically name a large number of defendants and do not identify any particular Watts products as a source of asbestos exposure. To date, we have obtained a dismissal in every case before it has reached trial because discovery has failed to yield evidence of substantial exposure to any Watts products. Based on the facts currently known to us, we do not believe that the ultimate outcome of these claims will have a material adverse effect on our liquidity, financial condition or results of operations.

Other Litigation

Other lawsuits and proceedings or claims, arising from the ordinary course of operations, are also pending or threatened against us. Based on the facts currently known to us, we do not believe that the ultimate outcome of these other litigation matters will have a material adverse effect on our liquidity, financial condition or results of operations.

Item 1A. *RISK FACTORS.*

Current economic cycles, particularly reduced levels of residential and non-residential starts and remodeling, may continue to have an adverse effect on our revenues and operating results.

We have experienced and expect to continue to experience fluctuations in revenues and operating results due to economic and business cycles. The businesses of most of our customers, particularly plumbing and heating wholesalers and home improvement retailers, are cyclical. Therefore, the level of our business activity has been cyclical, fluctuating with economic cycles. The current economic downturn may also affect the financial stability of our customers, which could impact their ability to pay amounts owed vendors, including us. We also believe our level of business activity is influenced by residential and non-residential starts and renovation and remodeling, which are, in turn, heavily influenced by interest rates, consumer debt levels, changes in disposable income, employment growth and consumer confidence. The current conditions in the housing and debt markets have caused a significant reduction in residential and non-residential starts and renovation and remodeling. These conditions have caused a decrease in our revenue and profit. If these conditions continue or worsen in the future, our revenues and profits could decrease and could result in a material adverse effect on our financial condition and results of operations.

Our ability to make large acquisitions may be limited due to the current credit market conditions.

As widely reported, the financial markets worldwide have been experiencing, among other things, severely diminished liquidity and credit availability. One of our strategies is to increase our revenues and profitability and expand our markets through acquisitions. We may require capital in excess of our available cash and the unused portion of our revolving credit facility to make large acquisitions, which we would generally obtain from access to the credit markets. However, the current economic environment may adversely impact the availability and cost of credit in the future. There can be no assurance that if a large acquisition is identified that we would have access to sufficient capital to complete such acquisition.

Sales of our products to customers serving the commercial market may be impacted by the delay or cancellation of projects due to the current credit market conditions.

Our products are sold to commercial builders and others in the commercial construction market. The current credit market conditions may prevent commercial builders or developers from obtaining the necessary capital to continue existing projects or to start new projects. This may result in the delay or cancellation of orders from our customers or potential customers and may adversely affect our revenues and our ability to manage inventory levels, collect customer receivables and maintain profitability.

Our ability to improve our profitability through the introduction of new technology in the manufacturing process may be delayed due to the reallocation of capital.

With the current economic outlook worldwide, it is necessary for us to make decisions on the best immediate use of capital. In reaching those decisions, certain planned capital expenditures which would modernize or improve throughput at our manufacturing locations may be delayed until the current credit market improves. The delay of these capital expenditures may impact our ability to realize efficiencies through new technologies and may result in increased maintenance costs in the business.

We face intense competition and, if we are not able to respond to competition in our markets, our revenues may decrease.

Competitive pressures in our markets could adversely affect our competitive position, leading to a possible loss of market share or a decrease in prices, either of which could result in decreased revenues and profits. We encounter intense competition in all areas of our business. Additionally, we believe our customers are attempting to reduce the number of vendors from which they purchase in order to reduce the size and diversity of their inventories and their transaction costs. To remain competitive, we will need to invest continually in manufacturing, marketing, customer service and support and our distribution networks. We may not have sufficient resources to continue to make such investments and we may be unable to maintain our competitive position. In addition, we anticipate that we may have to reduce the prices of some of our products to stay competitive, potentially resulting in a reduction in the profit margin for, and inventory valuation of, these products. Some of our competitors are based in foreign countries and have cost structures and prices in foreign currencies. Accordingly, currency fluctuations could cause our U.S. dollar-priced products to be less competitive than our competitors' products which are priced in other currencies.

Reductions or interruptions in the supply of raw materials and changes in the costs of raw materials could reduce our profit margins and adversely affect our ability to meet our customer delivery commitments.

We require substantial amounts of raw materials, including bronze, brass, cast iron, steel and plastic and substantially all of the raw materials we require are purchased from outside sources. The availability and costs of raw materials may be subject to curtailment or change due to, among other things, new laws or regulations, suppliers' allocations to other purchasers, interruptions in production by suppliers and changes in exchange rates and worldwide price and demand levels. We typically do not enter into long-term supply agreements. Our inability to obtain adequate supplies of raw materials for our products at favorable costs, or at all, could have a material adverse effect on our business, financial condition or results of operations by decreasing our profit margins and by hindering our ability to deliver products to our customers on a timely basis. During 2006 and continuing through approximately July 3, 2008, commodity costs rose significantly from demands in the worldwide marketplace. During the latter half of 2008, commodity costs, including copper, decreased significantly as most industrialized and emerging economies began experiencing recessions. If we cannot maintain our selling prices before our inventory costs reflect the recent rapid decline in copper prices our profitability could decline. Should commodity costs increase substantially again in the future, we may not be able to completely recover such costs, as happened in 2006 and 2007, through selling price increases to our customers or other product cost reductions, which would have a negative effect on our financial results. Additionally, we continue to purchase increased levels of finished product from international sources. If there is an interruption in delivering these finished products to our domestic warehouses, this could have a negative effect on our financial results.

Implementation of our acquisition strategy may not be successful, which could affect our ability to increase our revenues or our profitability.

One of our strategies is to increase our revenues and profitability and expand our markets through acquisitions that will provide us with complementary water-related products and increase market share for our existing product lines. We cannot be certain that we will be able to identify, acquire or profitably manage additional companies or successfully integrate such additional companies without substantial costs, delays or other problems. Also, companies acquired recently and in the future may not achieve revenues, profitability or cash flows that justify our investment in them. We expect to spend significant time and effort in expanding our existing businesses and identifying, completing and integrating acquisitions. We have faced increasing competition for acquisition candidates which have resulted in significant increases in the purchase prices of many acquisition candidates. This competition, and the resulting purchase price increases, may limit the number of acquisition opportunities available to us, possibly leading to a decrease in the rate of growth of our revenues and profitability. In addition, acquisitions may involve a number of special risks, including, but not limited to:

- inadequate internal controls over financial reporting and our ability to bring such controls into compliance with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 in a timely manner;
- adverse short-term effects on our reported operating results;
- diversion of management's attention;
- investigations of, or challenges to, acquisitions by competition authorities;
- loss of key personnel at acquired companies; and
- unanticipated management or operational problems or legal liabilities.

We are subject to risks related to product defects, which could result in product recalls and could subject us to warranty claims in excess of our warranty provisions or which are greater than anticipated due to the unenforceability of liability limitations.

We maintain strict quality controls and procedures, including the testing of raw materials and safety testing of selected finished products. However, we cannot be certain that our testing will reveal latent defects in our products or the materials from which they are made, which may not become apparent until after the products have been sold into the market. We also cannot be certain that our suppliers will always eliminate latent defects in products we purchase from them. Accordingly, there is a risk that product defects will occur, which could require a product recall. Product recalls can be expensive to implement and, if a product recall occurs during the product's warranty period, we may be required to replace the defective product. In addition, a product recall may damage our relationship with our customers and we may lose market share with our customers. Our insurance policies may not cover the costs of a product recall.

Our standard warranties contain limits on damages and exclusions of liability for consequential damages and for misuse, improper installation, alteration, accident or mishandling while in the possession of someone other than us. We may incur additional operating expenses if our warranty provision does not reflect the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, it could adversely affect our business, financial condition and results of operations.

We face risks from product liability and other lawsuits, which may adversely affect our business.

We have been and expect to continue to be subject to various product liability claims or other lawsuits, including, among others, that our products include inadequate or improper instructions for use or installation, or inadequate warnings concerning the effects of the failure of our products. In the event that we do not have adequate insurance or contractual indemnification, damages from these claims would have to be paid from our assets and could have a material adverse effect on our results of operations, liquidity and financial condition. We, like other manufacturers and distributors of products designed to control and regulate fluids and gases, face an inherent risk of exposure to product liability claims and other lawsuits in the event that the use of our products results in personal injury, property damage or business interruption to our customers. Although we maintain strict quality controls and procedures, including the testing of raw materials and safety testing of selected finished products, we cannot be certain that our products will be completely free from defect. In addition, in certain cases, we rely on third-party manufacturers for our products or components of our products. Although we have product liability and general insurance coverage, we cannot be certain that this insurance coverage will continue to be available to us at a reasonable cost, or, if available, will be adequate to cover any such liabilities. For more information, see "Item 1. Business Product Liability, Environmental and Other Litigation Matters."

Economic and other risks associated with international sales and operations could adversely affect our business and future operating results.

Since we sell and manufacture our products worldwide, our business is subject to risks associated with doing business internationally. Our business and future operating results could be harmed by a variety of factors, including:

- trade protection measures and import or export licensing requirements, which could increase our costs of doing business internationally;
- potentially negative consequences from changes in tax laws, which could have an adverse impact on our profits;
- difficulty in staffing and managing widespread operations, which could reduce our productivity;
- costs of compliance with differing labor regulations, especially in connection with restructuring our overseas operations;
- natural disasters and public health emergencies;
- laws of some foreign countries, which may not protect our intellectual property rights to the same extent as the laws of the United States; and
- unexpected changes in regulatory requirements, which may be costly and require time to implement.

Fluctuations in foreign exchange rates could materially affect our reported results.

We are exposed to fluctuations in foreign currencies, as a portion of our sales and certain portions of our costs, assets and liabilities are denominated in currencies other than U.S. dollars. Approximately 45.3% of our sales during the year ended December 31, 2008 were from sales outside of the U.S. compared to 41.7% for the year ended December 31, 2007. For the years ended December 31, 2008 and 2007, the appreciation of the euro against the U.S. dollar had a positive impact on sales of approximately $31.3 million and $34.1 million, respectively. There were also minor impacts on sales in other European currencies such as the pound sterling and Danish krone against the U.S. dollar. Additionally, our Canadian operations require significant amounts of U.S. purchases for their operations. Instead of buying or manufacturing domestically, we currently have a favorable cost structure for certain goods we source from our wholly-owned subsidiaries in China and our outside vendors. In 2005, China revalued its currency higher against the U.S. dollar and stated it would no longer tie the yuan to a fixed rate against the U.S. currency. The yuan was valued at 6.8 and 7.3 at December 31, 2008 and 2007, respectively. China also stated it will peg the yuan against numerous currencies, although it will keep the yuan in a tight band rather than letting it trade freely. The spot rate of the euro and Canadian dollar decreased in value and the yuan increased in value from December 31, 2007 to December 31, 2008 by approximately 19%, 5% and 6% respectively, against the U.S. dollar. If our share of revenue and purchases in non-dollar denominated currencies continues to increase in future periods, exchange rate fluctuations will likely have a greater impact on our results of operations and financial condition.

Our ability to achieve savings through our restructuring plans may be impacted by local regulations or factors beyond the control of management.

We implemented restructuring plans in 2007 and in 2009. Management's plans include a number of steps that we believe are necessary to reduce operating costs and increase efficiencies throughout our manufacturing footprint. Although we have considered the impact of local regulations, negotiations with employee representatives, the timing of capital expenditures necessary to prepare facilities and the related costs associated with these activities, factors beyond the control of management may impact the timing and therefore impact when the savings will be achieved under the plans. Further, if we are not successful in completing the restructuring projects in the time frames contemplated or if additional issues arise during the projects that add costs or disrupt customer service, then our operating results could be negatively affected.

If we cannot continue operating our manufacturing facilities at current or higher utilization levels, our results of operations could be adversely affected.

The equipment and management systems necessary for the operation of our manufacturing facilities may break down, perform poorly or fail, resulting in fluctuations in our ability to manufacture our products and to achieve manufacturing efficiencies. We operate a number of manufacturing facilities, all of which are subject to this risk, and such fluctuations at any of these facilities could cause an increase in our production costs and a corresponding decrease in our profitability. We also have a vertically-integrated manufacturing process. Each segment is dependent upon the prior process and any breakdown in one segment will adversely affect all later components. Fluctuations in our production process may affect our ability to deliver products to our customers on a timely basis. Our inability to meet our delivery obligations could result in a loss of our customers and negatively affect our business, financial condition and results of operations.

In addition, we have an ongoing manufacturing restructuring program to reduce our manufacturing costs. If our planned manufacturing plant consolidations in the United States, Europe and China are not successful, our results of operations and financial condition could be materially adversely affected.

If we continue to experience declines in demand, we will further reduce our production levels, resulting in lower capacity utilization that could negatively impact our results of operations.

In response to the current recessionary pressures and reduced order volumes, we have decreased our production levels to conserve cash. If we continue to experience declines in orders from customers, we will take further steps to reduce our production levels to avoid building inventory and increasing our working capital levels. While this step helps to preserve cash, a large amount of our production costs are fixed and therefore will negatively impact our ability to absorb these costs, resulting in lower gross margins for the products manufactured. Although we are expecting a certain level of decreased production volume in 2009, there can be no assurances that additional steps will not be required to reduce these levels further thereby decreasing our results from operations.

If we experience delays in introducing new products or if our existing or new products do not achieve or maintain market acceptance and regulatory approvals, our revenues and our profitability may decrease.

Our failure to develop new and innovative products or to custom design existing products could result in the loss of existing customers to competitors or the inability to attract new business, either of which may adversely affect our revenues. Our industry is characterized by:

- intense competition;
- changes in specifications required by our customers, plumbing codes and/or regulatory agencies;
- changes in requirements under new legislation;

technically complex products; and

constant improvement to existing products and introductions of new products.

We believe our future success will depend, in part, on our ability to anticipate or adapt to these factors and to offer, on a timely basis, products that meet customer demands and the requirements of plumbing codes and/or regulatory agencies. The development of new or enhanced products is a complex and uncertain process requiring the anticipation of technological and market trends. We may experience design, manufacturing, marketing or other difficulties, such as an inability to attract a sufficient number of experienced engineers, that could delay or prevent our development, introduction, approval or marketing of new products or enhancements and result in unexpected expenses. Such difficulties could cause us to lose business from our customers and could adversely affect our competitive position; in addition, added expenses could decrease the profitability associated with those products that do not gain market acceptance. Additionally, we recently developed lead free versions of many of our plumbing products to comply with new lead content standards going into effect in California and Vermont. If our lead free products fail to comply with these new standards or if we encounter difficulties in the manufacturing processes for these products, we could lose a substantial amount of business from customers in California and Vermont and any other states that adopt similar standards in the future.

Environmental compliance costs and liabilities could increase our expenses or reduce our profitability.

Our operations and properties are subject to extensive and increasingly stringent laws and regulations relating to environmental protection, including laws and regulations governing air emissions, water discharges, waste management and disposal and workplace safety. Such laws and regulations can impose substantial fines and sanctions for violations and require the installation of costly pollution control equipment or operational changes to limit pollution emissions and/or decrease the likelihood of accidental hazardous substance releases. We could be required to halt one or more portions of our operations until a violation is cured. We could also be liable for the costs of property damage or personal injury to others. Although we attempt to operate in compliance with these environmental laws, we may not succeed in this effort at all times. The costs of curing violations or resolving enforcement actions that might be initiated by government authorities could be substantial.

Under certain environmental laws, the current and past owners or operators of real property may be liable for the costs of cleaning up contamination, even if they did not know of or were not responsible for such contamination. These laws also impose liability on any person who arranges for the disposal or treatment of hazardous waste at any site. We have been named as a potentially responsible party or are otherwise conducting remedial activities with respect to a limited number of identified contaminated sites, including sites we currently own or operate. There can be no assurances that our ownership and operation of real property and our disposal of waste will not lead to other liabilities under these laws.

We have incurred, and expect to continue to incur, costs relating to environmental matters. In addition, new laws and regulations, stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination or the imposition of new clean-up requirements could require us to incur additional costs or become the basis for new or increased liabilities that could be significant. Environmental litigation, enforcement and compliance are inherently uncertain and we may experience significant costs in connection with environmental matters. For more information, see "Item 1. Business Product Liability, Environmental and Other Litigation Matters."

Third parties may infringe our intellectual property and we may expend resources enforcing our rights or suffer competitive injury.

We rely on a combination of patents, copyrights, trademarks, trade secrets, confidentiality provisions and licensing arrangements to establish and protect our proprietary rights. We may be required to spend resources to monitor and police our intellectual property rights. If we fail to successfully enforce our intellectual property rights, our competitive position could suffer, which could harm our operating results. We have been limited from selling products from time-to-time because of existing patents.

The requirements of Financial Accounting Standards Board Statement No. 142, "Goodwill and Other Intangible Assets" (FAS 142) may result in a write-off of all or a portion of our goodwill and non-amortizable intangible assets, which would negatively affect our operating results and financial condition.

As of December 31, 2008, we recorded goodwill and non-amortizable intangible assets of $431.3 million and $62.0 million, respectively. In lieu of amortization, we are required to perform an annual impairment review of both goodwill and non-amortizable intangible assets. In 2008, in performing our annual goodwill review, we recognized a non-cash pre-tax charge of approximately $22.0 million as an impairment of all the goodwill value related to one reporting unit. Although we did not experience goodwill impairment in our remaining reporting units, there can be no assurances that future goodwill impairment will not occur. We perform our annual test for indications of goodwill and non-amortizable intangible assets impairment in the fourth quarter of our fiscal year or sooner if indicators of impairment exist.

The loss or financial instability of a major customer could have an adverse effect on our results of operations.

In 2008, our top ten customers accounted for approximately 20% of our total net sales with no one customer accounting for more than approximately 5% of our total net sales. Our customers generally are not obligated to purchase any minimum volume of products from us and are able to terminate their relationships with us at any time. In addition, increases in the prices of our products could result in a reduction in orders for our customers. A significant reduction in orders from, or change in terms of contracts with, any significant customers could have a material adverse effect on our future results of operations. Furthermore, some of our major customers are facing financial challenges due to market declines and heavy debt levels; should these challenges become acute, our results could be materially adversely affected due to reduced orders and/or payment delays or defaults.

Certain indebtedness may limit our ability to pay dividends, incur additional debt and make acquisitions and other investments.

Our revolving credit facility and other senior indebtedness contain operational and financial covenants that restrict our ability to make distributions to stockholders, incur additional debt and make acquisitions and other investments unless we satisfy certain financial tests and comply with various financial ratios. If we do not maintain compliance with these covenants, our creditors could declare a default under our revolving credit facility or senior notes and our indebtedness could be declared immediately due and payable. Our ability to comply with the provisions of our indebtedness may be affected by changes in economic or business conditions beyond our control. Further, given the current condition of the credit markets, should we require additional debt financing above our existing credit limit, we cannot be assured such financing would be available to us or available to us on reasonable economic terms.

Investments in auction rate securities and rights issued by UBS are subject to risks which may cause losses and affect the liquidity of these investments.

At December 31, 2008, we held $6.0 million in auction rate securities (ARS) at fair value whose underlying investments are AA rated municipal bonds and student loans and $2.3 million in rights issued by UBS, AG (UBS). All of our ARS were sold by UBS. In the fourth quarter of 2008, UBS issued a settlement offer to the holder of certain ARS including all of the securities held by us. Under the terms of the settlement offer, UBS issued non-transferable rights entitling the holder to sell the underlying ARS at par to UBS at any time during the period June 30, 2010 through July 2, 2012, after which time the rights expire. UBS could elect at any time from the settlement through the expiration of the settlement agreement to purchase the ARS, in which case UBS would be required to pay par value for the ARS. The value of the ARS and the related rights from UBS are subject to the credit risk of the underlying agencies which originally issued the bonds as well as the credit risk of UBS. If UBS is unable to perform under the terms of the rights agreements, we could incur losses to liquidate the remaining securities or hold the securities to maturity.

One of our stockholders can exercise substantial influence over our Company.

As of February 1, 2009, Timothy P. Horne, a member of our board of directors, beneficially owned approximately 19.8% of our outstanding shares of Class A Common Stock (assuming conversion of all shares of Class B Common Stock beneficially owned by Mr. Horne into Class A Common Stock) and approximately 99.0% of our outstanding shares of Class B Common Stock, which represents approximately 70.7% of the total outstanding voting power. As long as Mr. Horne controls shares representing at least a majority of the total voting power of our outstanding stock, Mr. Horne will be able to unilaterally determine the outcome of most stockholder votes, and other stockholders will not be able to affect the outcome of any such votes.

Conversion and sale of a significant number of shares of our Class B Common Stock could adversely affect the market price of our Class A Common Stock.

As of February 1, 2009, there were outstanding 29,251,739 shares of our Class A Common Stock and 7,293,880 shares of our Class B Common Stock. Shares of our Class B Common Stock may be converted into Class A Common Stock at any time on a one for one basis. Under the terms of a registration rights agreement with respect to outstanding shares of our Class B Common Stock, the holders of our Class B Common Stock have rights with respect to the registration of the underlying Class A Common Stock. Under these registration rights, the holders of Class B Common Stock may require, on up to two occasions, that we register their shares for public resale. If we are eligible to use Form S-3 or a similar short-form registration statement, the holders of Class B Common Stock may require that we register their shares for public resale up to two times per year. If we elect to register any shares of Class A Common Stock for any public offering, the holders of Class B Common Stock are entitled to include shares of Class A Common Stock into which such shares of Class B Common Stock may be converted in such registration. However, we may reduce the number of shares proposed to be registered in view of market conditions. We will pay all expenses in connection with any registration, other than underwriting discounts and commissions. If all of the available registered shares are sold into the public market the trading price of our Class A Common Stock could decline.

Our Class A Common Stock has insignificant voting power.

Our Class B Common Stock entitles its holders to ten votes for each share and our Class A Common Stock entitles its holders to one vote per share. As of February 1, 2009, our Class B Common Stock constituted 20.0% of our total outstanding common stock and 71.4% of the total outstanding voting power and thus is able to exercise a controlling influence over our business.

Item 1B. ***UNRESOLVED STAFF COMMENTS.***

None.

Item 2. ***PROPERTIES.***

As of December 31, 2008, we maintained approximately 74 facilities worldwide, including our corporate headquarters located in North Andover, Massachusetts. The remaining facilities consist of foundries, manufacturing facilities, warehouses, sales offices and distribution centers. The principal properties in each of our three geographic segments and their location, principal use and ownership status are set forth below:

North America:

Location	Principal Use	Owned/Leased
North Andover, MA	Corporate Headquarters	Owned
Export, PA	Manufacturing	Owned
Franklin, NH	Manufacturing/Distribution	Owned
Burlington, ON, Canada	Manufacturing/Distribution	Owned
Kansas City, KS	Manufacturing	Owned
Fort Myers, FL	Manufacturing	Owned
St. Pauls, NC	Manufacturing	Owned
Spindale, NC	Manufacturing/Distribution	Owned
Chesnee, SC	Manufacturing	Owned
Dunnellon, FL	Warehouse	Owned
San Antonio, TX	Warehouse	Owned
Springfield, MO	Manufacturing/Distribution	Leased
Langley, BC, Canada	Manufacturing	Leased
Houston, TX	Manufacturing	Leased
Brea, CA	Manufacturing	Leased
Phoenix, AZ	Warehouse	Leased
Kansas City, KS	Distribution Center	Leased
Reno, NV	Distribution Center	Leased
Vernon, CA	Distribution Center	Leased
Calgary, AB, Canada	Distribution Center	Leased

Europe:

Location	Principal Use	Owned/Leased
Eerbeek, Netherlands	European Headquarters/Manufacturing	Owned
Biassono, Italy	Manufacturing	Owned
Brescia, Italy	Manufacturing	Owned
Landau, Germany	Manufacturing	Owned
Fresseneville, France	Manufacturing	Owned
Hautvillers, France	Manufacturing	Owned
Plovdiv, Bulgaria	Manufacturing	Owned
Ammanford, United Kingdom	Manufacturing	Owned
Vildjberg, Denmark	Manufacturing	Owned
Rosières, France	Manufacturing	Leased
Monastir, Tunisia	Manufacturing	Leased
Gardolo, Italy	Manufacturing	Leased
Sorgues, France	Manufacturing	Leased
Grenoble, France	Manufacturing	Leased
Vojens, Denmark	Warehouse	Leased

China:

Location	Principal Use	Owned/Leased
Shanghai, China	Asian Headquarters	Leased
Tianjin Tanggu District, THMT, China	Manufacturing	Owned
Taizhou, Yuhuan, China	Manufacturing	Owned
Hunan, Changsha, China	Manufacturing	Owned
Ningbo, Beilun, China	Manufacturing	Owned
Ningbo, Beilun Port, China	Distribution Center	Leased

Certain of our facilities are subject to mortgages and collateral assignments under loan agreements with long-term lenders. In general, we believe that our properties, including machinery, tools and equipment, are in good condition, well maintained and adequate and suitable for their intended uses. Many of our manufacturing plants, especially in North America and China, are currently operating at levels that our management considers below normal capacity due to the current worldwide recession. As part of its continuous manufacturing footprint review, in 2009, management will execute a plan to further consolidate its North America and Chinese operations. See Recent Developments in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," for more details.

Item 3. ***LEGAL PROCEEDINGS.***

We are from time to time involved in various legal and administrative procedures. See Item 1, "Business Product Liability, Environmental and Other Litigation Matters," which is incorporated herein by reference.

Item 4. ***SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.***

There were no matters submitted during the fourth quarter of the fiscal year covered by this Annual Report to a vote of security holders through solicitation of proxies or otherwise.

PART II

Item 5. ***MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.***

The following table sets forth the high and low sales prices of our Class A Common Stock on the New York Stock Exchange during 2008 and 2007 and cash dividends paid per share.

	2008			2007		
	High	**Low**	**Dividend**	**High**	**Low**	**Dividend**
First Quarter	$30.75	$24.02	$ 0.11	$46.71	$35.05	$ 0.10
Second Quarter	31.00	24.17	0.11	41.34	36.10	0.10
Third Quarter	33.00	21.89	0.11	39.96	30.40	0.10
Fourth Quarter	29.90	16.67	0.11	33.09	25.40	0.10

There is no established public trading market for our Class B Common Stock, which is held exclusively by members of the Horne family. The principal holders of such stock are subject to restrictions on transfer with respect to their shares. Each share of our Class B Common Stock (10 votes per share) is convertible into one share of Class A Common Stock (1 vote per share).

Aggregate common stock dividend payments for 2008 and 2007 were $16.2 million and $15.6 million, respectively. While we presently intend to continue to pay cash dividends, the payment of future cash dividends depends upon the Board of Directors' assessment of our earnings, financial condition, capital requirements and other factors.

The number of record holders of our Class A Common Stock as of February 22, 2009 was 166. The number of record holders of our Class B Common Stock as of February 22, 2009 was 7.

We satisfy the minimum withholding tax obligation due upon the vesting of shares of restricted stock and the conversion of restricted stock units into shares of Class A Common Stock by automatically withholding from the shares being issued a number of shares with an aggregate fair market value on the date of such vesting or conversion that would satisfy the withholding amount due.

We did not withhold any Class A Common Stock for withholding tax obligations during the quarter ended December 31, 2008.

The following table includes information with respect to repurchases we made of our Class A Common Stock during the quarter ended December 31, 2008.

Issuer Purchases of Equity Securities

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs(1)	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs(1)
September 29, 2008 - October 26, 2008				553,615
October 27, 2008 - November 23, 2008				553,615
November 24, 2008 - December 31, 2008				553,615
Total				553,615

(1)

On November 9, 2007, we announced that our Board of Directors had authorized a stock repurchase program. Under the program, we may repurchase up to an aggregate of 3.0 million shares of our Class A Common Stock in open market purchases or in privately negotiated transactions. On October 28, 2008, the Company announced that it had temporarily suspended its stock repurchase program. No shares were repurchased during the quarter ended December 31, 2008. As of December 31, 2008, we had repurchased 2.45 million shares of stock for a total cost of $68.1 million.

Performance Graph

Set forth below is a line graph comparing the cumulative total shareholder return on our Class A Common Stock for the last five years with the cumulative return of companies on the Standard & Poor's 500 Stock Index and the Russell 2000 Index. We chose the Russell 2000 Index because it represents companies with a market capitalization similar to that of Watts. The graph assumes that the value of the investment in our Class A Common Stock and each index was $100 at December 31, 2003 and that all dividends were reinvested.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*
Among Watts Water Technologies, Inc., The S&P 500 Index
and The Russell 2000 Index

* $100 invested on December 31, 2003 in stock or index, including reinvestment of dividends. Fiscal year ending December 31.

Cumulative Total Return

	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08
Watts Water Technologies, Inc	100.00	146.82	139.36	191.03	140.11	119.52
S&P 500	100.00	110.88	116.33	134.70	142.10	89.53
Russell 2000	100.00	118.33	123.72	146.44	144.15	95.44

The above Performance Graph and related information shall not be deemed "soliciting material" or to be "filed" with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that we specifically incorporate it by reference into such filing.

Item 6. ***SELECTED FINANCIAL DATA.***

The selected financial data set forth below should be read in conjunction with our consolidated financial statements, related Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included herein.

FIVE-YEAR FINANCIAL SUMMARY

(Amounts in millions, except per share and cash dividend information)

	Year Ended 12/31/08(1)(8)	Year Ended 12/31/07(2)(8)	Year Ended 12/31/06(3)(8)	Year Ended 12/31/05(4)(5)(8)	Year Ended 12/31/04(6)(7)(8)
Statement of operations data:					
Net sales	$ 1,459.4	$ 1,382.3	$ 1,230.8	$ 924.3	$ 824.6
Income from continuing operations	47.3	77.6	77.1	55.0	48.7
Loss from discontinued operations, net of taxes	(0.7)	(0.2)	(3.4)	(0.4)	(1.9)
Net income	46.6	77.4	73.7	54.6	46.8
Income per share from continuing operations diluted	1.28	1.99	2.29	1.67	1.49
Loss per share from discontinued operations diluted	(0.02)	(0.01)	(0.10)	(0.01)	(0.06)
Net income per share diluted	1.26	1.99	2.19	1.66	1.43
Cash dividends declared per common share	$ 0.44	$ 0.40	$ 0.36	$ 0.32	$ 0.28
Balance sheet data (at year end):					
Total assets	$ 1,660.1	$ 1,729.3	$ 1,660.9	$ 1,101.0	$ 922.7
Long-term debt, net of current portion	$ 409.8	$ 432.2	$ 441.7	$ 293.4	$ 180.6

(1) For the year ended December 31, 2008, net income includes the following net pre-tax costs: goodwill impairment, severance costs, asset write-downs and other costs in North America of $22.0 million, $2.6 million, $0.4 million and $1.5 million respectively; accelerated depreciation and other costs in China of $1.0 million and $0.2 million, respectively and minority interest income of $0.2 million; severance costs in Europe of $0.2 million. The after-tax cost of these items was $21.2 million.

(2) For the year ended December 31, 2007, net income includes the following net pre-tax costs: change in estimate of workers' compensation costs of $2.9 million, severance and product line discontinuance costs in North America of $0.4 million and $3.1 million, respectively; accelerated depreciation and asset write-downs, product line discontinuance costs and severance costs in China of $2.9 million, $0.7 million and $0.4 million, respectively, and minority interest income of $0.9 million. The after-tax cost of these items was $6.9 million.

(3) For the year ended December 31, 2006, net income includes the following net pre-tax gain: gain on sales of buildings of $8.2 million, restructuring costs consisting primarily of European severance of $2.2 million and amortization of $0.4 million, other costs consisting of accelerated depreciation and severance in our Chinese joint venture of $4.7 million and minority interest income of $1.5 million. The after-tax gain of these items was $1.5 million.

(4) For the year ended December 31, 2005, net income includes the following pre-tax costs: restructuring of $0.7 million and other costs consisting of accelerated depreciation and asset write-downs of $1.8 million. The after-tax cost of these items was $1.6 million.

(5)

For the year ended December 31, 2005, net income includes a net after-tax charge of $0.9 million for a selling, general and administrative expense charge of $1.5 million related to a contingent earn-out agreement.

(6)

For the year ended December 31, 2004, net income includes a net after-tax charge of $2.3 million for certain accrued expense adjustments, which are included in selling, general and administrative expense after-tax charges of $3.5 million related to a contingent earn-out agreement and $0.7 million for various accrual adjustments and $0.5 million recorded as an income tax benefit.

(7)

For the year ended December 31, 2004, net income includes the following pre-tax costs: restructuring of $0.1 million and other costs consisting of accelerated depreciation of $2.9 million. The after-tax cost of these items was $1.8 million.

(8)

In December 2004, we decided to divest our interest in our minority-owned subsidiary, Jameco International, LLC (Jameco LLC). We recorded in discontinued operation a net of tax impairment charge of $0.7 million for the year ended December 31, 2004. Also included in discontinued operations is the net of tax operating results of Jameco LLC of $0.1 million of loss and $0.1 million of income for the year ended December 31, 2004 and 2003, respectively. In September 1996, we divested our Municipal Water Group of businesses, which included Henry Pratt, James Jones Company and Edward Barber and Company Ltd. Costs and expenses related to the Municipal Water Group, for 2008, 2007, 2006, 2005 and 2004 relate to legal and settlement costs associated with the James Jones Litigation. The loss, net of taxes, consists of $ 0.7 million, $0.2 million, $3.4 million, $0.4 million and $1.1 million for the years ended December 31, 2008, 2007, 2006, 2005 and 2004, respectively.

Item 7. ***MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.***

Overview

We are a leading supplier of products for use in the water quality, water safety, water flow control and water conservation markets in both North America and Europe with an expanding presence in Asia. For over 130 years, we have designed and manufactured products that promote the comfort and safety of people and the quality and conservation of water used in commercial and residential applications. We earn revenue and income almost exclusively from the sale of our products. Our principal product lines include:

- water quality products, including backflow preventers and check valves for preventing reverse flow within water lines and fire protection systems and point-of-use water filtration and reverse osmosis systems for both commercial and residential applications;
- a wide range of water pressure regulators for both commercial and residential applications;
- drainage products for industrial, commercial, marine and residential applications;
- water supply products for commercial and residential applications;
- temperature and pressure relief valves for water heaters, boilers and associated systems;
- thermostatic mixing valves for tempering water in commercial and residential applications;
- systems for under-floor radiant applications and hydraulic pump groups for gas boiler manufacturers and renewable energy applications, including solar and heat pump control packages;
- flexible stainless steel connectors for natural and liquid propane gas in commercial food service and residential applications; and
- large diameter butterfly valves for use in China's water infrastructure.

Our business is reported in three geographic segments, North America, Europe and China. We distribute our products through three primary distribution channels, wholesale, do-it-yourself (DIY) and original equipment manufacturers (OEMs). Interest rates have an indirect effect on the demand for our products due to the effect such rates have on the number of new residential and commercial construction starts and remodeling projects. All three of these activities have an impact on our sales and earnings. An additional factor that has had an effect on our sales is fluctuation in foreign currencies, as a portion of our sales and certain portions of our costs, assets and liabilities are denominated in currencies other than the U.S. dollar.

We believe that the factors relating to our future growth include our ability to continue to make selective acquisitions, both in our core markets as well as in new complementary markets, regulatory requirements relating to the quality and conservation of water, increased demand for clean water with continued enforcement of plumbing and building codes and a healthy economic environment. We have completed 32 acquisitions since divesting our industrial and oil and gas business in 1999. Our acquisition strategy focuses on businesses that manufacture preferred brand name products that address our themes of water quality, water conservation, water safety and water flow control and related complementary markets. We target businesses that will provide us with one or more of the following: an entry into new markets, an increase in shelf space with existing customers, a new or improved technology or an expansion of the breadth of our water quality, water conservation, water safety and water flow control products for the residential and commercial markets. In 2008 and 2007, sales from acquisitions contributed approximately 4.6% and 3.9%, to our total sales growth over the prior year.

Products representing a majority of our sales are subject to regulatory standards and code enforcement, which typically require that these products meet stringent performance criteria. Together with our commissioned manufacturers' representatives, we have consistently advocated for the development and enforcement of such plumbing codes. We are focused on maintaining stringent quality control and testing procedures at each of our manufacturing facilities in order to manufacture products in compliance with code requirements and take advantage of the resulting demand for compliant products. We believe that the product development, product testing capability and investment in plant and equipment needed to manufacture products in compliance with code requirements, represent a barrier to entry for competitors. We believe that, over the long term, there is an increasing demand among consumers for products to ensure water quality, which creates growth opportunities for our products.

Adverse economic developments in 2008 created a challenging environment for us. The credit crisis and recessionary pressures negatively impacted the primary markets we serve. We took steps during the year to reduce costs and conserve cash. During the fourth quarter of 2008, we reduced our workforce by 10% in the U.S. This step is expected to save us approximately $10.0 million to $11.0 million per year. In addition to the reduction in force, we took several steps to help conserve cash into 2009, including suspending our stock repurchase program, first freezing U.S. wages and salaries and later implementing salary reductions, controlling capital spending levels and continuing to focus on working capital levels. We also announced a further operational restructuring program to consolidate our manufacturing footprint in North America and China. We will continue to evaluate acquisition candidates during 2009, but we expect funds to be spent on acquisitions will be less than that spent in 2008. We are enhancing our focus on productivity and continuous improvement, and on managing our working capital levels as well as positioning many of our products to benefit when the market returns. We believe that we are well positioned to weather the current economic crisis due to our ability to continue to generate positive cash flows and control spending levels. We are not faced with any major liquidity events until 2010, at which time $50.0 million of our debt will come due.

We require substantial amounts of raw materials to produce our products, including bronze, brass, cast iron, steel and plastic, and substantially all of the raw materials we require are purchased from outside sources. We have experienced volatility in the costs of certain raw materials, particularly copper. Bronze and brass are copper-based alloys. During the fourth quarter of 2008, prices of copper dropped from highs experienced less than nine months earlier.

A risk we face is our ability to deal effectively with changes in raw material costs. We manage this risk by monitoring related market prices, working with our suppliers to achieve the maximum level of stability in their costs and related pricing, seeking alternative supply sources when necessary, implementing cost reduction programs and passing increases in costs to our customers. Additionally from time to time we may use commodity futures contracts on a limited basis to manage this risk. We are not able to predict whether or for how long this volatility will continue. If costs continue to decrease, we may experience pressure from customers to reduce product pricing. We are unable to predict the timing and impact that these pricing decreases could have to our profit margins.

Another risk we face in all areas of our business is competition. We consider brand preference, engineering specifications, code requirements, price, technological expertise, delivery times and breadth of product offerings to be the primary competitive factors. As mentioned previously, we believe that the product development, product testing capability and investment in plant and equipment needed to manufacture products in compliance with code requirements, represent a barrier to entry for competitors. We are committed to maintaining our capital equipment at a level consistent with current technologies, and thus we spent approximately $26.6 million in 2008 and $37.8 million in 2007.

Recent Developments

On February 10, 2009, a plan was approved by the Board of Directors to expand our program to consolidate our manufacturing footprint in North America and China. The plan provides for the closure of three plants, with the relocation of those operations to existing facilities in either North America or China or to a new central facility in the United States.

The footprint consolidation pre-tax charge will be approximately $11.7 million, including severance charges of approximately $3.2 million, relocation costs of approximately $3.3 million and asset write-downs of approximately $5.2 million. We also expect to record a net gain on property sales of $2.4 million. One-time tax charges of approximately $7.0 million regarding the payback of prior tax holiday benefits are also expected to be incurred as part of the building relocations. Approximately 400 positions will be eliminated in connection with this consolidation. The net after tax charge for this manufacturing consolidation program is expected to be approximately $14.9 million ($4.4 million non cash), with costs being incurred through December 2009. We expect to spend approximately $4.8 million in capital expenditures to consolidate operations. We expect this entire project will be self-funded through net proceeds from the sale of buildings and other assets being disposed of as part of the plan.

On February 9, 2009, we declared a quarterly dividend of eleven cents ($0.11) per share on each outstanding share of Class A Common Stock and Class B Common Stock.

Results of Operations

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Net Sales. Our business is reported in three geographic segments: North America, Europe and China. Our net sales in each of these segments for the years ended December 31, 2008 and 2007 were as follows:

	Year Ended December 31, 2008		Year Ended December 31, 2007			
	Net Sales	**% Sales**	**Net Sales**	**% Sales**	**Change**	**Change to Consolidated Net Sales**
			(Dollars in millions)			
North America	**$ 866.2**	**59.4**%	$ 871.0	63.0%	$ (4.8)	(0.4)%
Europe	**546.0**	**37.4**	452.6	32.7	93.4	6.8
China	**47.2**	**3.2**	58.7	4.3	(11.5)	(0.8)
Total	**$ 1,459.4**	**100.0**%	$ 1,382.3	100.0%	$ 77.1	5.6%

The change in net sales is attributable to the following:

					Change As a % of Consolidated Net Sales				Change As a % of Segment Net Sales		
	North America	**Europe**	**China**	**Total**	**North America**	**Europe**	**China**	**Total**	**North America**	**Europe**	**China**
					(Dollars in millions)						
Organic growth	$ (18.2)	$ 11.3	$ (12.1)	$ (19.0)	(1.3)%	0.8%	(0.9)%	(1.4)%	(2.1)%	2.5%	(20.6)%
Foreign exchange	0.5	31.3	3.8	35.6		2.3	0.3	2.6		6.9	6.5
Acquisitions	12.9	50.8		63.7	0.9	3.7		4.6	1.5		
Total assets acquired	9,594,626										
Accounts payable and accrued expenses	4,676,259										
Funds payable to customers	123,089										
Taxes payable	1,181,607										
Social security payable	395,112										
Other liabilities	1,602,269										
Non current liabilities	14,000										
Provisions	1,506,447										
Total liabilities assumed	9,498,783										

Net assets acquired	95,843	
Goodwill	52,949,111	
Trademarks	5,622,188	
Customer lists	1,227,600	
Non compete agreement	573,484	
Deferred income tax on intangible assets	(2,598,145)	
Total purchase price	57,870,081	
Cash and cash equivalents acquired	(691,632)	
Payment for businesses acquired, net of cash acquired	$ 39,178,449	$
Seller financing for DeRemate business acquisition	$ 18,000,000	$

The accompanying notes are an integral part of these condensed consolidated financial statements.

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

1. Nature of Business

MercadoLibre, Inc. (the Company) is a marketplace manager. The Company s mission is to build an online marketplace that enables practically anyone to trade almost anything in Latin America, helping to make inefficient markets more efficient.

The Company operates in several reporting segments. The MercadoLibre marketplace segments include Brazil, Argentina, Mexico and Other countries (Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Panama, Peru, Uruguay and Venezuela). The MercadoPago segment includes our regional payments platform consisting of our MercadoPago business available in Brazil, Argentina, Mexico and Other countries (Chile, Colombia, and Venezuela).

Traditional offline marketplaces can be inefficient because they (i) are fragmented and regional, (ii) offer a limited variety and breadth of goods, (iii) have high transaction costs, and (iv) provide buyers with less information upon which they can make decisions. The Company makes these inefficient marketplaces more efficient because (i) its community of users can easily and inexpensively communicate and complete transactions, (ii) its marketplace includes a very wide variety and selection of goods, and (iii) it brings buyers and sellers together for much lower fees than traditional intermediaries. The Company attracts buyers by offering selection, value, convenience and entertainment, and sellers by offering access to broad markets, efficient marketing and distribution costs, ability to maximize prices and opportunity to increase sales.

The Company pioneered online commerce in the region by developing a Web-based community in which buyers and sellers are brought together to browse, buy and sell items such as computers, electronics, collectibles, automobiles and a host of practical and miscellaneous items. The Company s trading platform is a fully automated, topically arranged, intuitive, and easy-to-use online service that is available 24 hours-a-day, seven-days-a-week. The Company s platform supports a fixed price format in which sellers and buyers trade items at a fixed price established by sellers, and an auction format in which sellers list items for sale and buyers bid on items of interest.

Providing more efficient and effective payment methods from buyers to sellers is essential to creating a faster, easier and safer online commerce experience. Traditional payment methods such as bank deposits and cash on delivery present various obstacles to the online commerce experience, including lengthy processing time, inconvenience and high costs. The Company addressed this opportunity through the introduction in 2004 of MercadoPago, an integrated online payments solution. MercadoPago was designed to facilitate transactions on the MercadoLibre Marketplace by providing an escrow mechanism that enables users to securely, easily and promptly send and receive payments online, and has experienced consistent growth since its launch.

In 2004, the Company introduced an online classified advertisements service platform for motor vehicles, vessels and aircrafts. Buyers usually require a physical inspection of these items or specific types of interactions before completing a transaction, and therefore an online classified advertisements service is better suited for purchase and sales of these types of items than the traditional online purchase and sales method. For these items, buyers can search by make, model, year and price, and sellers can list their phone numbers and receive prospective buyers e-mail addresses, in order to allow for instant and direct communication between sellers and potential buyers.

During 2005, the online classified advertisements service platform was expanded to include real estate. Much in the same way as with motor vehicles, vessels and aircrafts, purchases of real estate, require physical inspection of the property and is therefore a business more suited to a classifieds model. For real estate listings, in addition to posting their contact information, individual owners or real estate agents can also upload pictures and videos of the property for sale and include maps of the property s location and layout.

MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

During 2006, the Company launched several initiatives to improve its platformand expand its reach. Particularly relevant were the launch of a new platform for eShops, to attract lower rotation items and increase the breadth of products offered, the introduction of user generated information guides for buyers that improve the shopping experience, and the expansion of the online classifieds model by adding a services category. In terms of geographic expansion, the Company launched sites in Costa Rica, the Dominican Republic, and Panama.

In August 2007, the Company successfully completed its initial public offering pursuant to which the Company sold 3,000,000 shares of common stock and certain selling shareholders sold 15,488,762 shares of common stock, resulting in net proceeds for the Company of approximately $49,573,239.

During 2007, the Company also launched a new and improved version of its MercadoPago payments platform in Chile and Colombia as well as in Argentina during 2008. The new MercadoPago, in addition to improving the ease of use and efficiency of payments for marketplace purchases, also allows for payments outside of the Company s marketplaces. Users are able to transfer money to other users with MercadoPago accounts and to incorporate MercadoPago as a means of payments for their websites. In this way MercadoPago 3.0 as it has been called is designed to meet the growing demand for Internet based payments systems in Latin America.

As of September 30, 2008, the Company, through its wholly owned-subsidiaries, operated online commerce platforms directed towards Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Mexico, Panama, Peru, Uruguay and Venezuela, and online payments solutions directed towards Argentina, Brazil, Mexico, Venezuela, Chile and Colombia.

2. Summary of Significant Accounting Policies

Basis of presentation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated. Certain reclassifications have been made to prior year information to conform to current year presentation.

Substantially all revenues and operating costs are generated in the Company s foreign operations, amounting to approximately 98.3% and 98.9% of the consolidated totals during the nine-month periods ended September 30, 2008 and 2007, respectively. Long-lived assets located in the foreign operations totaled $135,389,616 and $38,203,854 as of September 30, 2008 and December 31, 2007, respectively. Cash and cash equivalents as well as short-term investments, totaling $30,892,591 and $67,977,414 at September 30, 2008 and December 31, 2007, respectively, are mainly located in the United States of America.

These unaudited interim financial statements reflect the Company s consolidated financial position as of September 30, 2008 and December 31, 2007. These statements also show the Company s consolidated statement of income, its consolidated statement of shareholders equity (deficit) and its consolidated statement of cash flows for the nine months ended September 30, 2008 and 2007. These statements include all normal recurring adjustments that management believes are necessary to fairly state the Company s financial position, operating results and cash flows. Because all of the disclosures required by generally accepted accounting principles in the United States of America for annual consolidated financial statements are not included herein, these interim financial statements should be read in conjunction with the audited financial statements and the notes thereto for the year ended December 31, 2007, contained in the Company´s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on March 31, 2008. The condensed consolidated statements of income, shareholders equity (deficit) and cash flows for the periods presented are not necessarily indicative of results expected for any future period.

MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

Taxes on revenues

The Company s subsidiaries in Brazil, Argentina, Venezuela and Colombia are subject to certain taxes on revenues which are classified as cost of revenues. Taxes on revenues totaled $2,342,207 and $1,354,203 for the three-month periods ended September 30, 2008 and 2007, respectively. Taxes on revenues totaled $6,183,290 and $3,399,375 for the nine-month periods ended September 30, 2008 and 2007, respectively.

Income and Asset Taxes

The Company is subject to a recently enacted Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The Company pays the higher of IETU or income tax. Although the Company´s Mexican subsidiary had net operating loss carryforward (NOL s) as of September 30, 2008, it had to pay IETU for the three-month period ended September 30, 2008. Once NOL s are consumed, the Company expects it will only accrue and pay income tax. The effect of IETU has been included in the income / asset tax expense line for the nine-month period ended September 30, 2008 for approximately $486,014.

The Company s Argentine subsidiary is a beneficiary of a software development law. Part of the benefits obtained from being a beneficiary of the aforementioned law is a relief of 60% of total income tax determined in each year, for 10 years.

Use of estimates

The preparation of condensed consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used for, but not limited to accounting for allowance for doubtful accounts, depreciation, amortization, impairment and useful lives of long-lived assets, compensation cost related to cash and share-based compensation and restricted shares, recognition of current and deferred income taxes and contingencies. Actual results could differ from those estimates.

Fair Value Measurements

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards (FAS) No. 157, Fair Value Measurements (FAS 157). In February 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 157-2, Effective Date of FASB Statement No. 157, which provides a one year deferral of the effective date of FAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, the Company has adopted the provisions of FAS 157 with respect to its financial assets and liabilities only. The adoption of FAS 157 did not have a material impact on the consolidated results of operations or financial condition. See note 6 for further details.

Recent Accounting Pronouncements

1. Business Combinations

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations (SFAS 141 R). This Statement replaces SFAS 141, Business Combinations . This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. Statement 141 did not define the acquirer, although it included guidance on identifying the acquirer, as does this Statement. This Statement s scope is broader than that of Statement 141, which applied only to business combinations in which control was obtained by transferring consideration.

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This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date.

2. Noncontrolling Interests in Consolidated Financial Statements

In December 2007, the FASB issued Statement of Financial Accounting Standards No.160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160). This Statement amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited.

3. Fair Value of Stock Options

On December 27, 2007, the Securities and Exchange Commission issued staff accounting bulletin No. 110 (SAB No. 110) expresses the views of the staff regarding the use of a simplified method, as discussed in SAB No. 107 (SAB 107), in developing an estimate of expected term of plain vanilla share options in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*. In particular, the staff indicated in SAB 107 that it will accept a company s election to use the simplified method, regardless of whether the company has sufficient information to make more refined estimates of expected term. At the time SAB 107 was issued, the staff believed that more detailed external information about employee exercise behavior (e.g., employee exercise patterns by industry and/or other categories of companies) would, over time, become readily available to companies. Therefore, the staff stated in SAB 107 that it would not expect a company to use the simplified method for share option grants after December 31, 2007. The staff understands that such detailed information about employee exercise behavior may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007.

4. Determination of the useful life of intangible assets

In April 2008, the FASB issued FASB Staff Position 142-3, Determination of the Useful Life of Intangible (FSP 142-3). Under FSP 142-3, for renewable intangible assets acquired in fiscal years beginning after December 15, 2008, an entity should consider its own historical experience in renewing or extending similar arrangements when developing its assumptions about renewals or extensions used to determine the useful life of an intangible asset; however, these assumptions should be adjusted for the entity specific factors in paragraph 11 of FAS 142. In the absence of that experience, an entity should consider the assumptions that market participants would use about renewals or extensions (consistent with the highest and best use of the asset by market participants), adjusted for the entity specific factors in paragraph 11 of FAS 142. The Company will evaluate the impact of FSP 142-3 on its condensed consolidated financial statements.

5. Determination of the fair value of financial assets

In October 2008, the FASB issued FASB Staff Position FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP 157-3). FSP 157-3 clarified the application of FAS 157. FSP 157-3 demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not have an impact on the Company s condensed consolidated financial statements.

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6. Hierarchy of Generally Accepted Accounting Principles

In May 2008, the FASB issued Statement of Financial Accounting Standards No.162, The Hierarchy of Generally Accepted Accounting Principles . This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The Board believes that the GAAP hierarchy should be directed to entities because it is the entity that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. Accordingly, the Board concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and is issuing this Statement to achieve that result. This Statement is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

7. Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities

In June 2008, the FASB issued Financial Standard Position No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities . This FASB Staff Position (FSP) addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, *Earnings per Share.* Issue 03-6 provides guidance on share-based payment awards that contain a right to receive dividends declared on the common stock of the issuer that are fully vested. However, in Issue 2(a) the Task Force declined to provide guidance on share-based payment awards that were not fully vested (that is, awards for which the requisite service had not yet been rendered). This FSP shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented shall be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of this FSP. Early application is not permitted.

3. Net income per share

Basic earnings per share for the Company s common stock is computed by dividing net income available to common shareholders for the period by the weighted average number of common shares outstanding during the period.

Net income available to common shareholders is computed by deducting from net income accretion of preferred stock.

The Company s mandatorily redeemable convertible preferred stock outstanding until August 15, 2007 was a participating security. Accordingly, net income for the three- and nine-month periods ended September 30, 2007 was allocated between common stock and preferred stock under the two class method for purposes of computing basic earnings per share.

Subsequent to conversion on August 15, 2007, the common shares issued were included in the weighted average calculation of shares outstanding used for both basic and diluted earnings per share.

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Diluted earnings per share for the Company s common stock assumes the exercise of outstanding stock options under the Company s stock based employee compensation plans.

For diluted earnings per common share, net income for the three- and nine-month periods ended September 30, 2007, was also allocated between common stock and preferred stock under the two class method because assuming that mandatorily redeemable convertible preferred stock is fully converted into common stock would result in the same dilutive effect.

The following table shows how net income is allocated using the two-class method for earnings per common share, for the three-month periods ended September 30, 2008 and 2007:

	Three Months Ended September 30,			
	2008		2007	
	Basic	Diluted	Basic	Diluted
Net income	$ 5,875,792	$ 5,875,792	$ 2,785,474	$ 2,785,474
Accretion of preferred stock			(61,860)	(61,860)
Net income available to common shareholders	$ 5,875,792	$ 5,875,792	$ 2,723,614	$ 2,723,614
Net income available to common shareholders attributable to preferred stock			(900,128)	(894,939)
Net income available to common shareholders attributable to common stock	$ 5,875,792	$ 5,875,792	$ 1,823,486	$ 1,828,675

The following table shows how net income is allocated using the two-class method for earnings per common share, for the nine-month periods ended September 30, 2008 and 2007:

	Nine Months Ended September 30,			
	2008		2007	
	Basic	Diluted	Basic	Diluted
Net income	$ 10,890,564	$ 10,890,564	$ 4,370,547	$ 4,370,547
Accretion of preferred stock			(309,299)	(309,299)
Net income available to common shareholders	$ 10,890,564	$ 10,890,564	$ 4,061,248	$ 4,061,248
Net income available to common shareholders attributable to preferred stock			(2,249,087)	(2,219,379)

Net income available to common shareholders attributable to common stock	$ 10,890,564	$ 10,890,564	$ 1,812,161	$ 1,841,869

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Notes to Condensed Consolidated Financial Statements (unaudited)

Net income per share of common stock is as follows for the three-month periods ended September 30, 2008 and 2007:

	Three Months Ended September 30,			
	2008		2007	
	Basic	Diluted	Basic	Diluted
Net income available to common shareholders per common share	$ 0.13	$ 0.13	$ 0.07	$ 0.07
Numerator:				
Net income available to common shareholders	$ 5,875,792	$ 5,875,792	$ 1,823,486	$ 1,828,675
Denominator:				
Weighted average of common stock outstanding for Basic earnings per share	44,290,540	44,290,540	27,538,652	27,538,652
Adjustment for stock options		77,400		146,376
Adjustment for restricted shares		1,333		
Adjustment for additional shares		10,409		
Adjusted weighted average of common stock outstanding for Diluted earnings per share	44,290,540	44,379,682	27,538,652	27,685,028

Net income per share of common stock is as follows for the nine-month periods ended September 30, 2008 and 2007:

	Nine Months Ended September 30,			
	2008		2007	
	Basic	Diluted	Basic	Diluted
Net income available to common shareholders per common share	$ 0.25	$ 0.25	$ 0.10	$ 0.10
Numerator:				
Net income available to common shareholders	$ 10,890,564	$ 10,890,564	$ 1,812,161	$ 1,841,869
Denominator:				
Weighted average of common stock outstanding for Basic earnings per share	44,255,985	44,255,985	18,214,978	18,214,978
Adjustment for stock options		111,613		393,203
Adjustment for restricted shares		1,547		
Adjustment for additional shares		4,979		
Adjusted weighted average of common stock outstanding for Diluted earnings per share	44,255,985	44,374,124	18,214,978	18,608,181

The calculation of diluted net income per share excludes all anti-dilutive shares. For the three- and nine-month periods ended September 30, 2008 and 2007, the numbers of anti-dilutive shares are as follows:

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
Anti-dilutive shares				
Warrants		153,223		92,136
Options		2,000		2,000
		155,223		94,136

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As of September 30, 2008, there were 21,591 non-vested shares granted under the Long Term Retention Plan. Since the performance condition required under the plan has not been met yet, those shares were not considered for purposes of computing earnings per share.

4. Business Combinations, Goodwill and Intangible Assets

Business Combinations

a) Classified Media Group, Inc.

On January 22, 2008, the Company completed the acquisition of 100% of the issued and outstanding shares of capital stock of CMG Classified Media Group, Inc. (CMG) and its subsidiaries from 2050 Capital Group Inc., a Panama corporation, Abax Group Inc., a Panama corporation, Gabinete De Diseño Industrial Inc., a Panama corporation, Stamford One Group Ltd., a British Virgin Islands limited company, EO Financial Group Inc., a Panama corporation, Meck Investments Ltd., a British Virgin Islands limited company, CG Interventures Inc., a Panama corporation, and other individuals (the Sellers). CMG and its subsidiaries operate an online classified advertisements platform primarily dedicated to the sale of automobiles (at www.tucarro.com) in Colombia, Venezuela and Puerto Rico and real estate (at www.tuinmueble.com) in Venezuela, Colombia, Panama, the United States, Costa Rica and the Canary Islands. This acquisition allows the Company to expand its operations mainly in Venezuela and Colombia, solidify its market leadership position in those countries and continue growing of online classified advertisements platform in the locations were the acquired company operates.

On the acquisition date, the Company paid in cash for CMG $19,000,000.

The purchase price for the shares of CMG and its subsidiaries was $17,024,380, subject to an escrow to cover unexpected liabilities and working capital adjustments. In addition, acquisition costs amounting to $204,424 which were considered in the purchase price allocation as part of the aggregate purchase price. On May 7, 2008, the Company paid $150,000 related to certain working capital adjustments. On the Closing Date, an aggregate of $1,975,620, was placed into an escrow account for a period of twelve (12) months after the Closing Date, in order to secure the obligations of the former CMG shareholders that remained as managers, pursuant to each of their respective employment agreements.

Under EITF 95-8 Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination the Company has recognized this contingent consideration paid to the former shareholders, as compensation for services. On May 12, 2008, the Company and these former shareholders agreed to an early release of the $1,975,620 escrow on or before June 30, 2008, in exchange for a discount to the Company.

On June 27, 2008, the Company released to the former CMG shareholders $1,919,870 in full satisfaction of the management escrow after deducting the aforementioned discount.

As of September 30, 2008, the compensation expenses related to escrow release were included in Compensation costs related to acquisitions , within operating expenses, for a total amount of $1,919,870.

There are no accrued compensation expenses for the three-month period ended September 30, 2008.

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Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the allocation of the cash paid in the acquisition:

Purchase Price	$ 17,024,380
Post-closing working capital adjustments	150,000
Direct cost of the business combination	204,424
Total aggregate purchase price	$ 17,378,804
Compensation Cost	1,919,870
Total Cash paid	$ 19,298,674

From the acquisition date in January 2008, the acquired company results of operations have been included in the Company s income statement.

The following table summarizes an allocation of the purchase price for the companies acquired in the transaction (in thousands):

Company Name	Country	Post Acquisition Ownership	Net Tangible Assets / (Liabilities)	Identifiable Intangible Assets	Deferred Tax Liabilities	Goodwill	Aggregate Purchase Price
CMG Classified Media Group Inc.	Panama	100%	$ 846.3	$	$	$	$ 846.3
Venecapital Group Inc.	Panama	100%	(26.8)				(26.8)
Grupo Veneclasificados C.A.	Venezuela	100%	(125.4)	4,934.2	(1,727.0)	11,442.0	14,523.8
Clasificados Internacionales S.A.	Panama	100%	(44.8)				(44.8)
ColClasificados S.A.	Colombia	100%	36.4	688.0	(240.8)	1,595.5	2,079.1
Clasificados Florida LLC	USA	100%	1.2				1.2
Total			$ 686.9	$ 5,622.2	$ (1,967.8)	$ 13,037.5	$ 17,378.8

Tangible net assets were valued at their respective carrying amounts adjusted to US GAAP since the management of the Company believes that these amounts approximated their current fair values at the acquisition date. The valuation of identifiable intangible assets acquired reflects management s estimates based on, among other factors, use of established valuation methods. Such assets consist of trademarks and trade names for a total amount of $5,622,188.

Management of the Company estimates that trademarks have an indefinite lifetime. For that reason, these intangible assets are not amortized but they are subject to an annual impairment test.

The goodwill of $13,037,504 is not expected to be deductible for tax purposes.

b) <u>DeRemate Operations</u>

On September 5, 2008, the Company completed, through one of its subsidiaries, Hammer.com, LLC, the acquisition of all of the issued and outstanding shares of capital stock of DeRemate.com de Argentina S.A., a company organized under the laws of Argentina (DR Argentina), DeRemate.com Chile S.A., a company organized under the laws of Chile (DR Chile), Interactivos y Digitales México S.A. de C.V., a company organized under the laws of Mexico (ID Mexico) and Compañía de Negocios Interactiva de Colombia E.U., a company organized under the laws of Colombia (CNI Colombia and together with DR Argentina, DR Chile, and ID Mexico, the Acquired Entities). Also, on September 5, 2008, the Company entered into an asset purchase agreement to acquired certain URLs, domain names, trademarks, databases and intellectual property rights that are used or useful in connection with the online platforms of the Acquired Entities. The Acquired Entities operate online trading platforms in Argentina (www.deremate.com.ar), Chile (www.deremate.cl), Mexico (www.dereto.com.mx) and Colombia (www.dereto.com.co).

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The aggregate purchase price paid by the Company to the Sellers for the shares of capital stock of the Acquired Entities and the related assets was $40,000,000. The Company paid the Sellers $22,000,000 in cash. In addition, on September 5, 2008, the Company issued to the Sellers ten (10) unsecured promissory notes having an aggregate principal amount of $18,000,000, $8,000,000 of which are subject to set-off rights in favor of the Company for working capital adjustments and liabilities relating to the assumption of certain contracts by the Company, $4,000,000 of which are subject to set-off rights in favor of the Company for indemnification obligations of the Sellers and the remaining $6,000,000 are not subject to set-off rights. Each of the promissory notes have a one-year term, bear interest at 3.17875% plus 1.5% for the first four months, 2.0% for the second four months and 2.5% for the third four months and can be prepaid by the Company without penalty. Pursuant to the terms of each promissory note, until the principal amount plus interest is repaid, the Company may not incur indebtedness in excess of $55,000,000 in the aggregate.

The Sellers and certain of their affiliates have also agreed to enter into certain non-compete agreements with the Company for 5 years.

The purchase price allocation, as fully described below, is preliminary pending the final working capital adjustment as defined in purchase agreement.

The Company s statement of income includes the results of operations of the acquired companies from September 1, 2008.

The following table summarizes the allocation of the cash paid and debt assumed in the acquisition:

Cash paid	$ 22,000,000
Seller financing	18,000,000
Direct cost of the business combination	491,277
Total aggregate purchase price	$ 40,491,277

The following table summarizes the purchase price allocation of the Acquired Entities in the transaction (in thousands):

Company Name	Country	Post Acquisition Ownership	Net Tangible Assets / (Liabilities)	Identifiable Intangible Assets	Deferred Tax Liabilities	Goodwill	Aggregate Purchase Price
DeRemate.com de Argentina S.A.	Argentina	100%	$ 2,830.0	$ 1,444.1	$ (505.4)	$ 28,492.7	$ 32,261.4
DeRemate.com Chile S.A.	Chile	100%	(1,969.7)	302.2	(105.8)	7,729.6	$ 5,956.3
Compañía de Negocios Interactiva de Colombia E.U.	Colombia	100%	(870.6)	25.6	(9.0)	2,271.7	$ 1,417.7
Interactivos y Digitales México S.A. de C.V.	Mexico	100%	(580.8)	29.2	(10.2)	1,417.7	$ 855.9
Total			$ (591.1)	$ 1,801.1	$ (630.4)	$ 39,911.7	$ 40,491.3

Assets acquired and liabilities assumed were valued at their respective carrying amounts adjusted to U.S. GAAP because management of the Company believes that these amounts approximated their current fair values at the acquisition date. The valuation of identifiable intangible assets acquired reflects management s estimates based on, among other factors, use of established valuation methods. Such assets consist of customer lists and non-compete agreement for a total amount of $1,801,084. Intangible assets associated with customer list and non-compete agreements are amortized over a five year period.

The company recognized a significant amount of goodwill because the acquisition is expected to significantly expand the company s business in Chile while strengthening the company s leadership position in Argentina. Management expects significant synergies between both businesses to be realized, mainly through improving the monetization of DeRemate s gross

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merchandise volume and by generating efficiencies in operations and technology. As a result, a significant portion of the consideration was based on the expected financial performance and the synergies of the DeRemate business acquired and not the asset value on the books of DeRemate at the time of acquisition.

Goodwill of $39,911,607 is not expected to be deductible for tax purposes.

The results of operations for periods prior to the acquisition for each acquisition, both individually and in the aggregate, were not material to the condensed consolidated statements of operations of the Company and, accordingly, pro forma results of operations have not been presented.

Goodwill and Intangible Assets

The composition of goodwill and intangible assets is as follows:

	September 30, 2008	December 31, 2007
Indefinite lived assets		
- Goodwill	$ 73,036,320	$ 23,000,467
- Trademarks	5,556,857	
Amortizable intangible assets		
- Licenses and others	1,381,017	1,352,945
- Non-compete agreement	1,227,812	731,101
- Customer list	1,740,430	597,257
Total intangible assets	$ 82,942,436	$ 25,681,770
Accumulated amortization	(2,350,361)	(2,253,124)
	$ 80,592,075	$ 23,428,646

Goodwill

The changes in the carrying amount of goodwill for the nine-month period ended September 30, 2008 and the year ended December 31, 2007, are as follows:

	Nine Months Ended September 30, 2008							
	Marketplaces							
	Brazil	Argentina	Chile	Mexico	Venezuela	Colombia	Other Countries	Total
Balance, beginning of year	$ 12,351,542	$	$	$ 4,898,867	$ 2,194,480	$ 2,257,830	$ 1,297,748	$ 23,000,467
-Purchase of CMG		$	$		11,442,022	1,595,482		$ 13,037,504
-Purchase of DR Operations		$ 28,492,600	$ 7,729,639	1,417,674		2,271,693		$ 39,911,606
	(922,671)	$ (1,051,618)	$ (396,370)	(74,143)		(473,992)	5,537	$ (2,913,257)

- Effect of exchange rates changes								
Balance, end of the period	$ 11,428,871	$ 27,440,982	$ 7,333,269	$ 6,242,398	$ 13,636,502	$ 5,651,013	$ 1,303,285	$ 73,036,320

	Year Ended December 31, 2007 Marketplaces					
	Brazil	Mexico	Venezuela	Colombia	Other Countries	Total
Balance, beginning of year	$ 10,233,062	$ 4,911,840	$ 2,194,480	$ 2,031,895	$ 1,201,515	$ 20,572,792
- Effect of exchange rates changes	2,118,480	(12,973)		225,935	96,233	2,427,675
Balance, end of the period	$ 12,351,542	$ 4,898,867	$ 2,194,480	$ 2,257,830	$ 1,297,748	$ 23,000,467

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Amortizable intangible assets

Amortizable intangible assets are comprised of customer lists and user base, trademarks and trade names, non-compete agreements, acquired software licenses and other acquired intangible assets including developed technologies. Aggregate amortization expense for intangible assets totaled $82,313 and $92,775 for the three-month periods ended September 30, 2008 and 2007, respectively. Aggregate amortization expense for intangible assets totaled $223,614 and $287,574 for the nine-month periods ended September 30, 2008 and 2007, respectively.

Expected future intangible asset amortization from acquisitions completed as of September 30, 2008 is as follows:

For year ended 12/31/2008 (remaining three month)	$ 389,980
For year ended 12/31/2009	465,549
For year ended 12/31/2010	394,426
For year ended 12/31/2011	346,037
Thereafter	402,906
	$ 1,998,898

5. Segments

Reporting segments are based upon the Company s internal organizational structure, the manner in which the Company s operations are managed, the criteria used by the management to evaluate Company´s performance, the availability of separate financial information, and overall materiality considerations.

The Marketplace segments include Brazil, Argentina, Mexico and Other countries (Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Panama, Peru, Uruguay and Venezuela) online marketplaces commerce platforms. The Payments segment is the Company s regional payments platform consisting of its MercadoPago business in Brazil, Argentina, Mexico, Chile, Colombia, and Venezuela.

Direct contribution consists of revenues less direct costs. Direct costs include specific costs of net revenues, sales and marketing expenses, and general and administrative expenses over which segment managers have direct discretionary control, such as advertising and marketing programs, customer support expenses, bank charges, allowances for doubtful accounts, authorized credits and transaction losses.

Expenses over which segment managers do not currently have discretionary control, such as certain technology and general and administrative costs, are monitored by management through shared cost centers and are not evaluated in the measurement of segment performance.

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The following tables summarize the financial performance of the Company s reporting segments:

	Three Months Ended September 30, 2008						
	Marketplaces						
	Brazil	Argentina	Mexico	Other Countries	Total	Payments	Consolidated
Net revenues	$ 14,922,939	$ 5,369,344	$ 3,560,840	$ 7,889,132	$ 31,742,255	$ 8,518,388	$ 40,260,643
Direct costs	(10,316,048)	(2,340,884)	(2,023,418)	(4,501,162)	(19,181,512)	(5,020,589)	(24,202,101)
Direct contribution	4,606,891	3,028,460	1,537,422	3,387,970	12,560,743	3,497,799	16,058,542
Operating expenses and indirect costs of net revenues							(4,382,605)
Income from operations							11,675,937
Other income (expenses):							
Interest income							330,139
Interest expense and other financial results							(1,132,524)
Foreign exchange							(2,648,584)
Other expenses, net							39,587
Net income before income / asset tax expense							$ 8,264,555

	Three Months Ended September 30, 2007						
	Marketplaces						
	Brazil	Argentina	Mexico	Other Countries	Total	Payments	Consolidated
Net revenues	$ 9,735,433	$ 3,117,546	$ 2,480,155	$ 2,809,492	$ 18,142,626	$ 4,657,504	$ 22,800,130
Direct costs	(6,275,225)	(1,488,304)	(1,699,950)	(1,438,725)	(10,902,204)	(2,886,354)	(13,788,558)
Direct contribution	3,460,208	1,629,242	780,205	1,370,767	7,240,422	1,771,150	9,011,572
Operating expenses and indirect costs of net revenues							(2,714,201)
Income from operations							6,297,371
Other income (expenses):							
Interest income							352,968
Interest expense and other financial results							(700,631)

Foreign exchange	(802,348)
Other expenses, net	(960,358)
Net income before income / asset tax expense	$ 4,187,002

	Nine Months Ended September 30, 2008						
	Marketplaces						
	Brazil	Argentina	Mexico	Other Countries	Total	Payments	Consolidated
Net revenues	$ 40,447,913	$ 13,147,737	$ 9,609,505	$ 20,328,181	$ 83,533,336	$ 20,039,545	$ 103,572,881
Direct costs	(26,239,812)	(6,213,127)	(6,230,842)	(11,256,163)	(49,939,944)	(12,814,364)	(62,754,308)
Direct contribution	14,208,101	6,934,610	3,378,663	9,072,018	33,593,392	7,225,181	40,818,573
Operating expenses and indirect costs of net revenues							(14,452,564)
Income from operations							26,366,009
Other income (expenses):							
Interest income							1,350,068
Interest expense and other financial results							(3,453,671)
Foreign exchange							(5,689,938)
Other expenses, net							41,874
Net income before income / asset tax expense							$ 18,614,342

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

	Nine Months Ended September 30, 2007						
	Marketplaces						
	Brazil	Argentina	Mexico	Other Countries	Total	Payments	Consolidated
Net revenues	$ 26,306,517	$ 7,859,816	$ 6,917,780	$ 7,339,954	$ 48,424,067	$ 9,808,688	$ 58,232,755
Direct costs	(16,638,220)	(3,987,398)	(4,498,440)	(4,341,008)	(29,465,066)	(7,502,044)	(36,967,110)
Direct contribution	9,668,297	3,872,418	2,419,340	2,998,946	18,959,001	2,306,644	21,265,645
Operating expenses and indirect costs of net revenues							(7,158,466)
Income from operations							14,107,179
Other income (expenses):							
Interest income							872,207
Interest expense and other financial results							(1,688,275)
Foreign exchange							(1,806,520)
Other expenses, net							(3,006,416)
Net income before income / asset tax expense							$ 8,478,175

The following table summarizes the allocation of the long-lived tangible assets based on geography:

	September 30, 2008	December 31, 2007
US long-lived tangible assets	$ 2,590,753	$ 2,091,307
Other countries long-lived tangible assets		
Argentina	1,706,051	1,232,998
Brazil	630,162	699,599
Mexico	107,843	30,275
Other countries	840,059	89,025
	$ 3,284,115	$ 2,051,897
Total long-lived tangible assets	**$ 5,874,868**	**$ 4,143,204**

The following table summarizes the allocation of the goodwill and intangible assets based on geography:

	September 30, 2008	December 31, 2007

US intangible assets	$ 45,195	$ 30,017
Other countries goodwill and intangible assets		
Argentina	28,912,591	198,886
Brazil	11,478,011	12,423,659
Mexico	6,327,430	4,957,400
Venezuela	18,587,221	2,216,994
Other countries	15,241,627	3,601,690
	$ 80,546,880	$ 23,398,629
Total goodwill and intangible assets	**$ 80,592,075**	**$ 23,428,646**

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the allocation of net revenues based on geography:

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
Brazil	$ 57,327,087	$ 34,110,804	$ 22,183,814	$ 13,614,300
Argentina	14,308,603	8,719,291	5,848,000	3,477,587
Mexico	10,720,894	7,661,833	3,974,533	2,743,238
Other countries	21,216,297	7,740,827	8,254,296	2,965,005
Total net revenues	**$ 103,572,881**	**$ 58,232,755**	**$ 40,260,643**	**$ 22,800,130**

6. Fair Value Measurement of Assets and Liabilities

The following table summarizes the Company s financial assets and liabilities measured at fair value on a recurring basis in accordance with FAS 157 as of September 30, 2008:

Description	Balances as of September 30, 2008	Quoted Prices in active markets for identical Assets (Level 1)
Assets		
Short-Term Investments		
Money Market Funds	$ 434,722	$ 434,722
Total Financial Assets	$ 434,722	$ 434,722

The Company s financial assets are valued using market prices on active markets (level 1). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets. As of September 30, 2008, the Company did not have any assets or liabilities obtained from readily-available pricing sources for comparable instruments (level 2) or without observable market values that would require a high level of judgment to determine fair value (level 3).

The unrealized net gains on short term investments are reported as a component of accumulated other comprehensive income. The Company does not anticipate any significant realized losses associated with those investments as the Company s historical cost basis is not significant.

In addition to the Money Market Funds noted above, the Company had $21,010,151 of short-term and long-term investments at September 30, 2008, which consisted of time deposits, commercial papers, sovereign debt securities and corporate debt securities considered held to maturity securities. Those investments are accounted for at amortized cost which, as of September 30, 2008, approximates their fair values.

As of September 30, 2008, the carrying value of the Company s cash and cash equivalents approximated their fair value which was held primarily in bank deposits. For the nine-month periods ended September 30, 2008 and 2007, the Company held no direct investments in auction rate securities, collateralized debt obligations, structured investment vehicles or mortgage-backed securities.

7. Compensation Plan for Outside Directors

On September 17, 2007, the Board of Directors of the Company (the Board), upon the recommendation of the Compensation Committee of the Board, adopted a compensation plan for outside directors. Under the terms of the plan, the outside directors will receive an annual cash retainer fee of $30,000 and an annual grant of restricted Common Stock (Restricted Shares).

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

On September 17, 2007, the Company awarded each of the two outside directors 1,000 Restricted Shares for their original grants. On January 24, 2008, the Company awarded a new outside director 600 Restricted Shares for his original grant. On May 6, 2008, the Board also designated a new director and a current director as outside directors, determining to extend the Company s outside director compensation program to these two directors. On June 9, 2008, the Company awarded each of the two new outside directors 674 Restricted Shares for their original grants.

On the first anniversary of each director s respective original Restricted Shares grant date, each outside director will receive a grant of additional shares having a value equal to $30,000. On the second anniversary of each director s respective original Restricted Shares grant date, each outside director will receive a grant of additional shares having a value equal to $40,000.

The number of shares to be issued on each of the first and the second anniversary of the original Restricted Shares grant date will be based on the closing sale price of the Common Stock on the prior trading day.

Each grant of Restricted Shares vests twelve months following the first and second anniversary date. Restricted Shares are and will be granted pursuant to the Company s Amended and Restated 1999 Stock Option and Restricted Stock Plan (See Note 8 Restricted Shares for discussion of accounting treatment).

On August 8, 2008, the Board approved additional cash compensation for the Company s directors who serve as a committee chair or as lead independent director. Under the terms of the plan, effective August 8, 2008, the Chair of the Company s Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee and the lead independent director of the Company are entitled to receive annual cash compensation in addition to existing director compensation in the amount of $15,000, $12,000, $5,000 and $10,000, respectively. The Board also determined that payments of outside director s cash and stock compensation will coincide with the Company s annual stockholders meeting. As a result, beginning in 2009, the outside director s cash compensation will be paid out in the second quarter of each year and Restricted Shares issuable to the directors during the relevant year will be issued on the date of the annual stockholder s meeting

8. Stock Option and Restricted Shares

Pursuant to the Amended and Restated 1999 Stock Option and Restricted Stock Plan , (the Plan) the Company has reserved 4,732,400 shares of Common Stock for issuance under the Plan.

Stock Options

Stock option awards granted under the Plan are at the discretion of the Company s Board of Directors and may be in the form of either incentive or nonqualified stock options. Options granted under the Plan generally vest over a three to four year period and expire ten years after the date of grant. At September 30, 2008, there were 297,426 shares of Common Stock available for additional awards under the Plan.

Stock-based compensation expense related to stock options for the three- and nine-month periods ended September 30, 2008 and 2007 was allocated as follows:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	**2007**	**2008**	**2007**

Product and technology development	$ 575	$ 1,441	$ 191	$ 147
Sales and marketing	$ 1,282	$ 3,214	$ 426	$ 329
General and administrative	$ 1,827	$ 15,779	$ 607	$ 6,410
Total	$ 3,684	$ 20,434	$ 1,224	$ 6,886

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

In accordance with SFAS No. 123(R), the Company uses the Black-Scholes option pricing model to measure the fair value of its option awards granted after January 1, 2006. The Black-Scholes model requires the input of highly subjective assumptions including volatility, expected term, risk-free interest rate and dividend yield. In 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB No. 107) which provides supplemental implementation guidance for SFAS No. 123(R). Because the Company had no history of volatility, the expected volatility was based on the historical volatilities of similar entities common stock over the most recent period commensurate with the estimated expected term of the awards. The expected term of an award is based on the simplified method allowed by SAB No. 107, whereby the expected term is equal to the midpoint between the vesting date and the end of the contractual term of the award. The risk-free interest rate is based on the rate on U.S. Treasury zero coupon issues with maturities consistent with the estimated expected term of the awards. The Company has not paid dividends and does not anticipate paying a dividend in the foreseeable future and accordingly, uses an expected dividend yield of zero.

There was no granting during the year ended December 31, 2007 and the nine-month period ended September 30, 2008.

The following weighted-average assumptions were used in estimating the fair value of outstanding options:

Stock price volatility: 36%

Expected term: 7 years

Risk-free interest rate: 6%

Stock-based compensation expense recognized is based on the estimated portion of the awards that are expected to vest. The Company also estimated expected forfeitures of stock options. In developing a forfeiture rate estimate, management of the Company considered its historical experience and expectations. Actual forfeiture activity may differ from the estimated forfeiture rate.

Stock option activity, for the three-month period ended September 30, 2008, was as follows:

	2008	
	Number of options	Weighted- average exercise price
Outstanding, beginning of period	80,568	$ 1.02
Forfeited or expired		
Lapsed		
Exercised	(2,500)	0.80
Outstanding, end of the period	78,068	1.10
Exercisable, end of the period	69,694	$ 0.95

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

Stock option activity, for the nine-month period ended September 30, 2008, was as follows:

	2008	
	Number of options	Weighted-average exercise price
Outstanding, beginning of year	144,174	$ 1.04
Lapsed		
Exercised	(66,106)	0.98
Outstanding, end of the period	78,068	1.10
Exercisable, end of the period	69,694	$ 0.95

The following table details the outstanding options at September 30, 2008:

	September 30, 2008		
	Outstanding		Exercisable
Exercise price	Number of options	Weighted-average remaining contractual life (years)	Number of options
$ 0.01	22,331	4.84	22,331
$ 0.75	4,330	1.25	4,330
$ 1.00	20,000	1.32	20,000
$ 1.50	27,407	6.52	20,595
$ 3.00	1,000	1.67	1,000
$ 6.00	3,000	7.84	1,438
	78,068	4.40	69,694

Weighted average Exercise Price	
- Options outstanding	$ 1.10
- Options exercisable	$ 0.95
Aggregate intrinsic value	
- Options outstanding	$ 1,503,102
- Options exercisable	$ 1,352,285

The aggregate intrinsic value represents the difference between the Company s closing stock price of $20.35 as of September 30, 2008 and the exercise price multiplied by the number of options (outstanding and exercisable) as of that date.

Restricted Shares

As mentioned in Note 7, the Company granted awards to its outside directors for 3,948 Restricted Shares. Non-vested shares awarded to employees are measured at their fair value by the grant-date price of the Company s shares.

Based on the fair value of the Company s share at the grant date, total compensation cost for the 3,948 Restricted Shares awarded amounted to $149,470. For the three- and nine-month period ended September 30, 2008, the Company recognized $35,546 and $81,875, respectively, of compensation expense related to these awards, which are included in operating expenses in the accompanying consolidated statement of income.

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

In accordance with Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (SFAS 150) and SFAS 123(R), the additional grants for fixed amounts of $30,000 and $40,000 are classified as liabilities in the accompanying consolidated balance sheet. For the three- and nine-month period ended September 30, 2008, the Company recognized $39,409 and $83,609 of compensation expense related to these awards, which are included in operating expenses in the accompanying condensed consolidated statement of income.

9. Commitments and Contingencies

Litigation and Other Legal Matters

At the beginning of 2008, the Brazilian subsidiary of the Company had 146 cases in litigation in ordinary courts, 7 of which (QIX Skateboards Industria e Comercio Ltda., Editora COC Empreendimentos Culturais Ltda., Vintage Denim Ltda., Fallms Distribuição de Fitas Ltda., and 100% Nacional Distribuidora de Fitas Ltda., Xuxa Promoções e Produções Artísticas Ltda., Praetorium Instituto de Ensino, Pesquisas e Atividades de Extensão e Direito Ltda., and Botelho Indústria e Distribuição Cinematográfica Ltda.) were related to alleged intellectual property infringement.

During the nine-month period ended September 30, 2008, the Brazilian subsidiary of the Company was sued in 102 cases in ordinary courts. In most of these cases the plaintiffs asserted that the Company was responsible for fraud committed against them, or responsible for damages suffered when purchasing an item on the Company s website, when using MercadoPago, or when the Company invoiced them.

As of September 30, 2008, 246 legal actions were pending in the Brazilian ordinary courts 7 of which (QIX Skateboards Industria e Comercio Ltda., Editora COC Empreendimentos Culturais Ltda., Vintage Denim Ltda., Fallms Distribuição de Fitas Ltda., and 100% Nacional Distribuidora de Fitas Ltda., Xuxa Promoções e Produções Artísticas Ltda., Praetorium Instituto de Ensino, Pesquisas e Atividades de Extensão e Direito Ltda.,and Botelho Indústria e Distribuição Cinematográfica Ltda.) were related to alleged intellectual property infringement. In addition, during the nine-month period ended September 30, 2008, the Brazilian subsidiary of the Company received approximately 1,600 summons of legal actions filed in Brazilian consumer courts, where a lawyer is not required to file or pursue a claim. In most of the cases, the plaintiffs asserted that the Company was responsible for fraud committed against them, or responsible for damages suffered when purchasing an item on the Company s website, when using MercadoPago, or when the Company invoiced them. As of September 30, 2008, there were more than 1,970 cases still pending in these Brazilian consumer courts.

On October 25, 2007, Iglesia Mesianica Mundial Sekai Kyusei Kio en la Argentina, or Iglesia Mesianica, filed suit against our Argentine subsidiary, MercadoLibre S.A., in the Thirteenth Civil Court of the City of Buenos Aires, Argentina. The complaint was officially notified on April 17, 2008. Iglesia Mesianica alleged in the complaint that the Company s Argentine subsidiary should be held liable as a result of users selling books that allegedly plagiarized certain Iglesia Mesianica s books through the Argentine page of our website. Iglesia Mesianica seeks monetary damages. The Company presented its defense on May 9, 2008.

On October 5, 2007 a state prosecutor of the State of Minas Gerais, city of Uberlandia, Brazil presented a claim against the Company s Brazilian subsidiary. The state prosecutor alleges that the Brazilian subsidiary should be held liable for any fraud committed by sellers on the Brazilian version of the Company s website, or responsible for damages suffered by buyers when purchasing an item on the Brazilian version of the MercadoLibre website. The Brazilian subsidiary were summoned on June 30, 2008 and presented its defense on July 25, 2008.

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MercadoLibre, Inc.

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On February, 29, 2008, Mr. Eduardo Paoletti presented a claim against the Brazilian subsidiary and Banco do Brasil S.A. and Banco Nossa Caixa S.A., in the Forty Second Civil Court of the Central Court of the City of São Paulo. Plaintiff alleges that his personal information was used by third parties to (i) register in the Company s Brazilian website and (ii) open bank accounts in the aforementioned banks in order to commit fraud against users of the Brazilian website. Plaintiff alleges that the Brazilian subsidiary shall be held joint and severally responsible with the other defendants for damages. Mr. Paoletti seeks compensatory and statutory damages estimated for approximately $1.8 million. The Brazilian subsidiary was summoned on June 19, 2008 and presented its defense on July 28, 2008.

On July 25, 2008, Nike International Ltd. or Nike, requested a preliminary injunction against the Company s Argentine subsidiary in the First Civil and Commercial Federal Court, Argentina. The subsidiary was officially notified on August 14, 2008. Nike requested the injunction alleging that this subsidiary was infringing Nike s trademarks as a result of sellers listing allegedly counterfeit Nike branded products through the Argentine page of the Company s website. A preliminary injunction was granted on August 11, 2008 to suspend the offer of Nike-branded products until sellers could be properly identified. The Argentine subsidiary appealed the decision on August 22, 2008.

At September 30, 2008, the Company had established reserves for proceeding-related contingencies of $890,568 to cover 334 legal actions against the Company and $33,155 to cover certain lawsuits against DeRemate Brazil where the Company has determined that a loss is probable. As of September 30, 2008 no loss amount has been accrued over 1,170 legal actions for the aggregate amount up to $3,559,888 because a loss is not considered probable.

Other third parties have from time to time claimed, and others may claim in the future, that the Company was responsible for fraud committed against them, or that the Company has infringed their intellectual property rights. The underlying laws with respect to the potential liability of online intermediaries like the Company are unclear in the jurisdictions where the Company operates. Management believes that additional lawsuits alleging that the Company has violated copyright or trademark laws will be filed against the Company in the future.

Intellectual property claims, whether meritorious or not, are time consuming and costly to resolve, could require expensive changes in the Company s methods of doing business, or could require the Company to enter into costly royalty or licensing agreements. The Company may be subject to patent disputes, and be subject to patent infringement claims as the Company s services expand in scope and complexity. In particular, the Company may face additional patent infringement claims involving various aspects of the Payments businesses.

From time to time, the Company is involved in other disputes or regulatory inquiries that arise in the ordinary course of business. The number and significance of these disputes and inquiries are increasing as the Company s business expands and the Company grows larger. Any claims or regulatory actions against the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, and result in the diversion of significant operational resources.

Litigation after September 30, 2008

After September 30, 2008 and up to the date of issuance of these condensed consolidated financial statements, the Company s Brazilian subsidiary was sued in 15 other cases in Brazilian ordinary courts and 219 new cases in consumer courts. No loss amount has been accrued in connection with these actions because a loss is not considered probable.

Other contingencies

As of September 30, 2008, the Company had reserved $181,164 against certain tax contingencies, other than income tax, identified in some of its subsidiaries.

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

Other Commitments

On June 19, 2008, the Company s Argentine subsidiary agreed to participate in a real estate trust for the construction of an office building located in the City of Buenos Aires, buying 5,340 square meters divided into 5 (five) floors and 70 parking spaces, where the Company plans to move its headquarters and Argentine operation offices. The total estimated contractual obligation of the Company to the Trust is $10,109,398 which will be paid over 20 months. As of September 30, 2008, the Argentine subsidiary has invested $2,343,059 in the aforementioned trust.As this investment represents an undivided interest for more than 20% of the total amount of the real estate trust, it is accounted for under the equity method and it is classified as Long-Term Investments in the balance sheet.

Operating Leases

The Company has leases for office space in the various countries where it operates. Total rental expense amounted to approximately $420,867 and $281,518 for the three-month period ended September 30, 2008 and 2007, respectively. Total rental expense amounted to approximately $1,218,974 and $686,095 for the nine-month period ended September 30, 2008 and 2007, respectively.

Minimum remaining annual commitments under the non-cancelable operating leases are as follows:

For the year ended December 31, 2008 (remaining three months)	$ 448,722
For the year ended December 31, 2009	1,628,380
For the year ended December 31, 2010	1,145,656
For the year ended December 31, 2011	545,313
Thereafter	24,882
	$ 3,792,953

Employment Contracts

Each of the executive officers of the Company are a party to individual employment agreements that provide for annual base estimated salaries aggregating approximately $1,085,000 per year, a performance based estimated bonus aggregating to approximately $975,000 per year, and some fringe benefits. The employment agreements automatically renew annually, if not terminated by either party. Each agreement includes clauses that provide in the event of employment termination without cause, the Company must pay the employee 12 months of base salary.

10. Long Term Retention Plan

On August 8, 2008, the Board of Directors approved an employee retention program that will be payable 50% in cash and 50% in shares, in addition to the annual salary and bonus of certain executives. Payments will be made in the first quarter on annual basis according to the following vesting schedule:

Year 1 (2008): 17%

Year 2 (2009): 22%

Year 3 (2010): 27%

Year 4 (2011): 34%

In addition, the Long Term Retention Plan (LTRP) has a performance condition to be achieved in year one and also requires the employee to stay in the Company at the payment day. The compensation cost is recognized in accordance with the graded-vesting attribution method and is accrued up to each payment day.

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MercadoLibre, Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

The total compensation cost of the LTRP amounts to approximately $2.1 million including cash and shares. The 21,591 shares granted were valued at the grant date fair value of the shares. As of September 30, 2008, the related accrued compensation expense was $352,271.

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Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statement Regarding Forward-Looking Statements

Certain statements regarding our future performance made in this report are forward-looking statements. Forward-looking statements may relate to such matters as continued growth of online commerce and Internet usage in Latin America; our ability to expand our operations and adapt to rapidly changing technologies; government regulation; litigation and legal liability; systems interruptions or failures; our ability to attract and retain qualified personnel; consumer trends; security breaches and illegal uses of our services; competition; reliance on third-party service providers; enforcement of intellectual property rights; our ability to attract new customers, retain existing customers and increase revenues; seasonal fluctuations; and political, social and economic conditions in Latin America in general, and Venezuela and Argentina in particular.

These statements are based on currently available information and our current assumptions, expectations and projections about future events. While we believe that our assumptions, expectations and projections are reasonable in view of the currently available information, you are cautioned not to place undue reliance on our forward-looking statements. These statements are not guarantees of future performance. They are subject to future events, risks and uncertainties many of which are beyond our control as well as potentially inaccurate assumptions, that could cause actual results to differ materially from our expectations and projections. Some of the material risks and uncertainties that could cause actual results to differ materially from our expectations and projections are described in Item 1A Risk Factors in Part II of this report and Item 1A Risk Factors in Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007 filed with the Securities and Exchange Commission on March 31, 2008 as supplemented by our Quarterly report on Form 10-Q for the quarter ended June 30, 2008 as filed with the Securities and Exchange Commission on August 13, 2008. You should read that information in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 2 of Part I of this report and our unaudited condensed consolidated financial statements and related notes in Item 1 of Part I of this report. We note such information for investors as permitted by the Private Securities Litigation Reform Act of 1995. There also may be other factors that we cannot anticipate or that are not described in this report, generally because we do not perceive them to be material, that could cause results to differ materially from our expectations.

Forward-looking statements speak only as of the date they are made, and we do not undertake to update these forward-looking statements except as may be required by law. You are advised, however, to review any further disclosures we make on related subjects in our periodic filings with the Securities and Exchange Commission.

Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

MercadoLibre, Inc. (together with its subsidiaries us , we , our or the company) hosts the largest online commerce platform in Latin America focused on enabling e-commerce and its related services. Our services are designed to provide our users with mechanisms to buy, sell, pay for and collect on e-commerce transactions effectively and efficiently. With a population of over 550 million people and a region with one of the fastest-growing Internet penetration rates, we provide buyers and sellers with a robust online commerce environment that fosters the development of a large and growing e-commerce community. We offer technological and commercial solutions that seek to address the distinctive cultural and geographic challenges of operating an online commerce platform in Latin America.

In August 2007, we successfully completed our initial public offering through which 16,077,185 shares of our common stock were sold at a initial public offering price of $18.00 per share less an underwriting discount of 4.5%. Out of that total, 2,608,696 shares of common stock were sold by us and 13,468,489 were sold by selling shareholders. We, along with certain shareholders, granted to the underwriters an option, exercisable for 30 days from August 9, 2007, to purchase up to 2,411,577 additional shares at the public offering price less the underwriting discount. The option was exercised in full, and of that total, an additional 391,304 shares were sold by us and 2,020,273 were sold by the selling shareholders.

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We operate in several reporting segments. The MercadoLibre marketplace segments are the online marketplace commerce platforms in each of Brazil, Argentina, Mexico and Other countries (Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Panama, Peru, Uruguay and Venezuela). The MercadoPago segment consisting of our MercadoPago business is our regional payments platform available in each of Brazil, Argentina, Mexico and Chile, Colombia, and Venezuela.

We offer our users two principal services:

The MercadoLibre marketplace: The MercadoLibre marketplace, which we sometimes refer to as our Marketplace business, is a fully-automated, topically-arranged and user-friendly online commerce service. This service permits both businesses and individuals to list items and conduct their sales and purchases online in either a fixed-price or auction-based format. Additionally, through online classified advertisements, our registered users can also list and purchase motor vehicles, vessels, aircraft, real estate and services. Any Internet user can browse through the various products and services that are listed on our website and register with MercadoLibre to list, bid for and purchase items and services.

The MercadoPago online payments solution: To complement the MercadoLibre marketplace, we developed MercadoPago, which we sometimes refer to as our Payments business, an integrated online payments solution. MercadoPago is designed to facilitate transactions on the MercadoLibre marketplace and off our marketplace in certain markets, by providing a mechanism that allows our users to securely, easily and promptly send and receive payments online.

Recent Developments

On August 8, 2008 the Board of Directors approved a four year employee retention program which will be payable 50% in cash and 50% in shares. The vesting schedule will be the following:

Year One Paid on or before March 31, 2009: 17% (8.5% in cash and 8.5% in common stock);

Year Two Paid on or before March 31, 2010: 22% (11% in cash and 11% in common stock);

Year Three Paid on or before March 31, 2011: 27% (13.5% in cash and 13.5% in common stock); and

Year Four Paid on or before March 31, 2012: 34% (17% in cash and 17% in common stock).

In addition, the Long Term Retention Plan (LTRP) has a performance condition to be achieved in year one and also requires the employee to remain in the Company at the payment date. The compensation cost is recognized in accordance with the graded-vesting attribution method and is accrued up to each payment date.

The total compensation cost of the LTRP amounts to approximately $2.1 million considering that the shares granted were valued at the grant date fair value of the shares. As of September 30, 2008, the related accrued compensation expense was $352,271.

On August 8, 2008, the Board of Directors approved additional cash compensation for our directors that serve as a committee chair or as lead independent director. Under the terms of the plan, effective August 8, 2008, the Chair of each of the Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee and the lead independent director are entitled to receive annual cash compensation in addition to existing director compensation in the amount of $15,000, $12,000, $5,000 and $10,000, respectively. The Board also determined that outside director compensation dates should coincide with our annual stockholders meeting. As a result, beginning in 2009, outside director compensation will be paid out in the second quarter of each year.

On September 5, 2008, we completed, through one of our wholly-owned subsidiary, Hammer.com LLC, our previously announced acquisition of all of the issued and outstanding shares of capital stock of DeRemate.com de Argentina S.A., a company organized under the laws of

Argentina (DR Argentina), DeRemate.com Chile S.A., a company organized under the laws of Chile (DR Chile), Interactivos y Digitales México S.A. de C.V., a company organized under the laws of Mexico (ID Mexico) and Compañía de Negocios Interactiva de Colombia E.U., a company organized under the laws of Colombia (CNI Colombia and together with

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DR Argentina, DR Chile, ID Mexico and CNI Colombia, the Acquired Entities). We completed the stock purchase from Hispanoamerican Educational Investments BV, a corporation organized under the laws of Holland (HEI) and S.A. La Nación, a company organized under the laws of Argentina (SALN and together with HEI, the Sellers). The Acquired Entities operate online trading platforms in Argentina (www.deremate.com.ar), Chile (www.deremate.cl), Mexico (www.dereto.com.mx) and Colombia (www.dereto.com.co).

The aggregate purchase price paid by us to the Sellers for the shares of capital stock of the Acquired Entities was $37.6 million. On the closing date, we paid the Sellers $19.6 million in cash. In addition, we issued to HEI ten (10) unsecured promissory notes having an aggregate principal amount of $18.0 million, $8.0 million of which is subject to set-off rights in our favor for working capital adjustments and liabilities relating to the assumption of certain contracts by us, $4.0 million of which is subject to set-off rights in our favor for indemnification obligations of the Sellers and the remaining $6.0 million without set-off rights. Each of the promissory notes has a one-year term, bears interest at 3.17875% plus 1.5% for the first four months, 2.0% for the second four months and 2.5% for the third four months and can be prepaid by us without penalty. Pursuant to the terms of each promissory note, until the principal amount plus interest is repaid, we may not incur indebtedness in excess of $55.0 million in the aggregate.

We also completed the purchase of certain URLs, domain names, trademarks, databases and intellectual property rights that are used or useful in connection with the online platforms of the Acquired Entities. The aggregate purchase price paid by us to Intangible Assets LLC, a Delaware limited liability company (IA), an affiliate of the Sellers, pursuant to the asset purchase agreement was $2.4 million in cash. The set-off rights in our favor for indemnification obligations of the Sellers under the stock purchase agreement also secure the indemnification obligations of IA under the asset purchase agreement.

On June 19, 2008, our Argentine subsidiary agreed to participate in a real estate trust for the construction of an office building located in the City of Buenos Aires, buying 5,340 square meters divided in 5 (five) floors and 70 parking spaces, where we plan to move our headquarters and Argentine operation offices. Our total estimated contractual obligation to the real estate trust is $10,109,398 which will be paid over 20 months. As of September 30, 2008, our Argentine subsidiary has invested $2,343,059 in the aforementioned trust which represents an undivided interest for more than 20% of the total amount of the real estate trust. This investment is accounted for under the equity method and it is classified as Long-Term Investments in the Balance Sheet. We expect this investment to decrease our aggregate rental space over time.

Principal trends

Growth in net revenue over comparable periods from year to year

Since our inception, we have consistently generated revenue growth from the MercadoLibre marketplace and MercadoPago, driven by the strong growth of our key operational metrics. Our net revenues for the three-month period ended September 30, 2008, as compared to the same period for 2007, increased by 75.0% and 82.9% for the MercadoLibre marketplace and MercadoPago payments platform, respectively. As our business grows, we expect that this year-to-year rate of increase of net revenues and the related operational metrics, will decline.

Increased diversification of revenues.

We have grown revenues from our Payments business at a faster rate than revenues from our Marketplace business, and anticipate this trend to continue. For the three-month period ended September 30, 2008 and 2007, payments represented 21.2% and 20.4%, of net revenues, respectively.

Gross profit margins

Our business has generated sustained high gross profit margins over time, as defined by total net revenues minus total cost of net revenues, as a percentage of net revenues. These gross profit margins were 79.7% for the three month period ended September 30, 2008 as compared to 78.6% for the same period in 2007. This variation is attributable to increased economies of scale in customer

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service, Internet Service Provider (ISP) connectivity and site operations, as well as improved economic terms obtained from payment processors that more than offset a faster rate of increase of our lower gross profit margin Payments business. We expect that cost of net revenues could increase as a percentage of net revenues as revenues related to our Payments business grow faster relative to our marketplace business revenues. If these increased costs are not offset by improved economies of scale, gross profit margins will decline in the future.

Improving operating income margins

We have generated and expect to continue to generate economies of scale in operating expenses. For the three-month period ended September 30, 2008, our operating income margins, defined as income from operations as a percentage of net revenues, increased from 27.6% in 2007, to 29.0% during the same period in 2008.

For the three-month period ended September 30, 2008, operating expenses increased at a lower rate than our net revenues, from 51.0% during the same period in 2007 to 50.7% in 2008. For the three-month period ended September 30, 2008, our operating income margins improved to 29.0%, driven by the impact of these economies of scale and by improvements in gross profit margins. We anticipate, however, that as we continue to invest in product development, sales and marketing and human resources in order to promote our services and capture the long term business opportunity offered by the Internet in Latin America, it may become increasingly difficult to sustain growth in operating income margins, and at some point in the future we could experience decreasing operating income margins.

Description of line items

Net revenues

We recognize revenues in each of our reporting segments. The MercadoLibre marketplace segments include Brazil, Argentina, Mexico and Other countries (Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Panama, Peru, Uruguay and Venezuela). The MercadoPago segment includes our regional payments platform consisting of our MercadoPago business.

We generate revenues from the MercadoLibre marketplace segments from:

- listing fees;
- optional feature fees;
- final value fees; and
- online advertising.

We generate revenues from our MercadoPago payments segment by charging users a commission that we recognize once the transaction is completed and a financial charge when the client elects to pay in installments. For the transactions where we finance the extended payment terms internally rather than by discounting receivables or incurring financial debt, the financial charge is recognized over the life of the financing for payments in installments. During the three-month period ended September 30, 2008, commission and financial charges averaged 6.8% and 3.6%, respectively, of the payment amount made by the user through the system.

Our MercadoLibre marketplace is available in 12 countries (Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Mexico, Panama, Peru, Uruguay and Venezuela), and our MercadoPago Payments platform is available in 6 countries (Argentina, Brazil, Mexico, Venezuela, Colombia and Chile). The functional currency in each country s operations is the local currency. Therefore, our net revenues are generated in multiple foreign currencies and then translated into U.S. dollars at the average monthly exchange rate.

Our subsidiaries in Brazil, Argentina, Venezuela and Colombia are subject to certain taxes on revenues which are classified as costs of net revenues. These taxes represented 5.8% of net revenues for the three-month period ended September 30, 2008.

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Cost of net revenues

Cost of net revenues primarily represents bank and credit card processing charges for transactions and fees paid with credit cards and other payment methods, certain taxes on revenues, compensation for customer support personnel, ISP connectivity charges, depreciation charges and hosting and site operations fees.

Product and technology development

Our product and technology development related expenses consist primarily of depreciation and amortization costs related to product and technology development, compensation for our engineering and web-development staff, telecommunications costs and payments to third-party suppliers that provide technology maintenance services to our company.

Sales and marketing

Our sales and marketing expenses consist primarily of marketing costs for our platforms through online and offline advertising, bad debt charges, the salaries of employees involved in these activities, public relations costs, marketing activities for our users and depreciation and amortization costs.

We carry out the vast majority of our marketing efforts on the Internet. In that context, we enter in agreements with portals, search engines, ad networks and other sites that seek to attract Internet users to the MercadoLibre marketplace and convert them into confirmed registered users and active traders on our platform. Additionally, we invest a portion of our marketing budget on cable television advertising, in order to improve our brand awareness and to complement our online efforts.

We also work intensively on attracting, developing and growing sellers through our supply generation efforts. We have dedicated professionals in most of our operations that work with sellers through trade show participation, seminars and meetings to provide them with important tools and skills to become effective sellers on our platform.

General and administrative

Our general and administrative expenses consist primarily of salaries for management and administrative staff, compensation for our outside directors, long term retention plan compensation and expenses for legal, accounting and other professional services, insurance, office space, travel and business expenses, as well as depreciation and amortization costs. General and administrative expenses include the costs of the following areas of our company: general management, finance, administration, accounting, legal and human resources.

Compensation Cost related to acquisitions

As part of our acquisition of Classified Media Group, Inc. (CMG) which closed in the first quarter of 2008, we entered into a management escrow agreement to secure the obligations of the CMG shareholders that remained as managers. We accrued those compensation expenses as operating expenses, instead of considering them part of the purchase price, following EITF 95-8 Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination (See note 4 to our unaudited condensed consolidated financial statements included in this report).

Other income (expenses)

Other income (expenses) consists of interest expense and other financial charges derived mainly from the financing of certain working capital requirements of our Payments business operations in Brazil, certain taxes on financial transactions, interest income derived primarily from our short-term investments and cash equivalents, foreign currency gains or losses, and other non-operating results.

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Income / asset tax

We are subject to federal and state taxes in the United States, as well as foreign taxes in the multiple jurisdictions in which we operate. Our tax obligations consist of current and deferred income taxes and asset taxes incurred in these jurisdictions. We account for income taxes following the liability method of accounting. Therefore, our income tax expense consists of taxes currently payable, if any (given that in certain jurisdictions we still have net operating loss carry-forwards), plus the change during the period in our deferred tax assets and liabilities.

Critical accounting policies and estimates

The preparation of our unaudited condensed consolidated financial statements and related notes requires us to make judgments, estimates and assumptions that affect our reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We have based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our management has discussed the development, selection and disclosure of these estimates with our Board of Directors. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. We believe that the following critical accounting policies reflect the more significant estimates and assumptions used in the preparation of our condensed consolidated financial statements. You should read the following descriptions of critical accounting policies, judgments and estimates in conjunction with our unaudited condensed consolidated financial statements and other disclosures included in this report.

Impairment of long-lived assets and goodwill

We review long-lived assets for impairments whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired on this basis, the impairment loss to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

Goodwill is reviewed at least annually for impairment. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit s carrying amount, including goodwill, to the fair value of the reporting unit. The fair values of the reporting units are estimated using a combination of the income or discounted cash flows approach and the market approach, which utilizes comparable companies data. If the carrying amount of the reporting unit exceeds its fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any. No impairments were recognized during the reporting periods.

We believe that the accounting estimate related to impairment of long lived assets and goodwill is a critical accounting estimate because it is highly susceptible to change from period to period because: (i) it requires management to make assumptions about gross merchandise volume growth, future interest rates, sales and costs; and (ii) the impact that recognizing an impairment would have on the assets reported on our balance sheet as well as our net income would be material. Management s assumptions about future sales and future costs require significant judgment.

Provision for doubtful accounts

We are exposed to losses due to uncollectible accounts and credits to sellers. Provisions for these items represent our estimate of future losses based on our historical experience. Historically, our actual losses have been consistent with our charges. However, future changes in trends could result in a material impact to future consolidated statements of income and cash flows.

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Legal contingencies

In connection with certain pending litigation and other claims, we have estimated the range of probable loss and provided for such losses through charges to our condensed consolidated statement of income. These estimates have been based on our assessment of the facts and circumstances at each balance sheet date and are subject to change based upon new information and future events.

From time to time, we are involved in disputes that arise in the ordinary course of business. We are currently involved in certain legal proceedings as described in Legal Proceedings in Item 1 of Part II of this report. We believe that we have meritorious defenses for, and will accordingly defend ourselves vigorously. However, even if successful, our defense could be costly and could divert management s time. If the plaintiffs in any of the pending litigation matters were to prevail on certain claims, we might be forced to pay damages or modify our business practices. Any of these results could materially harm our business and could result in a material adverse impact on the financial position, results of operations or cash flows.

Income taxes

We are required to recognize a provision for income taxes based upon the taxable income and temporary differences for each of the tax jurisdictions in which we operate. This process requires a calculation of taxes payable under currently enacted tax laws in each jurisdiction and an analysis of temporary differences between the book and tax bases of our assets and liabilities, including various accruals, allowances, depreciation and amortization. The tax effect of these temporary differences and the estimated tax benefit from our tax net operating losses are reported as deferred tax assets and liabilities in our condensed consolidated balance sheet. We also assess the likelihood that our net deferred tax assets will be realized from future taxable income. To the extent we believe that it is more likely than not that some portion or all of deferred tax asset will not be realized, we establish a valuation allowance. At September 30, 2008, we had a valuation allowance on certain foreign and domestic net operating losses based on our assessment that it is more likely than not that the deferred tax asset will not be realized. To the extent we establish a valuation allowance or change the allowance in a period, we reflect the change with a corresponding increase or decrease in our tax provision in our condensed consolidated statement of income.

Results of operations for the three-month period ended September 30, 2008 compared to three-month period ended September 30, 2007 and the nine-month period ended September 30, 2008 compared to the nine-month period ended September 30, 2007.

The selected financial data for the three- and nine- month periods ended September 30, 2008 and 2007 have been derived from our unaudited condensed consolidated financial statements included in Item 1 of Part I of this report. These statements include all normal recurring adjustments that management believes are necessary to fairly state our financial position, results of operations and cash flows. Results of operations for the three- and nine- month period ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008 or for any other period.

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Statement of income data (In millions)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
	(Unaudited)		(Unaudited)	
Net revenues	$ 103.6	$ 58.2	$ 40.3	$ 22.8
Cost of net revenues	(21.1)	(12.4)	(8.2)	(4.9)
Gross profit	82.5	45.9	32.1	17.9
Operating expenses:				
Product and technology development	(5.2)	(3.2)	(1.7)	(1.2)
Sales and marketing	(30.9)	(19.6)	(11.4)	(7.0)
General and administrative	(18.1)	(9.0)	(7.3)	(3.5)
Compensation Cost related to acquisitions	(1.9)			
Total operating expenses	(56.1)	(31.8)	(20.4)	(11.6)
Income from operations	26.4	14.1	11.7	6.3
Other income (expenses):				
Interest income	1.4	0.9	0.3	0.4
Interest expense and other financial charges	(3.5)	(1.7)	(1.1)	(0.7)
Foreign currency loss	(5.7)	(1.8)	(2.6)	(0.8)
Other expenses, net		(3.0)		(1.0)
Net income before income / asset tax expense	18.6	8.5	8.3	4.2
Income / asset tax expense	(7.7)	(4.1)	(2.4)	(1.4)
Net income	$ 10.9	$ 4.4	$ 5.9	$ 2.8
Accretion of preferred stock		(0.3)		(0.1)
Net income available to common shareholders	$ 10.9	$ 4.1	$ 5.9	$ 2.7

Other Data

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
Number of confirmed registered users at end of the period [1]	32.0	23.3	32.0	23.3
Number of confirmed new registered users during the period [2]	7.1	5.1	3.9	1.7
Gross merchandise volume [3]	1,555.2	1,050.5	590.1	394.9
Number of successful items sold [4]	15.3	12.8	5.6	4.6
Total payment volume [5]	200.6	101.2	81.5	43.6
Capital expenditures	61.1	2.7	60.3	0.7
Depreciation and Amortization	2.5	1.7	1.0	0.6

1 - Measure of the cumulative number of users who have registered on the MercadoLibre marketplace and confirmed their registration.
2 - Measure of the number of new users who have registered on the MercadoLibre marketplace and confirmed their registration. As of September 30, 2008 the number of confirmed new registered users includes 2.2 million coming from the DeRemate integration.
3 - Measure of the total U.S. dollar sum of all transactions completed through the MercadoLibre marketplace, excluding motors, real estate and services.
4 - Measure of the number of items that were sold/purchased through the MercadoLibre marketplace.
5 - Measure of the total U.S. dollar sum of all transactions paid for using MercadoPago.

Net revenues

Net revenues were $40.3 million for the three-month period ended September 30, 2008, an increase of $17.5 million, or 76.6%, from net revenues of $22.8 million for the same period in 2007. This increase was attributable to a 75.0% increase in revenues derived from our MercadoLibre marketplace, from $18.1 million for the three-month period ended September 30, 2007 to $31.7 million for the same period in 2008 and to an 82.9% increase in revenues derived from MercadoPago, from $4.7 million for the three-month ended September 30, 2007 to $8.5 million for the same period in 2008.

Growth in MercadoLibre marketplace revenues resulted principally from a 49.4% increase in the gross merchandise volume transacted through our platform, and from an increase in our take rate, defined as marketplace revenues as a percentage of gross merchandise volume, from 4.6% to 5.4%, for the three-month period ended September 30, 2008, compared to the same period in 2007. The growth in MercadoPago revenues for the three-month ended September 30, 2008 resulted principally from 87.0% increase in the total payments volume completed on our MercadoPago payments platform. In the same periods, our take rate, defined as payments revenues as a percentage of total payment volume, decreased from 10.7% to 10.5%, driven by an increased funding of MercadoPago working capital with cash provided by marketplace operating activities, rather than by discounting receivables or by incurring financial debt (see Description of Line items: Net Revenue section for an explanation on how revenues are recorded for MercadoPago installments).

Net revenues for the nine-month period ended September 30, 2008 were $103.6 million, a $45.3 million, or 77.9%, increase over the same period in 2007. This growth was the result of 72.5% growth in the MercadoLibre marketplace revenues, from $48.4 million for the first nine-months of 2007 to $83.5 million for the same period in 2008, and a 104.3% growth in MercadoPago revenues, from $9.8 million for the nine-month ended September 30, 2007 to $20.0 million for the same period in 2008.

On a segment basis, for the three-month period ended September 30, 2008 net revenue increased by $17.5 million compared to the same period in 2007, primarily due to increases of $5.2 million, or 53.3% in our Marketplace segment in Brazil, $2.3 million, or 72.2% in our Marketplace in Argentina, $1.1 million, or 43.6% in our Marketplace in Mexico, $5.1 million or 180.8% from our Marketplace in all other countries and $3.9 million, or 82.9% from our MercadoPago payments platform.

For the nine-month period ended September 30, 2008, net revenue increased by $45.3 million compared to the same period in 2007. This increase was primarily attributable to an increase of $14.1 million, or 53.8% in net revenues in our Marketplace Brazil, an increase of $5.3 million, or 67.3% in net revenues in our Marketplace in Argentina, an increase of $2.7 million, or 38.9% in net revenues in our Marketplace in Mexico, a combined growth of $13.0 million or 177.0%, for our Marketplace in all other countries, and an increase of $10.2 million, or 104.3% in net revenues for MercadoPago.

Based on geography, for the three-month period ended September 30, 2008 the net revenue increase of $17.5 million over the same period in 2007, can primarily be attributed to increases of $8.6 million, or 62.9% in Brazil, $2.4 million, or 68.2% in Argentina, $1.2 million, or 44.9% in Mexico, and $5.3 million or 178.4% in all other countries.

For the nine-month period ended September 30, 2008, revenue growth by geography compared to the same period in 2007 was attributable primarily to an increase of $23.2 million, or 68.1% in net revenues in Brazil, an increase of $5.6 million, or 64.1% in Argentina, an increase of $3.1 million, or 39.9% in Mexico, and a combined growth of $13.5 million or 174.1% in all other countries.

Cost of net revenues

Cost of net revenues was $8.2 million and $21.1 million for the three- and nine-month period ended September 30, 2008, respectively, an increase of 67.0% and 70.4% from cost of net revenues for the same periods in 2007. Cost of net revenues improved to 20.3% of net revenues for the three-month period ended September 30, 2008 from 21.4% for the same period in 2007 and to 20.3% of net revenues for the nine-month period ended September 30, 2008 from 21.2% compared to the same period in 2007. These increases were primarily attributable to additional billing and collections costs, sales taxes, and customer support expenditures.

Billing and collections fees increased by $1.3 million, or 59.8% for the three-month period ended September 30, 2008 compared to the same period in 2007 or by $3.6 million, or 72.8%, for the first nine-months of 2008 compared to 2007. Sales taxes on our net revenues increased by $1.0 million, or 73.0%, and $2.8 million, or 81.9%, for the three and nine-month period ended September 30, 2008, respectively, compared to the same period for 2007. Expenditures relating to our in-house customer support operations grew in the amount of $0.6 million, an increase of 55.8% compared to the three-month period ended September 30, 2007 or 41.4% and $1.3 million, compared to the nine-month period ended September 30, 2007, mostly driven by an increase in compensation costs, investments in improved service and initiatives to combat fraud, illegal items and fee evasion.

Product and technology development

Product and technology development expenses were $1.7 million for the three-month period ended September 30, 2008, an increase of $0.5 million, or 51.1%, from $1.2 million for the same period in 2007. For the nine-month period ended September 30, 2008 these expenses were $5.2 million, representing an increase of $2.1 million, or 65.3%, over the same period in 2007. Product and technology development expenses as a percentage of net revenues were 4.3% for the three-month period ended September 30, 2008 from 5.1% of net revenues for the same period in 2007, and 5.0% of net revenues for the nine-month period ended September 30, 2008, from 5.4% for the same period in 2007.

The growth in product and technology development expenses was primarily attributable to an increase in compensation costs of 77.2% and 92.2% for the three and nine-month periods ended September 30, 2008, respectively, over the same periods for 2007. These added compensation expenses, were primarily related to the addition of engineers and to a lesser extent related to increases in salaries, as we continue to invest in top quality talent to develop enhancements and new features across our trading platforms. We believe product development is one of our key competitive advantages and intend to continue to invest in added engineers to meet the increasingly sophisticated product expectations of our customer base.

Sales and marketing

Sales and marketing expenses were $11.4 million for the three-month period ended September 30, 2008, an increase of $4.4 million, or 63.6%, from $7.0 million over the same period in 2007. For the nine-month period ended September 30, 2008, sales and marketing expenses were $30.9 million, an increase of $11.3 million, or 57.4%, over the same period in 2007. Sales and marketing expenses represented 28.4% of our net revenues for the three-month period ended September 30, 2008, and 29.8% of net revenues for the nine-month period ended September 30, 2008, down from 30.6% and 33.7% for the same three and nine-month periods in 2007.

The growth in sales and marketing expenses resulted primarily from our increased expenditures in online advertising programs in the amount of $1.9 million, a 48.4% increase over the three-month period ended September 30, 2007, and of $5.0 million, a 47.0% over the nine-month periods ended September 30, 2007. Online advertising represented 14.6% and 15.2% of our net revenues in the three and nine-month period ended September 30, 2008, respectively, down from 17.4% and 18.4% for the same periods in 2007. Sales and marketing expenses also grew from 2007 to 2008 due to an increase in compensation costs in the amount of $1.0 million, or 121.6%, for the three-month period ended September 30, 2008, and $2.4 million, or 105.5%, for the nine-month period ended September 30, 2008, driven by additional headcount of the Company, the incorporation of CMG employees, and increased salaries to retain talent. Additionally, bad debt charges increased $1.3 million or 90.7% for the three-month period ended September 30, 2008 when compared to the same period in 2007 and increased by $2.8 million or 61.1% for the nine-months ended September 30, 2008 when compared to the same period in 2007. Bad debt charges for the three and nine-month period ended September 30, 2008, represented 6.8% and 7.2% of net revenues, respectively, versus 6.3% and 7.9% respectively, for the same periods in 2007.

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General and administrative

Our general and administrative expenses were $7.3 million for the three-month period ended September 30, 2008, an increase of $3.8 million, or 108.4%, over the same period in 2007, and $18.1 million for the nine-month period ended September 30, 2008, an increase of $9.1 million, or 101.6%, over the same period in 2007. As a percentage of net revenues, our general and administrative expenses were 18.0% for the three-month period ended September 30, 2008, from 15.3% for the same period in 2007, and 17.5% for the nine-months ended September 30, 2008 compared to 15.4% for the same period in 2007.

The major component that drove growth in general and administrative expenses over the comparable periods in 2007 was $1.6 million in increased compensation costs during the three-month period ended September 30, 2008, a 99.6% rate of growth and a $4.0 million increase in compensation costs, or a 94.6% rate of growth, during the nine-month period ended September 30, 2008. These added compensation costs primarily went into hiring additional employees to support our growing business and public company requirements, increases in salaries to retain talent, long term retention plan compensation costs, compensation for outside directors and the incorporation of CMG employees. Additionally, outside service fees grew $1.1 million, or 117.3%, for the three-month period ended September 30, 2008 when compared to the same period in 2007, and $2.8 million, or 119.2%, for the nine-months ended September 30, 2008 when compared to the same period in 2007, due to increased legal expenses and other costs associated with being a publicly traded company, and expenses related to the follow-on offering that was withdrawn in March, 2008.

Compensation Cost related to acquisitions

As part of the $19.0 million acquisition of CMG, which closed in the first quarter of 2008, $2.0 million of the purchase price was placed into an escrow account for twelve months in order to secure the obligations of the shareholders that remained as managers. On June 27, 2008, we released to the former shareholders $ 1.9 million of the total Management Escrow Agreement, in exchange for a discount, which were totally accrued in the first half of 2008. The compensation expense was recorded as operating expenses, instead of considering them part of the purchase price, following EITF 95-8   Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination   (See note 4 to our unaudited condensed consolidated financial statements included in this report). There is no expense related to compensation cost for the three-month period ended September 30, 2008.

Other income (expenses)

Our other expenses were $3.4 million for the three-month period ended September 30, 2008, an increase of $1.3 million from other expenses of $2.1 million for the same period in 2007. For the nine-month period ended September 30, 2008 other expenses were $7.8 million, an increase of $2.2 million from $5.6 million during the same period in 2007.

The growth during the three-month period ended September 30, 2008 was primarily a result of foreign currency losses of $2.6 million for the three-month period ended September 30, 2008, an increase of $1.8 million from foreign currency losses of $0.8 million for the same period in 2007. This increase was primarily due to the cost of transferring funds from Venezuela to other countries of $3.2 million, offset by gains in Brazil ($0.2) million, Mexico ($0.2) million and Argentina ($0.4) million due to the impact of the currency depreciation on the cash balances held by those subsidiaries in U.S. dollars. In addition, these expenses also grew due to an increase in interest expense and other financial charges from $0.7 million in the three-month period ended September 30, 2007 to $1.1 million in the same period of 2008, derived from an increase of $0.4 million in interest expenses from $0.4 million to $0.8 million, as a result of financing incurred to fund working capital needs in our Payments operations in Brazil. As of September 30, 2008, total interest expense regarding working capital requirement of our MercadoPago operations has been recorded as interest expense and not as cost of net revenues. In the three-month period ended September 30, 2007, interest expenses of $0.3 million, have been reclassified for comparison purposes to current year s presentation. The foreign currency losses and interest expenses were partially offset by $1.0 million of accrued expenses related to the fair value of warrants that were recorded for the three-month period ended September 30, 2007, versus no impact for this item for the three-month period ended September 30, 2008.

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For the nine-month period ended September 30, 2008, the increase in other expenses was also primarily attributable to $5.7 million in foreign currency loss, an increase of $3.9 million from $1.8 million for the same period in 2007, generated mostly in Venezuela by an increase of $3.5 million to $4.8 million as we transferred funds out of the country. In addition, other expenses increased by $1.8 million in interest expense and other financial charges from $1.7 million for the same period in 2007, driven mainly by financing incurred to fund working capital needs in our Payments operations in Brazil. These charges were partially offset by a decrease of $3.0 million related to the fair value of warrants that were recorded for the nine-month period ended September 30, 2007, versus no impact for this item for the nine-month period ended September 30, 2008, and by a $0.5 million increase in interest income, from $0.9 million for the nine-month period ended September 30, 2007, to $1.4 million during the same period in 2008.

Income and asset tax

Our reported income and asset tax expense for the three-month period ended September 30, 2008 was $2.4 million compared to a reported tax expense of $1.4 million for the same period in 2007, an increase of $1.0 million, or 70.4%. For the nine-month period ended September 30, 2008 reported tax expense was $7.7 million compared to $4.1 million for the same period in 2007, an increase of $3.6 million, or 88.0%. Our blended tax rate, defined as income and asset tax expense as a percentage of income before income and asset tax, was 28.9% and 41.5% for the three and nine-month period ended September 30, 2008, respectively, and 33.5% and 48.4% for the three and nine-month periods ended September 30, 2007.

The improvement during the nine-month period ended September 30, 2008 in the blended tax rate was driven in part by the impact in the same period of 2007 of the expense described above (See Other income (expenses)) related to the fair value of warrants, because this charge reduced pre-tax income, but the related tax credit had a full valuation allowance. There was no tax impact related to this item in 2008. In addition, the blended tax rate improved due to a lower tax rate in Argentina beginning in 2008, as we are a beneficiary of a software development law (that provides for a relief of 60% of total income tax determined in each year, for 10 years) and due to some tax efficiencies obtained through our tax planning strategy. These year-over-year improvements were partially offset by certain impacts in the nine month period ended September 30, 2008, such as $ 0.5 million of a new Mexican tax called Impuesto Empresarial a Tasa Única (IETU) , which affects our Mexican operations, by $0.5 million of foreign exchange losses in Venezuela that were not deductible, and by the impact of $ 1.9 million of accrued compensation expenses following EITF 95-8 Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination (See Compensation Cost related to acquisitions above), because this charge reduced pre-tax income, but the related tax credit had a full valuation allowance.

Our effective income tax rate, defined as the provision for income taxes as a percentage of pre tax income, was 37.1% and 38.4% for the three and nine-month period ended September 30, 2008, respectively, compared to 38.2% and 40.9% for the three and nine-month period ended September 30, 2007. The effective income tax rate excludes the effects of the deferred income tax, and of the IETU tax.

Liquidity and Capital Resources

Our main cash requirement is working capital to fund MercadoPago. We also require cash for capital expenditures relating to technology infrastructure, software applications and office space. Since our inception, we funded our operations primarily through contributions received from our stockholders obtained during the first two years of operations, from funds raised during our initial public offering, and from cash generated from our operations. We have funded MercadoPago by discounting credit card receivables, with loans backed with credit card receivables, and through cash advances derived from our MercadoLibre marketplace business.

At September 30, 2008, our principal source of liquidity was $30.9 million of cash and cash equivalents, and short-term investments, provided by the net proceeds of our initial public offering as well as cash generated from operations.

The significant components of our working capital are cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued expenses, funds receivable from and payable to MercadoPago users, and short-term debt. As MercadoPago grows as a percentage of total revenues we anticipate increased working capital needs. Thus far we have funded these needs through a combination of cash advances from our marketplace business, discounting credit card receivables and loans backed by these credit card receivables.

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The following table presents our cash flows from operating activities, investing activities and financing activities for the nine-month periods ended September 30, 2008 and 2007:

(In millions)	Nine Months ended September 30, 2008	2007
	(Unaudited)	
Net Cash provided by (used in):		
Operating activities	$ 16.1	$ 8.1
Investment activities	(12.1)	(44.4)
Financing activities	(9.5)	44.2
Effect of exchange rate changes on cash and cash equivalents	0.3	(0.5)
Net decrease in cash and cash equivalents	$ (5.3)	$ 7.4

Net cash provided by operating activities

Cash provided by operating activities consisted of net income adjusted for certain non-cash items, and the effect of changes in working capital and other activities. Our net cash from operating activities was $16.1 million for the nine-month period ended September 30, 2008 as compared to $8.1 million for the same period in 2007, an increase of $8.0 million or 98.3%. This improvement was mainly a result of an increase in net income of $6.5 million to $10.9 million for the nine-month period ended September 30, 2008 when compared to $4.4 million for the same period in 2007. Net cash provided by operating activities during the nine-month period ended September 30, 2008 also grew by $5.3 million versus the same period of 2007 as a consequence of increases in accounts payable to $7.8 million and $5.0 million as a consequence of decreases in accounts receivables to $4.8 million.

These increases in cash provided by operations were partially offset by a decrease of $2.0 million in working capital in our Payments segment, from $(2.9) million for the nine-month period ended September 30, 2007 to $(4.9) million for the same period in 2008, derived mostly from funds receivable from customers growing to $9.0 million. Also affecting cash provided by operations were the increase in other liabilities of $ 2.3 million, the decrease in non-cash charges to earnings such as changes in fair value of warrants during the nine-months ended September 30, 2007 of $3.0 million, and the impacts of realized gains on investments of $0.9 million and deferred income taxes of $0.9 million.

Net cash used in investing activities

Net cash used in investing activities was $(12.1) million for the nine-month period ended September 30, 2008 compared to $(44.4) million during the same period in 2007. Net cash used in investing activities resulted mainly from purchases of investments for $59.6 million which includes $2.3 million for our real estate investment in the Arias trust and due to payments for CMG and DeRemate acquisitions, net of cash acquired for $ 39.2 million.

The purchase of DeRemate, includes the fair value of the assets and liabilities acquired of $(0.6) million, customer lists and non-compete agreement net of tax of $1.2 million and goodwill of $39.9 million and the purchase of 100% of the issued and outstanding shares of capital stock of CMG which includes the fair value of the assets and liabilities acquired of $0.7 million, trademarks of $5.6 million and goodwill of $13.0 million. The related CMG acquisition outflow of our statement of cash flow amounts to $ 16.8 million which is net of cash acquired ($0.5 million) and excludes $ 1.9 million recorded as compensation expense and not as part of the purchase price, following EITF 95-8 (See Note 4 to our unaudited condensed consolidated financial statements and General and Administrative above). The related DeRemate acquisition outflow of our statement of cash flow does not include $18.0 million of promissory notes issued to the seller.

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Additionally, net cash used in investing activities resulted from capital expenditures related to technological equipment, software licenses and to a lesser degree office equipment, in the amount of $3.9 million for the nine-month period ended September 30, 2008.

During the nine-month period ended September 30, 2008, the decrease of cash used in investment activities was partially offset by proceeds from the sale and maturity of investments for $90.6 million mainly due to sale of investments to pay acquisitions and as part of our financial strategy

Net cash provided by (used in) financing activities

Cash used in financing activities was $(9.5) million for the nine-month period ended September 30, 2008 as we reduced our financing from loans backed by Payments credit card receivables.

The promissory notes issued to the seller related to DeRemate acquisition for $18.0 million was considered as a non-cash transaction and for that reason was not included in the financing activities caption of our cash flow statement.

In the event that we decide to pursue strategic acquisitions in the future, we may fund them with available cash, third party debt financing, or by raising equity capital, as market conditions allow.

Debt

In connection with the DeRemate acquisition, on September 5, 2008, we issued to the Seller ten (10) unsecured promissory notes having an aggregate principal amount of $18 million. Each of the promissory notes have a one-year term, bear interest at 3.17875% plus 1.5% for the first four months, 2.0% for the second four months and 2.5% for the third four months and can be prepaid by us without penalty (See Recent Developments section of this report). As of September 30, 2008 the balance (including principal and accrued interest) of those promissory notes amounts to $18.1 million.

In 2007, we began to finance Payments funds payable with loans backed by Payments credit card receivables, which are recorded as financial debt, and not as a reduction in the receivable balance. As a result, the cash inflow is recorded as cash flow from financing activities in the statements of cash flows, and not as cash flow from operating activities.

Capital expenditures

Our capital expenditures increased $58.4 million, to $61.1 million for the nine-month period ended September 30, 2008 as compared to $2.7 million for the same period in 2007. This increase was mainly due to the $39.2 million that we recorded as payments for the CMG and DeRemate acquisitions (net of cash acquired), as described above in the sections Liquidity and Capital resources and Net cash used in investing activities .

Additionally, in property and equipment we primarily recorded purchases of hardware and software licenses necessary to maintain and update the technology of our platform, and to a lesser degree cost of computer software developed internally, office equipment and investing in new office space, for a total of $3.9 million for the period ended September 30, 2008. We anticipate continued investments in capital expenditures in the future as we strive to maintain our position in the Latin American e-commerce market.

Our Argentine subsidiary has invested in a real estate trust. The investment in this trust represents a beneficial ownership interest in 5,340 square meters divided in five floors of an office building and 70 parking spots under construction in the City of Buenos Aires, Argentina, where we expect to relocate our office headquarters upon completion of the building. As of September 30, 2008, the Argentine subsidiary has paid $2,343,059 into the trust. For U.S. GAAP purposes the investment was recorded as a long term investment instead of as Property and equipment.

We believe that our existing cash and cash equivalents, the net proceeds from our initial public offering, discounting of credit card receivables and cash generated from operations will be sufficient to fund our operating activities, property and equipment expenditures and other obligations going forward.

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Off-balance sheet arrangements

At September 30, 2008, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities for the purpose of facilitating contractually narrow or limited purposes.

Recent accounting pronouncements

Business Combinations

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations (SFAS 141 R). This Statement replaces SFAS 141, Business Combinations . SFAS 141 R retains the fundamental requirements in SFAS 141 that the acquisition method of accounting (which SFAS 141 called the purchase method) be used for all business combinations. SFAS 141 R defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. SFAS 141 did not define the acquirer, although it included guidance on identifying the acquirer, as does SFAS 141 R. SFAS 141 R scope is broader than that of SFAS 141, which applied only to business combinations in which control was obtained by transferring consideration.

SFAS 141 applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date.

Noncontrolling Interests in Consolidated Financial Statements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160). SFAS 160 amends Accounting Research Bulletin (ARB) No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited.

Fair Value of Stock Options

On December 27, 2007, the Securities and Exchange Commission issued staff accounting bulletin No. 110 (SAB. 110) expresses the views of the staff regarding the use of a simplified method, as discussed in SAB No. 107 (SAB 107), in developing an estimate of expected term of plain vanilla share options in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment . In particular, the staff indicated in SAB 107 that it will accept a company s election to use the simplified method, regardless of whether the company has sufficient information to make more refined estimates of expected term. At the time SAB 107 was issued, the staff believed that more detailed external information about employee exercise behavior (e.g., employee exercise patterns by industry and/or other categories of companies) would, over time, become readily available to companies. Therefore, the staff stated in SAB 107 that it would not expect a company to use the simplified method for share option grants after December 31, 2007. The staff understands that such detailed information about employee exercise behavior may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007.

Determination of the useful life of intangible assets

In April 2008, the FASB issued FASB Staff Position 142-3, Determination of the Useful Life of Intangible (FSP 142-3). Under FSP 142-3, for renewable intangible assets acquired in fiscal years beginning after December 15, 2008, an entity should consider its own historical experience in renewing or extending similar arrangements when developing its assumptions about renewals or extensions used to determine the useful life of an intangible asset; however, these assumptions should be adjusted for the entity specific factors in paragraph 11 of FAS 142. In the absence of that experience, an entity should consider the assumptions that market participants would use about renewals or extensions (consistent with the highest and best use of the asset by market participants), adjusted for the entity specific factors in paragraph 11 of FAS 142. The Company will evaluate the impact of FSP 142-3 on its financial statements.

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Determination of the fair value of financial assets

In October 2008, the FASB issued FASB Staff Position FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP 157-3). FSP 157-3 clarified the application of FAS 157. FSP 157-3 demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not have an impact on our consolidated financial statements.

Hierarchy of Generally Accepted Accounting Principles

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, The Hierarchy of Generally Accepted Accounting Principles . This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The Board believes that the GAAP hierarchy should be directed to entities because it is the entity that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. Accordingly, the Board concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and is issuing this Statement to achieve that result. This Statement is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities

In June 2008, the FASB issued Financial Standard Position No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities . This FASB Staff Position (FSP) addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, *Earnings per Share.* Issue 03-6 provides guidance on share-based payment awards that contain a right to receive dividends declared on the common stock of the issuer that are fully vested. However, in Issue 2(a) the Task Force declined to provide guidance on share-based payment awards that were not fully vested (that is, awards for which the requisite service had not yet been rendered). This FSP shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented shall be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of this FSP. Early application is not permitted.

Contractual obligations

We have certain fixed contractual obligations and commitments that include future estimated payments. Changes in our business needs, cancellation provisions and other factors may result in actual payments differing materially from the estimates. We cannot provide certainty regarding the timing and amount of payments. Below is a summary of the most significant assumptions used in our determination of amounts presented in the table. Contractual obligations at September 30, 2008 are as follows:

		Payment due by period			
(In millions)	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Operating lease obligations (1)	$ 3.8	$ 1.7	$ 2.0	$ 0.1	
Purchase obligations (2)	12.6	9.3	3.3		
Total	$ 16.4	$ 11.0	$ 5.3	$ 0.1	

(1) Includes leases of office space.

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(2) On June 19, 2008, our Argentine subsidiary offered to participate in a real estate trust, which investment represents a beneficial ownership interest in 5,340 square meters divided in five floors of an office building and 70 parking spots under construction in the City of Buenos Aires, Argentina. We expect to relocate our office headquarters to this newly acquired office space upon completion of the building, which we expect to occur in the second quarter of 2010. Under the terms of our commitments, the total estimated contractual obligation with the Trust was $10.1 million which shall be paid within 20 months. As of September 30, 2008, the Argentine subsidiary has invested $2.3 million in the aforementioned trust. Due to the impact of the Argentine inflation, future payments could differ significantly from our estimates. Certain of our officers and former officers also entered into an investment in a portion of the trust, which investment represents a beneficial ownership interest in a separate floor of the same building. We do not intend to occupy the space to be owned by this group.

Due to the DeRemate acquisition, on September 5, 2008, we issued to HEI 10 unsecured promissory notes having an aggregate principal amount of $18.0 million. Each of the promissory notes have a one-year term, bear interest at 3.2% plus 1.5% for the first four months, 2.0% for the second four months and 2.5% for the third four months and can be prepaid by the Company without penalty.

We do not have long-term debt obligations. We have leases for office space in certain countries in which we operate. These are our only operating leases. Purchase obligation amounts include an obligation in Arias Trust, minimum purchase commitments for advertising, capital expenditures (technological equipment and software licenses) and other goods and services that were entered into in the ordinary course of business. We have developed estimates to project payment obligations based upon historical trends, when available, and our anticipated future obligations. Given the significance of performance requirements within our advertising and other arrangements, actual payments could differ significantly from these estimates.

Item 3 Qualitative and Quantitative Disclosure About Market Risk

We are exposed to market risks arising from our business operations. These market risks arise mainly from the possibility that changes in interest rates and the U.S. dollar exchange rate with local currencies, particularly the Brazilian reais due to Brazil s share of our revenues, may affect the value of our financial assets and liabilities.

Foreign currencies

At September 30, 2008, the Seller financing related to DeRemate Acquisition consisting of unsecured promissory notes for an aggregate principal amount of $18.0 million, was denominated in U.S. dollars. We hold cash and cash equivalents in local currencies in our subsidiaries, and have receivables denominated in local currencies in all of our operations. Our subsidiaries generate revenues and incur most of their expenses in local currency. As a result, our subsidiaries use their local currency as their functional currency. At September 30, 2008, the total cash and cash equivalents denominated in foreign currencies totaled $9.0 million, and accounts receivable and funds receivable from customers in foreign currencies totaled $40.2 million. To manage exchange rate risk, our treasury policy is to transfer all cash and cash equivalents in excess of working capital requirements into dollar-denominated accounts in the United States. At September 30, 2008, these dollar-denominated cash and cash equivalents and short-term investments totaled $20.5 million. For the nine-month period ended September 30, 2008, we incurred in foreign currency losses in the amount of $5.7 million due to the cost of transferring funds from our Venezuelan subsidiary to the United States, and as the cash balances of the subsidiaries held in U.S. dollars depreciated in local current terms.

In addition, if the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions will result in increased net revenues, operating expenses, and net income. Similarly, our net revenues, operating expenses and net income will decrease if the U.S. dollar strengthens against foreign currencies. During the nine-month period ended September 30, 2008, 55.3% of our revenues were denominated in Brazilian reais, 13.8% in Argentine pesos and 10.4% in Mexican pesos.

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We have estimated that the impact of exchange rate fluctuations on our results of operations for the three-month period ended September 30, 2008 resulted in higher net revenues of approximately $3.4 million, and higher aggregate cost of net revenues and operating expenses of approximately $2.6 million, as compared to the same period in 2007. For net income, we estimated an increase of $0.7 million for the three-month period ended September 30, 2008. This calculation was made taking the average monthly exchange rates for each month in the third quarter of 2007, and applying them to the corresponding months in 2008, so as to calculate what our financial results would have been had exchange rates remained stable from one year to the next.

The following table summarizes the distribution of net revenues based on geography:

	Nine months ended September 30, 2008		Nine months ended September 30, 2007	
Brazil	$	57.3	$	34.1
Argentina		14.3		8.7
Mexico		10.7		7.7
Other countries		21.2		7.7
Total net revenues	$	103.6	$	58.2

We have entered in the past into transactions to hedge portions of our foreign currency translation exposure. Even though such transactions are expensive, due to current volatile environment, we are evaluating entering into hedging transactions in the future to seek to reduce some of the effects of our foreign currency exposure.

Interest

Our earnings and cash flows are also affected by changes in interest rates. These changes can have an impact on our interest expenses derived from discounting our MercadoPago receivables. At September 30, 2008, MercadoPago funds receivable from customers totaled approximately $34.9 million. Interest fluctuations could also negatively affect certain of our fixed rate and floating rate investments comprised primarily of time deposits, money market funds, commercial paper, investment grade corporate debt securities, sovereign debt securities and treasury bills. Investments in both fixed rate and floating rate interest earning products carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. In addition, we issued unsecured promissory notes to finance the DeRemate acquisition, for an aggregate principal amount of $18.0 million. The promissory notes have a one-year term, and bear interest at 3.17875% plus 1.5% for the first four months, 2.0% for the second four months and 2.5% for the third four months. Fixed rate liabilities may have their fair market value adversely impacted due to a decrease in interest rates.

Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. Due to the short-term nature of substantially all of our investments, a 100 basis point movement in market interest rates would not have a material impact on the total fair market value of our portfolio as of September 30, 2008 or interest expenses derived from discounting our MercadaPago receivables or our promissory notes issued in connection with the DeRemate acquisition.

We consider substantially all of our investments to be short-term investments, which are classified on our balance sheet as current assets, because the investments can be readily converted at any time into cash or into securities with a shorter remaining time to maturity. We determine the appropriate classification of our investments at the time of purchase and re-evaluate such designations as of each balance sheet date. Commercial papers, sovereign debt securities, corporate debt securities and time deposits are considered held-to-maturity securities. The book value of held-to-maturity securities approximates their respective fair values and consequently there are no significant unrecognized gains or losses.

Certain working capital requirements of our MercadoPago business in Brazil were financed through loans backed by credit card receivables. See Item 1A Risk Factors Risks related to doing business in Latin America in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, for a further discussion of some of our foreign currency risks.

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Credit

We invest in high-quality financial instruments, consisting primarily of time deposits, money market funds, commercial paper, investment grade corporate and sovereign debt securities, and treasury bills, which we believe are subject to limited credit risk. Credit risk is risk due to uncertainty in a counterparty s ability to meet its financial obligations. For the nine-month period ended September 30, 2008, market perception of these risks, together with certain market dislocations, had an adverse effect on the fair value of certain classes of securities, including in some cases, high-quality financial instruments that were not previously viewed as having credit risk. We seek, however, to minimize such risk by entering into transactions with counterparties that are believed to be creditworthy financial institutions or classes which we believe have not been affected by the current credit market environment.

Item 4T Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports pursuant to the Securities Exchange Act of 1934, as amended (the Exchange Act) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Evaluation of disclosure controls and procedures

Based on the evaluation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) required by Exchange Act Rules 13a-15(b) or 15d-15(b), our chief executive officer and our chief financial officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Changes in Internal Controls Over Financial Reporting

As a newly public company, we are in the process of upgrading our internal controls over financial reporting in view of our upcoming annual assessment, first required by the Exchange Act for this fiscal year end, including, among other things, reengineering certain processes, reinforcing accesses and segregation of duties in our systems, and improving the documentation of certain controls the Company already had in place.

Except as described above, there were no changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the three months ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1 Legal Proceedings

From time to time, we are involved in disputes that arise in the ordinary course of our business. The number and significance of these disputes is increasing as our business expands and our company grows. Any claims against us, whether meritorious or not, may be time consuming, result in costly litigation, require significant amounts of management time, result in the diversion of significant operational resources and require expensive implementations of changes to our business methods to respond to these claims. See Item 1A Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, for additional discussion of the litigation and regulatory risks facing our company.

At September 30, 2008, our total reserves for proceeding-related contingencies were approximately $0.9 million for 334 legal actions against us where we have determined that a loss is probable. We do not reserve for losses we determine to be possible or remote.

At September 30, 2008, there were 246 lawsuits pending against our Brazilian subsidiary in the Brazilian ordinary courts. In addition, at September 30, 2008, there were more than 1,970 lawsuits pending against our Brazilian subsidiary in the Brazilian consumer courts, where a lawyer is not required to file or pursue a claim. In most of these cases, the plaintiffs asserted that we were responsible for fraud committed against them, or responsible for damages suffered when purchasing an item on our website, when using MercadoPago, or when we invoiced them. We believe we have meritorious defenses to these claims and intend to continue defending them.

We do not believe that any single pending lawsuit or administrative proceeding, if adversely decided, would have a material adverse effect on our financial condition results of operations and cash flows. Set forth below is a description of the legal proceedings that we have determined to be material to our business. We have excluded ordinary routine legal proceedings incidental to our business. In each of these proceedings we also believe we have meritorious defenses, and intend to continue defending these actions. We have established a reserve for these proceedings.

Litigation

On March 28, 2003, Qix Skateboards Indústria e Comercio Ltda., or Qix, sued MercadoLivre.com Atividades de Internet Ltda., our Brazilian subsidiary, in the 3rd Civil Court, County of Novo Hamburgo, State of Rio Grande do Sul, Brazil. Qix alleged that our Brazilian subsidiary was infringing Qix s trademarks as a result of users selling allegedly counterfeit Qix shoes through the Brazilian page of our website, based on Brazilian Industrial Property Law (Law 9,279/96). Qix sought an order enjoining the sale of Qix-branded shoes on the MercadoLibre marketplace with a $50,000 daily non-compliance penalty. On April 25, 2003 we were summoned of an injunction granted to prohibit the offer of Qix products on our platform, but the penalty was established at $500. On May 5 2003 we appealed the decision, but the injunction was not lifted. To date, we have not received the summons for the original action because we filed an appeal challenging the jurisdiction of the court, which appeal is still pending.

On November 5, 2003, Editora COC Empreendimentos Culturais Ltda., or Editora COC, sued our Brazilian subsidiary in the 3rd Civil Court of the County of Bauru, State of São Paulo, Brazil. Editora COC alleged that our Brazilian subsidiary and an identified user were both infringing Editora COC s trademarks as a result of our users selling allegedly pirate copies of Editora s COC CD-ROMs through the Brazilian page of our website, based on Brazilian Industrial Property Law (Law 9,279/96) and the Brazilian Copyright Law (Law 9,610/98). Editora COC sought an order for the search and seizure of products held by the user and enjoining the sale of Editora COC-branded products on our platform. An injunction was granted to prohibit the offer of Editora COC s products on our platform. On September 8 2005, the court ruled against us and held that we had to pay $3,000 and our co-defendant had to pay $900 in moral damages, plus an amount of material damages to be defined at judgment execution, plus attorneys fees in the amount of 10% of the total damages paid by each defendant. On January 13, 2006 we appealed the ruling to the relevant court of appeals, which appeal is still pending.

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On March 17, 2006, Vintage Denim Ltda., or Vintage, sued our Brazilian subsidiaries MercadoLivre.com Atividades de Internet Ltda. and eBazar.com.br Ltda. in the 29th Civil Court of the County of São Paulo, State of São Paulo, Brazil. Vintage requested a preliminary injunction alleging that these subsidiaries were infringing Diesel trademarks and their right of exclusive distribution as a result of sellers listing allegedly counterfeit and original imported Diesel branded clothing through the Brazilian page of our website, based on Brazilian Industrial Property Law (Law 9,279/96). Vintage sought an order enjoining the sale of Diesel-branded clothing on our platform. A preliminary injunction was granted on April 11, 2006 to prohibit the offer of Diesel-branded products, and a fine for non-compliance was imposed in the approximate amount of $5,300 per defendant per day of non-compliance. We appealed the decision, but the preliminary injunction was not lifted. On August 16, 2007 we presented another appeal to the Superior Court of Justice, in Brasilia. Vintage filed an action requesting a permanent injunction on May 12, 2006, alleging the same facts as alleged in the preliminary injunction request. In September of 2006, a fine of $157,000 was imposed on our Brazilian subsidiaries due to the alleged non-compliance of the preliminary injunction. We filed an appeal to the fine and requested its suspension pending a final adjudication on the merits. In October of 2006, the fine was suspended and on January 23, 2007, the fine was declared null and void. However, because our appeal of the preliminary injunction failed, in March of 2007, Vintage presented new petitions alleging non-compliance of the preliminary injunction granted to Vintage and requested a fine of approximately $3.3 million against us, which represents approximately $5,300 per defendant per day of alleged non-compliance since April 13, 2006. On July 4, 2007, the judge ordered the payment of the fine mandated in the preliminary injunction, without specifying the amount. When we are officially notified of the amount of the fine, we will present a new appeal against the application of the fine. On July 18, 2007 the judge set a conciliatory hearing for August 1, 2007. We attended the hearing but could not reach an agreement. On September 14, 2007, the judge decided that (i) our Brazilian subsidiaries were not responsible for alleged infringement of intellectual property rights by its users; and that (ii) the plaintiffs did not prove the alleged infringement of its intellectual property rights. The decision maintained the injunction until such ruling is non-appealable. We presented a request that the injunction should be revoked, but it was rejected. Plaintiff presented appeal against the decision on the September 14, 2007 ruling, which appeal was published on December 11, 2007. On January 8, 2008, we presented an appeal to the Court of the State of São Paulo against the decision that maintained the injunction, and, on January 14, 2008, we presented a reply to the appeal filed by the plaintiff. On June 30, our appeal against the decision that maintained the injunction was rejected and we presented another appeal to the same court on July 7, 2008.

On April 6, 2006, Fallms Distribuição de Fitas Ltda., or Fallms, and 100% Nacional Distribuidora de Fitas Ltda., or 100% Nacional, sued our Brazilian subsidiary in the Second Civil Court of Santo Amaro, County of São Paulo, State of São Paulo, Brazil. Fallms and 100% Nacional alleged that our Brazilian subsidiary was infringing their intellectual property rights as a result of users selling unauthorized copies of their copyrighted movies through the Brazilian page of our website and by using their trademark Brasileirinhas on such copies. Fallms and 100% Nacional sought an order enjoining the sale of Fallms, 100% Nacional and Brasileirinhas branded movies on our platform. An injunction was granted to prohibit the offer of Fallms, 100% Nacional and Brasileirinhas branded movies. We were summoned in March of 2007 and presented our defense on March 14, 2007. In June of 2007, Fallms filed a petition to increase the fine imposed in the preliminary injunction, from approximately $200, to approximately $530 per day of noncompliance, based on alleged non-compliance by our Brazilian subsidiary. On July 2, 2007, we presented a petition requesting the judge to revoke the preliminary injunction. On July 25, 2007, the judge revoked the preliminary injunction. On the same date, the judge decided that (i) our Brazilian subsidiary was not responsible for alleged infringement of intellectual property rights by its users; and that (ii) the plaintiffs did not prove that (a) they own the trademark Brasileirinhas and copyrights of Brasileirinhas branded movies and (b) the alleged infringement of intellectual property rights resulted in an effective copyright violation. The plaintiffs presented a request asking for clarification of the decision, but it was rejected. On November 6, 2007, plaintiffs appealed the July 25, 2007 decision that dismissed the case, and we presented our reply to that appeal on February 1, 2008.

On March 7, 2007, Xuxa Promoções e Produções Artísticas Ltda., or Xuxa, sued our Brazilian subsidiary in the Court of Barra da Tijuca, Rio de Janeiro, State of Rio de Janeiro, Brazil. Xuxa, a popular television personality in Brazil, alleged that counterfeit copies of one of her CDs and of a movie with her participation as an actress (for which she owns the copyright and distribution rights) are being sold on our platform, and as such our Brazilian subsidiary is infringing her intellectual and property rights. Xuxa seeks an injunction, the establishment of preventive measures, fines, and compensatory and statutory damages. An injunction ordering the removal of any offers of copies of this CD and movie was granted to Xuxa. We appealed the injunction on July 2, 2007 and

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presented our defense on July 6, 2007. On December 17, 2007, both parties filed a joint petition requesting suspension of the process for 60 days until March 10, 2008, due to negotiation of a settlement of the case. On March 10, 2008, both parties presented a joint petition requesting the extension of the suspension term for 30 more days, however, did not reach an agreement to settle the case. Our appeal against the injunction was rejected on July 14, 2008 and we presented another appeal against that decision to the same court on July 18, 2008.

On June 11, 2007, Praetorium Instituto de Ensino, Pesquisas e Atividades de Extensão e Direito Ltda., or Praetorium, sued our Brazilian subsidiary in the Fourth Civil Court of the County of Belo Horizonte, State of Minas Gerais, Brazil. Praetorium alleged that our Brazilian subsidiary was infringing Praetorium s copyrights as a result of our users selling allegedly counterfeit copies of Praetorium s courses through the Brazilian page of our website. Praetorium seeks an injunction, fines, and compensatory and statutory damages. An injunction ordering the removal of any offers containing the name of Praetorium was granted to Praetorium on July 11, 2007 giving us 48 hours to comply. In addition to the preliminary injunction, a fine of approximately $5,300 per day of noncompliance was imposed up to a maximum of approximately $131,000 and a fine of approximately $530 was also imposed for each new product posted after July 13, 2007 containing the name of Praetorium and listed in the Brazilian page of our website. On August 3, 2007, we appealed the preliminary injunction to the State Court of Minas Gerais and presented our defense on August 8, 2007. On November 20, 2007, the State Court of Minas Gerais rejected our request that the injunction should be suspended until judgment of the appeal. Notwithstanding, the appeal against the decision that granted the preliminary injunction is still pending.

On August 23, 2007, Serasa S.A., or Serasa, sued our Brazilian subsidiary in the Sixth Civil Court of Santo Amaro, City of São Paulo, State of São Paulo, Brazil. Serasa, a company which provides credit-related analysis, information services and data bank and payment habits related to individuals and corporations, alleged that our Brazilian subsidiary should be responsible for the sale by its users of allegedly unlawful content and unfair uses of its services and Serasa s trade name and trademarks. Serasa seeks an injunction, fines, and compensatory damages. On November 5, 2007 a preliminary injunction was granted to Serasa, ordering our Brazilian subsidiary (a) to remove any content offering: (i) consultation of Serasa s database; and (ii) passwords, texts or any material that promises to consult, remove or teach how to remove someone name from Serasa s database; (b) the prohibition to allow in its website any content similar to the aforementioned; and (c) to provide certain personal data of certain users who have offered such products. In addition to the preliminary injunction, a fine of approximately $5,500 per day of noncompliance was imposed. On December 17, 2007, our Brazilian subsidiary presented the information requested. We appealed the preliminary injunction to the State Court of São Paulo and presented our defense on January 7, 2008. Serasa replied to our appeal on January 30, 2008. On March 26, 2008, we were summoned with a petition presented by Serasa alleging non-compliance with the injunction. We presented our response on March 31, 2008, arguing that we are in full compliance with the injunction. On August 26, 2008 the State Court of São Paulo lifted the prohibition to allow in the Brazilian website any content related to Serasa as established in the injunction.

On November 23, 2007 Botelho Indústria e Distribuição Cinematográfica Ltda., or Botelho, sued our Brazilian subsidiary in the Third Civil Court of the City of Rio de Janeiro, State of Rio de Janeiro, Brazil. Botelho alleged that our Brazilian subsidiary was infringing its intellectual property rights as a result of users selling unauthorized copies of Botelho s courses through the Brazilian website. Botelho seeks an injunction, fines, and compensatory and statutory damages, which was not yet analyzed by the judge. On February 25, 2008 we presented arguments to give the judge support and background to analyze the requested injunction. We presented our defense on March 5, 2008.

On October 25, 2007, Iglesia Mesianica Mundial Sekai Kyusei Kio en la Argentina, or Iglesia Mesianica, filed suit against our Argentine subsidiary, MercadoLibre S.A., in the Thirteenth Civil Court of the City of Buenos Aires, Argentina. The complaint was officially notified on April 17, 2008. Iglesia Mesianica alleged in the complaint that our Argentine subsidiary should be held liable as a result of our users selling books that allegedly plagiarized certain Iglesia Mesianica s books through the Argentine page of our website. Iglesia Mesianica seeks monetary damages in the amount of approximately $95,000. We presented our defense on May 9, 2008.

On February 29, 2008, Mr. Eduardo Paoletti presented a claim against our Brazilian subsidiary and Banco do Brasil S.A. and Banco Nossa Caixa S.A., in the Forty Second Civil Court of the Central Court of the City of São Paulo. Plaintiff alleges that his personal information was used by third parties to (i) register in our Brazilian website and (ii) open bank accounts in the aforementioned banks in order to commit fraud against users of our Brazilian website. Plaintiff alleges that our Brazilian shall be held joint and severally responsible with the other defendants for damages. Mr. Paoletti seeks compensatory and statutory damages estimated for approximately $1.8 million. We were summoned on June 19, 2008 and presented our defense on July 28, 2008.

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On July 25, 2008, Nike International Ltd. or Nike requested a preliminary injunction against our Argentine subsidiary in the First Civil and Commercial Federal Court, Argentina. We were officially notified on August 14, 2008. Nike requested the injunction alleging that this subsidiary was infringing Nike trademarks as a result of sellers listing allegedly counterfeit Nike branded products through the Argentine page of our website. A preliminary injunction was granted on August 11, 2008 to suspend the offer of Nike-branded products until sellers could be properly identified. We appealed the decision on August 22, 2008.

State of São Paulo Fraud Claim

On June 12, 2007, a state prosecutor of the State of São Paulo, Brazil presented a claim against our Brazilian subsidiary. The state prosecutor alleges that our Brazilian subsidiary should be held liable for any fraud committed by sellers on the Brazilian version of our website, or responsible for damages suffered by buyers when purchasing an item on the Brazilian version of the MercadoLibre website. We were summoned on December 12, 2007 and presented our defense on January 4, 2008.

State of Minas Gerais Fraud Claim

On October 5, 2007, a state prosecutor of the State of Minas Gerais, city of Uberlandia, Brazil presented a claim against our Brazilian subsidiary. The state prosecutor alleges that our Brazilian subsidiary should be held liable for any fraud committed by sellers on the Brazilian version of our website, or responsible for damages suffered by buyers when purchasing an item on the Brazilian version of the MercadoLibre website. We were summoned on June 30, 2008 and presented our defense on July 25, 2008.

City of São Paulo Tax Claim

On September 13, 2007, we paid to tax authorities in São Paulo, Brazil approximately $1.1 million, consisting of $1.0 million in accrued taxes and $0.1 million in fines, related to our Brazilian subsidiary s activities in São Paulo for the period 2002 through 2004. We had reserved approximately $1.1 million against these taxes as of December 31, 2006 so no additional provision was recorded for the payment. São Paulo tax authorities have also asserted taxes and fines against us relating to the period from 2005 to 2007 in an approximate additional amount of $5.9 million. In January 2005, we had moved our operations to Santana de Parnaíba City, Brazil and began paying taxes to that jurisdiction, therefore we believe we have strong defenses to the claims of the São Paulo authorities with respect to this period. We believe the risk of loss for this period is remote, and as a result, have not reserved provisions for this claim. On August 31, 2007, we presented administrative defenses against the authorities claim; however, their response is still pending.

Brazilian National Public Treasury Tax Claim

On March 17, 2008, our Brazilian subsidiary received a tax claim for approximately $198,000 presented by the National Public Treasury of Brazil. The notice claims non-payment of income taxes that we believe we paid, and accordingly, we consider the risk of loss for this claim to be remote. On March 28, 2008, we presented our defense requesting a declaration that no such taxes are due.

Trademark Claim

We filed our first three applications to register the name MercadoLivre in Brazil with the Instituto Nacional da Propriedade Industrial (the National Institute of Industrial Property, or INPI) on October 7, 1999. Editora Livre Mercado Ltda., a publishing company, challenged these three applications based on their trademark Livre Mercado, a trade magazine. These challenges are currently pending with INPI. In addition to these processes, Agência Folha de Notícias Ltda., a news company, filed an application to register the name MercadoLivre on October 7, 1999, a few hours before we filed our application. We challenged that application. However, we cannot assure you that we will succeed in obtaining these trademarks or in our challenges to existing or future applications by other parties. If we are not successful, we could face claims by any future trademark owners. Any past or future

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claims relating to these issues, whether meritorious or not, could cause us to enter into costly royalty and/or licensing agreements. We may also have to modify our brand name in Brazil (or other jurisdictions) if any successful demands against us are too expensive. Any of these circumstances could adversely affect our business, results of operations and financial condition.

Other third parties have from time to time claimed, and others may claim in the future, that we have infringed their intellectual property rights. We have been notified of several potential third-party claims for intellectual property infringement through our website. These claims, whether meritorious or not, are time consuming, can be costly to resolve, could cause service upgrade delays, and could require expensive implementations of changes to our business methods to respond to these claims. See Item 1A Risk factors Risks related to our business We could potentially face legal and financial liability for the sale of items that infringe on the intellectual property rights of others and for information disseminated on the MercadoLibre marketplace in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Item 1A Risk Factors

There have been no material changes in our risk factors from those disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007 as filed with the Securities and Exchange Commission on March 31, 2008 as supplemented by our Quarterly Report on Form 10-Q for the quarter ended June 30, 2008 as filed with the Securities and Exchange Commission on August 13, 2008.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

Recent Sales of Unregistered Securities

There were no sales of unregistered securities by us during the three-month period ending September 30, 2008.

Use of Proceeds from IPO

Our registration statement on Form S-1, as amended (Registration No. 333-142880) (the Registration Statement), with respect to our initial public offering (the Offering) of common stock, par value $0.001 per share, was declared effective on August 9, 2007. We sold a total of 3,000,000 shares of common stock in the Offering and the selling shareholders sold a total of 15,488,762 shares of common stock in the Offering. The net proceeds to us of the Offering were approximately $49.6 million. These proceeds have been used to repay a $9.5 million outstanding loan (including interest) with eBay Inc., $19.4 million for our acquisition of CMG, and the remainder for our acquisition of the DeRemate Operations and general corporate purposes. These funds are invested in interest-bearing, investment-grade securities. See our quarterly report on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2007 for a further discussion of our use of proceeds from the Offering and Sections Interest and Credit above.

Item 6 Exhibits

31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rule 13a-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rule 13a-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signatures

Pursuant to the requirements 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.

MERCADOLIBRE, INC.

Registrant

Date: November 12, 2008	By:	/s/ Marcos Galperín Marcos Galperín
		President and Chief Executive Officer
	By:	/s/ Nicolás Szekasy Nicolás Szekasy
		Executive Vice President and Chief Financial Officer

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MercadoLibre, Inc.

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