WATERS CORP /DE/
Form 10-Q
October 31, 2008

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

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

For the quarterly period ended September 27, 2008

or

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

Commission File Number: 01-14010

Waters Corporation

(Exact name of registrant as specified in its charter)

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

34 Maple Street
Milford, Massachusetts 01757
(Address, including zip code, of principal executive offices)
(508) 478-2000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

Large accelerated filer þ Accelerated filer o

Non-accelerated filer (Do not check if a smaller reporting company) o Smaller reporting company o

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

Indicate the number of shares outstanding of the registrant s common stock as of October 24, 2008: 98,311,425

WATERS CORPORATION AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
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WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	September 27, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 892,600	$ 597,333
Short-term investments		95,681
Accounts receivable, less allowances for doubtful accounts and sales returns of $9,018 and $9,634 at September 27, 2008 and December 31, 2007, respectively	289,271	317,792
Inventories	206,231	175,888
Other current assets	45,940	50,368
Total current assets	1,434,042	1,237,062
Property, plant and equipment, net	166,569	160,856
Intangible assets, net	148,716	141,759
Goodwill	272,077	272,626
Other assets	82,378	68,752
Total assets	$ 2,103,782	$ 1,881,055
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and debt	$ 377,488	$ 384,176
Accounts payable	55,011	47,451
Accrued employee compensation	45,507	58,771
Deferred revenue and customer advances	101,203	87,348
Accrued income taxes	14,663	994
Accrued warranty	11,706	13,119
Other current liabilities	60,620	66,575
Total current liabilities	666,198	658,434
Long-term liabilities:		
Long-term debt	650,000	500,000
Long-term portion of retirement benefits	46,714	52,353
Long-term income tax liability	78,815	70,079
Other long-term liabilities	16,972	14,113
Total long-term liabilities	792,501	636,545
Total liabilities	1,458,699	1,294,979
Commitments and contingencies (Notes 6, 7 and 11)		

Stockholders equity:				
Preferred stock, par value $0.01 per share, 5,000 shares authorized, none issued at September 27, 2008 and December 31, 2007				
Common stock, par value $0.01 per share, 400,000 shares authorized, 147,821 and 147,061 shares issued, 98,279 and 100,975 shares outstanding at September 27, 2008 and December 31, 2007, respectively		1,478		1,471
Additional paid-in capital		746,155		691,746
Retained earnings		1,814,050		1,590,924
Treasury stock, at cost, 49,542 and 46,086 shares at September 27, 2008 and December 31, 2007, respectively		(1,975,351)		(1,764,297)
Accumulated other comprehensive income		58,751		66,232
Total stockholders equity		645,083		586,076
Total liabilities and stockholders equity	$	2,103,782	$	1,881,055

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

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WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	Three Months Ended	
	September 27, 2008	September 29, 2007
Product sales	$ 277,717	$ 258,469
Service sales	108,593	94,169
Total net sales	386,310	352,638
Cost of product sales	109,278	106,316
Cost of service sales	49,242	47,363
Total cost of sales	158,520	153,679
Gross profit	227,790	198,959
Selling and administrative expenses	107,463	105,577
Research and development expenses	19,946	21,974
Purchased intangibles amortization	2,349	2,176
Operating income	98,032	69,232
Interest expense	(10,570)	(14,783)
Interest income	6,028	8,061
Income from operations before income taxes	93,490	62,510
Provision for income tax expense	21,987	9,227
Net income	$ 71,503	$ 53,283
Net income per basic common share	$ 0.72	$ 0.53
Weighted-average number of basic common shares	98,891	99,821
Net income per diluted common share	$ 0.71	$ 0.52

Weighted-average number of diluted common shares and equivalents	100,566	101,712

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

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WATERS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	Nine Months Ended	
	September 27, 2008	September 29, 2007
Product sales	$ 835,303	$ 759,173
Service sales	321,490	276,872
Total net sales	1,156,793	1,036,045
Cost of product sales	336,874	309,553
Cost of service sales	152,329	139,577
Total cost of sales	489,203	449,130
Gross profit	667,590	586,915
Selling and administrative expenses	325,235	301,707
Research and development expenses	61,960	59,811
Purchased intangibles amortization	6,973	6,434
Operating income	273,422	218,963
Interest expense	(31,534)	(41,306)
Interest income	17,893	21,353
Income from operations before income taxes	259,781	199,010
Provision for income taxes	36,655	29,881
Net income	$ 223,126	$ 169,129
Net income per basic common share	$ 2.24	$ 1.68
Weighted-average number of basic common shares	99,611	100,457
Net income per diluted common share	$ 2.21	$ 1.65

Weighted-average number of diluted common shares and equivalents	101,150	102,352

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

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

	Nine Months Ended	
	September 27, 2008	September 29, 2007
Cash flows from operating activities:		
Net income	$ 223,126	$ 169,129
Adjustments to reconcile net income to net cash provided by operating activities:		
Provisions for doubtful accounts on accounts receivable	2,671	825
Provisions on inventory	7,757	5,283
Stock-based compensation	23,181	20,902
Deferred income taxes	(14,313)	(2,199)
Depreciation	22,052	20,508
Amortization of intangibles	30,413	19,177
Change in operating assets and liabilities, net of acquisitions:		
Decrease in accounts receivable	28,255	14,863
Increase in inventories	(42,506)	(22,473)
Decrease in other current assets	3,973	3,498
Increase in other assets	(2,275)	(12,283)
Increase in accounts payable and other current liabilities	459	37,359
Increase in deferred revenue and customer advances	14,135	10,759
Increase in other liabilities	9,102	1,545
Net cash provided by operating activities	306,030	266,893
Cash flows from investing activities:		
Additions to property, plant, equipment and software capitalization	(49,078)	(45,023)
Business acquisitions, net of cash acquired	(2,982)	(7,105)
Investment in unaffiliated company		(3,532)
Purchase of short-term investments	(19,738)	(304,740)
Maturity of short-term investments	115,419	197,441
Cash received from escrow related to business acquisition		724
Net cash provided by (used in) investing activities	43,621	(162,235)
Cash flows from financing activities:		
Proceeds from debt issuances	468,429	1,100,549
Payments on debt	(325,117)	(1,093,495)
Payments of debt issuance costs	(501)	(1,081)
Proceeds from stock plans	23,122	51,225
Purchase of treasury shares	(211,054)	(180,749)
Excess tax benefit related to stock option plans	7,787	18,656
Payments of debt swaps and other derivatives contracts	(3,706)	(2,310)
Net cash used in financing activities	(41,040)	(107,205)
Effect of exchange rate changes on cash and cash equivalents	(13,344)	7,547

Increase in cash and cash equivalents	295,267	5,000
Cash and cash equivalents at beginning of period	597,333	514,166
Cash and cash equivalents at end of period	$ 892,600	$ 519,166

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

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WATERS CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 Basis of Presentation and Significant Accounting Policies

Waters Corporation (Waters or the Company), an analytical instrument manufacturer, designs, manufactures, sells and services, through its Waters Division, high performance liquid chromatography (HPLC), ultra performance liquid chromatography® (UPLC and together with HPLC, herein referred to as LC) and mass spectrometry (MS) instrumen systems and support products, including chromatography columns, other consumable products and comprehensive post-warranty service plans. These systems are complementary products that can be integrated together and used along with other analytical instruments. LC is a standard technique and is utilized in a broad range of industries to detect, identify, monitor and measure the chemical, physical and biological composition of materials, and to purify a full range of compounds. MS instruments are used in drug discovery and development, including clinical trial testing, the analysis of proteins in disease processes (known as proteomics) and environmental testing. LC is often combined with MS to create LC-MS instruments that include a liquid phase sample introduction and separation system with mass spectrometric compound identification and quantification. Through its TA Division (TA), the Company designs, manufactures, sells and services thermal analysis, rheometry and calorimetry instruments which are used in predicting the suitability of polymers and viscous liquids for various industrial, consumer goods and healthcare products. The Company is also a developer and supplier of software-based products that interface with the Company s instruments and are typically purchased by customers as part of the instrument system.

The Company s interim fiscal quarter typically ends on the thirteenth Saturday of each quarter. Since the Company s fiscal year end is December 31, the first and fourth fiscal quarters may not consist of thirteen complete weeks. The Company s third fiscal quarters for 2008 and 2007 ended on September 27, 2008 and September 29, 2007, respectively.

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

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

It is management s opinion that the accompanying interim consolidated financial statements reflect all adjustments (which are normal and recurring) that are necessary for a fair statement of the results for the interim periods. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company s annual report on Form 10-K for the year ended December 31, 2007, as filed with the Securities and Exchange Commission (SEC) on February 29, 2008.

Reclassifications

Certain amounts from the prior year have been reclassified in the accompanying financial statements in order to be consistent with the current year s classifications.

Short-term Investments

Short-term investments primarily represent highly liquid investments, with original maturities generally greater than 90 days, in commercial paper rated A1 or A1+ by Standard & Poor s and P1 by Moody s Investors Service; bank deposits; repurchase agreements; U.S. Government Treasury and Agency Debt and AAA rated money market funds which are convertible to a known amount of cash and carry an insignificant risk of change in market value. The cost of the short-term investments approximates fair value.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Fair Value Measurements

Fair values of cash, cash equivalents, accounts receivable, accounts payable and debt approximate cost.

Effective January 1, 2008, the Company adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements . This standard addresses how companies should measure fair value when they are required to use a fair-value measure for recognition or disclosure purposes under GAAP. The adoption of this standard did not have a material effect on the Company s financial position, results of operations or cash flows. Relative to SFAS No. 157, the FASB issued Financial Statement of Position (FSP) Nos. 157-1, 157-2 and 157-3. FSP No. 157-1 amends SFAS No. 157 to exclude SFAS No. 13, Accounting for Leases , and its related interpretive accounting pronouncements that address leasing transactions, while FSP No. 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for those that are recognized or disclosed at fair value in the financial statements on a recurring basis. As is permitted by FSP No. 157-2, the Company has elected to defer implementation of this standard as it relates to the Company s non-financial assets and non-financial liabilities that are recognized and disclosed at fair value in the financial statements on a non-recurring basis until January 1, 2009. The Company is in the process of evaluating whether the adoption of FSP No. 157-2 will have a material effect on its financial position, results of operations or cash flows. FSP No. 157-3 clarifies the application of SFAS No. 157 as it relates to the valuation of financial assets in a market that is not active for those financial assets. This FSP is effective immediately and includes those periods for which financial statements have not been issued. As of September 27, 2008, the Company currently does not have any financial assets that are valued using inactive markets, and as such are not currently impacted by the issuance of this FSP.

SFAS No. 157 establishes a three-level value hierarchy for disclosure of fair-value measurements. The valuation hierarchy is based on the transparency of the inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Inputs to the valuation methodology are quoted prices for similar assets and liabilities in active markets, quoted prices in markets that are not active or inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 Unobservable inputs (e.g. a reporting entity s own data).

In accordance with methodology prescribed by SFAS No. 157, the Company has measured and disclosed the fair value of the following financial instrument assets and liabilities as of September 27, 2008 (in thousands):

	Total September 27, 2008	Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents	$ 742,981	$	$ 742,981	$
Waters Retirement Restoration Plan assets	15,761		15,761	
Foreign currency exchange contract agreements	59		59	
Total	$ 758,801	$	$ 758,801	$

Liabilities:								
Interest rate swap agreements		2,151				2,151		
Total	$	2,151	$		$	2,151	$	

The fair values of the Company s cash equivalents, plan assets and derivative instruments are determined through market, observable and corroborated sources.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stockholders Equity

In February 2007, the Company s Board of Directors authorized the Company to repurchase up to $500 million of its outstanding common stock over a two-year period. During the nine months ended September 27, 2008 and September 29, 2007, the Company repurchased 3.4 million and 2.5 million shares at a cost of $209 million and $146 million, respectively, under this program. As of September 27, 2008, the Company repurchased an aggregate of 6.2 million shares for an aggregate of $375 million under this program.

In October 2005, the Company s Board of Directors authorized the Company to repurchase up to $500 million of its outstanding common stock over a two-year period. During the three months ended March 31, 2007, the Company repurchased 0.6 million shares at a cost of $35 million under this program. As of March 31, 2007, the Company repurchased an aggregate of 11.9 million shares of its common stock under the October 2005 program for an aggregate of $500 million, effectively completing this program.

Hedge Transactions

Cash Flow Hedges

The Company uses interest rate swap agreements to hedge the risk to earnings associated with fluctuations in interest rates related to outstanding U.S. dollar floating rate debt. In August 2007, the Company entered into two floating-to-fixed-rate interest rate swaps, each with a notional amount of $50 million and maturity dates of April 2009 and October 2009, to hedge floating rate debt related to the term loan facility of its outstanding debt.

Other

The Company enters into forward foreign exchange contracts, principally to hedge the impact of currency fluctuations on certain inter-company balances. Principal hedged currencies include the Euro, Japanese Yen, British Pound and Singapore Dollar. The periods of these forward contracts typically range from one to three months and have varying notional amounts which are intended to be consistent with changes in inter-company balances. Gains and losses on these forward contracts are recorded in selling and administrative expenses in the consolidated statements of operations. At September 27, 2008 and December 31, 2007, the Company held forward foreign exchange contracts with notional amounts totaling $114 million and $101 million, respectively.

Product Warranty Costs

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

The following is a summary of the activity of the Company s accrued warranty liability for the nine months ended September 27, 2008 and September 29, 2007 (in thousands):

	Balance at Beginning of Period	Accruals for Warranties	Settlements Made	Balance at End of Period
Accrued warranty liability:				
September 27, 2008	$ 13,119	$ 7,376	$ (8,789)	$ 11,706
September 29, 2007	$ 12,619	$ 8,866	$ (8,744)	$ 12,741

2 Out-of-Period Adjustments

During the second quarter of 2008, the Company identified errors originating in periods prior to the three months ended June 28, 2008. The errors primarily related to (i) an overstatement of the Company s income tax expense of $16 million as a result of errors in recording its income tax provision during the period from 2000 to March 29, 2008 and (ii) an understatement of amortization expense of $9 million for certain capitalized software. The Company incorrectly calculated its provision for income taxes by tax-effecting its tax liability utilizing a U.S. tax rate of 35% instead of an Irish tax rate of 10%. In addition, the Company incorrectly accounted for Irish-based capitalized

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

software and the related amortization expense as U.S. Dollar-denominated instead of Euro-denominated, resulting in an understatement of amortization expense and cumulative translation adjustment.

The Company identified and corrected the errors in the three months ended June 28, 2008, which had the effect of increasing cost of sales by $9 million; reducing gross profit and income from operations before income tax by $9 million; reducing the provision for income taxes by $16 million and increasing net income by $8 million. For the nine months ended September 27, 2008, the errors had the effect of reducing the Company s effective tax rate by 5.6 percentage points. In addition, as of June 28, 2008, the out-of-period adjustments increased the gross carrying value of capitalized software by $46 million; increased accumulated amortization for capitalized software by $36 million; reduced deferred tax liabilities by $14 million and increased accumulated other comprehensive income by $17 million.

The Company does not believe that the prior period errors, individually or in the aggregate, are material to any previously issued annual or quarterly financial statements. In addition, the Company does not believe that the adjustments described above to correct the cumulative effect of the errors in the three months ended June 28, 2008 are material to the three months ended June 28, 2008 or to the estimate of the full year results for 2008. As a result, the Company has not restated its previously issued annual financial statements or interim financial data.

3 Inventories

Inventories are classified as follows (in thousands):

	September 27, 2008	December 31, 2007
Raw materials	$ 66,294	$ 51,426
Work in progress	17,274	16,970
Finished goods	122,663	107,492
Total inventories	$ 206,231	$ 175,888

4 Acquisitions

In July 2008, the Company acquired the net assets of VTI Corporation (VTI), a manufacturer of sorption analysis and thermogravimetric analysis instruments, for $3 million in cash. This acquisition was accounted for under the purchase method of accounting and the results of VTI have been included in the consolidated results of the Company from the acquisition date. The purchase price of the acquisition was allocated to tangible and intangible assets and assumed liabilities based on their estimated fair values. The Company has allocated $1 million of the purchase price to intangible assets comprised of a non-compete agreement and acquired technology. These intangible assets are being amortized over a weighted-average period of nine years. The excess purchase price of $2 million after this allocation has been accounted for as goodwill. The goodwill is deductible for tax purposes.

In August 2007, the Company acquired all of the outstanding capital stock of Calorimetry Sciences Corporation (CSC), a privately held company that designs, develops and manufactures highly sensitive calorimeters, for $7 million in cash, including the assumption of $1 million of liabilities. This acquisition was accounted for under the purchase method of accounting and the results of operations of CSC have been included in the consolidated results of the Company from the acquisition date. The purchase price of the acquisition was allocated to tangible and intangible assets and assumed liabilities based on their estimated fair values. The Company has allocated $3 million of the purchase price to intangible assets comprised of customer relationships, non-compete agreements and acquired technology. These intangible assets are being amortized over a weighted-average period of nine years. The excess purchase price of $5 million after this allocation has been accounted for as goodwill. The goodwill is deductible for tax purposes.

The pro forma effect of the CSC and VTI acquisitions are immaterial.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5 Goodwill and Other Intangibles

The carrying amount of goodwill was $272 million and $273 million at September 27, 2008 and December 31, 2007, respectively. The decrease is primarily due to currency translation adjustments of $3 million offset by the Company s acquisition of VTI which increased goodwill by $2 million.

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

	September 27, 2008			December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period	Gross Carrying Amount	Accumulated Amortization	Weighted-Average Amortization Period
Purchased intangibles	$ 111,883	$ 49,956	10 years	$ 111,207	$ 43,180	10 years
Capitalized software	183,383	110,804	4 years	133,215	74,298	4 years
Licenses	9,902	7,319	9 years	10,522	7,011	9 years
Patents and other intangibles	21,164	9,537	8 years	19,182	7,878	8 years
Total	$ 326,332	$ 177,616	7 years	$ 274,126	$ 132,367	7 years

The gross carrying value of capitalized software and related accumulated amortization increased by $46 million and $36 million, respectively, during the six months ended June 28, 2008 primarily as a result of an out-of-period adjustment (Note 2). The gross carrying value of intangible assets and accumulated amortization for intangible assets decreased by $15 million and $9 million, respectively, in the nine months ended September 27, 2008 due to the effect of foreign currency translation.

For the three months ended September 27, 2008 and September 29, 2007, amortization expense for intangible assets was $7 million and $6 million, respectively. For the nine months ended September 27, 2008 and September 29, 2007, amortization expense for intangible assets was $30 million and $19 million, respectively. Included in amortization expense for the nine months ended September 27, 2008 is a $9 million out-of-period adjustment related to capitalized software. Amortization expense for intangible assets is estimated to be approximately $28 million for each of the next five years.

6 Debt

In March 2008, the Company entered into a new credit agreement (the 2008 Credit Agreement) that provides for a $150 million term loan facility. In January 2007, the Company entered into a credit agreement (the 2007 Credit Agreement) that provides for a $500 million term loan facility and $600 million in revolving facilities, which include both a letter of credit and a swingline subfacility. Both credit agreements mature on January 11, 2012 and require no scheduled prepayments before that date. The outstanding portions of the revolving facilities have been classified as short-term liabilities in the consolidated balance sheets due to the fact that the Company utilizes the revolving line of credit to fund its working capital needs. It is the Company s intention to pay the outstanding revolving line of credit balance during the subsequent twelve months following the respective period end date.

The interest rates applicable to the 2008 and 2007 Credit Agreements are, at the Company s option, equal to either the base rate (which is the higher of the prime rate or the federal funds rate plus 1/2%) or the applicable 1, 2, 3, 6, 9 or 12 month LIBOR rate, in each case plus an interest rate margin based upon the Company s leverage ratio, which can range between 33 basis points and 137.5 basis points for LIBOR rate loans and range between zero basis points and 37.5 basis points for base rate loans. The 2008 and 2007 Credit Agreements require that the Company comply with an interest coverage ratio test of not less than 3.50:1 and a leverage ratio test of not more than 3.25:1 for any period of four consecutive fiscal quarters, respectively. In addition, the 2008 and 2007 Credit Agreements include negative covenants that are customary for investment grade credit facilities. The 2008 and 2007 Credit Agreements also contain certain customary representations and warranties, affirmative covenants and events of default.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of September 27, 2008 and December 31, 2007, the Company had a total of $990 million and $865 million borrowed under the 2008 and 2007 Credit Agreements and a total amount available to borrow of $258 million and $233 million, respectively, after outstanding letters of credit. At September 27, 2008, $650 million of the total debt was classified as long-term debt and $340 million classified as short-term debt in the consolidated balance sheet. At December 31, 2007, $500 million of the total debt was classified as long-term debt and $365 million classified as short-term debt in the consolidated balance sheet. The weighted-average interest rates applicable to these borrowings were 3.39% and 5.67% at September 27, 2008 and December 31, 2007, respectively.

In October 2008, the Company utilized cash balances associated with the effective liquidation of certain foreign legal entities into the U.S. (Note 7) to voluntarily prepay the $150 million term loan under the 2008 Credit Agreement. There was no penalty for prepaying the term loan and the repayment of the term loan effectively terminated all lending arrangements under the 2008 Credit Agreement. In addition, the Company utilized these cash balances to voluntarily repay $340 million of revolving outstanding debt under the 2007 Credit Agreement. There were no penalties for prepaying this debt.

The Company, and its foreign subsidiaries, also had available short-term lines of credit, totaling $98 million and $99 million at September 27, 2008 and December 31, 2007, respectively. At September 27, 2008 and December 31, 2007, the related short-term borrowings were $37 million at a weighted-average interest rate of 4.74% and $19 million at a weighted average interest rate of 3.30%, respectively.

7 Income Taxes

The Company accounts for its uncertain tax return reporting positions in accordance with FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 requires financial statement reporting of the expected future tax consequences of uncertain tax return reporting positions on the presumption that all relevant tax authorities possess full knowledge of those tax reporting positions, as well as all of the pertinent facts and circumstances, but it prohibits any discounting of any of the related tax effects for the time value of money.

The following is a summary of the activity of the Company s unrecognized tax benefits for the nine months ended September 27, 2008 (in thousands):

Balance as of December 31, 2007	$ 68,463
Additions for tax positions of the current year	7,800
Balance as of September 27, 2008	$ 76,263

For the three months ended September 27, 2008 and September 29, 2007, the Company recorded increases of $6 million and $1 million, respectively, in unrecognized tax benefits via the income tax provision. For the nine months ended September 27, 2008 and September 29, 2007, the Company recorded increases of $8 million and $4 million, respectively, in unrecognized tax benefits via the income tax provision. Included in the income tax provision for the three and nine months ended September 27, 2008 is an unrecorded tax benefit of $5 million that is associated with the reorganization of certain foreign entities in early October 2008. If all of the Company s unrecognized tax benefits accrued as of September 27, 2008 were to become recognizable in the future, the Company would record a total reduction of approximately $75 million in the income tax provision. As of September 27, 2008, however, the Company is not able to estimate the portion of that total potential reduction that may occur within the next twelve months.

The Company s accounting policy is to record estimated interest and penalties related to the potential underpayment of income taxes, net of related tax effects, as a component of the income tax provision. For the three months ended September 27, 2008 and September 29, 2007, the Company included $0.3 million and $0.3 million, respectively, of interest expense, net of related tax benefits in the income tax provision. For the nine months ended September 27, 2008 and September 29, 2007, the Company included $1 million and $1 million, respectively, of interest expense, net of related tax benefits in the income tax provision. The Company has recorded no tax penalty expense in the income tax provision for the three and nine months ended September 27, 2008 and three and nine months ended September 29, 2007. As of September 27, 2008 and December 31, 2007, the Company had accrued $5

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

million and $4 million of such estimated interest expense, net of related tax benefits, respectively. As of both September 27, 2008 and December 31, 2007, the Company had no accrued income tax penalties.

The Company s uncertain tax positions are taken with respect to income tax return reporting periods beginning after December 31, 1999, which are the periods that remain generally open to income tax audit examination by the various income tax authorities that have jurisdiction over the Company s income tax reporting for that period of time. The Company has monitored and will continue to monitor the lapsing of statutes of limitations on potential tax assessments for related changes in the measurement of unrecognized tax benefits, related net interest and penalties, and deferred tax assets and liabilities. As of September 27, 2008, however, the Company does not expect to record any material changes in the measurement of unrecognized tax benefits, related net interest and penalties or deferred tax assets and liabilities due to the lapsing of statutes of limitations on potential tax assessments within the next twelve months.

The Company s effective tax rates for the three months ended September 27, 2008 and September 29, 2007 were 23.5% and 14.8%, respectively. Included in the income tax provision for the three months ended September 27, 2008 is a $5 million tax provision associated with the reorganization of certain foreign legal entities. This one-time provision increased the Company s effective tax rate by 5.4 percentage points for the three months ended September 27, 2008. Included in the effective tax rate for the three months ended September 29, 2007 is a $4 million tax benefit associated with the one-time contribution into the Waters Employee Investment Plan, a 401(k) defined contribution plan for U.S. employees. This one-time benefit reduced the Company s effective tax rate by 3.5 percentage points for the three months ended September 29, 2007.

The Company s effective tax rates for the nine months ended September 27, 2008 and September 29, 2007 were 14.1% and 15.0%, respectively. Included in the income tax provision for the nine months ended September 27, 2008 is a $5 million tax provision associated with the reorganization of certain foreign legal entities. This one-time provision increased the Company s effective tax rate by 2.0 percentage points for the nine months ended September 27, 2008. The income tax provision for the nine months ended September 27, 2008 also includes a $16 million benefit resulting from the out-of-period adjustments as described in Note 2. The tax benefit of the out-of-period adjustments had the effect of reducing the Company s effective tax rate by 5.6 percentage points for the nine months ended September 27, 2008. Included in the effective tax rate for the nine months ended September 29, 2007 is a $4 million tax benefit associated with the one-time contribution into the Waters Employee Investment Plan. This one-time benefit reduced the Company s effective tax rate by 1.2 percentage points for the nine months ended September 29, 2007. The remaining increase in the effective tax rate for the nine months ended September 27, 2008 is primarily attributable to proportionately greater growth in income in jurisdictions with comparatively high effective tax rates.

8 Stock-Based Compensation

The Company maintains various shareholder-approved stock-based compensation plans which allow for the issuance of incentive or non-qualified stock options, stock appreciation rights, restricted stock or other types of awards, such as restricted stock units.

The Company accounts for stock-based compensation costs in accordance with SFAS No. 123(R), Share-Based Payment , and SEC Staff Accounting Bulletin (SAB) No. 107, Share-Based Payment . These standards require that all share-based payments to employees be recognized in the statements of operations based on their fair values. The stock-based compensation expense recognized in the consolidated statements of operations is based on awards that ultimately are expected to vest; therefore, the amount of expense has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. If actual results differ significantly from these estimates, stock-based compensation expense and the Company s results of operations could be materially impacted. In addition, if the Company employs different assumptions in the application of SFAS No. 123(R), the compensation expense that the Company records in the future periods may differ significantly from what the Company has recorded in the current period.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The consolidated statements of operations for the three and nine months ended September 27, 2008 and September 29, 2007 include the following stock-based compensation expense related to stock option awards, restricted stock, restricted stock unit awards and the employee stock purchase plan (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Cost of sales	$ 735	$ 795	$ 2,273	$ 2,485
Selling and administrative	5,762	5,173	17,401	15,336
Research and development	1,175	1,138	3,507	3,081
Total stock-based compensation	$ 7,672	$ 7,106	$ 23,181	$ 20,902

Stock Options

In determining the fair value of the stock options, the Company makes a variety of assumptions and estimates, including volatility measures, expected yields and expected stock option lives. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model. The Company uses implied volatility on its publicly traded options as the basis for its estimate of expected volatility. The Company believes that implied volatility is the most appropriate indicator of expected volatility because it is generally reflective of historical volatility and expectations of how future volatility will differ from historical volatility. The expected life assumption for grants is based on historical experience for the population of non-qualified stock optionees. The risk-free interest rate is the yield currently available on U.S. Treasury zero-coupon issues with a remaining term approximating the expected term used as the input to the Black-Scholes model. The relevant data used to determine the value of the stock options granted during the nine months ended September 27, 2008 and September 29, 2007 are as follows:

Options Issued and Significant Assumptions Used to Estimate Option Fair Values	**September 27, 2008**	**September 29, 2007**
Options issued in thousands	28	47
Risk-free interest rate	3.8%	4.5%
Expected life in years	6.0	6.0
Expected volatility	.291	.280
Expected dividends		

Weighted-average Exercise Price and Fair Values of Options on the Date of Grant	**September 27, 2008**	**September 29, 2007**
Exercise price	$ 76.75	$ 48.88
Fair value	$ 28.25	$ 18.19

The following table summarizes stock option activity for the plans (in thousands, except per share data):

	Number of Shares	**Price per Share**	**Weighted Average Exercise Price**
Outstanding at December 31, 2007	7,097	$ 19.50 to $80.97	$ 43.93

Granted	28	$76.75	$ 76.75
Exercised	(595)	$ 19.69 to $72.06	$ 34.54
Canceled	(19)	$ 32.12 to $72.06	$ 48.19
Outstanding at September 27, 2008	6,511	$ 19.50 to $80.97	$ 44.92

Restricted Stock

During the nine months ended September 27, 2008, the Company granted eight thousand shares of restricted stock. The fair value of these awards on the grant date was $76.75. The restrictions on these shares lapse at the end of a three-year period.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted Stock Units

The following table summarizes the unvested restricted stock unit award activity for the nine months ended September 27, 2008 (in thousands, except for per share amounts):

	Shares	Weighted-Average Price
Unvested at December 31, 2007	489	$ 48.44
Granted	241	$ 60.37
Vested	(118)	$ 47.46
Forfeited	(11)	$ 50.92
Unvested at September 27, 2008	601	$ 53.37

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

9 Earnings Per Share

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

	Three Months Ended September 27, 2008		
		Weighted-Average	
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 71,503	98,891	$ 0.72
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			
Outstanding		1,628	
Exercised and cancellations		47	
Net income per diluted common share	$ 71,503	100,566	$ 0.71

	Three Months Ended September 29, 2007		
		Weighted-Average	
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 53,283	99,821	$ 0.53
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			
Outstanding		1,658	
Exercised and cancellations		233	

Net income per diluted common share	$ 53,283	101,712	$ 0.52

	Nine Months Ended September 27, 2008		
		Weighted-Average	
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 223,126	99,611	$ 2.24
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			
Outstanding		1,405	
Exercised and cancellations		134	
Net income per diluted common share	$ 223,126	101,150	$ 2.21

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Nine Months Ended September 29, 2007		
		Weighted-Average	
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Net income per basic common share	$ 169,129	100,457	$ 1.68
Effect of dilutive stock option, restricted stock and restricted stock unit securities:			
Outstanding		1,514	
Exercised and cancellations		381	
Net income per diluted common share	$ 169,129	102,352	$ 1.65

For both the three and nine months ended September 27, 2008, the Company had 1.3 million stock option securities that were antidilutive due to having higher exercise prices than the average price during the period. For both the three and nine months ended September 29, 2007, the Company had 1.1 million stock option securities that were antidilutive due to having higher exercise prices than the average price during the period. These securities were not included in the computation of diluted EPS. The effect of dilutive securities was calculated using the treasury stock method.

10 Comprehensive Income

Comprehensive income is detailed as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Net income	$ 71,503	$ 53,283	$ 223,126	$ 169,129
Foreign currency translation	(37,094)	12,801	(7,473)	21,165
Net appreciation (depreciation) and realized gains (losses) on derivative instruments	798	(7,422)	186	(12,180)
Income tax (expense) benefit	(279)	2,598	(65)	4,263
Net appreciation (depreciation) and realized gains (losses) on derivative instruments, net of tax	519	(4,824)	121	(7,917)
Net foreign currency adjustments	(36,575)	7,977	(7,352)	13,248
Unrealized losses on investments before income taxes	(114)	(713)	(198)	(1,038)
Income tax benefit	40	249	69	363
Unrealized losses on investments, net of tax	(74)	(464)	(129)	(675)
Retirement liability adjustment, net of tax		5,220		5,220

Other comprehensive income	(36,649)	12,733	(7,481)	17,793
Comprehensive income	$ 34,854	$ 66,016	$ 215,645	$ 186,922

11 Retirement Plans

The Company sponsors various retirement plans. In September 2007, the Company s Board of Directors approved various amendments to freeze the pay credit accrual under both the Waters Retirement Plan and the Waters Retirement Restoration Plan (the U.S. Pension Plans) effective December 31, 2007. In accordance with SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits , the Company recorded a curtailment gain of $1 million in the three months ended September 29, 2007. In addition, the Company re-measured the U.S. Pension Plans liabilities in September 2007 and the Company reduced the projected benefit obligation liability by $7 million with a corresponding adjustment, net of tax, to accumulated other comprehensive income as a result of the curtailment reducing the accrual for future service.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s Board of Directors also approved a $13 million payment that was contributed to the Waters Employee Investment Plan in the first quarter of 2008. The $13 million of expense was reduced by a curtailment gain of $1 million relating to various amendments to freeze the pay credit accrual, resulting in $12 million of expense recorded in the consolidated statements of operations in the three and nine months ended September 29, 2007 with $3 million of expense included in cost of sales, $7 million included in selling and administrative expenses and $2 million included in research and development expenses. In addition, effective January 1, 2008, the Company s Board of Directors increased the employer matching contribution in the Waters Employee Investment Plan to 100% for contributions up to 6% of eligible pay, an increase of 3%, and eliminated the one-year service requirement to be eligible for matching contributions. For the nine months ended September 27, 2008 and September 29, 2007, the Company s matching contribution into the Waters Employee Investment Plan amounted to $8 million and $3 million, respectively.

The summary of the components of net periodic pension costs for the plans for the three and nine months ended September 27, 2008 and September 29, 2007 is as follows (in thousands):

	Three Months Ended					
	September 27, 2008			September 29, 2007		
	U.S. Pension Plans	U.S. Retirement Healthcare Plan	Non-U.S. Pension Plans	U.S. Pension Plans	U.S. Retirement Healthcare Plan	Non-U.S. Pension Plans
Service cost	$ 31	$ 53	$ 374	$ 1,732	$ 64	$ 290
Interest cost	1,481	83	227	1,351	69	196
Expected return on plan assets	(1,528)	(39)	(114)	(1,327)	(30)	(97)
Curtailment gain				(466)		
Net amortization:						
Prior service costs	38	(14)		(14)	(14)	
Net actuarial loss	33		(7)	179		5
Net periodic pension cost	$ 55	$ 83	$ 480	$ 1,455	$ 89	$ 394

	Nine Months Ended					
	September 27, 2008			September 29, 2007		
	U.S. Pension Plans	U.S. Retirement Healthcare Plan	Non-U.S. Pension Plans	U.S. Pension Plans	U.S. Retirement Healthcare Plan	Non-U.S. Pension Plans
Service cost	$ 93	$ 159	$ 1,122	$ 5,614	$ 192	$ 870
Interest cost	4,443	249	681	3,953	207	588
Expected return on plan assets	(4,584)	(117)	(342)	(3,993)	(90)	(291)
Curtailment gain				(466)		
Net amortization:						
Prior service costs	114	(42)		(58)	(42)	
Net actuarial loss	99		(21)	583		15

Net periodic pension cost	$ 165	$ 249	$ 1,440	$ 5,633	$ 267	$ 1,182

For the three and nine months ended September 27, 2008, the Company contributed $2 million and $4 million to the U.S. Pension Plans. During fiscal year 2008, the Company expects to contribute approximately $5 million to the defined benefit plans.

12 Business Segment Information

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

Waters Division is in the business of designing, manufacturing, distributing and servicing LC and MS instruments, columns and other chemistry consumables that can be integrated and used along with other analytical instruments. TA Division is in the business of designing, manufacturing, distributing and servicing thermal analysis, rheometry and calorimetry instruments. The Company s two divisions are its operating segments and each has

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

similar economic characteristics; product processes; products and services; types and classes of customers; methods of distribution and regulatory environments. Because of these similarities, the two segments have been aggregated into one reporting segment for financial statement purposes. Please refer to the consolidated financial statements for financial information regarding the one reportable segment of the Company.

Net sales for the Company s products and services are as follows for the three and nine months ended September 27, 2008 and September 29, 2007 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Product net sales				
Waters instrument systems	$ 185,597	$ 174,710	$ 562,370	$ 517,200
Chemistry	59,239	54,436	181,778	162,258
TA instrument systems	32,881	29,323	91,155	79,715
Total product net sales	277,717	258,469	835,303	759,173
Service net sales				
Waters service	99,261	87,020	295,326	256,518
TA service	9,332	7,149	26,164	20,354
Total service net sales	108,593	94,169	321,490	276,872
Total net sales	$ 386,310	$ 352,638	$ 1,156,793	$ 1,036,045

13 Recent Accounting Standards Changes and Developments

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 , which is effective for fiscal years beginning after November 15, 2007. This standard permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The Company did not elect to re-measure any of its existing financial assets or liabilities under the provisions of this standard.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations , which replaces SFAS No. 141. This revised standard requires assets, liabilities and non-controlling interests acquired to be measured at fair value and requires that costs incurred to effect the acquisition be recognized separately from the business combination. In addition, this statement expands the scope to include all transactions and other events in which one entity obtains control over one or more businesses. This statement is effective for all 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. The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 . This statement establishes accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement is effective for fiscal years beginning on or after December 15, 2008. The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities . This statement is intended to help investors better understand how derivative instruments and hedging activities affect an entity s financial position, financial performance and cash flows through enhanced disclosure requirements. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In April 2008, the FASB issued FSP No. 142-3, Determination of the Useful Life of Intangible Assets . This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets . The objective of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R), and other U.S. GAAP. This FSP applies to all intangible assets, whether acquired in a business combination or otherwise, and shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years and applied prospectively to intangible assets acquired after the effective date. Early adoption is prohibited. The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles . This statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of non-governmental entities that are presented in accordance with GAAP. With the issuance of this statement, the FASB concluded that the GAAP hierarchy should be directed toward the entity and not its auditor, and reside in the accounting literature established by the FASB as opposed to the American Institute of Certified Public Accountants Statement on Auditing Standards No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles . This statement is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to U.S. Auditing Standards Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles . The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

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