

WATTS WATER TECHNOLOGIES INC
Form 10-Q
August 09, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended July 1, 2007

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____
Commission file number 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**

(Former Name, Former Address and Former Fiscal year, if changed since last report.)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated filer Accelerated filer Non-Accelerated filer

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

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

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

| Class | Outstanding at July 27, 2007 | |
|---------------------------------------|------------------------------|------------|
| Class A Common Stock, \$.10 par value | | 31,390,495 |
| Class B Common Stock, \$.10 par value | | 7,293,880 |

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

INDEX

Part I. Financial Information

Item 1. Financial Statements

Consolidated Balance Sheets at July 1, 2007 and December 31, 2006 (unaudited)

Consolidated Statements of Operations for the Second Quarters Ended July 1, 2007 and July 2, 2006 (unaudited)

Consolidated Statements of Operations for the Six Months Ended July 1, 2007 and July 2, 2006 (unaudited)

Consolidated Statements of Cash Flows for the Six Months Ended July 1, 2007 and July 2, 2006 (unaudited)

Notes to Consolidated Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

Part II. Other Information

Item 1. Legal Proceedings

Item 1A. Risk Factors

Item 4. Submission of Matters to a Vote of Security Holders

Item 6. Exhibits

Signatures

Exhibit Index

PART I. FINANCIAL INFORMATION**ITEM 1. Financial Statements**

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except share information)

(Unaudited)

| | July 1, 2007 | December 31, 2006 |
|---|---------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 327,437 | \$ 342,979 |
| Investment securities | 19,250 | 11,825 |
| Trade accounts receivable, less allowance for doubtful accounts of \$13,968 at July 1, 2007 and \$10,543 at December 31, 2006 | 257,432 | 228,502 |
| Inventories, net: | | |
| Raw materials | 116,238 | 103,587 |
| Work in process | 46,195 | 39,593 |
| Finished goods | 188,868 | 173,236 |
| Total Inventories | 351,301 | 316,416 |
| Prepaid expenses and other assets | 21,403 | 15,842 |
| Deferred income taxes | 35,259 | 26,739 |
| Assets of discontinued operations | 10,534 | 10,079 |
| Total Current Assets | 1,022,616 | 952,382 |
| PROPERTY, PLANT AND EQUIPMENT: | | |
| Property, plant and equipment, at cost | 408,522 | 391,923 |
| Accumulated depreciation | (200,661) | (185,763) |
| Property, plant and equipment, net | 207,861 | 206,160 |
| OTHER ASSETS: | | |
| Goodwill | 362,055 | 356,090 |
| Other, net | 140,278 | 146,218 |
| TOTAL ASSETS | \$ 1,732,810 | \$ 1,660,850 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 132,870 | \$ 120,954 |
| Accrued expenses and other liabilities | 93,972 | 100,437 |
| Accrued compensation and benefits | 36,866 | 42,593 |
| Current portion of long-term debt | 12,734 | 7,522 |
| Liabilities of discontinued operations | 27,483 | 27,852 |
| Total Current Liabilities | 303,925 | 299,358 |
| LONG-TERM DEBT, NET OF CURRENT PORTION | 454,932 | 441,697 |
| DEFERRED INCOME TAXES | 39,294 | 34,585 |
| OTHER NONCURRENT LIABILITIES | 53,563 | 52,686 |
| MINORITY INTEREST | 4,989 | 5,971 |
| STOCKHOLDERS EQUITY: | | |
| Preferred Stock, \$.10 par value; 5,000,000 shares authorized; no shares issued or outstanding | | |
| Class A Common Stock, \$.10 par value; 80,000,000 shares authorized; 1 vote per share; issued and outstanding, 31,390,495 shares at July 1, 2007 and 31,239,111 shares at December 31, 2006 | 3,139 | 3,124 |
| Class B Common Stock, \$.10 par value; 25,000,000 shares authorized; 10 votes per share; issued and outstanding, 7,293,880 shares at July 1, 2007 and at December 31, 2006 | 729 | 729 |
| Additional paid-in capital | 374,545 | 367,795 |
| Retained earnings | 458,648 | 429,555 |
| Accumulated other comprehensive income | 39,046 | 25,350 |

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

| | | |
|---|--------------|--------------|
| Total Stockholders Equity | 876,107 | 826,553 |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 1,732,810 | \$ 1,660,850 |

See accompanying notes to consolidated financial statements.

3

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except per share information)

(Unaudited)

| | Second Quarter Ended | |
|--|----------------------|------------------|
| | July 1, 2007 | July 2, 2006 |
| Net sales | 350,422 | \$ 300,175 |
| Cost of goods sold | 235,781 | 193,492 |
| GROSS PROFIT | 114,641 | 106,683 |
| Selling, general & administrative expenses | 84,055 | 73,799 |
| Restructuring and other charges | 270 | (5,676) |
| OPERATING INCOME | 30,316 | 38,560 |
| Other (income) expense: | | |
| Interest income | (3,637) | (891) |
| Interest expense | 6,744 | 4,952 |
| Minority interest | (832) | 58 |
| Other | 356 | (662) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 2,631 | 3,457 |
| Provision for income taxes | 9,992 | 12,560 |
| INCOME FROM CONTINUING OPERATIONS | 17,693 | 22,543 |
| Income (loss) from discontinued operations, net of taxes | 81 | (97) |
| NET INCOME | \$ 17,774 | \$ 22,446 |
| BASIC EPS | | |
| Income (loss) per share: | | |
| Continuing operations | \$.46 | \$.69 |
| Discontinued operations | | |
| NET INCOME | \$.46 | \$.69 |
| Weighted average number of shares | 38,659 | 32,654 |
| DILUTED EPS | | |
| Income (loss) per share: | | |
| Continuing operations | \$.45 | \$.68 |
| Discontinued operations | | |
| NET INCOME | \$.46 | \$.68 |
| Weighted average number of shares | 39,027 | 33,038 |
| Dividends per share | \$.10 | \$.09 |

See accompanying notes to consolidated financial statements.

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except per share information)

(Unaudited)

| | Six Months Ended | |
|--|------------------|------------------|
| | July 1, 2007 | July 2, 2006 |
| Net sales | 696,514 | \$ 575,125 |
| Cost of goods sold | 467,207 | 372,458 |
| GROSS PROFIT | 229,307 | 202,667 |
| Selling, general & administrative expenses | 168,154 | 142,850 |
| Restructuring and other charges | 470 | (5,441) |
| OPERATING INCOME | 60,683 | 65,258 |
| Other (income) expense: | | |
| Interest income | (7,249) | (1,309) |
| Interest expense | 13,051 | 9,144 |
| Minority interest | (1,110) | 142 |
| Other | 1,077 | (896) |
| | 5,769 | 7,081 |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 54,914 | 58,177 |
| Provision for income taxes | 17,174 | 20,547 |
| INCOME FROM CONTINUING OPERATIONS | 37,740 | 37,630 |
| Income (loss) from discontinued operations, net of taxes | 26 | (221) |
| NET INCOME | \$ 37,766 | \$ 37,409 |
| BASIC EPS | | |
| Income (loss) per share: | | |
| Continuing operations | \$.98 | \$ 1.15 |
| Discontinued operations | | |
| NET INCOME | \$.98 | \$ 1.15 |
| Weighted average number of shares | 38,615 | 32,623 |
| DILUTED EPS | | |
| Income (loss) per share: | | |
| Continuing operations | \$.97 | \$ 1.14 |
| Discontinued operations | | (.01) |
| NET INCOME | \$.97 | \$ 1.13 |
| Weighted average number of shares | 39,005 | 33,015 |
| Dividends per share | \$.20 | \$.18 |

See accompanying notes to consolidated financial statements.

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

(Unaudited)

| | Six Months Ended | |
|---|-------------------|-------------------|
| | July 1, 2007 | July 2, 2006 |
| OPERATING ACTIVITIES | | |
| Income from continuing operations | \$ 37,740 | \$ 37,630 |
| Adjustments to reconcile net income from continuing operations to net cash provided by (used in) continuing operating activities: | | |
| Depreciation | 14,158 | 13,703 |
| Amortization | 5,566 | 3,195 |
| Gain on disposal of property, plant and equipment | (33) | (6,655) |
| Stock-based compensation | 2,975 | 1,215 |
| Deferred income tax benefit | (3,200) | (3,348) |
| Other | 495 | (688) |
| Changes in operating assets and liabilities, net of effects from business acquisitions and divestitures: | | |
| Accounts receivable | (25,953) | (16,375) |
| Inventories | (31,795) | (24,959) |
| Prepaid expenses and other assets | (3,439) | (3,544) |
| Accounts payable, accrued expenses and other liabilities | 3,248 | 10,694 |
| Net cash provided by (used in) continuing operations | (238) | 10,868 |
| INVESTING ACTIVITIES | | |
| Additions to property, plant and equipment | (15,098) | (29,792) |
| Proceeds from the sale of property, plant and equipment | 464 | 26,486 |
| Investments in securities | (7,500) | |
| Proceeds from sale of securities | 75 | |
| Increase in other assets | (454) | (670) |
| Business acquisitions, net of cash acquired | (4,627) | (82,014) |
| Net cash used in investing activities | (27,140) | (85,990) |
| FINANCING ACTIVITIES | | |
| Proceeds from long-term debt | 38,279 | 339,775 |
| Payments of long-term debt | (22,258) | (192,393) |
| Debt issue costs | | (2,414) |
| Payments of capital leases | (920) | (3,181) |
| Share transactions under employee stock plans | 789 | 810 |
| Tax benefit of stock awards exercised | 1,321 | 251 |
| Dividends | (7,841) | (6,028) |
| Net cash provided by financing activities | 9,370 | 136,820 |
| Effect of exchange rate changes on cash and cash equivalents | 3,264 | 695 |
| Net cash provided by (used in) operating activities of discontinued operations | (798) | 1,213 |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (15,542) | 63,606 |
| Cash and cash equivalents at beginning of period | 342,979 | 45,758 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 327,437 | \$ 109,364 |
| NON CASH INVESTING AND FINANCING ACTIVITIES | | |
| Acquisition of businesses | | |
| Fair value of assets acquired | \$ 3,461 | \$ 142,104 |
| Cash paid, net of cash acquired | 4,627 | 82,014 |
| (Assets acquired) liabilities assumed | \$ (1,166) | \$ 60,090 |
| Acquisition of fixed assets under capital lease | | |
| | \$ | \$ 15,957 |
| Issuance of stock under management stock purchase plan | \$ 1,607 | \$ 614 |
| Retirement of variable rate demand bonds with cash collateral | \$ | \$ 8,900 |

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

CASH PAID FOR:

| | | | | |
|----------|----|---------------|----|--------|
| Interest | \$ | 13,710 | \$ | 7,832 |
| Taxes | \$ | 21,684 | \$ | 19,394 |

See accompanying notes to consolidated financial statements.

6

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)****1. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the Watts Water Technologies, Inc. Consolidated Balance Sheet as of July 1, 2007, the Consolidated Statements of Operations for the second quarter and six months ended July 1, 2007 and the second quarter and six months ended July 2, 2006, and the Consolidated Statements of Cash Flows for the six months ended July 1, 2007 and the six months ended July 2, 2006.

The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date. The accounting policies followed by the Company are described in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006. The financial statements included in this report should be read in conjunction with the financial statements and notes included in the Annual Report on Form 10-K for the year ended December 31, 2006. Operating results for the interim period presented are not necessarily indicative of the results to be expected for the year ending December 31, 2007.

The Company operates on a 52-week fiscal year ending on December 31. Any second quarter ended data contained in this Quarterly Report on Form 10-Q reflects the results of operations for the 13-week period ended on the Sunday nearest June 30 of the respective year.

Certain amounts in the second quarter and first six months of 2006 have been reclassified to permit comparison with the 2007 presentation. These reclassifications had no effect on reported results of operations or stockholders' equity.

2. Accounting Policies*Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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. Actual results could differ from those estimates.

Goodwill and Long-Lived Assets

The changes in the carrying amount of goodwill by geographic segment from December 31, 2006 to July 1, 2007 are as follows:

| | North America (in thousands) | Europe | China | Total |
|---|------------------------------------|------------|-----------|------------|
| Carrying amount at the beginning of period | \$ 198,863 | \$ 147,903 | \$ 9,324 | \$ 356,090 |
| Adjustments to goodwill during the period | (32) | 736 | 1,756 | 2,460 |
| Effect of change in exchange rates used for translation | 424 | 2,828 | 253 | 3,505 |
| Carrying amount at end of period | \$ 199,255 | \$ 151,467 | \$ 11,333 | \$ 362,055 |

Other intangible assets include the following and are presented in Other Assets: Other, net, in the July 1, 2007 Consolidated Balance Sheet:

| | Gross Carrying Amount (in thousands) | Accumulated Amortization |
|------------------------|---|-----------------------------|
| Patents | \$ 13,416 | \$ (5,740) |
| Customer relationships | 64,074 | (11,022) |

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

| | | | |
|---|------------|------------|---|
| Technology | 7,513 | (1,760 |) |
| Other | 16,304 | (5,048 |) |
| Total amortizable intangibles | 101,307 | (23,570 |) |
| Intangible assets not subject to amortization | 50,539 | | |
| Total | \$ 151,846 | \$ (23,570 |) |

Aggregate amortization expense for amortized intangible assets for the second quarters of 2007 and 2006 was \$2,769,000 and

7

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

\$1,800,000, respectively, and for the six-month periods of 2007 and 2006 was \$5,566,000 and \$3,195,000, respectively. Additionally, future amortization expense on amortizable intangible assets approximates \$4,740,000 for the remainder of 2007, \$8,827,000 for 2008, \$8,539,000 for 2009, \$8,515,000 for 2010 and \$8,078,000 for 2011. Amortization expense is provided on a straight-line basis over the estimated useful lives of the intangible assets. The weighted-average remaining life of total amortizable intangible assets is 11.5 years. Patents, customer relationships, technology and other amortizable intangibles have weighted-average remaining lives of 10.0 years, 9.8 years, 6.8 years and 22.9 years, respectively. Intangible assets not subject to amortization primarily include trademarks and unpatented technology.

Stock-Based Compensation

The Company maintains three stock incentive plans under which key employees and outside directors have been granted outstanding incentive stock options (ISOs) and nonqualified stock options (NSOs) to purchase the Company's Class A Common Stock. Only one plan, the 2004 Stock Incentive Plan, is currently available for the grant of new equity awards. Stock options granted under prior plans became exercisable over a five-year period at the rate of 20% per year and expire ten years after the date of grant. Under the 2004 Stock Incentive Plan, options become exercisable over a four-year period at the rate of 25% per year and expire ten years after the grant date. ISOs and NSOs granted under the plans may have exercise prices of not less than 100% and 50% of the fair market value of the Common Stock on the date of grant, respectively. The Company's current practice is to grant all options at fair market value on the grant date. The Company did not grant any options in the first six months of 2007 or 2006.

The Company also grants shares of restricted stock to key employees and non-employee members of the Company's Board of Directors under the 2004 Stock Incentive Plan, which vest either immediately or over a three-year period at the rate of one-third per year. The restricted stock awards are amortized to expense on a straight-line basis over the vesting period. The Company did not grant any restricted stock in the first six months of 2007 or 2006.

The Company also has a Management Stock Purchase Plan that allows for the granting of Restricted Stock Units (RSUs) to key employees. On an annual basis, key employees may elect to receive a portion of their annual incentive compensation in RSUs instead of cash. Each RSU provides the key employee with the right to purchase a share of Class A Common Stock at 67% of the fair market value on the date of grant. RSUs vest annually over a three-year period from the grant date. An aggregate of 2,000,000 shares of Class A Common Stock may be issued under the Management Stock Purchase Plan. The Company granted 159,869 RSUs and 87,125 RSUs in the first quarter of 2007 and 2006, respectively.

The fair value of each share issued under the Management Stock Purchase Plan is estimated on the date of grant, using the Black-Scholes-Merton Model, based on the following weighted average assumptions:

| | 2007 | 2006 |
|---------------------------------|------|----------|
| Expected life (years) | 3.0 | 3.0 |
| Expected stock price volatility | 35.3 | % 25.7 % |
| Expected dividend yield | 1.0 | % 1.5 % |
| Risk-free interest rate | 4.8 | % 4.5 % |

The above assumptions were used to determine the weighted average grant-date fair value of RSUs of \$16.79 and \$13.60 in 2007 and 2006, respectively.

A more detailed description of each of these stock and stock option plans can be found in Note 13 of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006.

Shipping and Handling

The Company's shipping costs included in selling, general and administrative expense were \$10,197,000 and \$9,217,000 for the second quarters of 2007 and 2006, respectively, and were \$19,659,000 and \$17,742,000 for the first six months of 2007 and 2006, respectively.

Research and Development

Research and development costs included in selling, general and administrative expense were \$3,755,000 and \$3,137,000 for the second quarters of 2007 and 2006, respectively, and were \$7,632,000 and \$6,309,000 for the first six months of 2007 and 2006, respectively.

Taxes, Other than Income Taxes

Research and Development

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

Taxes assessed by governmental authorities on sale transactions are recorded on a net basis and excluded from sales, in the Company's consolidated statement of operations.

8

Income Taxes

On January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). The purpose of FIN 48 is to increase the comparability in financial reporting of income taxes. FIN 48 requires that in order for a tax benefit to be recorded in the income statement, the item in question must meet the more-likely-than-not (greater than 50% likelihood of being sustained upon examination by the taxing authorities) threshold. The adoption of FIN 48 did not have a material effect on the Company's financial statements. No cumulative effect was booked through beginning retained earnings.

As of the adoption date, the Company had gross unrecognized tax benefits of approximately \$4,800,000, of which approximately \$4,200,000, if recognized, would affect the effective tax rate. The difference between the amount of unrecognized tax benefits and the amount that would impact the effective tax rate consists of the federal tax benefit of state income tax items. During the first six months of 2007, the Company reduced its unrecognized tax benefits by approximately \$600,000 for a tax issue in Italy. The Company does not expect further significant changes in the amounts of unrecognized tax benefits within the next twelve months.

The Company is currently under audit by the Internal Revenue Service for the 2003 and 2004 tax years. The expected completion date for this audit is April 2008. Watts conducts business in a variety of locations throughout the world resulting in tax filings in numerous domestic and foreign jurisdictions. The Company is subject to tax examinations regularly as part of the normal course of business. The Company's major jurisdictions are the U.S., Canada, China, Netherlands, U.K., Germany, Italy and France. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2002.

As of January 1, 2007 and July 1, 2007, the Company had approximately \$600,000 of interest related to uncertain tax positions. The Company accounts for interest and penalties related to uncertain tax positions as a component of income tax expense.

New Accounting Standards

In February 2007, the Financial Accounting Standards Board (FASB) issued Financial Accounting Standards Board Statement (FAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an Amendment to FAS No. 115, (FAS 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. FAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Earlier application is encouraged. The Company does not expect to measure its financial instruments at fair value and therefore does not expect the adoption of FAS 159 to have a material impact on its consolidated financial statements.

In September 2006, FASB issued FAS No. 157, Fair Value Measurements, (FAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Earlier application is encouraged provided that the reporting company has not yet issued financial statements for that fiscal year including financial statements for an interim period within that fiscal year. The Company does not expect the adoption of FAS 157 to have a material impact to its consolidated financial statements.

3. Discontinued Operations

In September 1996, the Company divested its Municipal Water Group businesses, which included Henry Pratt, James Jones Company and Edward Barber and Company Ltd. The 2007 income is due to reserve adjustments, net of charges, and the 2006 expenses primarily relate to legal and settlement costs associated with the James Jones Litigation, which is described in Part I, Item 1, Product Liability, Environmental and Other Litigation Matters of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Condensed operating statements and balance sheets for discontinued operations are summarized below:

| | Second Quarter Ended | |
|--|-----------------------------|-------------------------|
| | July 1, 2007 | July 2, 2006 |
| | (in thousands) | |
| Income (expenses)- Municipal Water Group | \$ 133 | \$ (159) |
| Income (loss) before income taxes | 133 | (159) |
| Income tax (charge) benefit | (52) | 62 |
| Income (loss) from discontinued operations, net of taxes | \$ 81 | \$ (97) |

| | Six Months Ended | |
|--|------------------|-----------------|
| | July 1, 2007 | July 2, 2006 |
| | (in thousands) | |
| Income (expenses)- Municipal Water Group | \$ 43 | \$ (359) |
| Income (loss) before income taxes | 43 | (359) |
| Income tax (charge) benefit | (17) | 138 |
| Income (loss) from discontinued operations, net of taxes | \$ 26 | \$ (221) |

| | July 1, 2007 | December 31, 2006 |
|--|-----------------|----------------------|
| | (in thousands) | |
| Prepaid expenses and other assets | \$ 494 | \$ 328 |
| Deferred income taxes | 10,040 | 9,751 |
| Assets of discontinued operations | \$ 10,534 | \$ 10,079 |
| Accrued expenses and other liabilities | 27,483 | 27,852 |
| Liabilities of discontinued operations | \$ 27,483 | \$ 27,852 |

The assets and liabilities at July 1, 2007 and December 31, 2006 primarily relate to the reserves for the James Jones Litigation.

4. Derivative Instruments

The Company uses foreign currency forward exchange contracts as an economic hedge to reduce the impact of currency fluctuations on certain anticipated intercompany purchase transactions that are expected to occur during the next six months and certain other foreign currency transactions. Realized and unrealized gains and losses on the contracts are recognized in other income/expense. These contracts do not subject the Company to significant market risk from exchange movement because they offset gains and losses on the related foreign currency denominated transactions. At July 1, 2007 and July 2, 2006, unrealized losses on the contracts were approximately \$336,000 and \$105,000, respectively.

The Company occasionally uses commodity futures contracts to fix the price on a portion of certain raw materials used in the manufacturing process. At July 1, 2007 and July 2, 2006, the Company had no commodity contracts.

5. Restructuring and Other Charges

For the second quarter of 2007, the Company recorded charges of \$129,000 in costs of goods sold and \$270,000 in restructuring and other charges for accelerated depreciation related to the Company's relocation and restructuring plan for its 60% owned Chinese joint venture. The Company also recognized income of \$122,000 in minority interest representing the 40% liability of its Chinese joint venture partner in the restructuring plan. For the second quarter of 2006, the Company recorded pre-tax income of \$5,676,000 to restructuring and other charges which consisted of a gain of approximately \$6,500,000 related to a building sale in Italy partially offset by costs of \$824,000 primarily for severance costs related to the Company's European and Chinese restructuring plans.

For the first six months of 2007, the Company recorded charges of \$224,000 in costs of goods sold and \$470,000 in restructuring and other charges for accelerated depreciation related to the Company's relocation and restructuring plan for its 60% owned Chinese joint venture. The Company also recognized income of \$211,000 in minority interest representing the 40% liability of its Chinese joint venture partner in the restructuring plan. For the first six months of 2006, the Company recorded charges of \$7,000 in costs of goods sold and pre-tax income of \$5,441,000 in restructuring and other charges which consisted of a gain of approximately \$6,500,000 related to the sale of a building in Italy, partially offset by costs of \$1,059,000 primarily for severance costs related to the Company's European and Chinese restructuring plans.

In the first six months of 2007, the Company paid approximately \$1,530,000 of previously accrued severance costs. At July 1, 2007, the remaining restructuring liability approximated \$2,660,000.

6. Earnings per Share

The following tables set forth the reconciliation of the calculation of earnings per share:

| | For the Second Quarter Ended July 1, 2007 | | Per Share Amount |
|-------------------------------------|--|----------------------|------------------|
| | Income (Numerator) (amounts in thousands, except share and per share amounts) | Shares (Denominator) | |
| Basic EPS | | | |
| Income from continuing operations | \$ 17,693 | 38,658,524 | \$.46 |
| Income from discontinued operations | 81 | | |
| Net income | \$ 17,774 | | \$.46 |
| Effect of dilutive securities | | | |
| Common stock equivalents | | 368,546 | |
| Diluted EPS | | | |
| Income from continuing operations | \$ 17,693 | | \$.45 |
| Income from discontinued operations | 81 | | |
| Net income | \$ 17,774 | 39,027,070 | \$.46 |

| | For the Second Quarter Ended July 2, 2006 | | Per Share Amount |
|-----------------------------------|--|----------------------|------------------|
| | Income (Numerator) (amounts in thousands, except share and per share amounts) | Shares (Denominator) | |
| Basic EPS | | | |
| Income from continuing operations | \$ 22,543 | 32,653,524 | \$.69 |
| Loss from discontinued operations | (97) | | |
| Net income | \$ 22,446 | | \$.69 |
| Effect of dilutive securities | | | |
| Common stock equivalents | | 384,669 | |
| Diluted EPS | | | |
| Income from continuing operations | \$ 22,543 | | \$.68 |
| Loss from discontinued operations | (97) | | |
| Net income | \$ 22,446 | 33,038,193 | \$.68 |

| | For the Six Months Ended July 1, 2007 | | Per Share Amount |
|-------------------------------------|--|----------------------|------------------|
| | Income (Numerator) (amounts in thousands, except share and per share amounts) | Shares (Denominator) | |
| Basic EPS | | | |
| Income from continuing operations | \$ 37,740 | 38,615,277 | \$.98 |
| Income from discontinued operations | 26 | | |
| Net income | \$ 37,766 | | \$.98 |
| Effect of dilutive securities | | | |
| Common stock equivalents | | 389,283 | |
| Diluted EPS | | | |
| Income from continuing operations | \$ 37,740 | | \$.97 |
| Income from discontinued operations | 26 | | |
| Net income | \$ 37,766 | 39,004,560 | \$.97 |

| | For the Six Months Ended July 2, 2006 | | Per Share Amount |
|------------------|--|----------------------|------------------|
| | Income (Numerator) (amounts in thousands, except share and per share amounts) | Shares (Denominator) | |
| Basic EPS | | | |

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

| | | | | | |
|-----------------------------------|------|--------|------------|------|------|
| Income from continuing operations | \$ | 37,630 | 32,622,658 | \$ | 1.15 |
| Loss from discontinued operations | (221 |) | | | |
| Net income | \$ | 37,409 | | \$ | 1.15 |
| Effect of dilutive securities | | | | | |
| Common stock equivalents | | | 392,151 | | |
| Diluted EPS | | | | | |
| Income from continuing operations | \$ | 37,630 | | \$ | 1.14 |
| Loss from discontinued operations | (221 |) | | (.01 |) |
| Net income | \$ | 37,409 | 33,014,809 | \$ | 1.13 |

11

7. Segment Information

Under the criteria set forth in Financial Accounting Standards Board Statement No.131 Disclosure about Segments of an Enterprise and Related Information, the Company operates in three geographic segments: North America, Europe, and China. Each of these segments is managed separately and has separate financial results that are reviewed by the Company's chief operating decision-maker. All intercompany sales transactions have been eliminated. Sales by region are based upon location of the entity recording the sale. The accounting policies for each segment are the same as those described in the summary of significant accounting policies.

The following is a summary of the Company's significant accounts and balances by segment, reconciled to the consolidated totals:

| | North America (in thousands) | Europe | China | Corporate (*) | Consolidated |
|--|------------------------------------|------------|-----------|---------------|--------------|
| For the quarter ended July 1, 2007 | | | | | |
| Net sales | \$ 224,452 | \$ 108,222 | \$ 17,748 | \$ | \$ 350,422 |
| Operating income (loss) | 20,216 | 12,833 | 4,015 | (6,748) | 30,316 |
| Capital expenditures | 3,274 | 3,982 | 1,608 | | 8,864 |
| Depreciation and amortization | 4,310 | 3,294 | 1,748 | | 9,352 |
| For the quarter ended July 2, 2006 | | | | | |
| Net sales | \$ 208,249 | \$ 83,857 | \$ 8,069 | \$ | \$ 300,175 |
| Operating income (loss) | 25,959 | 15,608 | 2,397 | (5,404) | 38,560 |
| Capital expenditures | 3,048 | 19,111 | 532 | | 22,691 |
| Depreciation and amortization | 4,378 | 3,446 | 1,576 | | 9,400 |
| As of and for the six months ended July 1, 2007 | | | | | |
| Net sales | \$ 442,777 | \$ 223,767 | \$ 29,970 | \$ | \$ 696,514 |
| Operating income (loss) | 41,415 | 27,243 | 6,064 | (14,039) | 60,683 |
| Identifiable assets | 1,062,933 | 532,373 | 137,504 | | 1,732,810 |
| Long-lived assets | 99,521 | 81,234 | 27,106 | | 207,861 |
| Intangibles | 73,471 | 45,268 | 9,537 | | 128,276 |
| Capital expenditures | 6,214 | 6,586 | 2,298 | | 15,098 |
| Depreciation and amortization | 8,682 | 7,800 | 3,242 | | 19,724 |
| As of and for the six months ended July 2, 2006 | | | | | |
| Net sales | \$ 404,815 | \$ 156,116 | \$ 14,194 | \$ | \$ 575,125 |
| Operating income (loss) | 48,527 | 25,178 | 3,412 | (11,859) | 65,258 |
| Identifiable assets | 799,219 | 464,890 | 110,859 | | 1,374,968 |
| Long-lived assets | 98,979 | 86,307 | 30,208 | | 215,494 |
| Intangibles | 77,859 | 28,067 | 5,605 | | 111,531 |
| Capital expenditures | 6,436 | 22,292 | 1,064 | | 29,792 |
| Depreciation and amortization | 8,807 | 5,515 | 2,576 | | 16,898 |

*Corporate expenses are primarily for compensation expense, Sarbanes-Oxley compliance, professional fees, including legal and audit expenses, shareholder services and benefit administration costs. These costs are not allocated to the geographic segments as they are viewed as corporate functions that support all segments.

The above operating segments are presented on a basis consistent with the presentation included in the Company's December 31, 2006 financial statements included in its Annual Report on Form 10-K.

The North American segment consists of U.S. net sales of \$208,294,000 and \$193,857,000 for the second quarters of 2007 and 2006, respectively, and \$412,366,000 and \$376,763,000 for the first six months of 2007 and 2006, respectively. The North American segment also consists of U.S. long-lived assets of \$92,497,000 and \$92,047,000 at July 1, 2007 and July 2, 2006, respectively.

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

Intersegment sales for the second quarter ended July 1, 2007 for North America, Europe and China were \$1,739,000, \$1,304,000 and \$47,318,000, respectively. Intersegment sales for the second quarter ended July 2, 2006 for North America, Europe and China were \$2,012,000, \$673,000 and \$18,162,000, respectively.

Intersegment sales for the six months ended July 1, 2007 for North America, Europe and China were \$3,782,000, \$2,597,000 and \$69,338,000, respectively. Intersegment sales for the six months ended July 2, 2006 for North America, Europe and China were \$3,432,000, \$1,230,000 and \$32,388,000, respectively.

12

8. Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) consists of the following:

| | Foreign Currency Translation and Other (in thousands) | Pension Adjustment | Accumulated Other Comprehensive Income (Loss) |
|----------------------------------|---|-----------------------|---|
| Balance December 31, 2006 | \$ 38,096 | \$ (12,746) | \$ 25,350 |
| Change in period | 3,216 | 1,482 | 4,698 |
| Balance April 1, 2007 | 41,312 | (11,264) | 30,048 |
| Change in period | 8,436 | 562 | 8,998 |
| Balance July 1, 2007 | \$ 49,748 | \$ (10,702) | \$ 39,046 |
| Balance December 31, 2005 | \$ 13,090 | \$ (7,827) | \$ 5,263 |
| Change in period | 4,611 | | 4,611 |
| Balance April 2, 2006 | 17,701 | (7,827) | 9,874 |
| Change in period | 6,841 | | 6,841 |
| Balance July 2, 2006 | \$ 24,542 | \$ (7,827) | \$ 16,715 |

Accumulated other comprehensive income (loss) in the consolidated balance sheets as of July 1, 2007 and July 2, 2006 consists primarily of cumulative translation adjustments and unrecognized pension related prior service costs and net actuarial loss. The Company's total comprehensive income was as follows:

| | Second Quarter Ended | |
|--|----------------------|-----------------|
| | July 1, 2007 | July 2, 2006 |
| | (in thousands) | |
| Net income | \$ 17,774 | \$ 22,446 |
| Foreign currency translation adjustments and other | 8,998 | 6,841 |
| Total comprehensive income | \$ 26,772 | \$ 29,287 |

| | Six Months Ended | |
|--|------------------|-----------------|
| | July 1, 2007 | July 2, 2006 |
| | (in thousands) | |
| Net income | \$ 37,766 | \$ 37,409 |
| Foreign currency translation adjustments and other | 12,214 | 11,452 |
| Total comprehensive income | \$ 49,980 | \$ 48,861 |

9. Debt

On April 27, 2006, the Company completed a private placement of \$225,000,000 of 5.85% senior unsecured notes due April 2016 (the 2006 Note Purchase Agreement). The 2006 Note Purchase Agreement includes operational and financial covenants with which the Company is required to comply, including, among others, maintenance of certain financial ratios and restrictions on additional indebtedness, liens and dispositions. Events of default under the 2006 Note Purchase Agreement include failure to comply with its financial and operational covenants, as well as bankruptcy and other insolvency events. The Company may, at its option, upon notice to the noteholders, prepay at any time all or part of the notes in an amount not less than \$1 million by paying the principal amount plus a make-whole amount, which is dependent upon the yield of respective U.S. Treasury Securities. The Company used the net proceeds from the private placement to repay \$147,000,000 outstanding under its revolving credit facility. The Company expects to use the balance of the net proceeds to finance future acquisitions and for general corporate

purposes. As of July 1, 2007, the Company was in compliance with all covenants related to the 2006 Note Purchase Agreement. The payment of interest on the senior unsecured notes is due semi-annually on April 30th and October 30th of each year. Additionally, the Company amended its 2003 Note Purchase Agreement to reflect the existence of the subsidiary guarantors and to substantially conform certain provisions of the 2003 Note Purchase Agreement to the 2006 Note Purchase Agreement.

On April 27, 2006, the Company amended and restated its unsecured revolving credit facility with a syndicate of banks (as amended, the revolving credit facility). The revolving credit facility provides for multi-currency unsecured borrowings and stand-by letters of credit of up to \$350,000,000 and expires in April 2011. Borrowings outstanding under the revolving credit facility bear interest at a fluctuating rate per annum equal to an applicable percentage equal to (i) in the case of Eurocurrency rate loans, the British Bankers Association LIBOR rate plus an applicable percentage of 0.60%, which is determined by reference to the Company's consolidated leverage ratio and debt rating, or (ii) in the case of base rate loans and swing line loans, the higher of (a) the federal funds rate plus 0.5% and (b) the rate of interest in effect for such day as announced by Bank of America, N.A. as its prime rate. For the first six

13

months of 2007, the average interest rate under the revolving credit facility for euro-based borrowings was approximately 4.3%. The revolving credit facility includes operational and financial covenants customary for facilities of this type, including, among others, restrictions on additional indebtedness, liens and investments and maintenance of certain leverage ratios. As of July 1, 2007, the Company was in compliance with all covenants related to the revolving credit facility; had \$211,882,000 of unused and potentially available credit under the revolving credit facility; had no U.S dollar denominated debt and \$104,362,000 of euro-based borrowings outstanding on its revolving credit facility; and had \$33,756,000 for stand-by letters of credit outstanding on its revolving credit facility.

Effective July 1, 2005, the Company entered into a three-year interest rate swap with a counter party for a notional amount of 25,000,000, which was outstanding under the revolving credit facility. The Company swapped three-month EURIBOR plus 0.6% for a fixed rate of 3.02%. At July 2, 2006, the fair value of the swap was approximately \$793,000, which was recorded as a reduction of interest expense for the second quarter of 2006. The swap was terminated on October 3, 2006.

On December 28, 2005, the closing date of the Dormont Manufacturing Company (Dormont) acquisition, Dormont had long-term debt outstanding of \$8,900,000 in the form of two series of taxable variable rate demand bonds (1998 Series with \$1,500,000 outstanding and the 2000 Series with \$7,400,000 outstanding) which, due to the provisions of the trust agreements, could only be redeemed at dates subsequent to the closing. Each of these bonds was secured by a letter of credit from a bank, which maintained a security interest in the assets of Dormont. As a condition of the purchase and to gain the bank's consent to the sale of Dormont to the Company, Dormont's former owners were required to establish a cash collateral account for the bonds in an amount equal to the potential obligation of Dormont to the bank under the letter of credit reimbursement agreements. The entire obligation under the bonds approximated \$9,096,000, which represented the \$8,900,000 in bond principal plus interest and related fees. At closing, a portion of the Dormont purchase price was placed in a cash collateral account as a guarantee of payment. The Company recorded this escrow deposit in prepaid expenses and other assets at December 31, 2005. The 1998 series bonds were repaid in full on January 17, 2006 and the 2000 series bonds were repaid in full on February 1, 2006 by the former owners using the cash collateral account.

10. Contingencies and Environmental Remediation

As disclosed in Part I, Item 1, "Product Liability, Environmental and Other Litigation Matters" of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, the Company is a party to litigation described as the James Jones Litigation and is also engaged in certain environmental remediation. This disclosure reported that the Relator had appealed the ruling of the California Superior Court for Los Angeles County that dismissed the claims of the remaining Phase II cities. On June 29, 2007, the Relator's appeal of the Phase II cities ruling was dismissed by the California Court of Appeal, but this appeal could be filed again at the end of the Armenta v. James Jones case in the trial court. This disclosure also reported that in the insurance coverage case with Zurich American Insurance Company, Zurich had appealed the denial of its motion to set aside as void the November 22, 2002 and August 6, 2004 summary adjudication indemnity payment orders. Zurich's appeal was dismissed on March 5, 2007, and, on June 13, 2007, the California Supreme Court declined to review this dismissal. There have been no other material developments with respect to the Company's contingencies and environmental remediation proceedings during the quarter and six months ended July 1, 2007.

11. Employee Benefit Plans

The Company sponsors funded and unfunded defined benefit pension plans covering substantially all of its domestic employees. Benefits are based primarily on years of service and employees' compensation. The funding policy of the Company for these plans is to contribute an annual amount that does not exceed the maximum amount that can be deducted for federal income tax purposes.

In September 2006, the FASB issued FAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" an amendment of FASB Statements No. 87, 88, 106 and 132(R) (FAS 158). This statement requires balance sheet recognition of the overfunded or underfunded status of pension and postretirement benefit plans. In addition, the measurement date (the date as of which plan assets and the benefit obligations are measured) is required to be the Company's fiscal year end. Except for the measurement date provisions, which are not effective until fiscal years ending after December 15, 2008, the provisions of FAS 158 were effective for fiscal years ending after December 15, 2006 and, as such, were adopted during 2006.

The Company has early-adopted the measurement date provisions of FAS 158 effective January 1, 2007. The Company's pension plans previously used a September 30 measurement date. All plans are now measured as of December 31, consistent with the Company's fiscal year end. The non-cash effect of the adoption of the measurement date provisions of FAS 158 increased stockholders' equity by approximately \$100,000 and decreased long-term liabilities by approximately \$129,000. There was no effect on the Company's results of operations.

The components of net periodic benefit cost are as follows:

| | Second Quarter Ended | |
|---------------------------------------|-----------------------------|-------------------------|
| | July 1, 2007 | July 2, 2006 |
| | (in thousands) | |
| Service cost - benefits earned | \$ 945 | \$ 887 |
| Interest costs on benefits obligation | 1,068 | 945 |
| Expected return on assets | (1,071) | (875) |
| Prior service cost amortization | 50 | 71 |
| Net actuarial loss amortization | 231 | 303 |
| Net periodic benefit cost | \$ 1,223 | \$ 1,331 |

| | Six Months Ended | |
|---------------------------------------|-------------------------|-------------------------|
| | July 1, 2007 | July 2, 2006 |
| | (in thousands) | |
| Service cost - benefits earned | \$ 1,890 | \$ 1,774 |
| Interest costs on benefits obligation | 2,136 | 1,890 |
| Expected return on assets | (2,142) | (1,750) |
| Prior service cost amortization | 100 | 142 |
| Net actuarial loss amortization | 462 | 606 |
| Net periodic benefit cost | \$ 2,446 | \$ 2,662 |

The information related to the Company's pension funds cash flow is as follows:

| | Six Months Ended | |
|------------------------|-------------------------|-------------------------|
| | July 1, 2007 | July 2, 2006 |
| | (in thousands) | |
| Employer contributions | \$ 78 | \$ 3,162 |

Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

Overview

The following discussion and analysis are provided to increase understanding of, and should be read in conjunction with, the accompanying unaudited consolidated financial statements and notes. In this quarterly report on Form 10-Q, references to the Company, Watts, we, us or our refer to Watts Water Technologies, Inc. and its consolidated subsidiaries.

We operate on a 52-week fiscal year ending on December 31. Any second quarter ended data contained in this Quarterly Report on Form 10-Q reflects the results of operations for the 13-week period ended on the Sunday nearest June 30 of the respective year.

We are a leading supplier of products for use in the water quality, water safety, water flow control and water conservation markets in North America and Europe, with an emerging presence in China. 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:

- backflow preventers for preventing contamination of potable water caused by reverse flow within water supply lines and fire protection systems;
- a wide range of water pressure regulators for both commercial and residential applications;
- water supply and drainage products for commercial and residential applications;
- temperature and pressure relief valves for water heaters, boilers and associated systems;
- point-of-use water filtration and reverse osmosis systems for both commercial and residential applications;
- 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 levels of 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 new complementary markets, regulatory requirements relating to the quality and conservation of water, increased demand for clean water and continued enforcement of plumbing and building codes and a healthy economic environment. We have completed thirty 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 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, 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.

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 there is an increasing demand among consumers for products to ensure water quality, which creates growth opportunities for our products.

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 increases in the costs of certain raw materials, particularly copper and nickel. Bronze and brass are copper-based alloys. Nickel is a significant commodity

16

used to make stainless steel. The spot price of copper and nickel increased approximately 19% and 5%, respectively, from December 31, 2006 to July 1, 2007.

A risk we face is our ability to deal effectively with increases 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, to the maximum extent possible, when they occur. Additionally from time to time we use commodity futures contracts on a limited basis to manage this risk. We are not able to predict whether or for how long these cost increases will continue. If these cost increases continue 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.

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 expect to spend approximately \$38,000,000 in 2007. We are committed to expanding our manufacturing capacity in lower cost countries such as China, Tunisia and Bulgaria. Manufacturing plant relocations and consolidations are an important part of our ongoing commitment to reduce production costs.

Acquisitions

On August 14, 2006, we acquired 100% of the outstanding stock of Black Teknigas, Limited (Teknigas) located in St. Neots, United Kingdom for approximately \$8,700,000, which is net of cash acquired of approximately \$300,000. The allocations for goodwill and intangible assets are approximately \$3,585,000 and \$4,493,000, respectively. The amount recorded as intangible assets is primarily for technology and customer relationships that have estimated useful lives ranging from 6 to 9 years and trade names with indefinite lives. Teknigas designs, develops and manufactures a range of gas control products and systems for combustion, industrial, medical, laboratory and specialty gas.

On June 7, 2006, we acquired 100% of the outstanding stock of Kim Olofsson Safe Corporation AB (KimSafe) located in Almhult, Sweden for approximately \$5,800,000, which is net of cash acquired of approximately \$2,900,000. The allocations for goodwill and intangible assets are approximately \$887,000 and \$4,436,000, respectively. The amount recorded as intangible assets is primarily for customer relationships that have estimated useful lives of 5 years and trade names with indefinite lives. KimSafe manufactures electronic controls for heat pump, solar and pellet heaters, which provide the ability to heat water using renewable energy.

On June 2, 2006, we acquired the assets and business of Calflex Manufacturing, Inc. (Calflex) located in Vernon, California and the stock of Ningbo Best Metal & Plastic Manufacturing, Ltd (Ningbo) located in Ningbo, China for an aggregate of approximately \$6,300,000. The allocation for intangible assets is approximately \$2,089,000. The amount recorded as intangible assets is primarily for customer relationships that have estimated useful lives of 12 years and trade names with indefinite lives. Calflex and Ningbo distribute and manufacture water connectors.

On May 19, 2006, we acquired 100% of the outstanding stock of ATS Expansion Group (ATS) located in Sorgues, Grenoble and Hautvillers, France for approximately \$62,100,000, which is net of cash acquired of approximately \$5,600,000 plus assumed debt of approximately \$14,100,000. The allocations for goodwill and intangible assets are approximately \$33,550,000 and \$25,590,000, respectively. The amount recorded as intangible assets is primarily for customer relationships with estimated useful lives of 6 years, patents with estimated useful lives from 6 to 12 years and trade names with indefinite lives. ATS products include a broad range of fittings, valves and manifolds for water, gas and heating applications and stainless steel flexible hoses.

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

On April 26, 2006, we acquired the assets and business of Changsha Valve Works (Changsha) located in Changsha, China for approximately \$9,200,000. The allocations for goodwill and intangible assets are approximately \$5,144,000 and \$3,655,000, respectively. The amount recorded as intangible assets is primarily for non-compete agreements that have estimated useful lives of 10 years and customer order backlog with an estimated useful life of 1 year. Changsha is a leading manufacturer of large diameter hydraulic-actuated butterfly valves for thermo-power and hydro-power plants, water distribution projects and water works projects in China.

On April 5, 2006, we completed the planned increase of our ownership in Watts Stern Rubinetti, S.r.l. (Stern) from 85% to 100%. The price paid for this additional 15% interest was approximately \$387,000.

17

Results of Operations**Second Quarter Ended July 1, 2007 Compared to Second Quarter Ended July 2, 2006**

Net Sales. Our business is reported in three geographic segments: North America, Europe and China. Our net sales in each of these segments for each of the second quarters of 2007 and 2006 were as follows:

| | Second Quarter Ended July 1, 2007 | | | Second Quarter Ended July 2, 2006 | | | Change | % Change to Consolidated Net Sales | |
|---------------|--------------------------------------|---------|---|--------------------------------------|---------|---|-----------|--|---|
| | Net Sales (dollars in thousands) | % Sales | | Net Sales | % Sales | | | | |
| North America | \$ 224,452 | 64.1 | % | \$ 208,249 | 69.4 | % | \$ 16,203 | 5.4 | % |
| Europe | 108,222 | 30.9 | | 83,857 | 27.9 | | 24,365 | 8.1 | |
| China | 17,748 | 5.0 | | 8,069 | 2.7 | | 9,679 | 3.2 | |
| Total | \$ 350,422 | 100 | % | \$ 300,175 | 100 | % | \$ 50,247 | 16.7 | % |

The increase in net sales is attributable to the following:

| | North America, Europe, China, Total (dollars in thousands) | | | | 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 | Total |
| Internal growth | \$ 14,851 | \$ 4,997 | \$ 6,735 | \$ 26,583 | 5.0 | % 1.7 | % 2.2 | % 8.9 | % 7.2 | % 6.0 | % 83.5 | % |
| Foreign exchange | 261 | 6,195 | 618 | 7,074 | - | 2.1 | .2 | 2.3 | .1 | 7.4 | 7.7 | |
| Acquisitions | 1,091 | 13,173 | 2,326 | 16,590 | .4 | 4.3 | .8 | 5.5 | .5 | 15.7 | 28.8 | |
| Total | \$ 16,203 | \$ 24,365 | \$ 9,679 | \$ 50,247 | 5.4 | % 8.1 | % 3.2 | % 16.7 | % 7.8 | % 29.1 | % 120.0 | % |

The internal growth in net sales in North America was primarily due to increased unit selling prices and increased unit sales in certain product lines into the wholesale market. Our wholesale market in the second quarter of 2007, excluding the sales from the acquisition of Calflex, grew by 11.1% compared to the second quarter of 2006. This was primarily due to increased sales of our backflow products. Our sales into the North American DIY market in the second quarter of 2007 decreased by 7.1% compared to the second quarter of 2006 primarily due to decreased unit sales of our residential brass and tubular products partially offset by increased prices in certain product lines.

The acquired growth in net sales in North America was due to the inclusion of net sales of Calflex acquired on June 2, 2006.

The internal growth in net sales in Europe resulted primarily from increased sales in the European OEM market. This is primarily due to price increases and increased unit shipments of under-floor radiant heating and solar product lines. Excluding the sales from the acquisitions of ATS, Kimsafe and Teknigas, our sales into the OEM market in the second quarter of 2007 grew by 17.8%, while we experienced a decrease of 4.1% in the European wholesale market, compared to the second quarter of 2006.

The acquired growth in net sales in Europe was due to the inclusion of the net sales of ATS, acquired on May 19, 2006, Kimsafe, acquired on June 7, 2006, and Teknigas, acquired on August 14, 2006.

The internal sales growth in China was primarily due to increased sales in both the Chinese domestic and export markets, which amounted to approximately \$3,484,000 and the elimination of a one-month reporting lag in two of our Chinese entities, which amounted to approximately \$3,251,000.

The acquired growth in net sales in China was due to the inclusion of the net sales of Changsha, acquired on April 26, 2006.

The increases in net sales due to foreign exchange in North America, Europe and China were primarily due to the appreciation of the Canadian dollar, the euro and the yuan, respectively, against the U.S. dollar. We cannot predict whether these currencies will continue to appreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our net sales.

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

Gross Profit. Gross profit and gross profit as a percent of net sales (gross margin) for the second quarters of 2007 and 2006 were as follows:

| | Second Quarter Ended | | |
|--------------|------------------------|-----------------|-----------------|
| | July 1, 2007 | July 2, 2006 | Point Change |
| | (dollars in thousands) | | |
| Gross profit | \$ 114,641 | \$ 106,683 | |
| Gross margin | 32.7 | % 35.5 | % (2.8)% |

Gross margin decreased in the second quarter of 2007 compared to second quarter of 2006 primarily due to increased material costs. The North American margin for the second quarter of 2007 was affected by cost increases for copper-based alloys and stainless steel products, which exceeded realized sales price increases and a net charge of approximately \$2,945,000 related to an increase in our

18

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

workers compensation reserve primarily due to a change in estimate. The European margin remained relatively flat primarily due to higher margins contributed by recent acquisitions and price increases, which were partially offset by increased material costs and a change in mix to lower margin products. Our China segment's gross margin decreased primarily due to higher material costs, value added tax increases and a shift in product mix.

Selling, General and Administrative Expenses. Selling, General and Administrative, or SG&A, expenses for the second quarter of 2007 increased \$10,256,000, or 13.9%, compared to the second quarter of 2006. The increase in SG&A expenses was attributable to the following:

| | (in thousands) | % Change |
|------------------|----------------|----------|
| Internal growth | \$ 4,574 | 6.2 % |
| Foreign exchange | 1,457 | 2.0 |
| Acquisitions | 4,225 | 5.7 |
| Total | \$ 10,256 | 13.9 % |

The internal increase in SG&A expenses was primarily due to increased product liability costs, increased variable selling expenses due to increased sales volumes, the elimination of a one-month reporting lag in two of our Chinese entities and increased stock-based compensation costs, partially offset by decreased compensation costs. The increase in SG&A expenses from foreign exchange was primarily due to the appreciation of the euro against the U.S. dollar. The increase in SG&A expenses from acquisitions was due to the inclusion of Changsha, ATS, Calflex, Ningbo, Kimsafe and Teknigas. Total SG&A expenses, as a percentage of sales, was 24.0% in the second quarter of 2007 compared to 24.6% in the second quarter of 2006.

Restructuring and Other Charges. In the second quarter of 2007, we recorded \$270,000 of accelerated depreciation related to the relocation and restructuring plan for our 60% owned Chinese joint venture. In the second quarter of 2006, we recorded a gain of approximately \$6,500,000 related to the sale of a building in Italy. This gain was partially offset by charges of \$824,000 primarily for severance costs related to our European and Chinese restructuring plans.

Operating Income. Operating income by geographic segment for the second quarters of 2007 and 2006 was as follows:

| | Second Quarter Ended | | Change | % Change to Consolidated Operating Income |
|---------------|------------------------|--------------|-------------|---|
| | July 1, 2007 | July 2, 2006 | | |
| | (dollars in thousands) | | | |
| North America | \$ 20,216 | \$ 25,959 | \$ (5,743) | (14.9)% |
| Europe | 12,833 | 15,608 | (2,775) | (7.2) |
| China | 4,015 | 2,397 | 1,618 | 4.2 |
| Corporate | (6,748) | (5,404) | (1,344) | (3.5) |
| Total | \$ 30,316 | \$ 38,560 | \$ (8,244) | (21.4)% |

The increase (decrease) in operating income is attributable to the following:

| | Change As a % of Consolidated Operating Income | | | | | Change As a % of Segment Operating Income | | | | |
|------------------|--|----------|----------|------------|------------|---|---------|-------|---------|----------|
| | North America | Europe | China | Corp. | Total | North America | Europe | China | Corp. | Total |
| | (dollars in thousands) | | | | | | | | | |
| Internal growth | \$ (5,504) | \$ 186 | \$ 1,635 | \$ (1,344) | \$ (5,027) | (14.3)% | .5 % | 4.2 % | (3.5)% | (13.1)% |
| Foreign exchange | 67 | 697 | 116 | | 880 | .2 | 1.8 | .3 | 2.3 | .3 |
| Acquisitions | (306) | 2,082 | 195 | | 1,971 | (.8) | 5.4 | .5 | 5.1 | (1.2) |
| Restructuring | | (5,740) | (328) | | (6,068) | - | (14.9) | (.8) | (15.7) | - |
| | | | | | | | | | | (21.2)% |
| | | | | | | | | | | 1.2 % |
| | | | | | | | | | | 68.2 % |
| | | | | | | | | | | (24.9)% |

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

| | | | | | | | | | | | | | | | |
|-------|------------|------------|----------|------------|------------|-------|---------|--------|---------|-----------|----------|----------|---------|----------|----|
| Total | \$ (5,743) | \$ (2,775) | \$ 1,618 | \$ (1,344) | \$ (8,244) | (14.9 |)% (7.2 |)% 4.2 |)% (3.5 |)% (21.4) |)% (22.1 |)% (17.8 |)% 67.5 |)% (24.9 |)% |
|-------|------------|------------|----------|------------|------------|-------|---------|--------|---------|-----------|----------|----------|---------|----------|----|

The decrease in internal operating income in North America was primarily due to increased material costs, a net charge of approximately \$2,945,000 related to an increase in our workers compensation reserve primarily due to a change in estimate and increased product liability costs, partially offset by decreased compensation costs. The acquired decrease is due to the inclusion of operating results from Calflex.

Europe's internally generated operating income was essentially flat due to our ability to leverage SG&A expenses, which was partially offset by increased material costs. In the second quarter of 2007, we did not record any costs associated with our manufacturing restructuring plan compared to a net gain of \$5,740,000 for the same period in 2006, primarily for a sale of a building in Italy. The increase in operating income from foreign exchange was primarily due to the appreciation of the euro against the U.S. dollar. We cannot predict whether the euro will continue to appreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our operating income. The acquired growth in Europe is due to the inclusion of the operating income from ATS, Kimsafe and Teknigas.

19

The increase in internal growth in China was primarily attributable to increased production levels at our wholly owned manufacturing plants, partially offset by increased SG&A expense. The acquired growth in China was primarily due to the inclusion of the operating income of Changsha. In the second quarter of 2007, we recorded \$399,000 of accelerated depreciation associated with our manufacturing restructuring plan in China compared to \$71,000 for the comparable period of 2006. The elimination of a one-month reporting lag in two of our Chinese entities did not have a material impact on China's operating income. We anticipate recording an additional \$900,000 in accelerated depreciation and relocation costs for the remainder of 2007.

The decrease in internal operating income in Corporate was primarily attributable to increased stock-based compensation costs and the timing of costs for complying with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) partially offset by decreased compensation costs. We expect SOX costs to decrease on a full year basis compared to 2006.

Interest Income. Interest income increased \$2,746,000, or 308.2%, in the second quarter of 2007 compared to the second quarter of 2006, primarily due to the investment of net proceeds of approximately \$219,000,000 from the public offering of 5,750,000 shares of our class A common stock in November 2006 and the investment of the residual proceeds from the \$225,000,000 private placement of senior notes in April 2006.

Interest Expense. Interest expense increased \$1,792,000, or 36.2%, for the second quarter of 2007 compared to the second quarter of 2006, primarily due to our April 27, 2006 issuance of \$225,000,000 5.85% senior notes due in 2016 and increased debt levels for acquisitions along with increases in the average variable rates charged on the revolving credit facility.

Other (Income) Expense. Other (income) expense increased \$1,018,000 for the second quarter of 2007 compared to the second quarter of 2006, primarily due to currency movements. Foreign currency losses were recorded in Europe, Canada and China in 2007, whereas foreign currency gains were recorded in 2006.

Income Taxes. Our effective tax rate for continuing operations increased to 36.1% in the second quarter of 2007 from 35.8% in the second quarter of 2006. The increase is primarily due to recording a valuation allowance related to deferred tax assets of our 60% owned Chinese joint venture, partially offset by a shift in income mix to Europe and China that have lower effective tax rates than our overall rate. We also had a lower effective tax rate in Europe in 2007 due to the 2006 gain on the sale of a building in Italy that was taxed at a higher than average rate.

Income From Continuing Operations. Income from continuing operations for the second quarter of 2007 decreased \$4,850,000, or 21.5%, to \$17,693,000, or \$0.45 per common share, from \$22,543,000, or \$0.68 per common share, for the second quarter of 2006, in each case, on a diluted basis. Income from continuing operations for the second quarters of 2007 and 2006 included costs, net of tax, from our restructuring plan of \$181,000, or \$0.00 per common share, and income, net of tax, of \$3,554,000, or \$0.11 per common share, respectively. The gain on the sale of our Italian building in the second quarter of 2006 resulted in an after-tax gain of \$4,100,000, or \$0.12 per share. The appreciation of the euro, Chinese yuan and Canadian dollar against the U.S. dollar resulted in a positive impact on income from continuing operations of \$0.01 per common share for the second quarter of 2007 compared to the comparable period last year. We cannot predict whether the euro, Canadian dollar or yuan will appreciate or depreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our net income.

Additionally, in November 2006, the Company completed a public offering of 5,750,000 shares of Class A common stock and received net proceeds of approximately \$219,000,000. The interest earned on the net proceeds provided approximately \$1,920,000 in after-tax income in the second quarter of 2007. The issuance of an additional 5,750,000 shares had a dilutive impact on earnings per share of \$0.02 per share in the second quarter of 2007, after considering the interest income from the net proceeds.

Income (Loss) From Discontinued Operations. We recorded income, net of tax, from discontinued operations for the second quarter of 2007 of \$81,000, or \$0.00 per common share, and expense for the second quarter of 2006 of \$97,000, or \$0.00 per common share, in each case, on a diluted basis. The 2007 income is due to reserve adjustments net of

charges, and the 2006 charges were primarily attributable to legal fees associated with the James Jones litigation, as described in Part I, Item 1. Business-Product Liability, Environmental and Other Litigation Matters in our Annual Report on Form 10-K for the year ended December 31, 2006.

Six Months Ended July 1, 2007 Compared to Six Months Ended July 2, 2006

Net Sales. Our business is reported in three geographic segments: North America, Europe and China. Our net sales in each of these segments for each of the six months ended 2007 and 2006 were as follows:

| | Six Months Ended July 1, 2007 | | | Six Months Ended July 2, 2006 | | | Change | % Change to Consolidated Net Sales | |
|---------------|----------------------------------|---------|---|----------------------------------|---------|---|------------|--|---|
| | Net Sales | % Sales | | Net Sales | % Sales | | | | |
| | (dollars in thousands) | | | | | | | | |
| North America | \$ 442,777 | 63.6 | % | \$ 404,815 | 70.4 | % | \$ 37,962 | 6.6 | % |
| Europe | 223,767 | 32.1 | | 156,116 | 27.1 | | 67,651 | 11.8 | |
| China | 29,970 | 4.3 | | 14,194 | 2.5 | | 15,776 | 2.7 | |
| Total | \$ 696,514 | 100 | % | \$ 575,125 | 100 | % | \$ 121,389 | 21.1 | % |

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

The increase in net sales is attributable to the following:

| | North America, Europe, China, Total | | | | Change As a % of Consolidated Net Sales | | | | Change As a % of Segment Net Sales | | |
|------------------|---|-----------|-----------|------------|---|--------|-------|--------|------------------------------------|--------|---------|
| | North America (dollars in thousands) | Europe | China | Total | North America | Europe | China | Total | North America | Europe | China |
| Internal growth | \$ 35,061 | \$ 17,875 | \$ 9,036 | \$ 61,972 | 6.1 | % 3.1 | % 1.6 | % 10.8 | % 8.7 | % 11.4 | % 63.7 |
| Foreign exchange | 149 | 13,858 | 942 | 14,949 | | 2.4 | .1 | 2.6 | | 8.9 | 6.6 |
| Acquisitions | 2,752 | 35,918 | 5,798 | 44,468 | .5 | 6.3 | 1.0 | 7.7 | .7 | 23.0 | 40.8 |
| Total | \$ 37,962 | \$ 67,651 | \$ 15,776 | \$ 121,389 | 6.6 | % 11.8 | % 2.7 | % 21.1 | % 9.4 | % 43.3 | % 111.1 |

The internal growth in net sales in North America was primarily due to increased unit selling prices and increased unit sales in certain product lines into the wholesale market. Our wholesale market in the first six months of 2007, excluding the sales from the acquisition of Calflex, grew by 11.9% compared to the first six months of 2006. This was primarily due to increased sales of our backflow products. Our sales into the North American DIY market in the first six months of 2007 decreased by 2.4% compared to the first six months of 2006 primarily due to decreased unit sales of our residential brass and tubular products partially offset by increased prices in certain product lines.

The acquired growth in net sales in North America was due to the inclusion of net sales of Calflex acquired on June 2, 2006.

The internal sales growth in Europe was broad-based, especially in the OEM market. This is primarily due to price increases and increased unit shipments of under-floor radiant heating and solar product lines. Our sales into the wholesale and OEM markets in the first six months of 2007, excluding the sales from the acquisitions of ATS, Kimsafe and Teknigas, grew by 3.9% and 20.4%, respectively, compared to the first six months of 2006.

The acquired growth in net sales in Europe was due to the inclusion of the net sales of ATS, acquired on May 19, 2006, Kimsafe, acquired on June 7, 2006, and Teknigas, acquired on August 14, 2006.

The internal sales growth in China was primarily due to increased export sales to Europe, increased sales into the domestic Chinese markets and the elimination of the one-month reporting lag in two of our Chinese entities.

The acquired growth in net sales in China was due to the inclusion of the net sales of Changsha, acquired on April 26, 2006, and Ningbo, acquired on June 2, 2006.

The increases in net sales due to foreign exchange in North America, Europe and China were primarily due to the appreciation of the Canadian dollar, euro and yuan, respectively, against the U.S. dollar. We cannot predict whether these currencies will continue to appreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our net sales.

Gross Profit. Gross profit and gross profit as a percent of net sales (gross margin) for the first six months of 2007 and 2006 were as follows:

| | Six Months Ended | | |
|--------------|------------------|--------------|--------------|
| | July 1, 2007 | July 2, 2006 | Point Change |
| Gross profit | \$ 229,307 | \$ 202,667 | |
| Gross margin | 32.9 | % 35.2 | % (2.3) |

Gross margin decreased in the first six months of 2007 compared to first six months of 2006 primarily due to increased material costs. The North American margin was affected by cost increases for copper-based alloys and for stainless steel products, which exceeded realized sales price increases, and from a net charge related to an increase in our workers compensation reserve primarily due to a change in estimate. The European segment experienced reductions in gross margin primarily due to increased material costs and increased inventory provisions, which were partially offset by higher margins contributed by recent acquisitions and price increases. The China segment's gross margin decreased primarily due to higher material costs, value added tax increases and a shift in product mix.

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

Selling, General and Administrative Expenses. Selling, General and Administrative, or SG&A, expenses for the first six months of 2007 increased \$25,304,000, or 17.7%, compared to the first six months of 2006. The increase in SG&A expenses was attributable to the following:

| | (in thousands) | % Change | |
|------------------|----------------|----------|---|
| Internal growth | \$ 11,650 | 8.2 | % |
| Foreign exchange | 2,958 | 2.0 | |
| Acquisitions | 10,696 | 7.5 | |
| Total | \$ 25,304 | 17.7 | % |

21

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

The internal increase in SG&A expenses was primarily due to increased variable selling expenses due to increased sales volumes, increased product liability costs and increased stock-based compensation costs. The increase in SG&A expenses from foreign exchange was primarily due to the appreciation of the euro and the yuan against the U.S. dollar. The increase in SG&A expenses from acquisitions was due to the inclusion of Changsha, ATS, Calflex, Ningbo, Kimsafe and Teknigas. Total SG&A expenses, as a percentage of sales, was 24.1% in the first six months of 2007 compared to 24.8% in the first six months of 2006.

Restructuring and Other Charges. In the first six months of 2007, we recorded \$470,000 of accelerated depreciation related to the relocation and restructuring plan for our 60% owned Chinese joint venture. In the first six months of 2006, we recorded income of \$5,441,000 primarily due to a gain of approximately \$6,500,000 related to the sale of a building in Italy partially offset by costs of \$1,059,000 primarily for severance costs related to our European and Chinese restructuring plans.

Operating Income. Operating income by geographic segment for the first six months of 2007 and 2006 was as follows:

| | Six Months Ended | | Change | % Change to Consolidated Operating Income |
|---------------|--|------------------|--------------------|---|
| | July 1, 2007 (dollars in thousands) | July 2, 2006 | | |
| North America | \$ 41,415 | \$ 48,527 | \$ (7,112) | (10.9)% |
| Europe | 27,243 | 25,178 | 2,065 | 3.2 |
| China | 6,064 | 3,412 | 2,652 | 4.0 |
| Corporate | (14,039) | (11,859) | (2,180) | (3.3) |
| Total | \$ 60,683 | \$ 65,258 | \$ (4,575) | (7.0)% |

The increase (decrease) in operating income is attributable to the following:

| | Change As a % of Consolidated Operating Income | | | | | Change As a % of Segment Operating Income | | | | |
|------------------|--|--------------|--------------|------------------|------------------|---|------------|------------|----------------|----------------|
| | North America | Europe | China | Corp. | Total | North America | Europe | China | Corp. | Total |
| Internal growth | (10.0)% | 2.0 | 3.5 | (3.3)% | (7.8)% | 13.6 | 5.3 | 68.1 | (18.4)% | |
| Foreign exchange | 52 | 1,699 | 172 | | 1,923 | 2.6 | .3 | | 2.9 | .1 |
| Acquisitions | (574) | 4,543 | 778 | | 4,747 | (.9) | 7.0 | 1.2 | 7.3 | (1.2) |
| Restructuring | | (5,505) | (623) | | (6,128) | - | (8.4) | (1.0) | (9.4) | (21.9) |
| Total | (7.112)% | 2.065 | 2.652 | (2.180)% | (4.575)% | (10.9)% | 3.2 | 4.0 | (3.3)% | (7.0)% |

The decrease in internal operating income in North America was primarily due to increased material costs, a net increase in our workers compensation reserve primarily due to a change in estimate and increased product liability costs, partially offset by decreased compensation costs. The acquired decrease is due to the inclusion of operating results from Calflex.

Europe's internal growth in operating income is due to our ability to leverage SG&A expenses, partially offset by increased material costs and sales of lower margin products primarily in the wholesale market. In the first six months of 2007, we did not record any costs associated with our manufacturing restructuring plan compared to a gain of \$5,505,000 for the same period in 2006. We recorded a gain of \$6,500,000 for the building sale in Italy partially offset by \$995,000 of primarily severance costs. The increase in operating income from foreign exchange was primarily due to the appreciation of the euro against the U.S. dollar. We cannot predict whether the euro will continue to appreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our operating income. The acquired growth in Europe is due to the inclusion of the operating income from ATS, Kimsafe and Teknigas.

The increase in internal growth in China was primarily attributable to increased production levels at our wholly owned manufacturing plants, partially offset by increased SG&A expense. The acquired growth in China was due to the inclusion of the operating income of Changsha and Ningbo. In the first six months of 2007, we recorded \$694,000 of accelerated depreciation associated with our manufacturing restructuring plan in China. The elimination of a one-month reporting lag in two of our Chinese entities did not have a material impact on China's operating

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

income. We anticipate recording an additional \$900,000 in accelerated depreciation and relocation costs for the remainder of 2007.

The decrease in internal operating income in Corporate was primarily attributable to increased stock-based compensation costs and the timing of SOX costs. We expect SOX costs to decrease on a full year basis as compared to 2006.

Interest Income. Interest income increased \$5,940,000, or 453.8%, in the first six months of 2007 compared to the first six months of 2006, primarily due to the investment of the net proceeds of approximately \$219,000,000 from the public offering of 5,750,000 shares of our class A common stock in November 2006 and to the investment of the residual proceeds from the \$225,000,000 private placement in April 2006.

Interest Expense. Interest expense increased \$3,907,000, or 42.7%, for the first six months of 2007 compared to the first six months of

2006, primarily due to our April 27, 2006 issuance of \$225,000,000 5.85% senior notes due in 2016 and increased debt levels for acquisitions along with increases in the average variable rates charged on the revolving credit facility.

Other (Income) Expense. Other (income) expense increased \$1,973,000 for the first six months of 2007 compared to the first six months of 2006, primarily due to currency movements and losses on forward currency contracts. Foreign currency losses were recorded in Europe, Canada and China in 2007, whereas foreign currency gains were recorded in 2006.

Income Taxes. Our effective tax rate for continuing operations decreased to 31.3% in the first six months of 2007 from 35.3% in the first six months of 2006. The decrease is primarily due to a tax refund in Italy due to recent changes in Italian tax laws and a shift in income mix to Europe and China that have lower effective tax rates than our overall rate, partially offset by the recording of a valuation allowance on the deferred tax assets of our 60 % owned Chinese joint venture. We also had a higher effective tax rate in Europe in 2006 due to the gain on the sale of a building in Italy that was taxed at a higher than average rate.

Income From Continuing Operations. Income from continuing operations for the first six months of 2007 increased \$110,000, or .3%, to \$37,740,000, or \$0.97 per common share, from \$37,630,000, or \$1.14 per common share, for the first six months of 2006, in each case, on a diluted basis. Income from continuing operations for the first six months of 2007 includes a tax refund of \$1,910,000, or \$0.05 per common share. Income from continuing operations for the first six months of 2007 and 2006 included costs, net of tax, from our restructuring plan of \$316,000, or \$0.01 per common share, and included income, net of tax, of \$3,405,000, or \$0.10 per share, respectively. The gain on the sale of our building in Italy resulted in an after-tax gain of \$4,100,000, or \$0.12 per share. The appreciation of the euro, Chinese yuan and Canadian dollar against the U.S. dollar resulted in a positive impact on income from continuing operations of \$0.03 per common share for the first six months of 2007 compared to the comparable period last year. We cannot predict whether the euro, Canadian dollar or yuan will appreciate or depreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our net income.

Additionally, in November 2006, the Company completed a public offering of 5,750,000 shares of Class A common stock and received net proceeds of approximately \$219,000,000. The interest earned on the net proceeds provided approximately \$3,730,000 in after-tax income in the first six months of 2007. The issuance of an additional 5,750,000 shares had a dilutive impact on earnings per share of \$0.06 per share in the first six months of 2007, after considering the interest income from the net proceeds.

Income (Loss) From Discontinued Operations. We recorded income, net of tax, from discontinued operations for the first six months of 2007 of \$26,000, or \$0.00 per common share, and a charge, net of tax, of \$221,000, or \$0.01 per common share, on a diluted basis for the comparable period. The 2007 income is due to reserve adjustments net of charges, and the 2006 charges were primarily attributable to legal fees associated with the James Jones litigation, as described in Part I, Item 1. **Business-Product Liability, Environmental and Other Litigation Matters** in our Annual Report on Form 10-K for the year ended December 31, 2006.

Liquidity and Capital Resources

We used \$238,000 of cash from continuing operations for the first six months of 2007. We experienced an increase in accounts receivable in North America and Europe. The increase in accounts receivable was primarily due to increased sales volume and increased selling prices. We also experienced increases in inventory in Europe, China and North America. The increases were primarily due to increased raw material costs, planned increases in European safety stocks and seasonality.

We used \$27,140,000 of net cash for investing activities for the first six months of 2007. We invested \$15,098,000 in capital equipment. For the remainder of fiscal year 2007, we expect to invest approximately \$22,900,000 for manufacturing machinery and equipment as part of our ongoing commitment to improve our manufacturing capabilities. We invested \$7,500,000 in investment grade auction rate securities. We paid \$4,627,000 for additional acquisition costs related to

prior years acquisitions.

We generated \$9,370,000 of net cash from financing activities for the first six months of 2007. This was primarily due to increased borrowings under our line of credit for use in Europe and tax benefits from the exercise of stock awards, partially offset by payments of debt and dividend payments.

In April 2006, we amended our revolving credit facility with a syndicate of banks to provide for multi-currency unsecured borrowings and stand-by letters of credit of up to \$350,000,000 and to extend the maturity date through April 2011. The revolving credit facility is being used to support our acquisition program, working capital requirements and for general corporate purposes.

Outstanding indebtedness under the revolving credit facility bears interest at a rate determined by the type of loan plus an applicable margin determined by our debt rating, depending on the applicable base rate and our bond rating. For the first six months of 2007 the average interest rate under the revolving credit facility for euro-based borrowings was approximately 4.3%. There were no U.S. dollar borrowings at July 1, 2007. The revolving credit facility includes operational and financial covenants customary for facilities of this type, including, among others, restrictions on additional indebtedness, liens and investments and maintenance of certain leverage ratios. As of July 1, 2007, we were in compliance with all covenants related to the revolving credit facility, had \$211,882,000 of unused and potentially available credit under the revolving credit facility and had \$104,362,000 of euro-based borrowings outstanding and \$33,756,000 for stand-by letters of credit outstanding on our revolving credit facility.

23

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

We used \$798,000 of net cash in discontinued operations. During the first six months of 2007, we paid approximately \$187,000 for defense costs and approximately \$223,000 for other legal costs we incurred in the James Jones Litigation.

Working capital (defined as current assets less current liabilities) as of July 1, 2007 was \$718,691,000 compared to \$653,024,000 as of December 31, 2006. This increase was primarily due to increases in accounts receivable, inventory and investment securities. Cash and cash equivalents decreased to \$327,437,000 as of July 1, 2007 compared to \$342,979,000 as of December 31, 2006 primarily due to cash used to fund operations. The ratio of current assets to current liabilities was 3.4 to 1 as of July 1, 2007 compared to 3.2 to 1 as of December 31, 2006.

We anticipate that available funds from current operations, existing cash and other sources of liquidity will be sufficient to meet current operating requirements and anticipated capital expenditures for at least the next 12 months. However, we may have to consider external sources of financing for any large future acquisitions.

Our contractual obligations as of July 1, 2007 are presented in the following table:

| Contractual Obligations | Payments Due by Period | | | | |
|--|-------------------------|---------------------|------------------|-------------------|----------------------|
| | Total (in thousands) | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Long-term debt obligations, including current maturities (a) | \$ 467,666 | \$ 12,734 | \$ 372 | \$ 154,560 | \$ 300,000 |
| Operating lease obligations | 22,248 | 4,631 | 10,036 | 4,607 | 2,974 |
| Capital lease obligations (a) | 14,890 | 1,430 | 2,291 | 2,155 | 9,014 |
| Pension contributions | 13,706 | 3,771 | 1,964 | 118 | 7,853 |
| Interest (b) | 172,275 | 13,034 | 49,615 | 42,742 | 66,884 |
| Other (c) | 24,664 | 19,089 | 1,042 | 782 | 3,751 |
| Total | \$ 715,449 | \$ 54,689 | \$ 65,320 | \$ 204,964 | \$ 390,476 |

(a) as recognized in the consolidated balance sheet

(b) assumes the balance on the revolving credit facility remains at \$104,362,000 and the interest rate remains at approximately 4.5% for the presented periods

(c) includes commodity, capital expenditure commitments and other benefits at July 1, 2007

We maintain letters of credit that guarantee our performance or payment to third parties in accordance with specified terms and conditions. Amounts outstanding were approximately \$46,226,000 as of July 1, 2007 and \$49,637,000 as of December 31, 2006. Our letters of credit are primarily associated with insurance coverage and to a lesser extent foreign purchases and generally expire within one year of issuance. These instruments may exist or expire without being drawn down, therefore they do not necessarily represent future cash flow obligations.

Off-Balance Sheet Arrangements

Except for operating lease commitments, we have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Application of Critical Accounting Policies and Key Estimates

The preparation of our consolidated financial statements in accordance with U.S. GAAP requires management to make judgments, assumptions and estimates that affect the amounts reported. A critical accounting estimate is an assumption about highly uncertain matters and could have a material effect on the consolidated financial statements if another, also reasonable, amount were used, or, a change in the estimate is reasonably likely from period to period. We base our assumptions on historical experience and on other estimates that we believe are reasonable under the circumstances. Actual results could differ significantly from these estimates. Except for the net increase in workers compensation reserves in the second quarter of 2007 primarily due to a change in estimate, there were no changes in accounting policies or significant changes in accounting estimates during the first six months of 2007.

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

We periodically discuss the development, selection and disclosure of the estimates with the Audit Committee. Management believes the following critical accounting policies reflect its more significant estimates and assumptions.

Revenue recognition

We recognize revenue when all of the following criteria are met: (1) we have entered into a binding agreement, (2) the product has shipped and title has passed, (3) the sales price to the customer is fixed or is determinable and (4) collectibility is reasonably assured. We recognize revenue based upon a determination that all criteria for revenue recognition have been met, which, based on the majority of our shipping terms, is considered to have occurred upon shipment of the finished product. Some shipping terms require the

24

goods to be received by the customer before title passes. In those instances, revenues are not recognized until the customer has received the goods. We record estimated reductions to revenue for customer returns and allowances and for customer programs. Provisions for returns and allowances are made at the time of sale, derived from historical trends and form a portion of the allowance for doubtful accounts. Customer programs, which are primarily annual volume incentive plans, allow customers to earn credit for attaining agreed upon purchase targets from us. We record customer programs as an adjustment to net sales.

Allowance for doubtful accounts

The allowance for doubtful accounts is established to represent our best estimate of the net realizable value of the outstanding accounts receivable. The development of our allowance for doubtful accounts varies by region but in general is based on a review of past due amounts, historical write-off experience, as well as aging trends affecting specific accounts and general operational factors affecting all accounts. In North America, management specifically analyzes individual accounts receivable and establishes specific reserves against financially troubled customers. In addition, factors are developed utilizing historical trends in bad debts, returns and allowances. The ratio of these factors to sales on a rolling twelve-month basis is applied to total outstanding receivables (net of accounts specifically identified) to establish a reserve. In Europe, management develops their bad debt allowance through an aging analysis of all their accounts. In China, management specifically analyzes individual accounts receivable and establishes specific reserves as needed. In addition, for waterworks customers, whose payment terms are generally extended, we reserve the majority of accounts receivable in excess of one year from the invoice date.

We uniformly consider current economic trends and changes in customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. We also aggressively monitor the creditworthiness of our largest customers, and periodically review customer credit limits to reduce risk. If circumstances relating to specific customers change or unanticipated changes occur in the general business environment, our estimates of the recoverability of receivables could be further adjusted.

Inventory valuation

Inventories are stated at the lower of cost or market with costs generally determined on a first-in first-out basis. We utilize both specific product identification and historical product demand as the basis for determining our excess or obsolete inventory reserve. We identify all inventories that exceed a range of one to four years in sales. This is determined by comparing the current inventory balance against unit sales for the trailing twelve months. New products added to inventory within the past twelve months are excluded from this analysis. A portion of our products contain recoverable materials, therefore the excess and obsolete reserve is established net of any recoverable amounts. Changes in market conditions, lower than expected customer demand or changes in technology or features could result in additional obsolete inventory that is not saleable and could require additional inventory reserve provisions.

In certain countries, additional inventory reserves are maintained for potential shrinkage experienced in the manufacturing process. The reserve is established based on the prior year's inventory losses adjusted for any change in the gross inventory balance.

Goodwill and other intangibles

Goodwill and intangible assets with indefinite lives are tested annually for impairment in accordance with the provisions of Financial Accounting Standards Board Statement No. 142 *Goodwill and Other Intangible Assets* (FAS 142). We use judgment in assessing whether assets may have become impaired between annual impairment tests. We concluded that no impairment existed at October 29, 2006, the time of our latest annual review. We perform our annual test for indicators of goodwill and non-amortizable intangible assets impairment in the fourth quarter of our fiscal year or sooner if indicators of impairment exist.

Intangible assets such as purchased technology are generally recorded in connection with a business acquisition. Values assigned to intangible assets are determined by an independent valuation firm based on estimates and judgments regarding expectations of the success and life cycle of products and technology acquired.

Since the adoption of FAS 142 our valuations have been greater than the carrying value of our goodwill and intangibles. While we believe that our estimates of future cash flows are reasonable, different assumptions regarding such factors as future sales volume, selling price changes, material cost changes, cost savings programs and capital expenditures could significantly affect our valuations. Other changes that may affect our valuations include, but are not limited to product acceptances and regulatory approval. If actual product acceptance differs significantly from the estimates, we may be required to record an impairment charge to write down the assets to their realizable value. A severe decline in market value could result in an unexpected impairment charge to goodwill, which could have a material impact on the results of operations and financial position.

Product liability and workers' compensation costs

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

Because of retention requirements associated with our insurance policies, we are generally self-insured for potential product liability claims and for workers' compensation costs associated with workplace accidents. For product liability cases in the U.S., management estimates expected settlement costs by utilizing loss reports provided by our third-party administrators as well as developing internal historical trend factors based on our specific claims experience. Management utilizes the internal trend factors that reflect final expected settlement costs. In other countries, we maintain insurance coverage with relatively high deductible payments, as product liability claims tend to be smaller than those experienced in the U.S. Changes in the nature of claims or the actual settlement amounts

25

could affect the adequacy of this estimate and require changes to the provisions. Because the liability is an estimate, the ultimate liability may be more or less than reported.

Workers' compensation liabilities in the U.S. are recognized for claims incurred (including claims incurred but not reported) and for changes in the status of individual case reserves. At the time a workers' compensation claim is filed, a liability is estimated to settle the claim. The liability for workers' compensation claims is determined based on management's estimates of the nature and severity of the claims and based on analysis provided by third party administrators and by various state statutes and reserve requirements. We have developed our own trend factors based on our specific claims experience. In other countries where workers' compensation costs are applicable, we maintain insurance coverage with limited deductible payments. Because the liability is an estimate, the ultimate liability may be more or less than reported.

We determine the trend factors for product liability and workers' compensation liabilities based on consultation with outside actuaries.

We maintain excess liability insurance with outside insurance carriers to minimize our risks related to catastrophic claims in excess of all self-insured positions. Any material change in the aforementioned factors could have an adverse impact on our operating results.

Legal contingencies

We are a defendant in numerous legal matters including those involving environmental law and product liability as discussed further in Part I, Item 1, "Product Liability, Environmental and Other Litigation Matters" of our Annual Report on Form 10-K for the year ended December 31, 2006. As required by Financial Accounting Standards Board Statement No. 5 "Accounting for Contingencies" (FAS 5), we determine whether an estimated loss from a loss contingency should be accrued by assessing whether a loss is deemed probable and the loss amount can be reasonably estimated, net of any applicable insurance proceeds. Estimates of potential outcomes of these contingencies are developed in consultation with outside counsel. While this assessment is based upon all available information, litigation is inherently uncertain and the actual liability to fully resolve this litigation cannot be predicted with any assurance of accuracy. Final settlement of these matters could possibly result in significant effects on our results of operations, cash flows and financial position.

Pension benefits

We account for our pension plans in accordance with Financial Accounting Standards Board Statement No. 87 "Employers Accounting for Pensions" (FAS 87) and Financial Accounting Standards Board Statement No. 158, "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans" an amendment of FASB Statements No. 87, 88, 106, and 132(R), (FAS 158). In applying FAS 87 and FAS 158, assumptions are made regarding the valuation of benefit obligations and the performance of plan assets. The primary assumptions are as follows:

- **Weighted average discount rate** this rate is used to estimate the current value of future benefits. This rate is adjusted based on movement in long-term interest rates.
- **Expected long-term rate of return on assets** this rate is used to estimate future growth in investments and investment earnings. The expected return is based upon a combination of historical market performance and anticipated future returns for a portfolio reflecting the mix of equity, debt and other investments indicative of our plan assets.
- **Rates of increase in compensation levels** this rate is used to estimate projected annual pay increases, which are used to determine the wage base used to project employees' pension benefits at retirement.

We determine these assumptions based on consultation with outside actuaries and investment advisors. Any variance in these assumptions could have a significant impact on future recognized pension costs, assets and liabilities.

Income taxes

We estimate and use our expected annual effective income tax rates to accrue income taxes. Effective tax rates are determined based on budgeted earnings before taxes, including our best estimate of permanent items that will affect the effective rate for the year. Management periodically reviews these rates with outside tax advisors and changes are made if material variances from expectations are identified.

We recognize deferred taxes for the expected future consequences of events that have been reflected in the consolidated financial statements in accordance with the rules of Financial Accounting Standards Board Statement No. 109 "Accounting for Income Taxes" (FAS 109). Under

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

FAS 109, deferred tax assets and liabilities are determined based on differences between the book values and tax bases of particular assets and liabilities, using tax rates in effect for the years in which the differences are expected to reverse. A valuation allowance is provided to offset any net deferred tax assets if, based upon the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. We consider estimated future taxable income and ongoing prudent tax planning strategies in assessing the need for a valuation allowance.

On January 1, 2007 we adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). The purpose of FIN 48 is to increase the comparability in financial reporting of income taxes.

26

FIN 48 requires that in order for a tax benefit to be recorded in the income statement, the item in question must meet the more-likely-than-not (greater than 50% likelihood of being sustained upon examination by the taxing authorities) threshold. The adoption of FIN 48 did not have a material effect on our financial statements. No cumulative effect was booked through beginning retained earnings.

As of the adoption date, we had gross unrecognized tax benefits of approximately \$4,800,000, of which approximately \$4,200,000, if recognized, would affect the effective tax rate. The difference between the amount of unrecognized tax benefits and the amount that would impact the effective tax rate consists of the federal tax benefit of state income tax items. During the first six months of 2007, we reduced our unrecognized tax benefits by approximately \$600,000 for a tax issue in Italy. We do not expect further significant changes in the amounts of unrecognized tax benefits within the next twelve months.

We are currently under audit by the Internal Revenue Service for the 2003 and 2004 tax years. The expected completion date for this audit is April 2008. Watts conducts business in a variety of locations throughout the world resulting in tax filings in numerous domestic and foreign jurisdictions. We are subject to tax examinations regularly as part of the normal course of business. Our major jurisdictions are the U.S., Canada, China, Netherlands, U.K., Germany, Italy and France. With few exceptions we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2002.

As of January 1, 2007 and July 1, 2007, we had approximately \$600,000 of interest related to uncertain tax positions. We account for interest and penalties related to uncertain tax positions as a component of income tax expense.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We use derivative financial instruments primarily to reduce exposure to adverse fluctuations in foreign exchange rates, interest rates and costs of certain raw materials used in the manufacturing process. We do not enter into derivative financial instruments for trading purposes. As a matter of policy, all derivative positions are used to reduce risk by hedging underlying economic exposure. The derivatives we use are instruments with liquid markets.

Our consolidated earnings, which are reported in United States dollars, are subject to translation risks due to changes in foreign currency exchange rates. This risk is concentrated in the exchange rate between the U.S. dollar and the euro; the U.S. dollar and the Canadian dollar; and the U.S. dollar and the Chinese yuan.

Our foreign subsidiaries transact most business, including certain intercompany transactions, in foreign currencies. Such transactions are principally purchases or sales of materials and are denominated in European currencies or the U.S. or Canadian dollar. We use foreign currency forward exchange contracts to manage the risk related to intercompany purchases that occur during the course of a year and certain open foreign currency denominated commitments to sell products to third parties. For 2007 and 2006, the amounts recorded in other (income) expense for the change in the fair value of such contracts was immaterial.

We have historically had a very low exposure on the cost of our debt to changes in interest rates. Interest rate swaps are used to mitigate the impact of interest rate fluctuations on certain variable rate debt instruments and reduce interest expense on certain fixed rate instruments. Information about our long-term debt including principal amounts and related interest rates appears in note 11 of notes to consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2006.

We purchase significant amounts of bronze ingot, brass rod, cast iron, stainless steel and plastic, which are utilized in manufacturing our many product lines. Our operating results can be adversely affected by changes in commodity prices if we are unable to pass on related price increases to our customers. 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 and passing increases in commodity costs to our customers, to the maximum extent possible, when they occur.

Item 4. Controls and Procedures

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934, as of the end of the period covered by this report, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures. In designing and evaluating our disclosure controls and procedures, we recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily applies its judgment in evaluating and implementing possible controls and procedures. The effectiveness of our disclosure controls and procedures is also necessarily limited by the staff and other resources available to us and the geographic diversity of our operations. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective, in that they provide reasonable

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

assurance that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act are accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

During the quarter ended July 1, 2007, certain subsidiaries in our North American segment implemented a new comprehensive

27

enterprise resource planning software, including a new accounting system. The system enhancement provides a scalable accounting platform for continued growth in the North American segment. The implementation of this system represents a material change in internal control over financial reporting. As part of the system implementation, we have reviewed the controls affected by the new system and have made the appropriate changes in our internal controls. Except for the new accounting system, there was no change in our internal control over financial reporting that occurred during the quarter ended July 1, 2007, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. In connection with these rules, we will continue to review and document our disclosure controls and procedures, including our internal control over financial reporting, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our business.

28

Part II. OTHER INFORMATION**Item 1. Legal Proceedings**

As disclosed in Part I, Item 1, "Product Liability, Environmental and Other Litigation Matters" of our Annual Report on Form 10-K for the year ended December 31, 2006, we are a party to litigation described as the James Jones Litigation and are also engaged in certain environmental remediation. This disclosure reported that the Relator had appealed the ruling of the California Superior Court for Los Angeles County that dismissed the claims of the remaining Phase II cities. On June 29, 2007, the Relator's appeal of the Phase II cities ruling was dismissed by the California Court of Appeal, but this appeal could be filed again at the end of the Armenta v. James Jones case in the trial court. This disclosure also reported that in the insurance coverage case with Zurich American Insurance Company, Zurich had appealed the denial of its motion to set aside as void the November 22, 2002 and August 6, 2004 summary adjudication indemnity payment orders. Zurich's appeal was dismissed on March 5, 2007, and, on June 13, 2007, the California Supreme Court declined to review this dismissal. There have been no other material developments with respect to our contingencies and environmental remediation proceedings during the quarter and six months ended July 1, 2007.

Item 1A. Risk Factors

This report includes 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 reflect Watts Water Technologies, Inc.'s current views about future results of operations and other forward-looking information. In some cases you can identify these statements by forward-looking words such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "should," "will" and "would" or similar words. You should not rely on forward-looking information because Watts' actual results may differ materially from those indicated by these forward-looking statements as a result of a number of important factors. These factors include, but are not limited to, the following: shortages in and pricing of raw materials and supplies including recent cost increases by suppliers of raw materials and our ability to pass these costs on to customers, loss of market share through competition, introduction of competing products by other companies, pressure on prices from competitors, suppliers, and/or customers, the identification and disclosure of material weaknesses in our internal control over financial reporting, failure to expand our markets through acquisitions, failure or delay in developing new products, lack of acceptance of new products, failure to manufacture products that meet required performance and safety standards, foreign exchange rate fluctuations, cyclicalities of industries, such as plumbing and heating wholesalers and home improvement retailers, in which the Company markets certain of its products, economic factors, such as the levels of housing starts and remodeling, affecting the markets where the Company's products are sold, manufactured, or marketed, environmental compliance costs, product liability risks, the results and timing of the Company's manufacturing restructuring plan, changes in the status of current litigation, including the James Jones case, and other risks and uncertainties discussed under the heading "Item 1 A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the Securities Exchange Commission and other reports we file from time to time with the Securities and Exchange Commission.

Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Stockholders of the Company was held on Wednesday, May 2, 2007.

The results of the voting on the proposals considered at the Annual Meeting of Stockholders were as follows:

1. Election of Directors

Each of the following persons were elected as a Director of the Company for a term expiring at the Company's 2008 Annual Meeting of Stockholders and until such director's successor is duly elected and qualified.

The voting results were as follows:

| Director | Votes For | Votes Withheld |
|-----------------------|------------|----------------|
| Robert L. Ayers | 98,983,068 | 602,307 |
| Timothy P. Horne | 98,917,273 | 668,102 |
| Ralph E. Jackson, Jr. | 98,074,986 | 1,510,389 |
| Kenneth J. McAvoy | 98,917,357 | 668,018 |
| John K. McGillicuddy | 99,004,808 | 580,567 |
| Gordon W. Moran | 98,025,015 | 1,560,360 |
| Daniel J. Murphy | 98,047,135 | 1,538,240 |
| Patrick S. O'Keefe | 98,958,804 | 626,571 |

Item 4. Submission of Matters to a Vote of Security Holders

2. Amendment of the Company's Restated Certificate of Incorporation

The proposed amendment to the Company's Restated Certificate of Incorporation, as amended, to increase the number of authorized shares of Class A Common Stock from 80,000,000 shares to 200,000,000 shares and to increase the number of authorized shares of

29

Edgar Filing: WATTS WATER TECHNOLOGIES INC - Form 10-Q

capital stock from 110,000,000 shares to 230,000,000 shares did not receive the requisite approval of a majority of the outstanding shares of the Company's Class A Common Stock voting as a single class and therefore was not approved. The voting results were as follows:

Class A Common Stock and Class B Common Stock voting together as a single class:

| | | |
|----------------------|--------------------------|------------------------|
| 86,219,192 votes FOR | 13,282,584 votes AGAINST | 83,599 votes ABSTAINED |
|----------------------|--------------------------|------------------------|

Class A Common Stock voting as a single class:

| | | |
|-----------------------|---------------------------|-------------------------|
| 13,780,392 shares FOR | 13,282,584 shares AGAINST | 83,599 shares ABSTAINED |
|-----------------------|---------------------------|-------------------------|

Class B Common Stock voting as a single class:

| | | |
|----------------------|------------------|--------------------|
| 7,243,880 shares FOR | 0 shares AGAINST | 0 shares ABSTAINED |
|----------------------|------------------|--------------------|

3. Amendment of the Management Stock Purchase Plan

The proposed amendment to the Company's Management Stock Purchase Plan, as amended and restated, to increase the number of shares of Class A Common Stock available for issuance thereunder from 1,000,000 shares to 2,000,000 shares was approved and the voting results were as follows:

| |
|----------------------------|
| 87,633,570 votes FOR |
| 5,012,423 votes AGAINST |
| 40,752 votes ABSTAINED |
| 6,898,630 broker non-votes |

4. Ratification of Independent Auditors

The selection of KPMG LLP as the independent auditors of the Company for the current fiscal year was ratified and the voting results were as follows:

| |
|------------------------|
| 99,132,737 votes FOR |
| 385,954 votes AGAINST |
| 66,684 votes ABSTAINED |

Item 6. Exhibits

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q and such Exhibit Index is incorporated herein by reference.

30

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.

WATTS WATER TECHNOLOGIES, INC.

Date: August 9, 2007

By:

/s/ Patrick S. O Keefe
Patrick S. O Keefe
Chief Executive Officer

Date: August 9, 2007

By:

/s/ William C. McCartney
William C. McCartney
Chief Financial Officer and Treasurer

31

EXHIBIT INDEX

Listed and indexed below are all Exhibits filed as part of this report.

| Exhibit No. | Description |
|-------------|--|
| 3.1 | Restated Certificate of Incorporation, as amended (1) |
| 3.2 | Amended and Restated By-Laws, as amended (2) |
| 10.1 | Watts Water Technologies, Inc. Management Stock Purchase Plan (Amended and Restated as of January 1, 2005), as amended |
| 10.2 | Watts Water Technologies, Inc. 2004 Stock Incentive Plan, as amended |
| 10.3 | Form of Non-Qualified Stock Option Agreement under the Watts Water Technologies, Inc. 2004 Stock Incentive Plan, as amended |
| 10.4 | Form of Restricted Stock Award Agreement for Employees under the Watts Water Technologies, Inc. 2004 Stock Incentive Plan, as amended |
| 11 | Statement Regarding Computation of Earnings per Common Share (3) |
| 31.1 | Certification of Principal Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended |
| 31.2 | Certification of Principal Financial Officer pursuant Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended |
| 32.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. 1350 |
| 32.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. 1350 |

(1) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q (File No. 001-11499) for the quarter ended July 3, 2005.

(2) Incorporated by reference to the Registrant's Current Report on Form 8-K (File No. 001-11499) dated February 5, 2007.

(3) Incorporated by reference to Note 6 to the Notes to Consolidated Financial Statements included in this Report.

32
