BADGER METER INC
Form 10-Q
October 29, 2015

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
for the quarterly period ended September 30, 2015

BADGER METER, INC.

4545 W. Brown Deer Road
Milwaukee, Wisconsin 53223
(414) 355-0400
A Wisconsin Corporation
IRS Employer Identification No. 39-0143280
Commission File No. 001-06706

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý
As of October 13, 2015, there were 14,512,987 shares of Common stock outstanding with a par value of $1 per share.

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Special Note Regarding Forward Looking Statements

Certain statements contained in this Quarterly Report on Form 10-Q, as well as other information provided from time to time by Badger Meter, Inc. (the “Company”) or its employees, may contain forward looking statements that involve risks and uncertainties that could cause actual results to differ materially from those in the forward looking statements. The words “anticipate,” “believe,” “estimate,” “expect,” “think,” “should,” “could” and “objective” or similar expressions are i to identify forward looking statements. All such forward looking statements are based on the Company’s then current views and assumptions and involve risks and uncertainties. Some risks and uncertainties that could cause actual results to differ materially from those expressed or implied in forward looking statements include those described in Item 1A of the Company’s Annual Report on Form 10-K for the year ended December 31, 2014 that include, among other things:

- the continued shift in the Company’s business from lower cost, manually read meters toward more expensive, value-added automatic meter reading (AMR) systems, advanced metering infrastructure (AMI) systems and advanced metering analytics (AMA) systems that offer more comprehensive solutions to customers’ metering needs;
- the success or failure of newer Company products;
- changes in competitive pricing and bids in both the domestic and foreign marketplaces, and continued intense price competition on government bid contracts for lower cost, manually read meters;
- the actions (or lack thereof) of the Company’s competitors;
- changes in the Company’s relationships with its alliance partners, primarily its alliance partners that provide radio solutions, and particularly those that sell products that do or may compete with the Company’s products;
- changes in the general health of the United States and foreign economies, including to some extent such things as the length and severity of global economic downturns, international or civil conflicts that affect international trade, the ability of municipal water utility customers to authorize and finance purchases of the Company’s products, the Company’s ability to obtain financing, housing starts in the United States, and overall industrial activity;
- unusual weather, weather patterns or other natural phenomena, including related economic and other ancillary effects of any such events;
- the timing and impact of government funding programs that stimulate national and global economies, as well as the impact of government budget cuts or partial shutdowns of governmental operations;
- changes in the cost and/or availability of needed raw materials and parts, such as volatility in the cost of brass castings as a result of fluctuations in commodity prices, particularly for copper and scrap metal at the supplier level, foreign-sourced electronic components as a result of currency exchange fluctuations and/or lead times, and plastic resin as a result of changes in petroleum and natural gas prices;
- the Company’s expanded role as a prime contractor for providing complete technology systems to governmental entities, which brings with it added risks, including but not limited to, the Company’s responsibility for subcontractor performance, additional costs and expenses if the Company and its subcontractors fail to meet the timetable agreed to with the governmental entity, and the Company’s expanded warranty and performance obligations;
- the Company’s ability to successfully identify, complete and integrate acquired businesses or products;
- changes in foreign economic conditions, particularly currency fluctuations in the United States dollar, the Euro and the Mexican peso;
- the inability to develop technologically advanced products;
- the failure of the Company’s products to operate as intended;
- the inability to protect the Company’s proprietary rights to its products;
- disruptions and other damages to information technology and other networks and operations due to breaches in data security;
- transportation delays or interruptions;
- the loss of certain single-source suppliers; and
- changes in laws and regulations, particularly laws dealing with the content or handling of materials used in the Company's products.

All of these factors are beyond the Company's control to varying degrees. Shareholders, potential investors and other readers are urged to consider these factors carefully in evaluating the forward looking statements contained in this Quarterly Report on Form 10-Q and are cautioned not to place undue reliance on such forward looking statements. The forward looking statements made in this document are made only as of the date of this document and the Company assumes no obligation, and disclaims any obligation, to update any such forward looking statements to reflect subsequent events or circumstances.

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Part I – Financial Information

Item 1 Financial Statements

BADGER METER, INC.

Consolidated Condensed Balance Sheets

	September 30, (Unaudited) (In thousands) 2015	December 31, 2014
Assets		
Current assets:		
Cash	$4,075	$6,656
Receivables	59,727	53,967
Inventories:		
Finished goods	26,349	25,362
Work in process	12,168	13,047
Raw materials	37,226	33,365
Total inventories	75,743	71,774
Prepaid expenses and other current assets	5,560	4,538
Deferred income taxes	4,282	4,170
Total current assets	149,387	141,105
Property, plant and equipment, at cost	187,983	177,400
Less accumulated depreciation	(101,475)	(95,594)
Net property, plant and equipment	86,508	81,806
Intangible assets, at cost less accumulated amortization	58,508	61,672
Prepaid pension	740	456
Other assets	9,231	8,397
Goodwill	48,443	47,722
Total assets	$352,817	$341,158
Liabilities and shareholders' equity		
Current liabilities:		
Short-term debt	$67,380	$75,927
Payables	18,946	16,059
Accrued compensation and employee benefits	9,581	11,901
Warranty and after-sale costs	2,351	1,739
Income and other taxes	2,358	1,449
Total current liabilities	100,616	107,075
Other long-term liabilities	4,211	1,735
Deferred income taxes	6,566	6,399
Accrued non-pension postretirement benefits	6,512	6,342
Other accrued employee benefits	5,486	5,276
Commitments and contingencies (Note 6)		
Shareholders' equity:		
Common stock	20,542	20,523
Capital in excess of par value	51,080	48,353
Reinvested earnings	201,451	189,365
Accumulated other comprehensive loss	(11,824)	(11,856)

Less: Employee benefit stock	(870)	(922)
Treasury stock, at cost	(30,953)	(31,132)
Total shareholders’ equity	229,426	214,331
Total liabilities and shareholders’ equity	$352,817	$341,158

See accompanying notes to unaudited consolidated condensed financial statements.

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BADGER METER, INC.

Consolidated Statements of Operations

	Three Months Ended September 30, (Unaudited)		Nine Months Ended September 30, (Unaudited)	
	(In thousands except share and per share amounts)			
	2015	2014	2015	2014
Net sales	$99,388	$96,271	$281,928	$275,429
Cost of sales	63,287	59,806	180,609	175,182
Gross margin	36,101	36,465	101,319	100,247
Selling, engineering and administration	22,477	20,482	68,460	62,353
Operating earnings	13,624	15,983	32,859	37,894
Interest expense, net	305	273	941	875
Earnings before income taxes	13,319	15,710	31,918	37,019
Provision for income taxes	4,992	5,479	11,463	13,342
Net earnings	$8,327	$10,231	$20,455	$23,677
Earnings per share:				
Basic	$0.58	$0.71	$1.42	$1.67
Diluted	$0.58	$0.71	$1.42	$1.66
Dividends declared per common share	$0.20	$0.19	$0.58	$0.55
Shares used in computation of earnings per share:				
Basic	14,392,517	14,312,847	14,373,470	14,177,483
Impact of dilutive securities	64,104	64,108	67,695	70,643
Diluted	14,456,621	14,376,955	14,441,165	14,248,126

See accompanying notes to unaudited consolidated condensed financial statements.

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BADGER METER, INC.

Consolidated Statements of Comprehensive Income

	Three Months Ended September 30, (Unaudited) (In thousands)		Nine Months Ended September 30, (Unaudited)	
	2015	2014	2015	2014
Net earnings	$8,327	$10,231	$20,455	$23,677
Other comprehensive income (loss):				
Foreign currency translation adjustment	(170)	(1,203)	(330)	(1,137)
Pension and postretirement benefits, net of tax	123	567	362	836
Comprehensive income	$8,280	$9,595	$20,487	$23,376

See accompanying notes to unaudited consolidated condensed financial statements.

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BADGER METER, INC.

Consolidated Condensed Statements of Cash Flows

	Nine Months Ended September 30 (Unaudited) (In thousands)	
	2015	2014
Operating activities:		
Net earnings	$20,455	$23,677
Adjustments to reconcile net earnings to net cash provided by (used for) operations:		
Depreciation	7,767	6,942
Amortization	7,627	3,821
Deferred income taxes	10	(98)
Noncurrent employee benefits	300	933
Stock-based compensation expense	1,161	1,089
Changes in:		
Receivables	(5,499)	(8,723)
Inventories	(3,983)	(3,554)
Prepaid expenses and other current assets	(1,232)	(412)
Liabilities other than debt	1,090	4,511
Total adjustments	7,241	4,509
Net cash provided by operations	27,696	28,186
Investing activities:		
Property, plant and equipment expenditures	(12,872)	(8,776)
Acquisitions, net of cash acquired and future payments	(3,273)	(1,500)
Net cash used for investing activities	(16,145)	(10,276)
Financing activities:		
Net decrease in short-term debt	(8,161)	(7,954)
Dividends paid	(8,369)	(7,900)
Proceeds from exercise of stock options	1,270	557
Tax benefit on stock options	296	161
Employee benefit stock purchase, net	(2)	—
Issuance of treasury stock	495	423
Net cash used for financing activities	(14,471)	(14,713)
Effect of foreign exchange rates on cash	339	(94)
Increase (decrease) in cash	(2,581)	3,103
Cash – beginning of period	6,656	7,263
Cash – end of period	$4,075	$10,366

See accompanying notes to unaudited consolidated condensed financial statements.

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BADGER METER, INC.

Notes to Unaudited Consolidated Condensed Financial Statements

Note 1 Basis of Presentation

In the opinion of management, the accompanying unaudited consolidated condensed financial statements of Badger Meter, Inc. (the “Company” or “Badger Meter”) contain all adjustments (consisting only of normal recurring accruals except as otherwise discussed) necessary to present fairly the Company’s consolidated condensed financial position at September 30, 2015, results of operations for the three- and nine-month periods ended September 30, 2015 and 2014, comprehensive income for the three- and nine-month periods ended September 30, 2015 and 2014, and cash flows for the nine-month periods ended September 30, 2015 and 2014. The results of operations for any interim period are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Note 2 Additional Financial Information Disclosures

The consolidated condensed balance sheet at December 31, 2014 was derived from amounts included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. Refer to the footnotes to the financial statements included in that report for a description of the Company’s accounting policies and for additional details of the Company’s financial condition. The details in those notes have not changed except as discussed below and as a result of normal adjustments in the interim.

Warranty and After-Sale Costs

The Company estimates and records provisions for warranties and other after-sale costs in the period in which the sale is recorded, based on a lag factor and historical warranty claim experience. After-sale costs represent a variety of activities outside of the written warranty policy, such as investigation of unanticipated problems after the customer has installed the product, or analysis of water quality issues. Changes in the Company’s warranty and after-sale costs reserve are as follows:

	Three months ended September 30,		Nine months ended September 30,	
(In thousands)	2015	2014	2015	2014
Balance at beginning of period	$2,360	$1,433	$1,739	$882
Net additions charged to earnings	337	366	1,576	1,544
Costs incurred	(346)	(659)	(964)	(1,286)
Balance at end of period	$2,351	$1,140	$2,351	$1,140

Note 3 Employee Benefit Plans

The Company maintains a non-contributory defined benefit pension plan that covers substantially all U.S. employees who were employed at December 31, 2011. After that date, no further benefits are being accrued in this plan. For the frozen pension plan, benefits are based primarily on years of service and, for certain employees, levels of compensation.

The Company also maintains supplemental non-qualified plans for certain officers and other key employees, and an Employee Savings and Stock Option Plan ("ESSOP").

The Company additionally has a postretirement healthcare benefit plan that provides medical benefits for certain U.S. retirees and eligible dependents hired prior to November 1, 2004. Employees are eligible to receive postretirement healthcare benefits upon meeting certain age and service requirements. No employees hired after October 31, 2004 are eligible to receive these benefits. This plan requires employee contributions to offset benefit costs.

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The following table sets forth the components of net periodic benefit cost for the three months ended September 30, 2015 and 2014 based on December 31, 2014 and 2013 actuarial measurement dates, respectively:

	Defined pension plan benefits		Other postretirement benefits	
(In thousands)	2015	2014	2015	2014
Service cost – benefits earned during the year	$8	$15	$36	$32
Interest cost on projected benefit obligations	450	496	62	67
Expected return on plan assets	(538)	(703)	—	—
Amortization of prior service cost	—	—	14	41
Amortization of net loss	177	174	—	—
Settlement expense	—	680	—	—
Net periodic benefit cost	$97	$662	$112	$140

The following table sets forth the components of net periodic benefit cost for the nine months ended September 30, 2015 and 2014 based on December 31, 2014 and 2013 actuarial measurement dates, respectively:

	Defined pension plan benefits		Other postretirement benefits	
(In thousands)	2015	2014	2015	2014
Service cost – benefits earned during the year	$22	$47	$110	$97
Interest cost on projected benefit obligations	1,350	1,489	188	202
Expected return on plan assets	(1,614)	(2,110)	—	—
Amortization of prior service cost	—	—	40	121
Amortization of net loss	532	521	—	—
Settlement expense	—	680	—	—
Net periodic benefit cost	$290	$627	$338	$420

The Company disclosed in its financial statements for the year ended December 31, 2014 that it was not required to make a minimum contribution to the defined benefit pension plan for the 2015 calendar year. The Company continues to believe no additional contributions will be required during 2015. During the third quarter of 2014, the Company began moving assets within its defined pension plan from its equity and fixed income policy towards a strategy more focused on fixed income. The intent was to more closely align assets with the corresponding pension liability and reduce exposure in equities.

The Company also disclosed in its financial statements for the year ended December 31, 2014 that it estimated it would pay $0.4 million in other postretirement benefits in 2015 based on actuarial estimates. As of September 30, 2015, $0.1 million of such benefits have been paid. The Company continues to believe that its estimated payments for the full year are reasonable. However, such estimates contain inherent uncertainties because cash payments can vary significantly depending on the timing of postretirement medical claims and the collection of the retirees' portion of certain costs. Note that the amount of benefits paid in calendar year 2015 will not impact the expense for postretirement benefits for 2015.

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Note 4 Accumulated Other Comprehensive Loss

Components of and changes in accumulated other comprehensive loss at September 30, 2015 are as follows:

(In thousands)	Unrecognized pension and postretirement benefits	Foreign currency	Total
Balance at beginning of period	$(11,891)	$35	$(11,856)
Other comprehensive loss before reclassifications	—	(330)	(330)
Amounts reclassified from accumulated other comprehensive loss, net of tax of $(0.2) million	362	—	362
Net current period other comprehensive income (loss), net of tax	362	(330)	32
Accumulated other comprehensive loss	$(11,529)	$(295)	$(11,824)

Details of reclassifications out of accumulated other comprehensive loss during the nine months ended September 30, 2015 are as follows:

(In thousands)	Amount reclassified from accumulated other comprehensive loss
Amortization of defined benefit pension items:	
Prior service cost (1)	$40
Amortization of actuarial loss (1)	532
Total before tax	572
Income tax benefit	(210)
Amount reclassified out of accumulated other comprehensive loss	$362

(1) These accumulated other comprehensive loss components are included in the computation of net periodic benefit cost in Note 3 “Employee Benefit Plans.”

Components of and changes in accumulated other comprehensive loss at September 30, 2014 are as follows:

(In thousands)	Unrecognized pension and postretirement benefits	Foreign currency	Total
Balance at beginning of period	$(9,280)	$1,756	$(7,524)
Other comprehensive income before reclassifications	—	(1,137)	(1,137)
Amounts reclassified from accumulated other comprehensive loss, net of tax of $(0.5) million	836	—	836
Net current period other comprehensive income (loss), net of tax	836	(1,137)	(301)
Accumulated other comprehensive (loss) income	$(8,444)	$619	$(7,825)

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Details of reclassifications out of accumulated other comprehensive loss during the nine months ended September 30, 2014 are as follows:

(In thousands)	Amount reclassified from accumulated other comprehensive loss
Amortization of defined benefit pension items:	
Prior service cost (1)	$ 121
Settlement expense (1)	680
Amortization of actuarial loss (1)	521
Total before tax	1,322
Income tax benefit	(486)
Amount reclassified out of accumulated other comprehensive loss	$ 836

(1) These accumulated other comprehensive loss components are included in the computation of net periodic benefit cost in Note 3 “Employee Benefit Plans.”

Note 5 Acquisitions

On August 17, 2015, the Company's wholly-owned subsidiary, National Meter & Automation (“National Meter”), acquired the assets of United Utilities, Inc. (“United Utilities”) of Smyrna, Tennessee, which was one of the Company's distributors serving Tennessee and Georgia. National Meter will do business in those and additional areas as United Utilities. The total purchase price was $3.3 million, which included assets of $0.8 million of receivables, $0.4 million of inventory, $0.1 million of fixed assets, and $2.0 million of intangibles and goodwill, offset by $2.9 million of pre-existing receivables. The intangible assets acquired are primarily customer relationships with an estimated average useful life of 12 years. The preliminary allocation of the purchase price to the assets acquired was based upon the estimated fair values at the date of acquisition. As of September 30, 2015, the Company had not completed its analysis for estimating the fair value of the assets acquired.

The United Utilities acquisition was accounted for under the purchase method, and accordingly, the results of operations were included in the Company's financial statements from the date of acquisition. The acquisition did not have a material impact on the Company's consolidated financial statements or the notes thereto at September 30, 2015.

On October 1, 2014, the Company acquired 100% of the outstanding common stock of National Meter and Automation, Inc. of Centennial, Colorado. The purchase was estimated to add approximately $15 million of incremental annual revenues to Badger Meter, after eliminating what would be intercompany sales. National Meter was a major distributor of Badger Meter products for the municipal water utility market, serving customers in Colorado, California, Nevada, Arizona and southern Wyoming. National Meter has become a regional distribution center for Badger Meter in the same areas. In addition to its primary product line of water meters and metering reading systems, National Meter provides services including meter testing, leak detection, water audits, and meter and meter reading system installation.

The total purchase consideration for National Meter was $22.9 million, which included $20.3 million in cash, a small working capital adjustment and settlement of pre-existing receivables. The Consolidated Balance Sheets at December 31, 2014 included $2.5 million of deferred payments, of which $2.0 million is payable in late 2015 and early 2016 and was recorded in payables, and $0.5 million is payable in early 2017 and was recorded in other long-term liabilities. The Company’s allocation of the purchase price as of December 31, 2014 included $3.9 million of receivables, $4.5

million of inventories, $2.8 million of property, plant and equipment, $9.8 million of intangibles, and $3.0 million of goodwill, offset by $0.1 million of current liabilities. The intangible assets acquired are primarily customer relationships with an estimated average useful life of 12 years. The preliminary allocation of the purchase price to the assets acquired and liabilities assumed was based upon the estimated fair values at the date of acquisition. The Company finalized the valuation at September 30, 2015 with no changes.

The National Meter acquisition was accounted for under the purchase method, and accordingly, the results of operations were included in the Company’s financial statements from the date of acquisition. The acquisition did not have a material impact on the Company’s consolidated financial statements or the notes thereto for 2014.

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Note 6 Contingencies, Litigation and Commitments

In the normal course of business, the Company is named in legal proceedings. There are currently no material legal proceedings pending with respect to the Company. The more significant legal proceedings are discussed below.

The Company is subject to contingencies related to environmental laws and regulations. The Company is named as one of many potentially responsible parties in two landfill lawsuits. The landfill sites are impacted by the Federal Comprehensive Environmental Response, Compensation and Liability Act and other environmental laws and regulations. At this time, the Company does not believe the ultimate resolution of these matters will have a material adverse effect on the Company's financial position or results of operations, either from a cash flow perspective or on the financial statements as a whole. This belief is based on the Company's assessment of its limited past involvement with these landfill sites as well as the substantial involvement of and government focus on other named third parties with these landfill sites. However, due to the inherent uncertainties of such proceedings, the Company cannot predict the ultimate outcome of any of these matters. A future change in circumstances with respect to these specific matters or with respect to sites formerly or currently owned or operated by the Company, off-site disposal locations used by the Company, and property owned by third parties that is near such sites, could result in future costs to the Company and such amounts could be material. Expenditures for compliance with environmental control provisions and regulations during 2014 and the first three quarters of 2015 were not material.

Like other companies in recent years, the Company is named as a defendant in numerous pending multi-claimant/multi-defendant lawsuits alleging personal injury as a result of exposure to asbestos, manufactured by third parties, and integrated into or sold with a very limited number of the Company's products. The Company is vigorously defending itself against these claims. Although it is not possible to predict the ultimate outcome of these matters, the Company does not believe the ultimate resolution of these issues will have a material adverse effect on the Company's financial position or results of operations, either from a cash flow perspective or on the financial statements as a whole. This belief is based in part on the fact that no claimant has proven or substantially demonstrated asbestos exposure caused by products manufactured or sold by the Company and that a number of cases have been voluntarily dismissed.

The Company relies on single suppliers for most brass castings and certain electronic subassemblies in several of its product lines. The Company believes these items would be available from other sources, but that the loss of certain suppliers would result in a higher cost of materials, delivery delays, short-term increases in inventory and higher quality control costs in the short term. The Company attempts to mitigate these risks by working closely with key suppliers, purchasing minimal amounts from alternative suppliers and by purchasing business interruption insurance where appropriate.

The Company reevaluates its exposures on a periodic basis and makes adjustments to reserves as appropriate.

Note 7 Income Taxes

The provision for income taxes as a percentage of earnings before income taxes for the third quarter of 2015 was 37.5% compared to 34.9% in the third quarter of 2014. The provision for income taxes as a percentage of earnings before income taxes for the first three quarters of 2015 was 35.9% compared to 36.0% in the first three quarters of 2014. Interim provisions are tied to an estimate of the overall annual r