EATON CORP
Form 10-Q
May 04, 2007

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**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 March 31, 2007**
**Commission file number 1-1396**
**EATON CORPORATION**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Ohio | 34-0196300 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification Number) |
| Eaton Center, Cleveland, Ohio | 44114-2584 |
| (Address of principal executive offices) | (Zip Code) |

(216) 523-5000
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

There were 146.5 million Common Shares outstanding as of March 31, 2007.

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# PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

**Eaton Corporation**
**Statements of Consolidated Income**

| | Three months ended March 31 | |
|---|---|---|
| (Millions except for per share data) | 2007 | 2006 |
| **Net sales** | $ 3,153 | $ 2,991 |
| Cost of products sold | 2,256 | 2,149 |
| Selling & administrative expense | 508 | 479 |
| Research & development expense | 83 | 80 |
| Interest expense-net | 30 | 28 |
| Other expense-net | 7 | 4 |
| **Income from continuing operations before income taxes** | 269 | 251 |
| Income taxes | 35 | 45 |
| **Income from continuing operations** | 234 | 206 |
| Income from discontinued operations | | 2 |
| **Net income** | $ 234 | $ 208 |
| **Net income per Common Share assuming dilution** | | |
| Continuing operations | $ 1.56 | $ 1.35 |
| Discontinued operations | | .01 |
| | $ 1.56 | $ 1.36 |
| Average number of Common Shares outstanding assuming dilution | 150.0 | 153.1 |
| **Net income per Common Share basic** | | |
| Continuing operations | $ 1.59 | $ 1.37 |
| Discontinued operations | | .01 |
| | $ 1.59 | $ 1.38 |
| Average number of Common Shares outstanding basic | 147.6 | 150.4 |
| **Cash dividends paid per Common Share** | $ .43 | $ .35 |

See accompanying notes.

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**Eaton Corporation**
**Condensed Consolidated Balance Sheets**

| (Millions) | Mar. 31, 2007 | Dec. 31, 2006 |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Cash | $ 106 | $ 114 |
| Short-term investments | 313 | 671 |
| Accounts receivable | 2,139 | 1,928 |
| Inventories | 1,389 | 1,293 |
| Deferred income taxes & other current assets | 458 | 402 |
| | 4,405 | 4,408 |
| Property, plant & equipment-net | 2,275 | 2,271 |
| Goodwill | 3,425 | 3,034 |
| Other intangible assets | 1,385 | 969 |
| Deferred income taxes & other assets | 750 | 735 |
| | $ 12,240 | $ 11,417 |
| **Liabilities & Shareholders Equity** | | |
| Current liabilities | | |
| Short-term debt, primarily commercial paper | $ 676 | $ 490 |
| Current portion of long-term debt | 61 | 322 |
| Accounts payable | 1,060 | 1,050 |
| Accrued compensation | 256 | 305 |
| Other current liabilities | 1,082 | 1,123 |
| | 3,135 | 3,290 |
| Long-term debt | 2,553 | 1,774 |
| Pension liabilities | 814 | 942 |
| Other postretirement liabilities | 780 | 766 |
| Other long-term liabilities | 680 | 539 |
| Shareholders equity | 4,278 | 4,106 |
| | $ 12,240 | $ 11,417 |

See accompanying notes.

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**Eaton Corporation**
**Condensed Statements of Consolidated Cash Flows**

| (Millions) | Three months ended March 31 2007 | 2006 |
|---|---|---|
| **Net cash provided by (used in) operating activities** | | |
| Net income | $ 234 | $ 208 |
| Adjustments to reconcile to net cash provided by operating activities | | |
| Depreciation & amortization | 109 | 106 |
| Pension liabilities | 47 | 45 |
| Changes in working capital, excluding acquisitions of businesses | (359) | (137) |
| Voluntary contributions to United States & United Kingdom qualified pension plans | (156) | (103) |
| Other-net | 11 | 8 |
| | (114) | 127 |
| **Net cash provided by (used in) investing activities** | | |
| Expenditures for property, plant & equipment | (67) | (62) |
| Cash paid for acquisitions of businesses | (733) | (143) |
| Sales (purchases) of short-term investments-net | 383 | (108) |
| Other-net | (29) | (26) |
| | (446) | (339) |
| **Net cash provided by (used in) financing activities** | | |
| Borrowings with original maturities of more than three months | | |
| Proceeds | 1,205 | 157 |
| Payments | (358) | (51) |
| (Payments) borrowings with original maturities of less than three months-net, primarily commercial paper | (164) | 82 |
| Cash dividends paid | (63) | (52) |
| Proceeds from exercise of employee stock options | 85 | 59 |
| Income tax benefit from exercise of employee stock options | 25 | 15 |
| Purchase of Common Shares | (178) | |
| | 552 | 210 |
| Total (decrease) in cash | (8) | (2) |
| Cash at beginning of year | 114 | 110 |
| Cash at end of period | $ 106 | $ 108 |

See accompanying notes.

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## Notes to Condensed Consolidated Financial Statements

Dollars in millions, except per share data (per share data assume dilution)

### Preparation of Financial Statements

The condensed consolidated financial statements of Eaton Corporation (Eaton or the Company) are unaudited. However, in the opinion of management, all adjustments have been made that are necessary for a fair presentation of financial position, results of operations and cash flows for the stated periods. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s 2006 Annual Report on Form 10-K. The interim period results are not necessarily indicative of the results to be expected for the full year.

### Financial Presentation Changes

Certain amounts for 2006 have been reclassified to conform to the current year presentation.

### Acquisitions of Businesses

In 2007 and 2006, Eaton acquired certain businesses in separate transactions. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. A summary of these transactions follows:

| Acquired business | Date of acquisition | Business segment | Annual sales |
|---|---|---|---|
| Argo-Tech<br>*A U.S.-based manufacturer of high performance aerospace engine fuel pumps and systems, airframe fuel pumps and systems, and ground fueling systems for commercial and military aerospace markets* | March 16, 2007 | Fluid Power | $206 for 2006 |
| Power Protection Business of Power Products Ltd.<br>*A Czech Republic distributor and service provider of Powerware and other uninterruptible power systems* | February 7, 2007 | Electrical | $3 for 2006 |
| Schreder-Hazemeyer<br>*Eaton acquired the remaining 50% ownership of the Belgium manufacturer of low and medium voltage electrical distribution switchgear* | December 1, 2006 | Electrical | $9 for 2006 |
| Diesel fuel processing technology & associated assets of Catalytica Energy Systems Inc.<br>*A U.S. developer of emission control solutions for Trucks* | October 26, 2006 | Truck | None |
| Senyuan International Holdings Limited<br>*A China-based manufacturer of vacuum circuit breakers and other electrical switchgear components* | September 14, 2006 | Electrical | $47 for 2005 |
| Ronningen-Petter business unit of Dover Resources, Inc.<br>*A U.S.-based manufacturer of industrial fine filters and components* | September 5, 2006 | Fluid Power | $30 for 2005 |
| Synflex business unit of Saint-Gobain Performance Plastics Corp.<br>*A U.S.-based manufacturer of thermoplastic hose and tubing* | March 31, 2006 | Fluid Power | $121 for 2005 |
| | March 24, 2006 | Electrical | $11 for 2005 |

Marina Power & Lighting
*A U.S. manufacturer of marine duty electrical distribution products*
On May 2, 2007, the Company announced it had acquired the fuel components division of Saturn Electronics & Engineering, Inc. This business had sales of $28 in 2006, and will be integrated into the Automotive segment.
On April 5, 2007, Eaton announced it had acquired Aphel Technologies Limited, a U.K.-based global supplier of high density, fault-tolerant power distribution solutions for datacenters, technical offices, laboratories and retail environments. This business had sales of $12 in 2006, and will be integrated into the Electrical segment.

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Eaton has undertaken restructuring activities at acquired businesses, including workforce reductions, plant consolidations and facility closures. In accordance with EITF Issue No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination, liabilities for these restructuring activities were recorded in the allocation of the purchase price related to the acquired business. A summary of these liabilities, and utilization of the various components, follows:

| | Workforce Reductions | | Plant closing | |
|---|---|---|---|---|
| | Employees | Dollars | & other | Total |
| Balance at January 1, 2007 | 1,076 | $ 33 | $ 22 | $ 55 |
| Liabilities recorded in 2007 | 59 | 4 | 14 | 18 |
| Utilized in 2007 | (177) | (4) | (15) | (19) |
| Balance at March 31, 2007 | 958 | $ 33 | $ 21 | $ 54 |

In accordance with EITF Issue No. 95-3, the Company finalizes its restructuring plans no later than one year from the date of the acquisition.

**Acquisition Integration Charges**

In 2007 and 2006, Eaton incurred charges related to the integration of acquired businesses. Charges in 2007 related to the integration of primarily the following acquisitions: In the Electrical segment, Powerware and Senyuan; and several acquisitions in the Fluid Power segment including the acquired operations of Cobham, PerkinElmer, and Hayward. Charges in 2006 related to the integration of primarily the following acquisitions: In the Electrical segment, Powerware; in the Fluid Power segment, Cobham, PerkinElmer, Hayward, and Winner; in the Truck segment, Pigozzi; and in the Automotive segment Tractech and Morestana. A summary of these charges follows:

| | Three months ended March 31 | |
|---|---|---|
| | 2007 | 2006 |
| Electrical | $ 2 | $ 2 |
| Fluid Power | 11 | 3 |
| Truck | | 2 |
| Automotive | | 2 |
| Pretax charges | $ 13 | $ 9 |
| After-tax charges | $ 9 | $ 6 |
| Per Common Share | $ .06 | $ .04 |

The acquisition integration charges were included in the Statements of Consolidated Income in Cost of products sold or Selling & administrative expense, as appropriate. The charges reduced Operating profit of the related business segment as shown in Business Segment Information below.

**Summary of Acquisition Integration and Excel 07 Plant Closing Charges**

A summary of liabilities related to acquisition integration charges, and remaining liabilities for the plant closings related to the Excel 07 program that was implemented in 2006, follows:

| | Workforce Reductions | | Plant closing | |
|---|---|---|---|---|
| | Employees | Dollars | & other | Total |
| Balance at January 1, 2007 | 1,603 | $ 49 | $ 6 | $ 55 |

| | | | | |
|---|---|---|---|---|
| Charges in 2007 | | 1 | 14 | 15 |
| Utilized in 2007 | (480) | (18) | (16) | (34) |
| Balance at March 31, 2007 | 1,123 | $ 32 | $ 4 | $ 36 |

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**Retirement Benefit Plans Expense**

The components of benefit costs follow:

| | Three months ended March 31 | | | |
|---|---|---|---|---|
| | Pension benefits | | Other postretirement benefits | |
| | 2007 | 2006 | 2007 | 2006 |
| Service cost | $ (36) | $ (35) | $ (3) | $ (4) |
| Interest cost | (41) | (36) | (12) | (12) |
| Expected return on plan assets | 45 | 41 | | |
| Amortization | (19) | (17) | (3) | (3) |
| | (51) | (47) | (18) | (19) |
| Curtailment loss | | (2) | | |
| Settlement loss | (7) | (11) | | |
| | $ (58) | $ (60) | $ (18) | $ (19) |

In January 2007, Eaton made a voluntary contribution of $150 to its United States qualified pension plan.

**Income Taxes**

The effective income tax rate for continuing operations for first quarter 2007 was 12.9% compared to 17.8% for first quarter 2006 and 17.0% for full year 2006, excluding the benefits resulting from the favorable resolution of income tax items in 2006. The lower rate in first quarter 2007 was due to several factors, the largest being the favorable resolution of multiple state income tax issues, as well as a change in income tax law in a foreign jurisdiction that eliminated an uncertainty in the application of tax law. Excluding the benefits of these factors, the income tax rate in first quarter 2007 would have been 16.7%.

Effective January 1, 2007, Eaton adopted Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . The net income tax assets recognized under FIN No. 48 did not differ from the net assets recognized before adoption, and, therefore, the Company did not record a cumulative-effect adjustment related to the adoption of FIN No. 48.

As of the adoption date of FIN No. 48, the Company has gross unrecognized worldwide income tax benefits of $93. The majority of these unrecognized income tax benefits involves the Company s foreign operations. Unrecognized income tax benefits for state and local issues comprise the next largest component. The net impact on the effective tax rate would be $83 if all income tax benefits were recognized.

The resolution of the majority of the Company s unrecognized income tax benefits is dependent on uncontrollable factors such as law changes, new case law, the willingness of the income tax authority to settle, including the timing thereof and other factors. Therefore, for the majority of unrecognized income tax benefits, it is not reasonably possible to estimate the increase or decrease in the next 12 months. For each of the unrecognized income tax benefits where it is possible to estimate the increase or decrease in the balance within the next 12 months, the Company does not anticipate any significant change.

The Company, or its subsidiaries, files income tax returns in the United States and other foreign jurisdictions. The Company is no longer subject to U.S. Federal income tax examinations for years before 2003. With only a few exceptions, the Company is no longer subject to state and local income tax examinations for years before 2003, or foreign examinations for years before 2001. The Internal Revenue Service (IRS) is currently conducting an examination of the Company s U.S. income tax returns for 2003 and 2004. The Company is also under examination for the income tax filings in various state and foreign jurisdictions. As of the adoption of FIN No. 48, the Company does not anticipate any adjustments that would result in a material change in financial position.

The Company recognizes interest and penalties accrued related to unrecognized income tax benefits in the provision for income tax expense. The Company has accrued penalties in jurisdictions where they are automatically applied to any deficiency, regardless of the merit of the position. As of the adoption date of FIN No. 48, the Company has accrued approximately $23 for the payment of interest and penalties.

**Long-term Debt**

In February 2007, Eaton entered into a $750 short-term 364-day revolving credit agreement. In March, the Company issued a $281 note at 5.6% under this new revolving credit agreement, to partially finance the acquisition of Argo-Tech. This note was classified as long-term debt on the Consolidated Balance Sheet at March 31st because the Company intends, and has the ability under its $1.5 billion of long-term revolving credit agreements, to refinance this

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note on a long-term basis. The Company currently has no plans to borrow any additional funds under the new short-term revolving credit agreement. In March 2007, Eaton issued $250 of 5.3% notes due 2017 and $250 of 5.8% notes due 2037. The proceeds from the issuance of the notes were used to repay $263 of 6% notes due in 2007, and to repay commercial paper.

**Common Shares**

On January 22, 2007, Eaton announced that it had authorized a new 10 million Common Share repurchase program, replacing the 1.3 million shares remaining from the 10 million share repurchase authorization approved in April 2005. The shares are expected to be repurchased over time, depending on market conditions, the market price of the Company s Common Shares, the Company s capital levels and other considerations. The number of Common Shares repurchased in the open market in 2007 and 2006, and the total cost, follow:

| | Shares repurchased | | Cost | |
|---|---|---|---|---|
| (Shares in millions) | 2007 | 2006 | 2007 | 2006 |
| First quarter | 2.312 | | $ 178 | |
| Second quarter | | 0.895 | | $ 63 |
| Third quarter | | 1.051 | | 69 |
| Fourth quarter | | 3.340 | | 254 |
| | 2.312 | 5.286 | $ 178 | $ 386 |

In first quarter 2007, 2.4 million stock options were exercised resulting in cash proceeds of $85.

**Net Income per Common Share**

A summary of the calculation of net income per Common Share assuming dilution and basic follows (shares in millions):

| | Three months ended March 31 | |
|---|---|---|
| | 2007 | 2006 |
| Income from continuing operations | $ 234 | $ 206 |
| Income from discontinued operations | | 2 |
| Net income | $ 234 | $ 208 |
| Average number of Common Shares outstanding assuming dilution | 150.0 | 153.1 |
| Less dilutive effect of stock options | 2.4 | 2.7 |
| Average number of Common Shares outstanding basic | 147.6 | 150.4 |
| Net income per Common Share assuming dilution | | |
| Continuing operations | $ 1.56 | $ 1.35 |
| Discontinued operations | | .01 |
| | $ 1.56 | $ 1.36 |
| Net income per Common Share basic | | |
| Continuing operations | $ 1.59 | $ 1.37 |

| | | |
|---|---|---|
| Discontinued operations | | .01 |
| | $ 1.59 | $ 1.38 |

**Comprehensive Income (Loss)**

The components of comprehensive income (loss) follow:

| | Three months ended March 31 | |
|---|---|---|
| | 2007 | 2006 |
| Net income | $ 234 | $ 208 |
| Foreign currency translation | 27 | 25 |
| Other | 15 | (5) |
| Comprehensive income | $ 276 | $ 228 |

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**Inventories**

The components of inventories follow:

| | Mar. 31, 2007 | Dec. 31, 2006 |
|---|---|---|
| Raw materials | $ 630 | $ 570 |
| Work-in-process & finished goods | 867 | 825 |
| Inventories at FIFO | 1,497 | 1,395 |
| Excess of FIFO over LIFO cost | (108) | (102) |
| | $ 1,389 | $ 1,293 |

**Business Segment Information**

| | Three months ended March 31 | |
|---|---|---|
| | 2007 | 2006 |
| **Net sales** | | |
| Electrical | $ 1,084 | $ 965 |
| Fluid Power | 1,041 | 974 |
| Truck | 576 | 607 |
| Automotive | 452 | 445 |
| | $ 3,153 | $ 2,991 |
| **Operating profit** | | |
| Electrical | $ 120 | $ 103 |
| Fluid Power | 117 | 104 |
| Truck | 107 | 117 |
| Automotive | 63 | 53 |
| **Corporate** | | |
| Amortization of intangible assets | (16) | (11) |
| Interest expense-net | (30) | (28) |
| Minority interest | (2) | (1) |
| Pension & other postretirement benefit expense | (38) | (40) |
| Stock option expense | (7) | (6) |
| Other corporate expense net | (45) | (40) |
| **Income from continuing operations before income taxes** | 269 | 251 |
| Income taxes | 35 | 45 |
| **Income from continuing operations** | 234 | 206 |
| Income from discontinued operations | | 2 |
| **Net income** | $ 234 | $ 208 |

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**Item 2. Management s Discussion & Analysis of Financial Condition & Results of Operations**

Dollars in millions, except for per share data (per share data assume dilution)

**Overview of the Company**

Eaton is a diversified industrial manufacturer with 2006 sales of $12.4 billion. The Company is a global leader in the design, manufacture, marketing and servicing of electrical systems and components for power quality, distribution and control; fluid power systems and services for industrial, mobile and aircraft equipment; intelligent truck drivetrain systems for safety and fuel economy; and automotive engine air management systems, powertrain solutions and specialty controls for performance, fuel economy and safety. The principal markets for the Electrical segment are industrial, non-residential and residential construction, commercial, government, institutional, and telecommunications customers. These customers are generally concentrated in North America, Europe and Asia/Pacific; however, sales are made globally. Sales are made directly by Eaton and indirectly through distributors and manufacturers representatives to such customers. The principal markets for the Fluid Power segment are original equipment manufacturers and after-market customers of off-highway agricultural vehicles, constructio