PENTAIR INC
Form 10-Q
October 26, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended October 1, 2011

OR

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

Commission file number 000-04689

Pentair, Inc.

(Exact name of Registrant as specified in its charter)

Minnesota	**41-0907434**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification number)**
5500 Wayzata Blvd, Suite 800, Golden Valley, Minnesota	**55416**
(Address of principal executive offices)	**(Zip code)**

Registrant s telephone number, including area code: (763) 545-1730

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 x 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 (§223.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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	x	Accelerated filer	¨
Non-accelerated filer	¨ (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 x

On October 1, 2011, 98,566,023 shares of Registrant s common stock were outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Income (Unaudited)

In thousands, except per-share data	Three months ended October 1, 2011	Three months ended October 2, 2010	Nine months ended October 1, 2011	Nine months ended October 2, 2010
Net sales	$ 890,546	$ 773,735	$ 2,590,994	$ 2,276,915
Cost of goods sold	618,484	537,193	1,782,137	1,578,503
Gross profit	272,062	236,542	808,857	698,412
Selling, general and administrative	159,068	128,854	462,260	392,787
Research and development	20,091	16,865	58,095	51,075
Operating income	92,903	90,823	288,502	254,550
Other (income) expense:				
Equity income of unconsolidated subsidiaries	(574)	(347)	(1,481)	(1,806)
Net interest expense	17,373	8,953	41,311	27,049
Income from continuing operations before income taxes and noncontrolling interest	76,104	82,217	248,672	229,307
Provision for income taxes	24,050	26,488	76,447	75,937
Income from continuing operations	52,054	55,729	172,225	153,370
Gain on disposal of discontinued operations, net of tax		549		1,666
Net income before noncontrolling interest	52,054	56,278	172,225	155,036
Noncontrolling interest	962	1,228	3,880	3,584
Net income attributable to Pentair, Inc.	$ 51,092	$ 55,050	$ 168,345	$ 151,452
Net income from continuing operations attributable to Pentair, Inc.	$ 51,092	$ 54,501	$ 168,345	$ 149,786
Earnings per common share attributable to Pentair, Inc.				
Basic				
Continuing operations	$ 0.52	$ 0.55	$ 1.71	$ 1.53
Discontinued operations		0.01		0.01
Basic earnings per common share	$ 0.52	$ 0.56	$ 1.71	$ 1.54
Diluted				
Continuing operations	$ 0.51	$ 0.55	$ 1.69	$ 1.51
Discontinued operations				0.01
Diluted earnings per common share	$ 0.51	$ 0.55	$ 1.69	$ 1.52
Weighted average common shares outstanding				
Basic	98,472	98,298	98,228	98,105

Diluted	99,802	99,514	99,759	99,326
Cash dividends declared per common share	$ 0.20	$ 0.19	$ 0.60	$ 0.57

See accompanying notes to condensed consolidated financial statements.

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Pentair, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Unaudited)

In thousands, except share and per-share data	**October 1, 2011**	**December 31, 2010**	**October 2, 2010**
Assets			
Current assets			
Cash and cash equivalents	$ 52,665	$ 46,056	$ 56,995
Accounts and notes receivable, net	556,688	516,905	490,221
Inventories	459,916	405,356	410,072
Deferred tax assets	61,411	56,349	50,991
Prepaid expenses and other current assets	147,568	44,631	48,555
Total current assets	1,278,248	1,069,297	1,056,834
Property, plant and equipment, net	394,922	329,435	327,602
Other assets			
Goodwill	2,516,692	2,066,044	2,070,911
Intangibles, net	619,262	453,570	461,378
Other	73,319	55,187	56,033
Total other assets	3,209,273	2,574,801	2,588,322
Total assets	$ 4,882,443	$ 3,973,533	$ 3,972,758
Liabilities and Shareholders Equity			
Current liabilities			
Short-term borrowings	$ 29,705	$ 4,933	$ 4,180
Current maturities of long-term debt	1,194	18	37
Accounts payable	281,448	262,357	266,416
Employee compensation and benefits	117,538	107,995	100,626
Current pension and post-retirement benefits	8,733	8,733	8,948
Accrued product claims and warranties	43,920	42,295	40,783
Income taxes	26,283	5,964	22,202
Accrued rebates and sales incentives	45,231	33,559	39,066
Other current liabilities	163,550	80,942	90,286
Total current liabilities	717,602	546,796	572,544
Other liabilities			
Long-term debt	1,317,454	702,521	673,265
Pension and other retirement compensation	190,221	209,859	219,463
Post-retirement medical and other benefits	26,933	30,325	28,506
Long-term income taxes payable	23,891	23,507	23,857
Deferred tax liabilities	228,737	169,198	147,772
Other non-current liabilities	79,489	86,295	93,681
Total liabilities	2,584,327	1,768,501	1,759,088
Commitments and contingencies			
Shareholders equity			
Common shares par value $0.16 2/3; 98,566,023, 98,409,192 and 98,960,604 shares issued and outstanding, respectively	16,427	16,401	16,493

Additional paid-in capital	481,028	474,489	489,028
Retained earnings	1,733,281	1,624,605	1,597,110
Accumulated other comprehensive loss	(48,039)	(22,342)	(4,955)
Noncontrolling interest	115,419	111,879	115,994
Total shareholders equity	2,298,116	2,205,032	2,213,670
Total liabilities and shareholders equity	$ 4,882,443	$ 3,973,533	$ 3,972,758

See accompanying notes to condensed consolidated financial statements.

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Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

In thousands	Nine months ended October 1, 2011	Nine months ended October 2, 2010
Operating activities		
Net income before noncontrolling interest	$ 172,225	$ 155,036
Adjustments to reconcile net income to net cash provided by (used for) operating activities		
Gain on disposal of discontinued operations		(1,666)
Equity income of unconsolidated subsidiaries	(1,481)	(1,806)
Depreciation	49,079	43,141
Amortization	29,807	19,742
Deferred income taxes	4,445	4,866
Stock compensation	14,695	16,598
Excess tax benefits from stock-based compensation	(3,137)	(2,193)
Loss on sale of assets	702	166
Changes in assets and liabilities, net of effects of business acquisitions and dispositions		
Accounts and notes receivable	22,657	(36,216)
Inventories	15,633	(49,822)
Prepaid expenses and other current assets	(26,380)	(1,476)
Accounts payable	(45,759)	60,162
Employee compensation and benefits	(12,334)	21,600
Accrued product claims and warranties	115	6,556
Income taxes	18,045	18,013
Other current liabilities	46,924	15,493
Pension and post-retirement benefits	(23,636)	(15,197)
Other assets and liabilities	(21,041)	(3,754)
Net cash provided by (used for) operating activities	240,559	249,243
Investing activities		
Capital expenditures	(53,063)	(42,981)
Proceeds from sale of property and equipment	139	340
Acquisitions, net of cash acquired	(733,105)	
Other	(441)	(1,232)
Net cash provided by (used for) investing activities	(786,470)	(43,873)
Financing activities		
Net short-term borrowings	24,772	1,975
Proceeds from long-term debt	1,370,423	493,821
Repayment of long-term debt	(771,793)	(624,007)
Debt issuance costs	(8,973)	(50)
Excess tax benefits from stock-based compensation	3,137	2,193
Stock issued to employees, net of shares withheld	11,788	7,861
Repurchases of common stock	(12,785)	(2,786)
Dividends paid	(59,669)	(56,584)
Net cash provided by (used for) financing activities	556,900	(177,577)
Effect of exchange rate changes on cash and cash equivalents	(4,380)	(4,194)
Change in cash and cash equivalents	6,609	23,599
Cash and cash equivalents, beginning of period	46,056	33,396

Cash and cash equivalents, end of period	$ 52,665	$ 56,995

See accompanying notes to condensed consolidated financial statements.

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Pentair, Inc.

Condensed Consolidated Statements of Changes in Shareholders Equity (Unaudited)

In thousands, except share and per-share data	Common shares Number	Common shares Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Total Pentair, Inc.	Noncontrolling interest	Total	Comprehensive income attributable to Pentair, Inc.
Balance - December 31, 2010	98,409,192	$ 16,401	$ 474,489	$ 1,624,605	$ (22,342)	$ 2,093,153	$ 111,879	$ 2,205,032	
Net income				168,345		168,345	3,880	172,225	$ 168,345
Change in cumulative translation adjustment					(29,263)	(29,263)	(340)	(29,603)	(29,263)
Changes in market value of derivative financial instruments, net of $2,303 tax					3,566	3,566		3,566	3,566
Comprehensive income									$ 142,648
Cash dividends - $0.60 per common share				(59,669)		(59,669)		(59,669)	
Share repurchase	(397,126)	(66)	(12,719)			(12,785)		(12,785)	
Exercise of stock options, net of 181,648 shares tendered for payment	601,207	100	13,091			13,191		13,191	
Issuance of restricted shares, net of cancellations	27,532	5	1,417			1,422		1,422	
Amortization of restricted shares			743			743		743	
Shares surrendered by employees to pay taxes	(74,782)	(13)	(2,752)			(2,765)		(2,765)	
Stock compensation			6,759			6,759		6,759	
Balance - October 1, 2011	98,566,023	$ 16,427	$ 481,028	$ 1,733,281	$ (48,039)	$ 2,182,697	$ 115,419	$ 2,298,116	

In thousands, except share and per-share data	Common shares Number	Common shares Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Total Pentair, Inc.	Noncontrolling interest	Total	Comprehensive income (loss) attributable to Pentair, Inc.
Balance - December 31, 2009	98,655,506	$ 16,442	$ 472,807	$ 1,502,242	$ 20,597	$ 2,012,088	$ 114,252	$ 2,126,340	
Net income				151,452		151,452	3,584	155,036	$ 151,452
Change in cumulative translation adjustment					(24,185)	(24,185)	(1,842)	(26,027)	(24,185)
Changes in market value of derivative financial instruments, net of ($851) tax					(1,367)	(1,367)		(1,367)	(1,367)
Comprehensive income (loss)									$ 125,900
Cash dividends - $0.57 per common share				(56,584)		(56,584)		(56,584)	

Share repurchases	(84,500)	(14)	(2,772)			(2,786)		(2,786)
Exercise of stock options, net of 27,177 shares tendered for payment	535,767	89	11,811			11,900		11,900
Issuance of restricted shares, net of cancellations	(7,689)	(1)	625			624		624
Amortization of restricted shares			2,878			2,878		2,878
Shares surrendered by employees to pay taxes	(138,480)	(23)	(4,639)			(4,662)		(4,662)
Stock compensation			8,318			8,318		8,318
Balance - October 2, 2010	98,960,604	$ 16,493	$ 489,028	$ 1,597,110	$ (4,955)	$ 2,097,676	$ 115,994	$ 2,213,670

See accompanying notes to condensed consolidated financial statements

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

1. Basis of Presentation and Responsibility for Interim Financial Statements

We prepared the unaudited condensed consolidated financial statements following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States can be condensed or omitted.

We are responsible for the unaudited financial statements included in this document. The financial statements include all normal recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results. As these are condensed financial statements, one should also read our consolidated financial statements and notes thereto for the year ended December 31, 2010, which are included in our Current Report on Form 8-K dated May 2, 2011.

Revenues, expenses, cash flows, assets and liabilities can and do vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be indicative of those for a full year.

Our fiscal year ends on December 31. We report our interim quarterly periods on a 13-week basis ending on a Saturday.

In connection with preparing the unaudited condensed consolidated financial statements for the nine months ended October 1, 2011, we have evaluated subsequent events for potential recognition and disclosure through the date of this filing.

2. New Accounting Standards

In June 2011, the Financial Accounting Standards Board (FASB) amended its guidance on the presentation of comprehensive income in financial statements to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items that are recorded in other comprehensive income. The new accounting guidance requires entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. The provisions of this new guidance are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011.

There were no other new accounting pronouncements issued or effective during the nine months ended of 2011 that have had or are expected to have a material impact on the Condensed Consolidated Financial Statements.

3. Stock-based Compensation

Total stock-based compensation expense was $4.2 million for each of the three months ended October 1, 2011 and October 2, 2010, and was $14.7 million and $16.6 million for the nine months ended October 1, 2011 and October 2, 2010, respectively.

During the first nine months of 2011, restricted shares and restricted stock units of our common stock were granted under the 2008 Omnibus Stock Incentive Plan to eligible employees with a vesting period of three to four years after issuance. Restricted share awards and restricted stock units are valued at market value on the date of grant and are typically expensed over the vesting period. Total compensation expense for restricted share awards and restricted stock units was $2.2 million and $1.8 million for the three months ended October 1, 2011 and October 2, 2010, respectively, and was $8.0 million and $8.3 million for the nine months ended October 1, 2011 and October 2, 2010, respectively.

During the first nine months of 2011, option awards were granted under the 2008 Omnibus Stock Incentive Plan with an exercise price equal to the market price of our common stock on the date of grant. Option awards are typically expensed over the vesting period. Total compensation expense for stock option awards was $2.0 million and $2.4 million for the three months ended October 1, 2011 and October 2, 2010, respectively, and $6.7 million and $8.3 million for the nine months ended October 1, 2011 and October 2, 2010, respectively.

We estimated the fair value of each stock option award on the date of grant using a Black-Scholes option pricing model, modified for dividends and using the following assumptions:

	October 1, 2011	October 2, 2010
Expected stock price volatility	35.5%	35.0%
Expected life	5.5yrs	5.5yrs
Risk-free interest rate	1.84%	1.54%
Dividend yield	2.06%	2.33%

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

The weighted-average fair value of options granted during the third quarter of 2011 and 2010 were $10.00 and $8.74 per share, respectively.

These estimates require us to make assumptions based on historical results, observance of trends in our stock price, changes in option exercise behavior, future expectations and other relevant factors. If other assumptions had been used, stock-based compensation expense, as calculated and recorded under the accounting guidance, could have been affected.

We based the expected life assumption on historical experience as well as the terms and vesting periods of the options granted. For purposes of determining expected volatility, we considered a rolling average of historical volatility measured over a period approximately equal to the expected option term. The risk-free rate for periods that coincide with the expected life of the options is based on the U.S. Treasury Department yield curve in effect at the time of grant.

4. Earnings Per Common Share

Basic and diluted earnings per share were calculated using the following:

	Three months ended		Nine months ended	
In thousands	**October 1, 2011**	**October 2, 2010**	**October 1, 2011**	**October 2, 2010**
Weighted average common shares outstanding basic	98,472	98,298	98,228	98,105
Dilutive impact of stock options and restricted stock	1,330	1,216	1,531	1,221
Weighted average common shares outstanding diluted	99,802	99,514	99,759	99,326
Stock options excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of the common shares	3,078	4,088	2,143	3,761

5. Restructuring

Restructuring accrual activity recorded on the Condensed Consolidated Balance Sheets is summarized as follows for the nine months ended October 1, 2011 and October 2, 2010 and year ended December 31, 2010:

In thousands	**October 1, 2011**	**December 31, 2010**	**October 2, 2010**
Beginning balance	$ 3,994	$ 14,509	$ 14,509
Cash payments and other	(1,274)	(10,515)	(7,524)
Ending balance	$ 2,720	$ 3,994	$ 6,985

6. Acquisitions

On May 12, 2011, we acquired as part of our Water Group the Clean Process Technologies (CPT) division of privately held Norit Holding B.V. for $715.3 million (502.7 million translated at the May 12, 2011 exchange rate). CPT s results of operations have been included in our consolidated financial statements since the date of acquisition. CPT is a global leader in membrane solutions and clean process technologies in the high growth water and beverage filtration and separation segments. CPT provides sustainable purification systems and solutions for desalination, water reuse, industrial applications and beverage segments that effectively address the increasing challenges of clean water

scarcity, rising energy costs and pollution. CPT s product offerings include innovative ultrafiltration and nanofiltration membrane technologies, aseptic valves, CO_2 recovery and control systems and specialty pumping equipment. Based in the Netherlands, CPT has broad sales diversity with the majority of 2010 revenues generated in European Union countries and Asia-Pacific region.

The fair value of the business acquired was allocated to the assets acquired and liabilities assumed based on their estimated fair values. The excess of the fair value acquired over the identifiable assets acquired and liabilities assumed is reflected as goodwill. Goodwill recorded as part of the purchase price allocation was $451.8 million, none of which is tax deductible. Identifiable intangible assets

Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

acquired as part of the acquisition were $197.2 million, including definite-lived intangibles, such as customer relationships, proprietary technology and trade names with a weighted average amortization period of approximately 10 years.

The CPT business records certain long term contracts under the percentage-of-completion method of accounting. Under this method, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion. We record costs and earnings in excess of billings on uncompleted contracts within P*repaid expenses and other current assets* and billings in excess of costs and earnings on uncompleted contracts within *Other current liabilities* in the Condensed Consolidated Balance Sheets. Amounts included in P*repaid expenses and other current assets* related to these contracts were $55.6 million at October 1, 2011. Amounts included in O*ther current liabilities* related to these contracts were $16.9 million at October 1, 2011.

The total purchase price has been allocated to the estimated fair values of assets acquired and liabilities assumed as follows:

(in thousands)	
Accounts and notes receivable	$ 70,038
Inventories	60,382
Deferred tax assets	4,926
Prepaid expenses and other current assets	40,252
Property, plant and equipment	69,010
Goodwill	451,809
Intangibles	197,231
Accounts payable	(41,061)
Income taxes	(3,937)
Other current liabilities	(59,229)
Long-term debt	(17,041)
Deferred tax liabilities	(57,069)
Purchase Price	$ 715,311

CPT s net sales and loss from continuing operations for the period from the acquisition date to October 1, 2011 were $142.2 million and $2.9 million, respectively, and include $11.1 million of non-recurring expenses for acquisition date fair value adjustments related to inventory and customer backlog.

The following pro forma consolidated condensed financial results of operations are presented as if the acquisitions described above had been completed at the beginning of each period presented:

	Three months ended		**Nine months ended**	
In thousands, except share and per-share data	**October 1, 2011**	**October 2, 2010**	**October 1, 2011**	**October 2, 2010**
Pro forma net sales	$ 890,546	$ 838,968	$ 2,712,770	$ 2,485,913
Pro forma income from continuing operations	56,287	48,404	181,366	133,122
Gain on disposal of discontinued operations, net of tax		549		1,666
Pro forma net income from continuing operations attributable to Pentair, Inc.	55,325	47,176	177,486	129,528
Pro forma earnings per common share - continuing operations				
Basic	$ 0.56	$ 0.48	$ 1.81	$ 1.32

Diluted	$ 0.55	$ 0.47	$ 1.78	$ 1.30
Weighted average common shares outstanding				
Basic	98,472	98,298	98,228	98,105
Diluted	99,802	99,514	99,759	99,326

The 2010 unaudited pro forma net income was adjusted to include the impact of approximately $7.4 million and $12.9 million for the three and nine months ended October 2, 2010, respectively, in non-recurring items related to acquisition date fair value adjustments to inventory and customer backlog. The 2011 unaudited pro forma net income was adjusted to exclude the impact of these items.

Acquisition-related transaction costs of approximately $7.8 million associated with the CPT acquisition were excluded from the pro forma net income in each of the 2011 and 2010 periods presented.

These pro forma condensed consolidated financial results have been prepared for comparative purposes only and include certain adjustments, such as increased interest expense on acquisition debt. They do not reflect the effect of costs or synergies that would have been expected to result from the integration of the acquisition. The pro forma information does not purport to be indicative of the results of operations that actually would have resulted had the combination occurred at the beginning of each period presented, or of future results of the consolidated entities.

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Notes to condensed consolidated financial statements (unaudited)

On January 31, 2011 we acquired as part of our Water Group all of the outstanding shares of capital stock of Hidro Filtros do Brasil (Hidro Filtros) for cash of $14.9 million and a note payable of $2.1 million. The Hidro Filtros results of operations have been included in our consolidated financial statements since the date of acquisition. Hidro Filtros is a leading manufacturer of water filters and filtering elements for residential and industrial applications operating in Brazil and neighboring countries. Goodwill recorded as part of the purchase price allocation was $10.1 million, none of which is tax deductible. Identified intangible assets acquired as part of the acquisition were $6.3 million including definite-lived intangibles, primarily customer relationships of $5.5 million, with an estimated life of 13 years. The proforma impact of this acquisition was deemed to be not material.

Additionally, during the first nine months of 2011, we completed other small acquisitions with purchase prices totaling $4.6 million, consisting of $2.9 million in cash and $1.7 million as a note payable, adding to our Water Group. Total goodwill recorded as part of the purchase price allocation was $4.3 million, none of which is tax deductible. The proforma impact of these acquisitions was deemed to be not material.

Total transaction costs related to acquisition activities for the nine months ended October 1, 2011 were $7.8 million, which were expensed as incurred and recorded in *Selling, general and administrative* in our Condensed Consolidated Statements of Income.

7. Inventories

Inventories were comprised of:

In thousands	**October 1, 2011**	**December 31, 2010**	**October 2, 2010**
Raw materials and supplies	$ 236,159	$ 223,482	$ 222,964
Work-in-process	49,393	37,748	42,780
Finished goods	174,364	144,126	144,328
Total inventories	$ 459,916	$ 405,356	$ 410,072

8. Goodwill and Other Identifiable Intangible Assets

The changes in the carrying amount of goodwill by segment were as follows:

In thousands	**December 31, 2010**	**Acquisitions/ Divestitures**	**Foreign Currency Translation/Other**	**October 1, 2011**
Water Group	$ 1,784,100	$ 466,182	$ (15,961)	$ 2,234,321
Technical Products Group	281,944		427	282,371
Consolidated Total	$ 2,066,044	$ 466,182	$ (15,534)	$ 2,516,692

In thousands	**December 31, 2009**	**Acquisitions/ Divestitures**	**Foreign Currency Translation/Other**	**October 2, 2010**
Water Group	$ 1,802,913	$	$ (14,754)	$ 1,788,159
Technical Products Group	285,884		(3,132)	282,752

Consolidated Total	$ 2,088,797	$	$ (17,886)	$ 2,070,911

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

The detail of acquired intangible assets consisted of the following:

	October 1, 2011			December 31, 2010			October 2, 2010		
In thousands	**Gross carrying amount**	**Accumulated amortization**	**Net**	**Gross carrying amount**	**Accumulated amortization**	**Net**	**Gross carrying amount**	**Accumulated amortization**	**Net**
Finite-life intangibles									
Patents	$ 5,893	$ (3,908)	$ 1,985	$ 15,469	$ (12,695)	$ 2,774	$ 15,462	$ (12,400)	$ 3,062
Proprietary technology	131,972	(37,094)	94,878	74,176	(29,862)	44,314	74,102	(28,306)	45,796
Customer relationships	366,540	(102,919)	263,621	282,479	(82,901)	199,578	283,313	(78,461)	204,852
Trade names	1,537	(500)	1,037	1,532	(383)	1,149	1,538	(345)	1,193
Total finite-life intangibles	$ 505,942	$ (144,421)	$ 361,521	$ 373,656	$ (125,841)	$ 247,815	$ 374,415	$ (119,512)	$ 254,903
Indefinite-life intangibles									
Trade names	257,741		257,741	205,755		205,755	206,475		206,475
Total intangibles, net	$ 763,683	$ (144,421)	$ 619,262	$ 579,411	$ (125,841)	$ 453,570	$ 580,890	$ (119,512)	$ 461,378

Intangible asset amortization expense was approximately $12.6 million and $6.3 million for the three months ended October 1, 2011 and October 2, 2010, respectively, and was approximately $29.8 million and $18.1 million for the nine months ended October 1, 2011 and October 2, 2010, respectively.

The estimated future amortization expense for identifiable intangible assets during the remainder of 2011 and the next five years is as follows:

In thousands	**2011 Q4**	**2012**	**2013**	**2014**	**2015**	**2016**
Estimated amortization expense	$ 12,183	$ 39,853	$ 39,688	$ 39,314	$ 39,032	$ 38,050

9. Debt

Debt and the average interest rates on debt outstanding are summarized as follows:

In thousands	**Average interest rate October 1, 2011**	**Maturity (Year)**	**October 1, 2011**	**December 31, 2010**	**October 2, 2010**
Revolving credit facilities - USD	1.98%	2016	$ 127,600	$ 97,500	$ 68,200
Revolving credit facilities - EUR	2.94%	2016	54,385		
Private placement - fixed rate	5.65%	2013-2017	400,000	400,000	400,000
Private placement - floating rate	0.82%	2012-2013	205,000	205,000	205,000

Public - fixed rate	5.00%	2021	500,000		
Other	3.58%	2011-2016	61,368	4,972	4,282
Total debt, including current portion			1,348,353	707,472	677,482
Less: Current maturities			(1,194)	(18)	(37)
Short-term borrowings			(29,705)	(4,933)	(4,180)
Long-term debt			$ 1,317,454	$ 702,521	$ 673,265

The fair value of total debt excluding the deferred gain on interest rate swaps was $1,400.1 million, $745.9 million and $712.4 million as of October 1, 2011, December 31, 2010 and October 2, 2010, respectively.

On May 9, 2011, we completed a public offering of $500 million aggregate principal amount of our 5.00% Senior Notes due 2021 (the Notes). The Notes are guaranteed by certain of our wholly-owned domestic subsidiaries that are also guarantors under our primary bank credit facility. We used the net proceeds from the offering of the Notes to finance in part the CPT acquisition.

Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

On April 28, 2011, we entered into a Fourth Amended and Restated Credit Agreement (the Credit Facility). The Credit Facility replaced our previous $800 million revolving credit facility. The Credit Facility creates an unsecured, committed credit facility of up to $700 million, with multi-currency sub facilities to support investments outside the U.S. The Credit Facility expires on April 28, 2016. Borrowings under the Credit Facility currently bear interest at the rate of London Interbank Offered Rate (LIBOR) plus 1.75%. Interest rates and fees on the Credit Facility will vary based on our credit ratings. We used borrowings under the Credit Facility to fund a portion of the CPT acquisition and to fund ongoing operations.

Total availability under our existing Credit Facility was $518.0 million as of October 1, 2011, which was not limited by any of the credit agreement s financial covenants as of that date.

Our debt agreements contain certain financial covenants, the most restrictive of which is a leverage ratio (total consolidated indebtedness, as defined, over consolidated net income before interest, taxes, depreciation, amortization and non-cash compensation expense, as defined) that may not exceed 3.75 to 1.0 as of October 1, 2011 and 3.5 to 1.0 as of the last date of each of our fiscal quarters thereafter. We were in compliance with all financial covenants in our debt agreements as of October 1, 2011.

In addition to the Credit Facility, we have various other credit facilities with an aggregate availability of $76.0 million, of which $40.0 million was outstanding at October 1, 2011. Borrowings under these credit facilities bear interest at variable rates. Additionally, as part of the CPT acquisition we assumed certain capital leases with an outstanding balance of $18.1 million at October 1, 2011.

We have $105 million of outstanding private placement debt maturing in May 2012. We classified this debt as long-term as of October 1, 2011 as we have the intent and ability to refinance such obligation on a long-term basis under the Credit Facility.

Debt outstanding at October 1, 2011 matures on a calendar year basis as follows:

In thousands	**2011 Q4**	**2012**	**2013**	**2014**	**2015**	**2016**	**Thereafter**	**Total**
Contractual debt obligation maturities	$ 29,016	$ 2,344	$ 201,838	$ 1,354	$ 1,192	$ 300,774	$ 811,835	$ 1,348,353

10. Derivatives and Financial Instruments

Fair value measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Assets and liabilities measured at fair value are classified using the following hierarchy, which is based upon the transparency of inputs to the valuation as of the measurement date:

Level 1: Valuation is based on observable inputs such as quoted market prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Valuation is based on inputs such as quoted market prices for similar assets or liabilities in active markets or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Valuation is based upon other unobservable inputs that are significant to the fair value measurement.

Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

In making fair value measurements, observable market data must be used when available. When inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement.

Cash-flow Hedges

In September 2005, we entered into a $100 million interest rate swap agreement with several major financial institutions to exchange variable rate interest payment obligations for fixed rate obligations without the exchange of the underlying principal amounts in order to manage interest rate exposures. The effective date of the fixed rate swap was April 25, 2006. The swap agreement has a fixed interest rate of 4.68% and expires in July 2013. The fixed interest rate of 4.68% plus the .60% interest rate spread over LIBOR results in an effective fixed interest rate of 5.28%. The fair value of the swap was a liability of $7.6 million, $9.4 million and $7.6 million at October 1, 2011, December 31, 2010 and October 2, 2010, respectively, and was recorded in *Other non-current liabilities* on the Condensed Consolidated Balance Sheets.

In August 2007, we entered into a $105 million interest rate swap agreement with a major financial institution to exchange variable rate interest payment obligations for a fixed rate obligation without the exchange of the underlying principal amounts in order to manage interest rate exposures. The effective date of the swap was August 30, 2007. The swap agreement has a fixed interest rate of 4.89% and expires in May 2012. The fixed interest rate of 4.89% plus the .50% interest rate spread over LIBOR results in an effective fixed interest rate of 5.39%. The fair value of the swap was a liability of $2.9 million, $6.4 million and $11.0 million at October 1, 2011, December 31, 2010 and October 2, 2010, respectively, and was recorded in *Other non-current liabilities* on the Condensed Consolidated Balance Sheets.

The variable to fixed interest rate swaps are designated as cash-flow hedges. The fair value of these swaps are recorded as assets or liabilities on the Condensed Consolidated Balance Sheets. Unrealized income/expense is included in *Accumulated other comprehensive income* (OCI) and realized income/expense and amounts due to/from swap counterparties are recorded in *Net interest expense* in our Condensed Consolidated Statements of Income. We realized incremental expense resulting from the swaps of $7.0 million and $6.9 million for the nine months ended October 1, 2011 and October 2, 2010, respectively.

The variable to fixed interest rate swaps are designated as and are effective as cash-flow hedges. The fair value of these swaps are recorded as assets or liabilities on the Condensed Consolidated Balance Sheets, with changes in their fair value included in OCI. Derivative gains and losses included in OCI are reclassified into earnings at the time the related interest expense is recognized or the settlement of the related commitment occurs.

Failure of one or more of our swap counterparties would result in the loss of any benefit to us of the swap agreement. In this case, we would continue to be obligated to pay the variable interest payments per the underlying debt agreements which are at variable interest rates of 3 month LIBOR plus .50% for $105 million of debt and 3 month LIBOR plus .60% for $100 million of debt. Additionally, failure of one or all of our swap counterparties would not eliminate our obligation to continue to make payments under our existing swap agreements if we continue to be in a net pay position.

Our interest rate swaps are carried at fair value measured on a recurring basis. Fair values are determined through the use of models that consider various assumptions, including time value, yield curves, as well as other relevant economic measures, which are inputs that are classified as Level 2 in the valuation hierarchy defined by the accounting guidance.

In April 2011, as part of our planned debt issuance to fund the CPT acquisition, we entered into interest rate swap contracts to hedge movement in interest rates through the expected date of closing for a portion of the expected fixed rate debt offering. The swaps had a notional amount of $400 million with an average interest rate of 3.65%. In May 2011, upon the sale of the Notes, the swaps were terminated at a cost of $11.0 million. Because we used the contracts to hedge future interest payments, this amount is recorded in *Prepaid expenses and other current assets* within the Condensed Consolidated Balance Sheets and will be amortized as interest exposure over the life of the Notes.

We manage our economic and transaction exposure to certain market-based risks through the use of foreign currency derivative instruments. Our objective in holding derivatives is to reduce the volatility of net earnings and cash flows associated with changes in foreign currency exchange rates.

Foreign currency contract

In March 2011, we entered into a foreign currency option contract to reduce our exposure to fluctuations in the euro related to the planned CPT acquisition. The contract had a notional amount of 286.0 million, a strike price of 1.4375 and a maturity date of May 13, 2011.

Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

In May 2011, we sold the foreign currency option contract for $1.0 million. The net cost of $2.1 million is recorded in *Selling, general and administrative* on the Condensed Consolidated Statements on Income.

Fair value of financial information

Financial assets and liabilities measured at fair value on a recurring basis were as follows:

In thousands	Fair Value October 1, 2011	(Level 1)	(Level 2)	(Level 3)
Cash-flow hedges	$ 10,504	$	$ 10,504	$
Deferred compensation plan (1)	21,684	21,684		

In thousands	Fair Value December 31, 2010	(Level 1)	(Level 2)	(Level 3)
Cash-flow hedges	$ 15,768	$	$ 15,768	$
Foreign currency contract	1,183		1,183	
Deferred compensation plan (1)	24,126	24,126		

In thousands	Fair Value October 2, 2010	(Level 1)	(Level 2)	(Level 3)
Cash-flow hedges	$ 18,535	$	$ 18,535	$
Deferred compensation plan (1)	22,699	22,699		

(1) Deferred compensation plan assets include mutual funds and cash equivalents for payment of certain non-qualified benefits for retired, terminated and active employees. The fair value of these assets was based on quoted market prices.

11. Income Taxes

The provision for income taxes consists of provisions for federal, state and foreign income taxes. We operate in an international environment with operations in various locations outside the U.S. Accordingly, the consolidated income tax rate is a composite rate reflecting the earnings in the various locations and the applicable rates.

The effective income tax rate for the nine months ended October 1, 2011 was 30.7% compared to 33.1% for the nine months ended October 2, 2010. We continue to actively pursue initiatives to reduce our effective tax rate. The tax rate in any quarter can be affected positively or negatively by adjustments that are required to be reported in the specific quarter of resolution.

The total gross liability for uncertain tax positions was $24.6 million, $24.3 million and $24.6 million at October 1, 2011,

December 31, 2010 and October 2, 2010, respectively. We record penalties and interest related to unrecognized tax benefits in *Provision for income taxes* and *Net interest expense*, respectively, on the Condensed Consolidated Statements of Income, which is consistent with our past practices.

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

12. Benefit Plans

Components of net periodic benefit cost were as follows:

	Three months ended			
	Pension benefits		Post-retirement	
In thousands	**October 1, 2011**	**October 2, 2010**	**October 1, 2011**	**October 2, 2010**
Service cost	$ 3,131	$ 2,886	$ 45	$ 50
Interest cost	8,225	7,887	472	503
Expected return on plan assets	(7,963)	(7,710)		
Amortization of transition obligation		6		
Amortization of prior year service cost (benefit)		8	(7)	(7)
Recognized net actuarial loss (gains)	971	406	(826)	(823)
Net periodic benefit cost (income)	$ 4,364	$ 3,483	$ (316)	$ (277)

	Nine months ended			
	Pension benefits		Post-retirement	
In thousands	**October 1, 2011**	**October 2, 2010**	**October 1, 2011**	**October 2, 2010**
Service cost	$ 9,392	$ 8,658	$ 135	$ 150
Interest cost	24,675	23,661	1,416	1,509
Expected return on plan assets	(23,890)	(23,130)		
Amortization of transition obligation		18		
Amortization of prior year service cost (benefit)		24	(21)	(21)
Recognized net actuarial loss (gains)	2,914	1,218	(2,479)	(2,469)
Net periodic benefit cost (income)	$ 13,091	$ 10,449	$ (949)	$ (831)

13. Business Segments

Financial information by reportable segment is shown below:

	Three months ended		Nine months ended	
In thousands	**October 1, 2011**	**October 2, 2010**	**October 1, 2011**	**October 2, 2010**
Net sales to external customers				
Water Group	$ 614,557	$ 512,587	$ 1,761,919	$ 1,539,943
Technical Products Group	275,989	261,148	829,075	736,972
Consolidated	$ 890,546	$ 773,735	$ 2,590,994	$ 2,276,915

Intersegment sales				
Water Group	$ 426	$ 442	$ 1,197	$ 1,386
Technical Products Group	1,755	1,154	4,313	2,904
Other	(2,181)	(1,596)	(5,510)	(4,290)
Consolidated	$	$	$	$
Operating income (loss)				
Water Group	$ 59,608	$ 58,457	$ 200,657	$ 176,549
Technical Products Group	48,611	42,605	144,959	113,693
Other	(15,316)	(10,239)	(57,114)	(35,692)
Consolidated	$ 92,903	$ 90,823	$ 288,502	$ 254,550

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

In thousands	October 1, 2011	December 31, 2010	October 2, 2010
		Identifiable assets [1]	
Water Group	$ 4,767,632	$ 3,409,556	$ 3,370,351
Technical Products Group	743,021	728,969	761,225
Other [1]	(628,210)	(164,992)	(158,818)
Consolidated	$ 4,882,443	$ 3,973,533	$ 3,972,758

[1] All cash and cash equivalents are included in Other

14. Warranty

The changes in the carrying amount of service and product warranties as were as follows:

In thousands	October 1, 2011	December 31, 2010	October 2, 2010
Balance at beginning of the year	$ 30,050	$ 24,288	$ 24,288
Service and product warranty provision	38,892	56,553	46,401
Payments	(40,611)	(50,729)	(39,843)
Acquired	3,551		
Translation	(197)	(62)	(63)
Balance at end of the period	$ 31,685	$ 30,050	$ 30,783

15. Commitments and Contingencies

There have been no further material developments from the disclosures contained in our 2010 Annual Report on Form 10-K.

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

16. Financial Statements of Subsidiary Guarantors

Certain of the domestic subsidiaries (the Guarantor Subsidiaries) of Pentair, Inc. (the Parent Company), each of which is directly or indirectly wholly-owned by the Parent Company, jointly and severally, and fully and unconditionally, guarantee the Parent Company s indebtedness under the Notes and the Credit Facility. The following supplemental financial information sets forth the Condensed Consolidated Statements of Income, the Condensed Consolidated Balance Sheets, and the Condensed Consolidated Statements of Cash Flows for the Parent Company, the Guarantor Subsidiaries, the non-Guarantor Subsidiaries, and total consolidated Pentair and subsidiaries.

Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Income (Unaudited)

For the three months ended October 1, 2011

In thousands	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	$	$ 549,306	$ 416,131	$ (74,891)	$ 890,546
Cost of goods sold		383,206	310,011	(74,733)	618,484
Gross profit		166,100	106,120	(158)	272,062
Selling, general and administrative	2,671	81,150	75,405	(158)	159,068
Research and development	218	10,093	9,780		20,091
Operating (loss) income	(2,889)	74,857	20,935		92,903
Earnings from investment in subsidiaries	(35,644)	1,686	(718)	34,676	
Other (income) expense:					
Equity income of unconsolidated subsidiaries	(512)		(62)		(574)
Net interest (income) expense	(26,822)	37,676	6,519		17,373
Income (loss) from continuing operations before income taxes and noncontrolling interest	60,089	35,495	15,196	(34,676)	76,104
Provision for income taxes	8,997	13,150	1,903		24,050
Income from continuing operations	51,092	22,345	13,293	(34,676)	52,054
Net income before noncontrolling interest	51,092	22,345	13,293	(34,676)	52,054
Noncontrolling interest			962		962
Net income attributable to Pentair, Inc.	$ 51,092	$ 22,345	$ 12,331	$ (34,676)	$ 51,092
Net income from continuing operations attributable to Pentair, Inc.	$ 51,092	$ 22,345	$ 12,331	$ (34,676)	$ 51,092

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Income (Unaudited)

For the nine months ended October 1, 2011

In thousands	**Parent Company**	**Guarantor Subsidiaries**	**Non-Guarantor Subsidiaries**	**Eliminations**	**Consolidated**
Net sales	$	$ 1,650,755	$ 1,156,342	$ (216,103)	$ 2,590,994
Cost of goods sold		1,138,037	859,570	(215,470)	1,782,137
Gross profit		512,718	296,772	(633)	808,857
Selling, general and administrative	15,942	249,902	197,049	(633)	462,260
Research and development	823	31,448	25,824		58,095
Operating (loss) income	(16,765)	231,368	73,899		288,502
Earnings from investment in subsidiaries	(126,938)	1,686	(718)	125,970	
Other (income) expense:					
Equity income of unconsolidated subsidiaries	(1,295)		(186)		(1,481)
Net interest (income) expense	(80,838)	114,269	7,880		41,311
Income (loss) from continuing operations before income taxes and noncontrolling interest	192,306	115,413	66,923	(125,970)	248,672
Provision for income taxes	23,961	39,932	12,554		76,447
Income from continuing operations	168,345	75,481	54,369	(125,970)	172,225
Net income before noncontrolling interest	168,345	75,481	54,369	(125,970)	172,225
Noncontrolling interest			3,880		3,880
Net income attributable to Pentair, Inc.	$ 168,345	$ 75,481	$ 50,489	$ (125,970)	$ 168,345
Net income from continuing operations attributable to Pentair, Inc.	$ 168,345	$ 75,481	$ 50,489	$ (125,970)	$ 168,345

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Pentair, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Unaudited)

October 1, 2011

In thousands	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Assets					
Current assets					
Cash and cash equivalents	$ 4,816	$ 5,010	$ 42,839	$	$ 52,665
Accounts and notes receivable, net	366	298,043	344,320	(86,041)	556,688
Inventories		201,372	258,544		459,916
Deferred tax assets	112,022	40,565	13,877	(105,053)	61,411
Prepaid expenses and other current assets	17,095	21,762	145,412	(36,701)	147,568
Total current assets	134,299	566,752	804,992	(227,795)	1,278,248
Property, plant and equipment, net	19,520	109,876	265,526		394,922
Other assets					
Investments in/advances to subsidiaries	2,834,569	563,756	649,722	(4,048,047)	
Goodwill		1,471,582	1,045,110		2,516,692
Intangibles, net		214,406	404,856		619,262
Other	69,916	5,452	23,000	(25,049)	73,319
Total other assets	2,904,485	2,255,196	2,122,688	(4,073,096)	3,209,273
Total assets	$ 3,058,304	$ 2,931,824	$ 3,193,206	$ (4,300,891)	$ 4,882,443
Liabilities and Shareholders Equity					
Current liabilities					
Short-term borrowings	$	$	$ 29,705	$	$ 29,705
Current maturities of long-term debt	2,719	(2)	26,865	(28,388)	1,194
Accounts payable	4,669	152,721	210,316	(86,258)	281,448
Employee compensation and benefits	39,319	25,149	53,070		117,538
Current pension and post-retirement benefits	8,733				8,733
Accrued product claims and warranties	12,235	20,431	11,254		43,920
Income taxes	26,011	1,531	(1,259)		26,283
Accrued rebates and sales incentives		33,855	11,376		45,231
Other current liabilities	25,831	42,854	131,604	(36,739)	163,550
Total current liabilities	119,517	276,539	472,931	(151,385)	717,602
Other liabilities					
Long-term debt	1,232,600	2,417,895	941,979	(3,275,020)	1,317,454
Pension and other retirement compensation	121,148	(7,107)	76,180		190,221
Post-retirement medical and other benefits	17,332	34,651		(25,050)	26,933
Long-term income taxes payable	23,891				23,891
Deferred tax liabilities	(79)	213,201	120,668	(105,053)	228,737

Due to/ (from) affiliates	(678,340)	(283,366)	896,497	65,209	
Other non-current liabilities	39,537	1,604	38,348		79,489
Total liabilities	875,606	2,653,417	2,546,603	(3,491,299)	2,584,327
Noncontrolling interest			115,419		115,419
Shareholders equity attributable to Pentair, Inc.	2,182,698	278,407	531,184	(809,592)	2,182,697
Total liabilities and shareholders equity	$ 3,058,304	$ 2,931,824	$ 3,193,206	$ (4,300,891)	$ 4,882,443

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

For the nine months ended October 1, 2011

In thousands	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Operating activities					
Net income before noncontrolling interest	$ 168,345	$ 75,481	$ 54,369	$ (125,970)	$ 172,225
Adjustments to reconcile net income to net cash provided by (used for) operating activities					
Equity income of unconsolidated subsidiaries	(1,295)		(186)		(1,481)
Depreciation	4,232	20,780	24,067		49,079
Amortization		11,494	18,313		29,807
Earnings from investments in subsidiaries	(126,938)	1,686	(718)	125,970	
Deferred income taxes	6,890	(536)	(1,909)		4,445
Stock compensation	14,695				14,695
Excess tax benefits from stock-based compensation	(3,137)				(3,137)
Loss on sale of assets	702				702
Changes in assets and liabilities, net of effects of business acquisitions and dispositions					
Accounts and notes receivable	(58,643)	67,192	(8,111)	22,219	22,657
Inventories		38,199	(22,566)		15,633
Prepaid expenses and other current assets	38,033	(11,493)	(64,380)	11,460	(26,380)
Accounts payable	61,962	(28,241)	(57,037)	(22,443)	(45,759)
Employee compensation and benefits	(6,326)	(8,160)	2,152		(12,334)
Accrued product claims and warranties		(1,299)	1,414		115
Income taxes	30,411	(2,429)	(9,937)		18,045
Other current liabilities	(34,504)	19,029	73,635	(11,236)	46,924
Pension and post-retirement benefits	(16,658)	(9,816)	2,838		(23,636)
Other assets and liabilities	(60,635)	57,799	(18,205)		(21,041)
Net cash provided by (used for) operating activities	17,134	229,686	(6,261)		240,559
Investing activities					
Capital expenditures	(6,509)	(20,837)	(25,717)		(53,063)
Proceeds from sale of property and equipment		82	57		139
Acquisitions, net of cash acquired			(733,105)		(733,105)
Other	1,533	(1,295)	(679)		(441)
Net cash provided by (used for) investing activities	(4,976)	(22,050)	(759,444)		(786,470)
Financing activities					
Net short-term borrowings	24,772				24,772
Proceeds from long-term debt	1,370,423				1,370,423
Repayment of long-term debt	(771,793)				(771,793)
Debt issuance costs	(8,973)				(8,973)
Net change in advances to subsidiaries	(568,347)	(249,605)	817,952		
Excess tax benefits from stock-based compensation	3,137				3,137

Stock issued to employees, net of shares withheld	11,788				11,788
Repurchases of common stock	(12,785)				(12,785)
Dividends paid	(59,660)		(9)		(59,669)
Net cash provided by (used for) financing activities	(11,438)	(249,605)	817,943		556,900
Effect of exchange rate changes on cash and cash equivalents	895	43,575	(48,850)		(4,380)
Change in cash and cash equivalents	1,615	1,606	3,388		6,609
Cash and cash equivalents, beginning of period	3,201	3,404	39,451		46,056
Cash and cash equivalents, end of period	$ 4,816	$ 5,010	$ 42,839	$	$ 52,665

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Income (Unaudited)

For the three months ended October 2, 2010

In thousands	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	$	$ 533,704	$ 305,030	$ (64,999)	$ 773,735
Cost of goods sold		371,926	230,085	(64,818)	537,193
Gross profit		161,778	74,945	(181)	236,542
Selling, general and administrative	(2,260)	84,655	46,640	(181)	128,854
Research and development	108	10,430	6,327		16,865
Operating income	2,152	66,693	21,978		90,823
Earnings from investment in subsidiaries	(35,774)			35,774	
Other (income) expense:					
Equity income of unconsolidated subsidiaries		(347)			(347)
Net interest (income) expense	(27,834)	38,462	(1,675)		8,953
Income (loss) from continuing operations before income taxes and noncontrolling interest	65,760	28,578	23,653	(35,774)	82,217
Provision for income taxes	11,259	8,907	6,322		26,488
Income from continuing operations	54,501	19,671	17,331	(35,774)	55,729
Gain on disposal of discontinued operations, net of tax	549				549
Net income before noncontrolling interest	55,050	19,671	17,331	(35,774)	56,278
Noncontrolling interest			1,228		1,228
Net income attributable to Pentair, Inc.	$ 55,050	$ 19,671	$ 16,103	$ (35,774)	$ 55,050
Net income from continuing operations attributable to Pentair, Inc.	$ 54,501	$ 19,671	$ 16,103	$ (35,774)	$ 54,501

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Income (Unaudited)

For the nine months ended October 2, 2010

In thousands	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net sales	$	$ 1,577,215	$ 890,692	$ (190,992)	$ 2,276,915
Cost of goods sold		1,094,977	674,009	(190,483)	1,578,503
Gross profit		482,238	216,683	(509)	698,412
Selling, general and administrative	(2,006)	249,353	145,949	(509)	392,787
Research and development	380	32,148	18,547		51,075
Operating income	1,626	200,737	52,187		254,550
Earnings from investment in subsidiaries	(96,737)			96,737	
Other (income) expense:					
Equity income of unconsolidated subsidiaries		(1,370)	(436)		(1,806)
Net interest (income) expense	(83,341)	115,440	(5,050)		27,049
Income (loss) from continuing operations before income taxes and noncontrolling interest	181,704	86,667	57,673	(96,737)	229,307
Provision for income taxes	31,918	30,326	13,693		75,937
Income from continuing operations	149,786	56,341	43,980	(96,737)	153,370
Gain on disposal of discontinued operations, net of tax	1,666				1,666
Net income before noncontrolling interest	151,452	56,341	43,980	(96,737)	155,036
Noncontrolling interest			3,584		3,584
Net income attributable to Pentair, Inc.	$ 151,452	$ 56,341	$ 40,396	$ (96,737)	$ 151,452
Net income from continuing operations attributable to Pentair, Inc.	$ 149,786	$ 56,341	$ 40,396	$ (96,737)	$ 149,786

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Pentair, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Unaudited)

October 2, 2010

In thousands	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Assets					
Current assets					
Cash and cash equivalents	$ 9,326	$ 4,059	$ 43,610	$	$ 56,995
Accounts and notes receivable, net	1,289	312,378	235,591	(59,037)	490,221
Inventories		242,716	167,356		410,072
Deferred tax assets	120,973	35,211	8,351	(113,544)	50,991
Prepaid expenses and other current assets	3,277	11,141	51,155	(17,018)	48,555
Total current assets	134,865	605,505	506,063	(189,599)	1,056,834
Property, plant and equipment, net	16,311	145,260	166,031		327,602
Investments in/advances to subsidiaries	2,365,958	94,241	734,158	(3,194,357)	
Goodwill		1,549,537	521,374		2,070,911
Intangibles, net		269,886	191,492		461,378
Other	58,818	5,914	19,146	(27,845)	56,033
Total other assets	2,424,776	1,919,578	1,466,170	(3,222,202)	2,588,322
Total assets	$ 2,575,952	$ 2,670,343	$ 2,138,264	$ (3,411,801)	$ 3,972,758
Liabilities and Shareholders Equity					
Current liabilities					
Short-term borrowings	$	$	$ 4,180	$	$ 4,180
Current maturities of long-term debt	114,000	16	24,346	(138,325)	37
Accounts payable	5,173	178,350	141,932	(59,039)	266,416
Employee compensation and benefits	33,938	31,613	35,075		100,626
Current pension and post-retirement benefits	8,948				8,948
Accrued product claims and warranties		23,491	17,292		40,783
Income taxes	12,165	8,037	2,000		22,202
Accrued rebates and sales incentives		28,897	10,169		39,066
Other current liabilities	20,988	33,691	52,623	(17,016)	90,286
Total current liabilities	195,212	304,095	287,617	(214,380)	572,544
Other liabilities					
Long-term debt	673,200	1,947,442	382,618	(2,329,995)	673,265
Pension and other retirement compensation	139,825	5,856	73,782		219,463
Post-retirement medical and other benefits	18,665	37,686		(27,845)	28,506
Long-term income taxes payable	23,857				23,857
Deferred tax liabilities	429	198,892	61,995	(113,544)	147,772
Due to/ (from) affiliates	(619,173)	(114,370)	767,246	(33,703)	

Other non-current liabilities	46,261	4,108	43,312		93,681
Total liabilities	478,276	2,383,709	1,616,570	(2,719,467)	1,759,088
Noncontrolling interest			115,994		115,994
Shareholders equity attributable to Pentair, Inc.	2,097,676	286,634	405,700	(692,334)	2,097,676
Total liabilities and shareholders equity	$ 2,575,952	$ 2,670,343	$ 2,138,264	$ (3,411,801)	$ 3,972,758

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Pentair, Inc. and Subsidiaries

Notes to condensed consolidated financial statements (unaudited)

Pentair, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

For the nine months ended October 2, 2010

In thousands	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Operating activities					
Net income before noncontrolling interest	$ 151,452	$ 56,341	$ 43,980	$ (96,737)	$ 155,036
Adjustments to reconcile net income to net cash provided by (used for) operating activities					
Gain on disposal of discontinued operations	(1,666)				(1,666)
Equity income of unconsolidated subsidiaries		(1,370)	(436)		(1,806)
Depreciation	1,795	22,424	18,922		43,141
Amortization	604	11,698	7,440		19,742
Earnings from investments in subsidiaries	(96,737)			96,737	
Deferred income taxes	4,391	39	436		4,866
Stock compensation	16,598				16,598
Excess tax benefits from stock-based compensation	(2,193)				(2,193)
Loss on sale of assets	166				166
Changes in assets and liabilities, net of effects of					

business acquisitions and dispositions					
Accounts and notes receivable	656	(15,688)	(27,558)	6,374	(36,216)
Inventories		(21,029)	(28,793)		(49,822)
Prepaid expenses and other current assets	34,620	(4,078)	(31,132)	(886)	(1,476)
Accounts payable	(1,434)	51,884	16,010	(6,298)	60,162
Employee compensation and benefits	11,880	4,286	5,434		21,600
Accrued product claims and warranties		5,777	779		6,556
Income taxes	(4,526)	22,916	(377)		18,013
Other current liabilities	(18,820)	603	32,900	810	15,493
Pension and post-retirement benefits	(12,070)	(5,355)	2,228		(15,197)
Other assets and liabilities	(2,659)	(8,747)	7,652		(3,754)
Net cash provided by (used for) operating activities	82,057	119,701	47,485		249,243
Investing activities					
Capital expenditures					

Interest Expense and Cost of Funds

Interest expense was $63.8 million and $17.3 million for the three months ended June 30, 2011 and 2010, respectively. Interest expense was $99.5 million and $32.9 million for the six months ended June 30, 2011 and 2010, respectively. The year-over-year increase in interest expense was due to an increase in our average repurchase agreement and other debt balance outstanding, partially offset by a decline in swap interest expense due to timing differences between asset settlements and the initiation of new interest rate swap agreements and a reduction of swap interest expense of $2.6 million and $6.3 million for terminated swap amortization expense recorded during the three and six month prior year periods, respectively.

For the three month period ended June 30, 2011 and 2010, our average repurchase agreement and other debt balance outstanding was $28.7 billion and $5.5 billion, respectively. For the six month period ended June 30, 2011 and 2010, our average repurchase agreement and other debt balance outstanding was $23.2 billion and $4.7 billion, respectively. The year-over-year increases were primarily driven by deploying new equity capital raised during the current periods on a levered basis. The average interest rate on our repurchase agreements and other debt remained unchanged for the three and six month periods ended June 30, 2011 and 2010 at approximately 0.25%. Including the net impact of interest rate swaps, the total three and six month average cost of funds declined year-over-year to 0.89% from 1.26% (or from 1.07% when excluding

amortization expense associated with previously terminated interest rate swaps), respectively, and to 0.86% from 1.42% (or from 1.15% when excluding amortization expense associated with previously terminated interest rate swaps), respectively.

For the current and prior year three month period, our interest rate swaps designated as cash flow hedges under ASC 815 increased the cost of our borrowings by $46.3 million and $11.2 million, or 0.65% and 0.81% of our interest bearing liabilities, respectively. When excluding forward starting swaps, for the current and prior year three month period, we had average notional amounts outstanding under our interest rate swap agreements designated as cash flow hedges of $12.0 billion and $2.6 billion (or 42% and 46% of our average repurchase agreement and other debt balance) with a weighted average fixed pay rate of 1.72% and 2.01%, respectively. For the current and prior year six month period, our interest rate swaps designated as cash flow hedges increased the cost of our borrowings by $69.5 million and $21.0 million, or 0.60% and 0.91% of our interest bearing liabilities, respectively. When excluding forward starting swaps, for the current and prior year six month period, we had average notional amounts outstanding under our interest rate swap agreements designated as cash flow hedges of $9.3 billion and $2.4 billion (or 40% and 51% of our average repurchase agreement and other debt balance) with a weighted average fixed pay rate of 1.69% and 2.0%, respectively.

Net Interest Income and Net Interest Rate Spread

Net interest income, which equals interest income less interest expense, was $200.9 million and $33.2 million for the three month period ended June 30, 2011 and 2010, respectively. The average net interest rate spread, which equals the average yield on our assets for the period less the average cost of funds for the three month period ended June 30, 2011 and 2010, was 2.46% and 2.18% (or 2.37% excluding terminated swap amortization expense), respectively. Net interest income was $329.8 million and $56.5 million for the six month period ended June 30, 2011 and 2010, respectively. The average net interest rate spread for the six month period ended June 30, 2011 and 2010, was 2.51% and 2.16% (or 2.43% excluding terminated swap amortization expense), respectively. As of June 30, 2011, our weighted average asset yield was 3.45%, our weighted average cost of funds was 1.09% and our net interest rate spread was 2.36%.

Our weighted average cost of funds as of June 30, 2011 is based on our total repurchase agreement and other debt balance outstanding, plus the net payable for unsettled trades, (altogether totaling $35.7 billion), a weighted average interest rate on our repurchase agreements of 0.23%, and an interest rate swap balance of $21.0 billion notional and an average pay rate of 1.64% (or 1.45% net of the receive rate). The interest rate swap balance includes interest rate swaps designated as cash flow hedges in effect as of June 30, 2011 totaling $14.1 billion, plus $6.9 billion of forward starting swaps, net of interest rate expirations, starting within three months of June 30, 2011.

As of June 30, 2011, we had a total of $7.9 billion of forward starting interest rate swaps with forward start dates ranging from one to six months from June 30, 2011. We enter into forward starting interest rate swaps based on a variety of factors, including our Manager s view of the forward yield curve and the timing of potential changes in short-term interest rates, time to deploy new capital, amount and timing of expirations of our existing interest swap portfolio and current and anticipated swap spreads.

Gain on Sale of Agency Securities, Net

The following table is a summary of our net gain on sale of agency securities for the current and prior year periods (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Agency securities sold, at cost	$ (10,448,371)	$ (2,624,277)	$ (12,383,828)	$ (4,741,787)
Proceeds from agency securities sold(1)	10,542,263	2,653,862	12,481,940	4,798,780
Net gains on sale of agency securities	$ 93,892	$ 29,585	$ 98,112	$ 56,993
Gross gains on sale of agency securities	$ 95,684	$ 31,327	$ 109,233	$ 61,381
Gross losses on sale of agency securities	(1,792)	(1,742)	(11,121)	(4,388)
Net gains on sale of agency securities	$ 93,892	$ 29,585	$ 98,112	$ 56,993

(1) Proceeds include cash received during the period, plus receivable for agency securities sold during the period as of period end.

Sales of securities are driven by our Manager s execution of our active portfolio management strategy. Our strategy for the periods presented was largely focused on repositioning our portfolio towards securities with attributes our Manager believes reduce the level of prepayment risk and overall exposure to interest rate risk in light of current and anticipated

interest rates, federal government programs, general economic conditions and other factors. During the three month period ended June 30, 2011, we sold holdings of higher coupon securities and reinvested the sales proceeds into lower coupon, shorter duration securities backed by loans our Manager believes have more favorable prepayment attributes relative to the current economic environment, including the general decline in interest rates as of the end of the current period. Sales of securities during the prior year periods were similarly driven by Manager s intent of reinvesting sales proceeds into assets with more favorable involuntary prepayment attributes in anticipation of the GSE Buyouts of built up delinquent mortgage loans from their outstanding mortgage pools during the prior year periods.

Gain (loss) on Derivative Instruments and Trading Securities, Net

The following table is a summary of our gain (loss) on derivative instruments and trading securities, net for current and prior year quarters (in thousands):

	For the three months ended June 30,		For the six months ended June 30,	
	2011	2010	2011	2010
Realized (loss) gain from derivative instruments and trading securities:				
Purchase of TBAs and forward settling agency securities	$ 25,777	$ 6,029	$ 36,911	$ 7,351
Sale of TBAs and forward settling agency securities	(125,598)	(11,715)	(111,281)	(10,590)
Interest rate payer swaptions	(3,563)		2,649	
Interest rate receiver swaptions	(369)		(369)	(243)
Interest rate swaps not designated as hedges	(694)	(281)	(5,079)	(1,111)
U.S. treasury securities	27,748	1,443	28,309	1,443
Short sales of U.S. treasury securities	(14,950)		(14,760)	
Markit IOS Index total return swaps	11,032		12,835	
Treasury futures	248		248	
Put options		(328)	1,133	(328)
Total realized (loss) gain from derivative instruments and trading securities, net	(80,369)	(4,852)	(49,404)	(3,478)
Unrealized (loss) gain from derivative instruments and trading securities:(1)				
Purchase of TBAs and forward settling agency securities	(24,362)	723,022	(68,568)	(418,344)
Sale of TBAs and forward settling agency securities	20,029	(732,762)	41,852	413,140

Interest-only and principal only strips	356	(9,026)	3,037	(6,938)
Interest rate payer swaptions	(17,281)	2,427	(28,896)	562
Interest rate receiver swaptions		(516)		(575)
Interest rate swaps not designated as hedges	(3,459)		118	
Short sales of U.S. treasury securities	14,276		14,955	
Put options		(37)		
Markit IOS total return swaps	(8,696)		(940)	
Hedge ineffectiveness on interest rate swaps	(507)	(123)	(638)	(314)
Total unrealized (loss) gain from derivative instruments and trading securities, net	(19,644)	(17,015)	(39,080)	(12,469)
Total loss from derivative instruments and trading securities, net	$ (100,013)	$ (21,867)	$ (88,484)	$ (15,947)

(1) Unrealized gain (loss) from derivatives and trading securities includes reversals of prior period amounts for settled or expired derivatives and trading securities.

The year over year increases in net losses from derivatives and trading securities (other supplemental hedges) were due to an increase in the size of our investment portfolio coupled with an increase in our use of other supplemental hedging strategies entered into to manage the potential adverse impact of near term changes in interest rates on our net asset value and future cash flows. We invest in other supplemental hedges, in addition to our use of interest rate swap agreements that are intended to hedge against longer-term increases in interest rates, based on a variety of factors, including our Manager s view of how our existing portfolio of agency securities will perform under different interest rate scenarios and the need to hedge against potential near-term changes in interest rates. The intended purpose of the other supplemental hedges held during the current three month period was to hedge against potential near-term increases in interest rates, consequently the net losses from our supplemental hedges for the current three month period were driven by a general decline in interest rates during the period.

For further details regarding our derivatives and related hedging activity please refer to Notes 3 and 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q.

Management Fees and General and Administrative Expenses

We pay our Manager a base management fee payable monthly in arrears in amount equal to one twelfth of 1.25% of our Equity. Our Equity is defined as our month-end stockholders equity, adjusted to exclude the effect of any unrealized gains or losses included in either retained earnings or OCI, each as computed in accordance with GAAP. There is no incentive compensation payable to our Manager pursuant to the management agreement. We incurred management fees of $12.4 million and $2.3 million for the three month periods ended June 30, 2011 and 2010, respectively, and $20.9 million and $4.1 million for the six month periods ended June 30, 2011 and 2010, respectively.

General and administrative expenses were $4.5 million and $1.8 million for the three month periods ended June 30, 2011 and 2010, respectively, and $7.1 million and $3.5 million for the six month periods ended June 30, 2011 and 2010, respectively. Our general and administrative expenses primarily consist of prime brokerage fees, information technology costs, allocation of overhead expenses from our Manager, accounting fees, legal fees, Board of Director fees and insurance expenses.

Our total management fee and general and administrative expenses as a percentage of our average stockholders equity on an annualized basis declined year-over-year to 1.80% from 2.33% for the current and prior three month period, respectively, and to 1.82% from 2.37% for the current and prior six month period, respectively, due to improved operating leverage.

Dividends

For the current and prior year periods, we declared quarterly dividends of $1.40 per share. As a REIT, we are required to distribute annually 90% of our taxable income to maintain our status as a REIT and all of our taxable income to avoid Federal, state and local corporate income taxes. We can treat dividends declared by September 15 and paid by December 31 as having been a distribution of our taxable income for our prior tax year. As of June 30, 2011, we have declared or paid all of our taxable income for the 2010 tax year and we have an estimated $78 million of undistributed taxable income related to our 2011 tax year, net of the June 30, 2011 dividend payable of $180.4 million. Income as determined under GAAP differs from income as determined under tax rules because of both temporary and permanent differences in income and expense recognition. Examples include temporary differences related to unrealized gains and losses on derivative instruments and trading securities that are recognized in income for GAAP but are excluded from taxable income until realized or settled, temporary differences in the CPR used to amortize premiums or accrete discounts, temporary differences related to timing of the recognition of hedge ineffectiveness, permanent and temporary differences related to the timing and amount recognized for stock-based compensation and permanent differences for excise tax expense.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of funds are borrowings under master repurchase agreements, equity offerings, asset sales and monthly principal and interest payments on our investment portfolio. Because the level of our borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on the balance sheet is significantly less important than the potential liquidity available under our borrowing arrangements. We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings, maintenance of any margin requirements and the payment of cash dividends as required for our continued qualification as a REIT. To qualify as a REIT, we must distribute annually at least 90% of our taxable income. To the extent that we annually distribute all of our taxable income in a timely manner, we will generally not be subject to federal and state income taxes. We currently expect to distribute all of our taxable income. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital from operations.

Equity Capital Raising Activities

To the extent we raise additional equity capital through follow-on equity offerings, through our Controlled Equity Offering^{SM} program or under our dividend reinvestment and direct stock purchase plan, we currently anticipate using cash proceeds from such transactions to purchase additional agency securities, to make scheduled payments of principal and interest on our repurchase agreements and for other general corporate purposes. There can be no assurance, however, that we will be able to raise additional equity capital at any particular time or on any particular terms.

Equity Offerings

During the six months ended June 30, 2011, we completed three follow-on public offerings of shares of our common stock summarized in the table below (in thousands, except per share amounts):

	For the Six Months Ended June 30, 2011		
Public Offering	**Public Offering Price Per Share(1)**	**Shares**	**Net Proceeds(2)**
January 2011	$ 28.00	26,910	$ 719,250
March 2011	$ 27.72	32,200	892,242
June 2011	$ 27.56	49,680	1,368,756
Total		108,790	$ 2,980,248

(1) Public offering price per share is gross of underwriters discount, if applicable

(2) Proceeds received, net of the underwriters discount, if applicable, and other offering costs

Controlled Equity Offering^{SM} Program

We have a sales agreement with an underwriter to, from time to time, publicly offer and sell up to 15 million shares of our common stock in privately negotiated and/or at-the-market transactions. During the three month period ended June 30, 2011 there were no sales under the sales agreement. During the six month period ended June 30, 2011, we sold 4.3 million shares of our common stock under the sales agreement at an average offering price of $29.41 per share for proceeds, net of the underwriter s discount and other program costs, of $126.1 million. As of June 30, 2011, 6.3 million shares of common stock remain under the sales agreement.

Dividend Reinvestment and Direct Stock Purchase Plan

We sponsor a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of our common stock by reinvesting some or all of the cash dividends received on shares of our common stock. Stockholders may also make optional cash purchases of shares of our common stock subject to certain limitations detailed in the plan prospectus. During the three month period

ended June 30, 2011 there were no shares issued under the plan. During the six month period ended June 30, 2011, we issued 0.5 million shares under the plan for net cash proceeds of $14.9 million. As of June 30, 2011, there were 4.7 million shares available for issuance under the plan.

Debt Capital

As part of our investment strategy, we borrow against our investment portfolio pursuant to master repurchase agreements. We expect that our borrowings pursuant to repurchase transactions under such master repurchase agreements generally will have maturities that range from 30 to 90 days, but may have maturities of less than 30 days or up to 364 days. When adjusted for net payables and receivables for agency securities purchased but not yet settled and other debt, our leverage ratio was 7.5 times the amount of our stockholders

equity as of June 30, 2011. Our cost of borrowings under master repurchase agreements generally corresponds to LIBOR plus or minus a margin. We have master repurchase agreements with 26 financial institutions, subject to certain conditions. As of June 30, 2011, borrowings under repurchase arrangements secured by agency securities totaled $33.5 billion, other debt associated with a structured transaction accounted for as a financing transaction totaled $0.1 billion and net payables for agency securities not yet settled was $2.1 billion. As of June 30, 2011, we did not have an amount at risk with any counterparty greater than 10% of our stockholders equity. Refer to Note 5 to our consolidated financial statements in this Quarterly Report on Form 10-Q for further details regarding our borrowings under repurchase agreements and other debt and weighted average interest rates as of June 30, 2011.

Amounts available to be borrowed under our repurchase agreements are dependent upon lender collateral requirements and the lender s determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates, credit quality and liquidity conditions within the investment banking, mortgage finance and real estate industries. Under the repurchase agreements, we may be required to pledge additional assets to the repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a margin call), which may take the form of additional securities or cash. Similarly, if the estimated fair value of investment securities increases due to changes in the market interest rates, lenders may release collateral back to us. Specifically, margin calls would result from a decline in the value of the agency securities securing our repurchase agreements and prepayments on the mortgages securing such agency securities. As of June 30, 2011, we have met all margin requirements. We had unrestricted cash and cash equivalents of $625.9 million and unpledged agency securities of $2.1 billion, excluding net unsettled purchases and sales of agency securities, available to meet margin calls on our repurchase agreements and derivative instruments as of June 30, 2011.

Although we believe that we will have adequate sources of liquidity available to us through repurchase agreement financing to execute our business strategy, there can be no assurances that repurchase agreement financing will be available to us upon the maturity of our current repurchase agreements to allow us to renew or replace our repurchase agreement financing on favorable terms or at all. If our repurchase agreement lenders default on their obligations to resell the underlying agency securities back to us at the end of the term, we could incur a loss equal to the difference between the value of the agency securities and the cash we originally received.

We maintain an interest rate risk management strategy under which we use derivative financial instruments to manage the adverse impact of interest rates changes on the value of our investment portfolio as well as our cash flows. In particular, we attempt to mitigate the risk of the cost of our short-term variable rate liabilities increasing at a faster rate than the earnings of our long-term assets during a period of rising interest rates. The principal derivative instruments that we use are interest rate swaps, supplemented with the use of interest rate swaptions, TBA agency securities, options, futures and other instruments.

We use interest rate swap agreements to effectively lock in fixed rates on a portion of our short-term borrowings because longer-term committed borrowings are not available at attractive terms. We have entered into

interest rate swap agreements to attempt to mitigate the risk of the cost of our short-term variable rate liabilities rising during a period of rising interest rates, thereby compressing the net spreads that we earn on our long-term fixed-rate assets. As of June 30, 2011, we had interest rate swap agreements that were designated as cash flow hedges for accounting purposes of a like amount of our short-term borrowings. Refer to Note 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q for further details regarding our outstanding interest rate swaps as of June 30, 2011 and the related activity for the first quarter 2011.

Off-Balance Sheet Arrangements

As of June 30, 2011, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest

entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of June 30, 2011, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that inherently involve risks and uncertainties. Our actual results and liquidity can differ materially from those anticipated in these forward-looking statements because of changes in the level and composition of our investments and other factors. These factors may include, but are not limited to, changes in general economic conditions, the availability of suitable investments from both an investment return and regulatory perspective, the availability of new investment capital, fluctuations in interest rates and levels of mortgage prepayments, deterioration in credit quality and ratings, the effectiveness of risk management strategies, the impact of leverage, liquidity of secondary markets and credit markets, increases in costs and other general competitive factors.

Item 3. ***Quantitative and Qualitative Disclosures About Market Risk***

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risks that we are exposed to are interest rate risk, prepayment risk, spread risk, liquidity risk, extension risk and inflation risk.

Interest Rate Risk

Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control.

Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our interest-earning assets and interest bearing liabilities. Changes in the level of interest rates can also affect the rate of prepayments of our securities and the value of the agency securities that constitute our investment portfolio, which affects our ability to realize gains from the sale of these assets and impacts our ability and the amount that we can borrow against these securities.

We may utilize a variety of financial instruments in order to limit the effects of changes in interest rates on our operations, including interest rate swap agreements, interest rate swaptions, interest rate cap or floor contracts and futures or forward contracts. We may also purchase or short TBA, U.S. Treasury securities and U.S. Treasury futures contracts, purchase or write put or call options on TBA securities or we may invest in other types of mortgage derivative securities, such as interest-only securities, and synthetic total return swaps, such as the Markit IOS Index. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to

certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of our common stock and that the losses may exceed the amount we invested in the instruments.

Our profitability and the value of our investment portfolio (including derivatives used for hedging purposes) may be adversely affected during any period as a result of changing interest rates including resulting changes in forward yield curves. The following table quantifies the estimated changes in net interest income and investment portfolio value should interest rates go up or down by 50 and 100 basis points, assuming the yield curves of the rate shocks will be parallel to each other and the current yield curve. These estimates were compiled using a combination of third-party services, market data and internal models. All changes in income and value are measured as percentage changes from the projected net interest income and investment portfolio value at the base interest rate

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scenario. The base interest rate scenario assumes interest rates as of June 30, 2011. Given the low level of interest rates, we also apply a floor of 0% for all anticipated interest rates included in our assumptions, such that any hypothetical interest rate decrease would have a limited positive impact on our funding costs beyond a certain level. However, because estimated prepayment speeds are unaffected by this floor, it is expected that an increase in our prepayment speeds as a result of a hypothetical interest rate decrease would result in an acceleration of our premium amortization and could result in reinvestment of such prepaid principal into lower yielding assets.

Actual results could differ materially from estimates, especially in the current market environment. The accuracy of the projected agency securities prices relies on assumptions that define specific agency securities spreads and varying prepayment assumptions at projected interest rate levels. To the extent that these estimates or other assumptions do not hold true, which is likely in a period of high price volatility, actual results will likely differ materially from projections and could be larger or smaller than the estimates in the table below. Moreover, if different models were employed in the analysis, materially different projections could result. In addition, while the tables below reflect the estimated impact of interest rate increases and decreases on a static portfolio, we may from time to time sell any of our agency securities as a part of our overall management of our investment portfolio.

Change in Interest Rate	**Percentage Change in Projected Net Interest Income**	**Percentage Change in Projected Portfolio Value, with Effect of Derivatives**
+100 Basis Points	-10.4%	-1.2%
+50 Basis Points	-4.7%	-0.5%
-50 Basis Points	1.0%	0.1%
-100 Basis Points	-4.7%	-0.5%

Prepayment Risk

Premiums and discounts associated with the purchase of agency securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method. Furthermore, U.S. Government agency or U.S. Government entity buyouts of loans in imminent risk of default, loans that have been modified, or loans that have defaulted will generally be reflected as prepayments on agency securities and also increase the uncertainty around these estimates. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate published prepayment data for similar agency securities, market consensus and current market conditions. If the actual prepayment experienced differs from our estimate of prepayments, we will be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

Spread Risk

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in

OCI pursuant to ASC 320. As of June 30, 2011, the fair value of these securities was $39.9 billion. When the spread between the yield on our agency securities and U.S. treasury securities or swap rates widens, this could cause the value of our agency securities to decline, creating what we refer to as spread risk. The spread risk associated with our agency securities and the resulting fluctuations in fair value of these securities can occur independent of interest rates and may relate to other factors impacting the mortgage and fixed income markets such as liquidity or changes in required rates of return on different assets.

Liquidity Risk

The primary liquidity risk for us arises from financing long-term assets with shorter-term borrowings in the form of repurchase agreements. Our assets that are pledged to secure repurchase agreements are high-quality agency securities and cash. As of June 30, 2011, we had unrestricted cash and cash equivalents of $625.9 million

and unpledged agency securities of $2.1 billion available to meet margin calls on our repurchase agreements, derivative instruments and for other corporate purposes. However, should the value of our agency securities pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. As such, we cannot assure that we will always be able to renew (or roll) our repurchase agreements. In addition, our counterparties have the option to increase our haircuts (margin requirements) on the assets we pledge against repurchase agreements, thereby reducing the amount that can be borrowed against an asset even if they agree to renew or roll the repurchase agreement. Significantly higher haircuts can reduce our ability to leverage our portfolio or even force us to sell assets, especially if correlated with asset price declines or faster prepayment rates on our assets.

Extension Risk

The projected weighted-average life and the duration (or interest rate sensitivity) of our investments is based on our Manager s assumptions regarding the rate at which the borrowers will prepay the underlying mortgage loans. In general, we use interest rate swaps and swaptions to help manage our funding cost on our investments in the event that interest rates rise. These swaps (or swaptions) allow us to reduce our funding exposure on the notional amount of the swap for a specified period of time by agreeing to pay a fixed-rate in exchange for receiving a floating rate that generally tracks our financing costs under our repurchase agreements.

However, if prepayment rates decrease in a rising interest rate environment, the average life or duration of our fixed-rate assets or the fixed-rate portion of the ARMs or other assets generally extends. This could have a negative impact on our results from operations, as our interest rate swap maturities are fixed and will, therefore, cover a smaller percentage of our funding exposure on our mortgage assets to the extent that their average lives increase due to slower prepayments. This situation may also cause the market value of our agency securities collateralized by fixed rate mortgages or hybrid ARMs to decline by more than otherwise would be the case while most of our hedging instruments (with the exception of short TBA mortgage positions, interest-only securities, Markit IOS Index total return swaps and certain other supplemental hedging instruments) would not receive any offsetting gains. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could cause us to incur realized losses.

Inflation Risk

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Further, our consolidated financial statements are prepared in accordance with GAAP and our distributions are determined by our Board of Directors based primarily by our net income as calculated for income tax purposes. In each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

Item 4. ***Controls and Procedures***

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act of 1934, as amended (the Exchange Act) reports is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of disclosure controls and procedures as promulgated under the Exchange Act and the rules and regulations there under. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2011. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

Changes in Internal Controls over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the three month or six month period ended June 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. ***Legal Proceedings***

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of June 30, 2011, we have no legal proceedings.

Item 1A. ***Risk Factors***

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010, except as described below.

You should carefully consider the risks described below and all other information contained in this interim report on Form 10-Q, including our interim consolidated financial statements and the related notes thereto before making a decision to purchase our securities. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us, or not presently deemed material by us, may also impair our operations and performance.

If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. If that happens, the trading price of our securities could decline, and you may lose all or part of your investment.

We have no employees and our Manager is responsible for making all of our investment decisions. Certain of our Manager s officers are employees of American Capital and are not required to devote any specific amount of time to our business and each of them may provide their services to American Capital, its affiliates and sponsored investment vehicles, which could result in conflicts of interest.

Because we have no employees, our Manager is responsible for making all of our investment decisions. Certain of our and our Manager s officers are employees of American Capital or its affiliates and these persons do not devote their time exclusively to us. Our Manager s investment committee consists of Malon Wilkus, John R. Erickson, Samuel A. Flax and Thomas A. McHale, each of whom is an officer of American Capital and has significant responsibilities to American Capital and certain of its portfolio companies, affiliated entities or managed funds. Gary Kain is

our President and Chief Investment Officer and also serves as the President and a member of the parent company of our Manager, and he may have significant responsibilities for new funds that are managed by the parent company of our Manager or affiliated entities of our Manager. Because certain of our and our Manager s officers are also responsible for providing services to American Capital and/or certain of its portfolio companies, affiliated entities or managed funds, they may not devote sufficient time to the management of our business operations.

American Capital has agreed that so long as the Manager or an affiliate of American Capital continues to manage our company, it will not sponsor another investment vehicle that invests predominantly in whole pool agency securities. This restriction does not prevent American Capital or an affiliate of American Capital from

investing in or sponsoring an investment vehicle that targets investments in agency securities so long as those investments are not predominately whole pool agency securities, and, as a result, American Capital or an affiliate of American Capital may compete with us. Our Manager has advised us that American Capital and its affiliates are sponsoring and investing in other investment vehicles, including investment vehicles that may make significant investments in agency securities, including whole pool agency securities. Our Manager and its employees are not restricted from participating in the management of such an entity.

Our Board of Directors has adopted investment guidelines that require that any investment transaction between us and American Capital or any affiliate of American Capital receive the prior approval of a majority of our independent directors. However, this policy does not eliminate the conflicts of interest that our and our Manager s officers will face in making investment decisions on behalf of American Capital, any other American Capital-sponsored investment vehicles and us. Further, we do not have any agreement or understanding with American Capital that would give us any priority over American Capital, any of its affiliates, or any such American Capital-sponsored investment vehicle in opportunities to invest in agency securities. Accordingly, we may compete for access to the benefits that we expect our relationship with our Manager and American Capital to provide.

We may change our policies at any time without stockholder approval, including our investment policy, which may adversely affect our financial condition, results of operations, the market price of our common stock or our ability to pay dividends or distributions.

Our Board of Directors and management determine all of our policies, including our investment, financing and distribution policies. They may amend or revise these policies at any time without a vote of our stockholders. Changes in our investment guidelines, including a change that would permit us to invest in non-agency securities, could increase the risk profile of our investment portfolio. If that were to happen, non-agency mortgage-backed securities would be subject to all of the risks of the respective underlying mortgage loans, including delinquency and foreclosure, which could result in significant losses to us. Changes to our investment and other policies could also adversely affect our financial condition, results of operations, the market price of our common stock or our ability to pay dividends or distributions.

Federal Reserve programs to purchase securities could have an adverse impact on the agency securities in which we invest.

Beginning in November 2008, the Federal Reserve initiated a program to purchase direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Bank and agency securities backed by Fannie Mae, Freddie Mac and Ginnie Mae. In total, this program resulted in the Federal Reserve purchasing $300 billion of direct obligations and $1.75 trillion of agency securities with the purchase program ending in the first quarter of 2010. One of the effects of this program has been to increase competition for available direct obligations and agency securities, with the result being an increase in pricing of such securities. The Federal Reserve may hold the direct obligations and agency mortgage securities to maturity or may sell them on the open market. For instance, in March 2011, the U.S. Treasury announced plans to start selling its remaining $142 billion of agency securities guaranteed by Fannie Mae or Freddie Mac. Sales by the Federal Reserve of the direct obligations or agency mortgage securities that it currently holds may reduce the market price of such securities.

Reductions in the market price of agency mortgage securities may negatively impact our book value. In addition, the Federal Reserve initiated a program in November 2010 to purchase up to $600 billion of long-term U.S. Treasury securities that ended in June 2011 as part of its continuing effort to help stimulate the economy by reducing mortgage and interest rates. The expiration of the program could negatively affect our income or our net book value by impacting interest rate levels and the spread between mortgage rates and other interest rates. Thus, these actions could reduce the yields on assets that we are targeting for purchase, thereby reducing our net interest spreads.

The market price of our common stock may fluctuate significantly.

The market price and marketability of shares of our securities may from time to time be significantly affected by numerous factors, including many over which we have no control and that may not be directly related to us. These factors include the following:

- price and volume fluctuations in the stock market from time to time, which are often unrelated to the operating performance of particular companies;
- significant volatility in the market price and trading volume of securities of REITs or other companies in our sector, which is not necessarily related to the operating performance of these companies;
- changes in regulatory policies, tax guidelines and financial accounting and reporting standards, particularly with respect to REITs;
- actual or anticipated changes in our dividend policy and earnings or variations in operating results;
- any shortfall in revenue or net income or any increase in losses from levels expected by securities analysts;
- issuances of additional equity securities;
- additions or departures of key management personnel, or changes in our relationship with our Manager and American Capital;
- decreases in our net asset value per share;
- general economic trends and other external factors; and
- loss of major repurchase agreement providers.

Fluctuations in the trading price of our common stock may adversely affect the liquidity of the trading market for our common stock and, in the event that we seek to raise capital through future equity financings, our ability to raise such equity capital.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

None.

Item 3.*Defaults Upon Senior Securities*

None.

Item 4.*Removed and Reserved*

Item 5.*Other Information*

None.

Item 6. ***Exhibits***

(a) Exhibits:

3.1	American Capital Agency Corp. Amended and Restated Certificate of Incorporation, as amended, filed herewith.
*3.2	American Capital Agency Corp. Second Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.1 of Form 8-K (File No. 001-34057), filed July 26, 2011.
4.1	Instruments defining the rights of holders of securities: See Article IV of our Amended and Restated Certificate of Incorporation, as amended, filed herewith as Exhibit 3.1.
*4.2	Instruments defining the rights of holders of securities: See Article VI of our Second Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.1 of Form 8-K (File No. 001-34057), filed July 26, 2011.
*4.3	Form of Certificate for Common Stock, incorporated herein by reference to Exhibit 4.1 to Amendment No. 4 to the Registration Statement on Form S-11 (Registration No. 333-149167), filed May 9, 2008.
10.1	Underwriting Agreement, dated June 22, 2011, among American Capital Agency Corp., American Capital Agency Management, LLC, Citigroup Global Markets Inc., J.P. Morgan Securities LLC, UBS Securities LLC and Wells Fargo Securities, LLC, as representatives of the several underwriters listed on Schedule I attached thereto, filed herewith.
31.1	Certification of CEO Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2	Certification of CFO Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32	Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Fully or partly previously filed

INDEX TO EXHIBITS

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AMERICAN CAPITAL AGENCY CORP.

Date: August 9, 2011

By: /s/ MALON WILKUS
Malon Wilkus

Chair of the Board and

Chief Executive Officer