Eaton Corp plc
Form 10-Q
May 03, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2013
Commission file number 000-54863
EATON CORPORATION plc
(Exact name of registrant as specified in its charter)

Ireland	98-1059235
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)
70 Sir John Rogerson's Quay, Dublin 2, Ireland	-
(Address of principal executive offices)	(Zip Code)

+1 (440) 523-5000
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o
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 (§232.405 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 þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ
There were 473.1 million Ordinary Shares outstanding as of March 31, 2013.

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

EATON CORPORATION plc
CONSOLIDATED STATEMENTS OF INCOME

	Three months ended March 31	
(In millions except for per share data)	2013	2012
Net sales	$5,310	$3,960
Cost of products sold	3,735	2,754
Selling and administrative expense	958	702
Research and development expense	152	105
Interest expense-net	75	28
Other (income) expense-net	(10)	3
Income before income taxes	400	368
Income tax expense	20	57
Net income	380	311
Less net income for noncontrolling interests	(2)	—
Net income attributable to Eaton ordinary shareholders	$378	$311
Net income per ordinary share		
Diluted	$0.79	$0.91
Basic	0.80	0.93
Weighted-average number of ordinary shares outstanding		
Diluted	475.1	339.8
Basic	471.9	335.4
Cash dividends declared per ordinary share	$0.42	$0.38

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EATON CORPORATION plc
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three months ended March 31	
(In millions)	2013	2012
Net income	$380	$311
Less net income for noncontrolling interests	(2)	—
Net income attributable to Eaton ordinary shareholders	378	311
Other comprehensive (loss) income, net of tax		
Currency translation and related hedging instruments	(206)	172
Pensions and other postretirement benefits	53	38
Cash flow hedges	(7)	16
Other comprehensive (loss) income attributable to Eaton ordinary shareholders	(160)	226
Total comprehensive income attributable to Eaton ordinary shareholders	$218	$537

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EATON CORPORATION plc
CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions)	March 31, 2013	December 31, 2012
Assets		
Current assets		
Cash	$639	$577
Short-term investments	397	527
Accounts receivable-net	3,685	3,510
Inventory	2,394	2,349
Deferred income taxes	459	449
Prepaid expenses and other current assets	622	432
Total current assets	8,196	7,844
Property, plant and equipment-net	3,841	3,877
Other noncurrent assets		
Goodwill	14,275	14,396
Other intangible assets	6,664	6,779
Deferred income taxes	1,103	1,254
Other assets	898	1,698
Total assets	$34,977	$35,848
Liabilities and shareholders’ equity		
Current liabilities		
Short-term debt	$84	$757
Current portion of long-term debt	569	314
Accounts payable	1,978	1,879
Accrued compensation	318	463
Other current liabilities	1,954	2,018
Total current liabilities	4,903	5,431
Noncurrent liabilities		
Long-term debt	9,473	9,762
Pension liabilities	1,794	1,997
Other postretirement benefits liabilities	728	732
Deferred income taxes	2,007	2,024
Other noncurrent liabilities	862	774
Total noncurrent liabilities	14,864	15,289
Shareholders’ equity		
Eaton shareholders’ equity	15,167	15,086
Noncontrolling interests	43	42
Total equity	15,210	15,128
Total liabilities and equity	$34,977	$35,848

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EATON CORPORATION plc
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three months ended March 31	
(In millions)	2013	2012
Operating activities		
Net income	$380	$311
Adjustments to reconcile to net cash provided by (used in) operating activities		
Depreciation and amortization	245	140
Pension expense	72	69
Contributions to pension plans	(208)	(330)
Changes in working capital	(546)	(388)
Other-net	157	100
Net cash provided by (used in) operating activities	100	(98)
Investing activities		
Cash paid for acquisitions of businesses	8	—
Capital expenditures for property, plant and equipment	(122)	(105)
Sales of short-term investments-net	132	262
Proceeds from sale of business	761	—
Other-net	(6)	(16)
Net cash provided by investing activities	773	141
Financing activities		
Payments on borrowings	(687)	(1)
Cash dividends paid	(194)	(127)
Exercise of employee stock options	56	43
Excess tax benefit from equity-based compensation	16	13
Other-net	(1)	3
Net cash used in financing activities	(810)	(69)
Effect of currency on cash	(1)	8
Total increase (decrease) in cash	62	(18)
Cash at the beginning of the period	577	385
Cash at the end of the period	$639	$367

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EATON CORPORATION plc
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Amounts are in millions unless indicated otherwise (per share data assume dilution).

Note 1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Eaton Corporation plc (Eaton or Company) have been prepared in accordance with generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, in the opinion of management, all adjustments (consisting of normal recurring accruals) have been made that are necessary for a fair presentation of the condensed consolidated financial statements for the interim periods. This Form 10-Q should be read in conjunction with the consolidated financial statements and related notes included in Eaton's 2012 Form 10-K. The interim period results are not necessarily indicative of the results to be expected for the full year. Management has evaluated subsequent events through the date this Form 10-Q was filed with the Securities Exchange Commission.

During the first quarter of 2013, Eaton re-segmented certain reportable operating segments due to a reorganization of the Company's businesses. The new reportable business segments include Electrical Products and Electrical Systems and Services (which include legacy Eaton and legacy Cooper electrical businesses), and Vehicle (which includes truck and automotive drivetrain and powertrain systems businesses). See Note 13 for additional information related to these segments.

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

Note 2. ACQUISITIONS AND SALE OF BUSINESSES

In 2012, Eaton acquired businesses in separate transactions. The Consolidated Statements of Income include the results of these businesses from the dates of the transactions. These transactions and the related annual sales prior to acquisition are summarized below:

Acquired businesses	Date of transaction	Business segment	Annual sales
Cooper Industries plc (Cooper) A diversified global manufacturer of electrical products and systems, with brands including Bussmann electrical and electronic fuses; Crouse-Hinds and CEAG explosion-proof electrical equipment; Halo and Metalux lighting fixtures; and Kyle and McGraw-Edison power systems products.	November 30, 2012	Electrical Products; Electrical Systems and Services	\$5,409 for 2011
Rolec Comercial e Industrial S.A. A Chilean manufacturer of integrated power assemblies and low- and medium-voltage switchgear, and a provider of engineering services serving mining and other heavy industrial applications in Chile and Peru.	September 28, 2012	Electrical Systems and Services	\$85 for the 12 months ended September 30, 2012
Jeil Hydraulics Co., Ltd. A Korean manufacturer of track drive motors, swing drive motors, main control valves and remote control valves for the construction equipment market.	July 6, 2012	Hydraulics	\$189 for 2011
Polimer Kaucuk Sanayi ve Pazarlama A.S. A Turkish manufacturer of hydraulic and industrial hose for construction, mining, agriculture, oil and gas, manufacturing, food and beverage, and chemicals markets. This business sells its products	June 1, 2012	Hydraulics	\$335 for 2011

under the SEL brand name.

Gycom Electrical Low-Voltage Power Distribution, Control and Automation A Swedish electrical low-voltage power distribution, control and automation components business.	June 1, 2012	Electrical Systems and Services	$24 for 2011

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Cooper Industries plc

On November 30, 2012, Eaton Corporation acquired Cooper for a purchase price of $13,192. The acquisition of Cooper has been accounted for using the acquisition method of accounting which requires, among other things, the assets acquired and liabilities assumed be recognized at their respective fair values as of the acquisition date. For accounting purposes, Eaton has been treated as the acquirer in the transaction. Acquisition accounting is dependent upon certain valuations and other studies that have yet to commence or progress to a stage where there is sufficient information for a definitive measurement. The process for estimating the fair values of identifiable intangible assets and certain tangible assets and assumed liabilities requires the use of judgment in determining the appropriate assumptions and estimates.

The entire purchase price allocation for Cooper is preliminary. As the Company finalizes the fair value of assets acquired and liabilities assumed, additional purchase price adjustments will be recorded during the measurement period in 2013. Fair value estimates are based on a complex series of judgments about future events and uncertainties and rely heavily on estimates and assumptions. The judgments used to determine the estimated fair value assigned to each class of assets acquired and liabilities assumed, as well as asset lives, can materially impact the Company's results of operations. The finalization of the purchase accounting assessment will result in changes in the valuation of assets acquired and liabilities assumed and may have a material impact on the Company's results of operations and financial position. See Note 2 in the 2012 Form 10-K for additional information related to the acquisition of Cooper.

Sale of Apex Tool Group, LLC

In July 2010, Cooper formed a joint venture, named Apex Tool Group, LLC (Apex), with Danaher Corporation (Danaher). Apex was formed by combining Cooper's tools business with certain tools businesses from Danaher's Tools and Components segment. Cooper and Danaher each owned a 50% interest in the joint venture, had equal representation on its board of directors and had a 50% voting interest in the joint venture.

On October 10, 2012, Cooper and Danaher announced they had entered into a definitive agreement to sell Apex to Bain Capital for approximately $1.6 billion subject to post-closing adjustments. On February 1, 2013, the sale of Apex was completed.

Note 3. ACQUISITION INTEGRATION CHARGES AND RESTRUCTURING CHARGES

Eaton incurs integration charges and transaction costs related to acquired businesses. A summary of these charges follows:

	Three months ended March 31	
	2013	2012
Acquisition integration charges		
Electrical Products	$3	$—
Electrical Systems and Services	5	2
Hydraulics	12	1
Total business segments	20	3
Corporate integration charges	6	—
Total acquisition integration charges	$26	$3
Transaction costs		
Corporate transaction costs	$5	$—
Total transaction costs	$5	$—
Total acquisition integration charges and transaction costs before income taxes	$31	$3
Total after income taxes	$22	$2
Per ordinary share - diluted	$0.05	$0.01

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Business segment integration charges for the first quarter of 2013 were related primarily to Cooper, Polimer Kaucuk Sanayi ve Pazarlama, Jeil Hydraulics and Rolec Comercial e Industrial S.A. Business segment integration charges for the first quarter of 2012 were related primarily to ACTOM Low Voltage, E. Begerow GmbH & Co. KG, Tuthill Coupling Group and Internormen Technology Group. These charges were included in Cost of products sold or Selling and administrative expense, as appropriate. In Business Segment Information the charges reduced Operating profit of the related business segment.

Corporate integration charges in 2013 were related to the acquisition of Cooper. These charges were included in Selling and administrative expense. In Business Segment Information the charges were included in Other corporate expense-net.

Acquisition-related transaction costs, such as investment banking, legal, and other professional fees are not included as a component of consideration transferred in an acquisition but are expensed as incurred. Acquisition related transaction costs in 2013 were related to the acquisition of Cooper. These charges were included in Selling and administrative expense, Interest expense-net and Other corporate expense-net, as appropriate. In Business Segment Information the charges were included in Interest expense-net and Other corporate expense-net.

See Note 2 for additional information about business acquisitions.

Restructuring Charges

During the fourth quarter of 2012, Eaton undertook restructuring activities to improve the efficiency of certain businesses. These actions resulted in a charge in 2012 of $50, comprised of severance costs totaling $34 and other non-cash expenses totaling $16. These charges were included in Cost of products sold or Selling and administrative expense, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related business segment. See Note 13 for additional information about business segments. As of March 31, 2013, the liability related to these restructuring actions totaled $32 and is expected to be paid out during the second quarter of 2013.

Note 4. GOODWILL

A summary of goodwill follows:

	March 31, 2013	December 31, 2012
Electrical Products	$6,163	$6,212
Electrical Systems and Services	5,338	5,378
Hydraulics	1,380	1,404
Aerospace	1,038	1,045
Vehicle	356	357
Total goodwill	$14,275	$14,396

The decrease in goodwill in 2013 was related to the impact of currency translation.

Note 5. DEBT

On November 30, 2012, the closing date of the acquisition of Cooper, Eaton borrowed $1,669 on a $6.75 billion, 364-day bridge facility (the Facility) which was obtained on May 21, 2012. The Facility was obtained to finance a portion of the cash paid to acquire Cooper and was available in a single draw on the closing date of the acquisition. On February 1, 2013, Eaton repaid the outstanding balance on the Facility.

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Note 6. RETIREMENT BENEFITS PLANS

The components of retirement benefits expense follow:

	Three months ended March 31					
	United States pension benefit expense		Non-United States pension benefit expense		Other postretirement benefits expense	
	2013	2012	2013	2012	2013	2012
Service cost	$32	$29	$15	$12	$5	$4
Interest cost	37	34	20	19	9	9
Expected return on plan assets	(57)	(45)	(21)	(19)	(2)	(1)
Amortization	33	29	7	4	3	4
	45	47	21	16	15	16
Settlement loss	6	4	—	2	—	—
Total expense	$51	$51	$21	$18	$15	$16

Note 7. LEGAL CONTINGENCIES

Eaton is subject to a broad range of claims, administrative and legal proceedings such as lawsuits that relate to contractual allegations, tax audits, patent infringement, personal injuries (including asbestos claims), antitrust matters and employment-related matters. Although it is not possible to predict with certainty the outcome or cost of these matters, the Company believes they will not have a material adverse effect on the consolidated financial statements.

In December 2010, a Brazilian court held that a judgment obtained by a Brazilian company, Raysul, against another Brazilian company, Saturnia, which was sold by Eaton in 2006, could be enforced against Eaton Ltda. This judgment is based on an alleged violation of an agency agreement between Raysul and Saturnia. At March 31, 2013, the Company has a total accrual of 91 Brazilian Reais related to this matter ($45 based on current exchange rates), comprised of 60 Brazilian Reais recognized in the fourth quarter of 2010 ($30 based on current exchange rates) with an additional 31 Brazilian Reais recognized through March 31, 2013 ($15 based on current exchange rates). In 2010, Eaton filed motions for clarification with the Brazilian court of appeals which were denied on April 6, 2011. Eaton Holding and Eaton Ltda. filed appeals on various issues to the Superior Court of Justice in Brasilia. In April 2013, the Superior Court of Justice ruled in favor of Raysul. The Company expects that any sum it may be required to pay in connection with this matter will not exceed the amount of the recorded liability.

On October 5, 2006, ZF Meritor LLC and Meritor Transmission Corporation (collectively, Meritor) filed an action against Eaton in the United States District Court for Delaware. The action sought damages, which would be trebled under United States antitrust laws, as well as injunctive relief and costs. The suit alleged that Eaton engaged in anti-competitive conduct against Meritor in the sale of heavy-duty truck transmissions in North America. Following a four week trial on liability only, on October 8, 2009, the jury returned a verdict in favor of Meritor. Eaton firmly believes that it competes fairly and honestly for business in the marketplace, and that at no time did it act in an anti-competitive manner. During an earlier stage in the case, the judge concluded that damage estimates contained in a report filed by Meritor were not based on reliable data and the report was specifically excluded from the case. On November 3, 2009, Eaton filed a motion for judgment as a matter of law and to set aside the verdict. That motion was denied on March 10, 2011. On March 14, 2011, Eaton filed a motion for entry of final judgment of liability, zero damages and no injunctive relief. That motion was denied on June 9, 2011. On August 19, 2011, the Court entered final judgment of liability but awarded zero damages to plaintiffs. The Court also entered an injunction prohibiting Eaton from offering rebates or other incentives based on purchasing targets but stayed the injunction pending appeal. Eaton appealed the liability finding and the injunction to the Third Circuit Court of Appeals. Meritor cross-appealed the finding of zero damages. On September 28, 2012, the Court of Appeals affirmed the District Court's denial of Eaton's motion for judgment as a matter of law, and let stand the jury verdict in favor of Meritor. The Third Circuit also ruled that the plaintiffs' damages report was properly excluded, but reversed the judgment of zero damages and ordered that the District Court must allow plaintiffs a limited opportunity to amend the damages report, which may be re-considered for reliability and admissibility. Injunctive relief also was vacated. An estimate of any potential loss related to this action cannot be made at this time.

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Note 8. INCOME TAXES

The effective income tax rate for the first quarter of 2013 was 5.0% compared to 15.6% for the first quarter of 2012. The lower effective tax rate in the first quarter of 2013 was primarily attributable to recording in the first quarter of 2013 the entire U.S. research and experimentation credit for 2012 as a result of a legislative change that occurred in January 2013, the effects of the Cooper transaction and integration, and enhanced utilization of foreign tax credits in the U.S.

At the end of the fourth quarter of 2011, the IRS issued a Statutory Notice of Deficiency (Notice) for Eaton's 2005 and 2006 tax years. The Notice proposes assessments of $75 in additional taxes plus $52 in penalties related primarily to transfer pricing adjustments for products manufactured in the Company's facilities in Puerto Rico and the Dominican Republic and sold to affiliated companies located in the U.S., net of agreed credits and deductions. The Company has set its transfer prices for products sold between these affiliates at the same prices that the Company sells such products to third parties. The Notice was issued despite the IRS having previously recognized the validity of the Company's transfer pricing methodology by entering into two successive binding Advance Pricing Agreements (APAs) that approved and, in fact, required the application of the Company's transfer pricing methodology for the ten year period of 2001 through 2010. For the years 2001 through 2004, the IRS had previously accepted the transfer pricing methodology related to these APAs after a comprehensive review conducted in two separate audit cycles. On December 16, 2011, immediately prior to the Notice being issued, the IRS sent a letter stating that it was canceling the APAs.

The Company firmly believes that the proposed assessments are without merit. The Company also believes that it was in full compliance with the terms of the two APAs, and that the IRS's unilateral attempt to retroactively cancel these two binding contracts is also without merit, and represents a breach of the two contracts. On February 29, 2012, the Company filed a Petition with the U.S Tax Court in which it asserted that the transfer pricing established in the two APA contracts meets the arms-length standard set by the U.S. income tax laws, and accordingly, that the two APA contracts should be enforced in accordance with their terms. On June 11, 2012, the Company filed a motion for partial summary judgment with the U.S. Tax Court, asking the U.S. Tax Court to find that the APAs are binding contracts and that the IRS has the burden of proving that it is entitled to cancel the APAs. On October 22, 2012, a hearing on the partial summary judgment motion was held at the U.S. Tax Court. A decision on the motion is pending. The Company believes that the ultimate resolution of this matter will not have a material adverse impact on its consolidated financial statements.

Note 9. EQUITY

The changes in Shareholders’ equity follow:

	Eaton shareholders’ equity	Noncontrolling interests	Total equity
Balance at December 31, 2012	$15,086	$42	$15,128
Net income	378	2	380
Other comprehensive loss	(160)	—	(160)
Cash dividends paid and accrued	(199)	(1)	(200)
Issuance of shares under equity-based compensation plans-net	62	—	62
Balance at March 31, 2013	$15,167	$43	$15,210

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The changes in Accumulated other comprehensive loss follow:

	Currency translation and related hedging instruments	Pensions and other postretirement benefits	Cash flow hedges	Total
Balance at December 31, 2012	$(393)	$(1,599)	$2	$(1,990)
Other comprehensive (loss) income before reclassifications	(206)	21	(6)	(191)
Amounts reclassified from Accumulated other comprehensive (loss) income	—	32	(1)	31
Net current-period other comprehensive (loss) income	(206)	53	(7)	(160)
Balance at March 31, 2013	$(599)	$(1,546)	$(5)	$(2,150)

The reclassifications out of Accumulated other comprehensive loss follow:

	Three months ended March 31, 2013	Consolidated Statements of Income classification
Amortization of defined benefit pension items		
Actuarial loss	$(49)	[1]
	(49)	
Tax benefit	17	
Total, net of tax	(32)	
Gains and losses on cash flow hedges		
Floating-to-fixed interest rate swaps	—	Interest expense-net
Currency exchange contracts	1	Cost of products sold
Commodity contracts	—	Cost of products sold
	1	
Tax expense	—	
Total, net of tax	1	
Total reclassifications for the period	$(31)	

[1] These components of Accumulated other comprehensive loss are included in the computation of net periodic pension cost. See Note 6 for additional information about defined benefit pension items.