

PENTAIR INC
Form 10-Q
October 21, 2008

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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 September 27, 2008

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 No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a 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

On September 27, 2008, 98,629,464 shares of Registrant's common stock were outstanding.

Pentair, Inc. and Subsidiaries

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Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****Pentair, Inc. and Subsidiaries
Condensed Consolidated Statements of Income (Unaudited)**

	Three months ended		Nine months ended	
	September 27 2008	September 29 2007	September 27 2008	September 29 2007
<i>In thousands, except per-share data</i>				
Net sales	\$864,167	\$821,215	\$2,614,328	\$2,513,359
Cost of goods sold	608,854	576,519	1,829,622	1,753,183
Gross profit	255,313	244,696	784,706	760,176
Selling, general and administrative	154,972	137,100	439,929	428,463
Research and development	16,691	14,446	48,871	44,204
Legal settlement			20,435	
Operating income	83,650	93,150	275,471	287,509
Other (income) expense:				
Gain on sale of interest in subsidiaries			(109,648)	
Equity losses of unconsolidated subsidiary	669	845	2,433	1,838
Loss on early extinguishment of debt	4,611		4,611	
Net interest expense	13,735	18,157	45,685	51,351
Income from continuing operations before income taxes and minority interest	64,635	74,148	332,390	234,320
Provision for income taxes	21,146	14,869	97,522	71,419
Minority Interest	2,100		2,100	
Income from continuing operations	41,389	59,279	232,768	162,901
Loss from discontinued operations, net of tax		(1,235)	(1,217)	(726)
Gain (loss) on disposal of discontinued operations, net of tax	(269)		(7,406)	207
Net income	\$ 41,120	\$ 58,044	\$ 224,145	\$ 162,382
Earnings (loss) per common share				
Basic				
Continuing operations	\$ 0.42	\$ 0.60	\$ 2.37	\$ 1.65
Discontinued operations		(0.01)	(0.08)	(0.01)
Basic earnings per common share	\$ 0.42	\$ 0.59	\$ 2.29	\$ 1.64
Diluted				
Continuing operations	\$ 0.42	\$ 0.59	\$ 2.34	\$ 1.63
Discontinued operations		(0.01)	(0.08)	(0.01)

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Diluted earnings per common share	\$ 0.42	\$ 0.58	\$ 2.26	\$ 1.62
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**Weighted average common shares
outstanding**

Basic	97,827	98,747	98,049	98,859
Diluted	99,319	100,365	99,372	100,339

Cash dividends declared per common share	\$ 0.17	\$ 0.15	\$ 0.51	\$ 0.45
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Pentair, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets (Unaudited)

<i>In thousands, except share and per-share data</i>	September 27 2008	December 31 2007	September 29 2007
Assets			
Current assets			
Cash and cash equivalents	\$ 93,544	\$ 70,795	\$ 56,555
Accounts and notes receivable, net	517,240	466,675	473,496
Inventories	430,386	392,416	395,638
Deferred tax assets	50,061	50,511	52,038
Prepaid expenses and other current assets	53,504	35,908	47,746
Current assets of discontinued operations		21,716	26,868
Total current assets	1,144,735	1,038,021	1,052,341
Property, plant and equipment, net	363,352	365,990	356,594
Other assets			
Goodwill	2,134,031	2,004,720	1,989,620
Intangibles, net	539,133	491,263	492,732
Other	69,874	82,237	77,084
Non-current assets of discontinued operations		18,383	18,500
Total other assets	2,743,038	2,596,603	2,577,936
Total assets	\$4,251,125	\$4,000,614	\$3,986,871
Liabilities and Shareholders Equity			
Current liabilities			
Short-term borrowings	\$	\$ 13,586	\$ 4,800
Current maturities of long-term debt	3,913	5,075	4,992
Accounts payable	225,928	229,937	204,360
Employee compensation and benefits	107,163	111,475	107,271
Current pension and post-retirement benefits	8,557	8,557	7,918
Accrued product claims and warranties	43,012	49,382	47,719
Income taxes	7,806	12,919	10,862
Accrued rebates and sales incentives	35,907	36,663	36,910
Other current liabilities	101,662	90,377	111,833
Current liabilities of discontinued operations		2,935	5,431
Total current liabilities	533,948	560,906	542,096
Other liabilities			
Long-term debt	1,035,150	1,041,925	1,102,707
Pension and other retirement compensation	164,776	161,042	222,098

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Post-retirement medical and other benefits	34,218	37,147	46,499
Long-term income taxes payable	25,356	21,306	18,214
Deferred tax liabilities	184,514	167,633	134,683
Other non-current liabilities	96,941	97,086	89,898
Non-current liabilities of discontinued operations		2,698	2,519
Total liabilities	2,074,903	2,089,743	2,158,714
Commitments and contingencies			
Minority interest	120,230		
Shareholders equity			
Common shares par value \$0.16 ^{2/3} ; 98,629,464, 99,221,831 and 99,468,474 shares issued and outstanding, respectively	16,438	16,537	16,578
Additional paid-in capital	456,144	476,242	478,396
Retained earnings	1,469,830	1,296,226	1,262,604
Accumulated other comprehensive income	113,580	121,866	70,579
Total shareholders equity	2,055,992	1,910,871	1,828,157
Total liabilities and shareholders equity	\$4,251,125	\$4,000,614	\$3,986,871

See accompanying notes to condensed consolidated financial statements.

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Pentair, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Unaudited)

	Nine months ended	
	September 27	September 29
<i>In thousands</i>	2008	2007
Operating activities		
Net income	\$ 224,145	\$ 162,382
Adjustments to reconcile net income to net cash provided by (used for) operating activities		
Loss from discontinued operations	1,217	726
(Gain) loss on disposal of discontinued operations	7,406	(207)
Equity losses of unconsolidated subsidiary	2,433	1,838
Minority interest	2,100	
Depreciation	45,759	45,538
Amortization	20,220	18,635
Deferred income taxes	25,927	(18,883)
Stock compensation	15,948	17,071
Excess tax benefits from stock-based compensation	(1,617)	(2,706)
Gain on sale of assets	87	(2,195)
Gain on sale of interest in subsidiaries	(109,648)	
Changes in assets and liabilities, net of effects of business acquisitions and dispositions		
Accounts and notes receivable	(55,727)	(27,927)
Inventories	(26,518)	13,973
Prepaid expenses and other current assets	(15,798)	(8,681)
Accounts payable	1,343	(1,088)
Employee compensation and benefits	(7,471)	3,037
Accrued product claims and warranties	(6,483)	3,199
Income taxes	(5,792)	(4,573)
Other current liabilities	9,380	15,955
Pension and post-retirement benefits	592	7,924
Other assets and liabilities	13,146	7,396
Net cash provided by (used for) continuing operations	140,649	231,414
Net cash provided by (used for) operating activities of discontinued operations	(3,432)	(2,081)
Net cash provided by (used for) operating activities	137,217	229,333
Investing activities		
Capital expenditures	(40,107)	(45,163)
Proceeds from sale of property and equipment	4,304	5,136
Acquisitions, net of cash acquired	(1,609)	(486,264)
Divestitures	29,526	
Other	(7)	(4,044)
Net cash provided by (used for) investing activities	(7,893)	(530,335)

Financing activities		
Net short-term borrowings	(14,180)	(10,378)
Proceeds from long-term debt	479,405	1,147,132
Repayment of long-term debt	(486,492)	(770,822)
Debt issuance costs	(114)	(1,876)
Excess tax benefits from stock-based compensation	1,617	2,706
Proceeds from exercise of stock options	5,140	5,512
Repurchases of common stock	(37,342)	(27,119)
Dividends paid	(50,541)	(44,986)
Net cash provided by (used for) financing activities	(102,507)	300,169
Effect of exchange rate changes on cash and cash equivalents	(4,068)	2,568
Change in cash and cash equivalents	22,749	1,735
Cash and cash equivalents, beginning of period	70,795	54,820
Cash and cash equivalents, end of period	\$ 93,544	\$ 56,555

See accompanying notes to condensed consolidated financial statements.

Table of Contents***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, which are included in our 2007 Annual Report on Form 10-K for the year ended December 31, 2007.

Certain line items within the 2007 Condensed Consolidated Statements of Income and the Condensed Consolidated Statements of Cash Flows have been reclassified from the 2007 presentation to conform to the 2008 presentation. The reclassification reflects the presentation of *Equity losses of unconsolidated subsidiary* of \$0.8 million and \$1.8 million for the three and nine months ended September 29, 2007, respectively, as a separate line item below *Operating income* in the Condensed Consolidated Statements of Income rather than as a component of *Selling, general and administrative*, and as a separate line in the *Adjustments to reconcile net income to net cash provided by(used for) by operating activities* in the Condensed Consolidated Statements of Cash Flows, rather than as a component of *Other assets and liabilities*. This reclassification corrects the previous presentation and was not material to the financial statements. It did not affect *Net income* within the Condensed Consolidated Statements of Income or net cash provided by (used for) operating, investing or financing activities within the Condensed Consolidated Statements of Cash Flows.

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.

2. New Accounting Standards

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB statement No. 133* (SFAS 161). SFAS 161 expands the disclosure requirements in Statement 133 about an entity's derivative instruments and hedging activities. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We are currently evaluating the impact of adopting SFAS 161.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51* (SFAS 160). SFAS 160 changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, except for the presentation and disclosure requirements, which will apply retrospectively. Upon adoption, we will classify minority interest as a component of equity for all periods presented.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141. SFAS 141R retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. SFAS 141R also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS 141R is effective for business combinations for which the acquisition date

is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will apply SFAS 141R prospectively to business combinations completed on or after that date. We do not expect adoption to have a significant impact to our current consolidated results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value (the Fair Value Option). SFAS 159 is effective for fiscal years beginning after November 15, 2007. We did not choose the Fair Value Option; therefore, the adoption of SFAS 159 did not have any impact on our consolidated results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, with the exception of the application of the statement to the determination of fair value of nonfinancial assets and liabilities that are recognized or disclosed on a nonrecurring basis, which is effective for fiscal years beginning after November 15, 2008.

Table of Contents***Pentair, Inc. and subsidiaries******Notes to condensed consolidated financial statements (unaudited)***

SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based upon our own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level of input that is significant to the fair value measurement.

At September 27, 2008, our interest rate swaps (see note 12) 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.

3. Stock-based Compensation

Total stock-based compensation expense was \$4.1 million and \$4.4 million for the three months ended September 27, 2008 and September 29, 2007, respectively, and was \$16.0 million and \$17.0 million for the nine months ended September 27, 2008 and September 29, 2007, respectively.

Non-vested shares of our common stock were granted to eligible employees with a vesting period of two to five years after issuance. Non-vested share awards are valued at market value on the date of grant and are typically expensed over the vesting period. Total compensation expense for non-vested share awards was \$2.0 million for the three months ended September 27, 2008 and September 29, 2007, respectively, and was \$7.5 million and \$7.4 million for the nine months ended September 27, 2008 and September 29, 2007, respectively.

During the first nine months of 2008, option awards were granted under the Omnibus Stock Incentive Plan, the 2008 Omnibus Stock Incentive Plan, as amended, and the Outside Directors Nonqualified Stock Option Plan (together the Plans), each with an exercise price equal to the market price of our common stock on the date of grant. Total compensation expense for stock option awards was \$2.1 million and \$2.4 million for the three months ended September 27, 2008 and September 29, 2007, respectively, and was \$8.5 million and \$9.6 million for the nine months ended September 27, 2008 and September 29, 2007, 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:

	September 27 2008	September 29 2007
Expected stock price volatility	27.0%	28.5%
Expected life	4.8 yrs	4.8 yrs
Risk-free interest rate	3.11%	4.46%
Dividend yield	1.90%	1.66%

The weighted-average fair value of options granted during the third quarter of 2008 and 2007 was \$8.35 and \$8.38 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 SFAS No. 123R (revised 2004), *Share Based Payment*, (SFAS 123R) 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.

Table of Contents***Pentair, Inc. and subsidiaries******Notes to condensed consolidated financial statements (unaudited)*****4. Earnings Per Common Share**

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

	Three months ended		Nine months ended	
	September 27 2008	September 29 2007	September 27 2008	September 29 2007
<i>In thousands</i>				
Weighted average common shares outstanding basic	97,827	98,747	98,049	98,859
Dilutive impact of stock options and restricted stock	1,492	1,618	1,323	1,480
Weighted average common shares outstanding diluted	99,319	100,365	99,372	100,339

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

	3,503	2,099	4,594	2,769
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In December 2007, the Board of Directors authorized the repurchase of shares of our common stock during 2008 up to a maximum dollar limit of \$50 million. As of September 27, 2008, we had purchased 1,094,059 shares for \$38.1 million pursuant to this authorization during 2008. This authorization expires on December 31, 2008.

5. Restructuring

During the second quarter of 2008, we announced and initiated certain business restructuring initiatives to further streamline our operations as a result of continuing deterioration in certain end markets. In relation to these initiatives, we recorded restructuring charges (reflected in *Selling, general and administrative* expense on the accompanying Condensed Consolidated Statements of Income) of \$2.7 million primarily for severance benefits paid or to be paid to terminated employees.

During the third quarter of 2008, we announced and initiated additional business restructuring initiatives aimed at reducing our fixed cost structure and rationalizing our manufacturing footprint. These initiatives included the announcement of the closure of certain manufacturing facilities as well as the reduction in hourly and salaried headcount of approximately 850 employees principally within the Water Group. These actions will generally be completed by the end of 2009. Restructuring related costs included in *Selling, general and administrative* expenses on the Condensed Consolidated Statements of Income include costs for severance and related benefits, asset impairment charges and other restructuring costs.

Restructuring costs are summarized as follows:

	Three months ended		Nine months ended	
	September 27 2008	September 29 2007	September 27 2008	September 29 2007
<i>In thousands</i>				
Severance and related costs	\$10,899	\$	\$13,583	\$
Asset impairment	4,600		4,600	

Total restructuring costs	\$15,499	\$	\$18,183	\$
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Restructuring accrual activity is summarized as follows:

In thousands

Balance at March 29, 2008				\$
Costs incurred				2,684
Cash payments				(723)
Balance at June 28, 2008				\$ 1,961
Costs incurred				10,899
Cash Payments				(3,338)
Balance at September 27, 2008				\$ 9,522

Table of Contents***Pentair, Inc. and subsidiaries******Notes to condensed consolidated financial statements (unaudited)*****6. Acquisitions**

On June 28, 2008, we entered into a transaction with GE Water & Process Technologies (a unit of General Electric Company) (*GE*) that was accounted for as an acquisition of an 80.1 percent ownership interest in *GE*'s global water softener and residential water filtration business in exchange for a 19.9 percent interest in our global water softener and residential water filtration business (the *GE Transaction*). The acquisition was effected through the formation of two new entities, a U.S. entity and an international entity, into which we and *GE* contributed certain assets, properties, liabilities and operations representing our respective global water softener and residential water filtration businesses. We are an 80.1 percent owner of the new entities and *GE* is a 19.9 percent owner. The fair value of the acquisition was \$228.9 million, which includes approximately \$2.9 million of acquisition related costs. The acquisition and related sale of our 19.9 percent interest resulted in a gain of \$109.6 million (\$85.8 million after tax), representing the difference between the carrying amount and the fair value of the 19.9 percent interest sold.

With the formation of this business, we believe we will be better positioned to serve residential customers with industry-leading technical applications in the areas of water conditioning, whole house filtration, point of use water management and water sustainability and expect to accelerate revenue growth by selling *GE*'s existing residential conditioning products through our sales channels.

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 approximately \$137.5 million. We continue to evaluate the purchase price allocation, including tangible and intangible assets, which primarily consist of trademarks, proprietary technology and customer relationships, contingent liabilities and liabilities associated with exit or disposal activities, and expect to revise the purchase price allocation in future periods as these estimates are finalized. The following table represents the preliminary purchase price allocation:

<i>In thousands</i>	September 27, 2008
Inventory	\$ 12,188
Property, plant & equipment	12,934
Goodwill	137,542
Identifiable intangible assets	66,483
Current liabilities	(234)
	\$ 228,913

On May 7, 2007, we acquired as part of our Technical Products Group the assets of Calmark Corporation (*Calmark*). *Calmark*'s results of operations have been included in our condensed consolidated financial statements since the date of acquisition.

On April 30, 2007, we acquired as part of our Water Group all of the capital interests in Porous Media Corporation and Porous Media, Ltd. (together, *Porous Media*). *Porous Media*'s results of operations have been included in our condensed consolidated financial statements since the date of acquisition.

On February 2, 2007, we acquired as part of our Water Group all of the outstanding shares of capital stock of Jung Pumpen GmbH (*Jung Pump*). *Jung Pump*'s results of operations have been included in our condensed consolidated financial statements since the date of acquisition.

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

Table of Contents***Pentair, Inc. and subsidiaries******Notes to condensed consolidated financial statements (unaudited)***

	Three months ended		Nine months ended	
	September	September	September	September
	27	29	27	29
<i>In thousands, except share and per-share data</i>	2008	2007	2008	2007
Pro forma net sales from continuing operations	\$ 864,167	\$ 842,740	\$ 2,668,801	\$ 2,601,906
Pro forma net income from continuing operations	41,389	59,279	232,768	162,714
Income (loss) from discontinued operations, net of tax	(269)	(1,235)	(8,623)	(519)
Pro forma net income	41,120	58,044	224,145	162,195
Pro forma earnings per common share continuing operations				
Basic	\$ 0.42	\$ 0.60	\$ 2.37	\$ 1.65

Revenues:

New vehicle sales

\$

496,121

\$

438,375

\$

923,871

\$

797,994

Used vehicle sales

230,909

200,769

439,987

398,091

Finance and insurance

32,776

27,204

60,330

51,820

Service, body and parts

85,736

75,417

168,209

149,682

Fleet and other

939

9,064

2,269

12,168

Total revenues

846,481

750,829

1,594,666

1,409,755

Cost of sales

702,256

623,817

1,319,660

1,165,610

Gross profit

144,225

127,012

275,006

244,145

Selling, general and administrative

107,536

93,323

208,253

182,455

Depreciation - buildings

1,114

886

2,204

1,714

Depreciation and amortization - other

3,098

2,520

6,054

5,080

Income from operations

32,477

30,283

58,495

54,896

Other income (expense):

Floorplan interest expense

(8,502

)

(7,865

)

(14,096

)

(9,633

)

Other interest expense

(3,641

)

(3,036

)

(6,972

)

(5,841

)

Other income, net

314

247

742

531

(11,829

)

(10,654

)

(20,326

)

(14,943

)

Income from continuing operations before income taxes

20,648

19,629

38,169

39,953

Income taxes

(8,706

)

(7,781

)

(15,538

)

(15,673

)

Income before discontinued operations

11,942

11,848

22,631

24,280

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Loss from discontinued operations, net of income tax benefit of \$153, \$285, \$882 and \$592

(51

)

(430

)

(1,372

)

(916

)

Net income

\$

11,891

\$

11,418

\$

21,259

\$

23,364

Basic income per share from continuing operations

\$

0.61

\$

0.62

\$

1.16

\$

1.27

Basic loss per share from discontinued operations

(0.02

)

(0.07

)

(0.05

)

Basic net income per share

\$

0.61

\$

0.60

\$

1.09

\$

1.22

Shares used in basic per share calculations

19,501

19,142

19,464

19,085

Diluted income per share from continuing operations

\$

0.56

\$

0.57

\$

1.07

\$

1.16

Diluted loss per share from discontinued operations

(0.02

)

(0.07

)

(0.04

)

Diluted net income per share

\$

0.56

\$

0.55

\$

1.00

\$

1.12

Shares used in diluted per share calculations

22,150

21,749

22,109

21,710

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

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LITHIA MOTORS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six months ended June 30,	
	2006	2005
	(Restated)	(Restated)
Cash flows from operating activities:		
Net income	\$ 21,259	\$ 23,364
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	8,258	6,794
Depreciation and amortization of discontinued operations		155
Stock-based compensation	1,692	278
Loss on sale of assets	85	224
Gain on sale of franchise		(44)
Deferred income taxes	3,771	1,527
Excess tax benefits from share-based payment arrangements	(366)	
(Increase) decrease, net of effect of acquisitions:		
Trade and installment contract receivables, net	(7,188)	(10,191)
Contracts in transit	(146)	(11,745)
Inventories	(250,019)	(103,530)
Vehicles leased to others	(1,341)	(498)
Prepaid expenses and other	2,821	1,057
Other non-current assets	(3,471)	745
Increase (decrease), net of effect of acquisitions:		
Floorplan notes payable	197,517	85,638
Trade payables	2,943	3,267
Accrued liabilities	8,514	5,501
Other long-term liabilities and deferred revenue	832	49
Net cash provided by (used in) operating activities	(14,839)	2,591
Cash flows from investing activities:		
Capital expenditures:		
Non-financeable	(8,962)	(12,769)
Financeable	(23,175)	(13,797)
Proceeds from sale of assets	302	258
Cash paid for acquisitions, net of cash acquired	(28,015)	(26,007)
Proceeds from sale of dealerships	3,926	6,577
Net cash used in investing activities	(55,924)	(45,738)
Cash flows from financing activities:		
Floorplan notes payable: non-trade	13,014	3,629
Net borrowings (repayments) on lines of credit	18,000	29,314
Principal payments on long-term debt and capital leases	(4,548)	(3,757)
Proceeds from issuance of long-term debt	19,723	13,334
Repurchase of common stock		(9)
Proceeds from issuance of common stock	3,768	4,322
Excess tax benefits from share-based payment arrangements	366	
Dividends paid	(4,691)	(3,064)
Net cash provided by financing activities	45,632	43,769
Increase (decrease) in cash and cash equivalents	(25,131)	622
Cash and cash equivalents:		
Beginning of period	48,566	28,869

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End of period	\$ 23,435	\$ 29,491
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 22,081	\$ 17,253
Cash paid during the period for income taxes	7,029	6,207
Supplemental schedule of non-cash investing and financing activities:		
Debt issued in connection with acquisitions	\$ 6,111	\$
Flooring debt assumed in connection with acquisitions	25,857	23,352
Flooring debt paid by purchaser in connection with dealership disposals	4,713	

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

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LITHIA MOTORS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

The financial information included herein as of June 30, 2006 and December 31, 2005 and for the three and six-month periods ended June 30, 2006 and 2005 is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments, which, in the opinion of management, are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods. The unaudited balance sheets at June 30, 2006 and December 31, 2005 reflect restated balances as a result of the restatement described in Note 2 and, therefore, the previously issued audited financial statements as of and for the years ended December 31, 2005, 2004 and 2003 should not be relied upon. We are filing an amended Form 10-K for the year ended December 31, 2005 and amended Form 10-Qs for the first and second quarters of 2006. The income statement data for the six-month period ended June 30, 2006 is not necessarily indicative of the results that we may achieve for the full year.

Note 2. Restatement

We are restating our previously reported financial information for the second quarter of 2006 to correct an error in those financial statements relating to our derivative accounting under Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. In addition, we are restating for other errors that were previously deemed to be immaterial.

We account for our derivative financial instruments in accordance with SFAS No. 133 as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FASB Statement No. 133 and SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities (collectively, the Standards). The Standards require that all derivative instruments (including certain derivative instruments embedded in other contracts) be recorded on the balance sheet as either an asset or liability measured at its fair value, and that changes in the derivatives fair value be recognized currently in earnings unless specific hedge accounting criteria are met. From inception of the hedging program, we applied a method of cash flow hedge accounting under SFAS No. 133 to account for the interest rate swap transactions that allowed us to assume the effectiveness of such transactions (the so-called short-cut method). We recently concluded that the interest rate swap transactions did not qualify for the short-cut method in prior periods because of the prepayment clauses in the debt agreements. Furthermore, although management believes that the interest rate swaps would have qualified for hedge accounting under SFAS No. 133, hedge accounting under SFAS No. 133 is not allowed retrospectively because the hedge documentation required was not in place at the inception of the hedge. Eliminating the application of cash flow hedge accounting reverses the fair value adjustments that were made on our balance sheet in other comprehensive income into floorplan interest expense on our income statement.

Although the swaps do not retrospectively qualify for hedge accounting under SFAS No. 133, there is no effect on cash flows from operating, investing or financing activities for these changes. The effectiveness of the swaps as hedge transactions has not been affected by these changes in accounting treatment.

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In addition, we are restating our previously reported financial information for other items that were individually deemed, and are currently deemed, to be immaterial. Because the interest rate swap adjustment has required a restatement, we have elected to record these adjustments in the proper periods.

These adjustments include the following:

- **Intra-company gross profit elimination:** We recorded adjustments to inventory and cost of sales in order to reflect the elimination of intra-company gross profit recognized on service work performed on new vehicle inventory.
- **Income tax expense:** We recorded an adjustment to accrued liabilities and income tax expense related to a tax contingency reserve.

The following tables detail the restatements (in thousands, except per share amounts):

	December 31, 2005		
	As Originally Reported	Adjustments	As Restated
Accrued liabilities	\$ 57,775	\$ (598)	\$ 57,177
Accumulated other comprehensive income	3,316	(3,316)	
Retained earnings	229,647	3,914	233,561
Total stockholders' equity	459,633	598	460,231

	June 30, 2006		
	As Originally Reported	Adjustments	As Restated
Accrued liabilities	\$ 65,431	\$ 24	\$ 65,455
Other long-term liabilities	11,272	1	11,273
Additional paid in capital	4,226	6	4,232
Accumulated other comprehensive income	4,223	(4,223)	-
Retained earnings	245,937	4,192	250,129
Total stockholders' equity	482,651	(25)	482,626

	Three Months Ended June 30, 2006		
	As Originally Reported	Adjustments	As Restated
Floorplan interest expense	\$ 8,931	\$ (429)	\$ 8,502
Other income, net	315	(1)	314
Income tax expense	8,503	203	8,706
Loss from discontinued operations	50	1	51
Net income	11,667	224	11,891
Basic net income per share	0.60	0.01	0.61
Diluted net income per share	0.55	0.01	0.56

	Three Months Ended June 30, 2005		
	As Originally Reported	Adjustments	As Restated
Cost of sales	\$ 623,584	\$ 233	\$ 623,817
Floorplan interest expense	6,000	1,865	7,865
Income tax expense	8,622	(841)	7,781
Net income	12,675	(1,257)	11,418
Basic net income per share	0.66	(0.06)	0.60
Diluted net income per share	0.60	(0.05)	0.55

Six Months Ended June 30, 2006

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	As Originally Reported	Adjustments	As Restated
Floorplan interest expense	\$ 15,546	\$ (1,450)	\$ 14,096
Income tax expense	14,373	1,165	15,538
Loss from discontinued operations	1,371	1	1,372
Net income	20,975	284	21,259
Basic net income per share	1.08	0.01	1.09
Diluted net income per share	0.99	0.01	1.00

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	Six Months Ended June 30, 2005		
	As Originally Reported	Adjustments	As Restated
Cost of sales	\$ 1,165,278	\$ 332	\$ 1,165,610
Floorplan interest expense	11,102	(1,469)	9,633
Other income, net	532	(1)	531
Income tax expense	15,236	437	15,673
Net income	22,665	699	23,364
Basic net income per share	1.19	0.03	1.22
Diluted net income per share	1.09	0.03	1.12

Note 3. Inventories

Inventories are valued at the lower of market value or cost, using the specific identification method for vehicles and parts. The cost of new and used vehicle inventories includes the cost of any equipment added, reconditioning and transportation. Inventories consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
New and program vehicles	\$ 732,832	\$ 491,486
Used vehicles	121,292	87,853
Parts and accessories	27,866	26,708
	\$ 881,990	\$ 606,047

Note 4. Earnings Per Share

Following is a reconciliation of the income from continuing operations and weighted average shares used for our basic earnings per share (EPS) and diluted EPS (in thousands, except per share amounts).

Three Months Ended June 30,	2006 (Restated)			2005 (Restated)		
	Income from Continuing Operations	Shares	Per Share Amount	Income from Continuing Operations	Shares	Per Share Amount
Basic EPS						
Income from continuing operations available to common stockholders	\$ 11,942	19,501	\$ 0.61	\$ 11,848	19,142	\$ 0.62
Effect of Dilutive Securities						
2 7/8% convertible senior subordinated notes	438	2,255	(0.04)	459	2,255	(0.04)
Stock options and unvested restricted stock		394	(0.01)		352	(0.01)
Diluted EPS						
Income from continuing operations available to common stockholders	\$ 12,380	22,150	\$ 0.56	\$ 12,307	21,749	\$ 0.57
Antidilutive Securities						
Shares issuable pursuant to stock options not included since they were antidilutive					392	

Six Months Ended June 30,	2006 (Restated) Income from Continuing Operations	Shares	Per Share Amount	2005 (Restated) Income from Continuing Operations	Shares	Per Share Amount
Basic EPS						
Income from continuing operations available to common stockholders	\$ 22,631	19,464	\$ 1.16	\$ 24,280	19,085	\$ 1.27
Effect of Dilutive Securities						
2 7/8% convertible senior subordinated notes	931	2,255	(0.07)	927	2,255	(0.09)
Stock options and unvested restricted stock		390	(0.02)		370	(0.02)
Diluted EPS						
Income from continuing operations available to common stockholders	\$ 23,562	22,109	\$ 1.07	\$ 25,207	21,710	\$ 1.16
Antidilutive Securities						
Shares issuable pursuant to stock options not included since they were antidilutive					392	

Note 5. Acquisitions

The following acquisitions were made in the first six months of 2006:

- In April 2006, we acquired the Fresno Dodge store in Fresno, California. The store has anticipated annualized revenues of \$50 million. The store was renamed Lithia Dodge of Fresno.

- In May 2006, we acquired the Latham Motors store in Twin Falls, Idaho. The store has anticipated annualized revenues of \$25 million. The store was renamed Lithia Chrysler Jeep Dodge of Twin Falls.

- In June 2006, we acquired the TradeMark Chrysler Jeep Dodge store in Bryan College Station, Texas. The store has anticipated annualized revenues of \$60 million. The store was renamed Lithia Chrysler Jeep Dodge of Bryan College Station.

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- In June 2006, we acquired the Eversole Motors store in La Crosse, Wisconsin. The store has anticipated annualized revenues of \$25 million. The store was renamed Lithia Chrysler Jeep Dodge of La Crosse.

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The above acquisitions were all accounted for under the purchase method of accounting. Pro forma results of operations, assuming all of the above acquisitions and the previously disclosed 2005 acquisitions occurred as of January 1, 2005, were as follows (in thousands, except per share amounts).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(Restated)	(Restated)	(Restated)	(Restated)
Total revenues	\$ 867,904	\$ 825,632	\$ 1,651,456	\$ 1,562,101
Net income	12,158	12,022	21,587	24,382
Basic earnings per share	0.62	0.63	1.11	1.28
-Diluted earnings per share	0.57	0.57	1.02	1.17

There are no future contingent payouts related to any of the 2006 acquisitions and no portion of the purchase price was paid with our equity securities. During the first two quarters of 2006, we acquired the four stores discussed above for \$28.0 million in cash, which included \$15.0 million of goodwill and \$7.0 million of other intangible assets.

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Within one year from the purchase date, we may update the value allocated to purchased assets and the resulting goodwill balances based on pending information received regarding the valuation of such assets. All of the goodwill from the above acquisitions is expected to be deductible for tax purposes.

Note 6. Dividend Payments

Cash dividends at the rate of \$0.12 per common share, which totaled approximately \$2.3 million and \$2.4 million were paid on March 6, 2006 and May 5, 2006, respectively.

Note 7. Stock-Based Compensation**Adoption of SFAS No. 123R**

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment, which establishes accounting for equity instruments exchanged for employee services. Under the provisions of SFAS No. 123R, stock-based compensation cost for equity classified awards is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity award). Prior to January 1, 2006, we accounted for share-based compensation to employees in accordance with Accounting Principles Board Option No. 25, Accounting for Stock Issued to Employees, (APB 25) and related interpretations. We also followed the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation.

We have elected to adopt the modified prospective transition method as provided by SFAS No. 123R and, accordingly, financial statement amounts for the prior periods presented in this Form 10-Q have not been restated to reflect the fair value method of expensing stock-based compensation. Under this method, the provisions of SFAS No. 123R apply to all awards granted or modified after the date of adoption, as well as to the unrecognized expense of awards not yet vested at the date of adoption. Such expense will be recognized as compensation expense in the periods after the date of adoption using the Black-Scholes valuation method over the remainder of the requisite service period. Our unearned compensation balance of \$1.1 million as of December 31, 2005, which was accounted for under APB 25, was reclassified into our Class A common stock upon the adoptions of SFAS No. 123R. The cumulative effect of the change in accounting principle from APB 25 to SFAS No. 123R was not material.

Disclosure of net income and earnings per share as if the method prescribed by SFAS No. 123, Accounting for Stock-Based Compensation, had been applied in measuring compensation expense in prior periods was as follows (in thousands, except per share amounts):

	Three Months Ended June 30, 2005 (Restated)	Six Months Ended June 30, 2005 (Restated)
Net income, as reported	\$ 11,418	\$ 23,364
Add Stock-based employee compensation expense included in reported net income, net of related tax effects	123	169
Deduct - total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(781)	(1,503)
Net income, pro forma	\$ 10,760	\$ 22,030
Basic net income per share:		
As reported	\$ 0.60	\$ 1.22
Pro forma	\$ 0.56	\$ 1.15
Diluted net income per share:		
As reported	\$ 0.55	\$ 1.12
Pro forma	\$ 0.52	\$ 1.06

2003 Stock Incentive Plan

Our 2003 Stock Incentive Plan (the 2003 Plan) allows for the granting of up to a total of 2.2 million nonqualified stock options and shares of restricted stock to our officers, key employees and consultants. We also have options outstanding and exercisable pursuant to their original terms pursuant to prior plans. Options canceled under prior plans do not return to the pool of options to be granted again in the future. All of our option plans are administered by the Compensation Committee

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of the Board and permit accelerated vesting of outstanding options upon the occurrence of certain changes in control. Options become exercisable over a period of up to five years from the date of grant with expiration dates up to ten years from the date of grant and at exercise prices as determined by the Board. Beginning in 2004, the expiration date of options granted was reduced to six years. At June 30, 2006, 2,423,872 shares of Class A common stock were reserved for issuance under the plans, of which 1,171,444 were available for future grant.

Activity under the above plan was as follows:

	Shares Subject to Options	Weighted Average Exercise Price
Balances, December 31, 2005	1,227,684	\$ 19.06
Granted	112,000	31.67
Forfeited	(27,402)	24.67
Expired		
Exercised	(59,854)	15.38
Balances, June 30, 2006	1,252,428	20.21

	Non-Vested Stock	Weighted Average Grant Date Fair Value
Balances, December 31, 2005	49,767	\$ 27.58
Granted	73,328	31.73
Vested	(4,400)	32.22
Forfeited	(8,148)	29.91
Balances, June 30, 2006	110,547	29.97

Certain information regarding options outstanding as of June 30, 2006 was as follows:

	Options Outstanding	Options Exercisable
Number	1,252,428	495,855
Weighted average per share exercise price	\$ 20.21	\$ 13.77
Aggregate intrinsic value	\$ 12.7 million	\$ 8.2 million
Weighted average remaining contractual term	4.6 years	4.0 years

As of June 30, 2006, unrecognized stock-based compensation related to outstanding, but unvested stock option and stock awards was \$5.9 million, which will be recognized over the weighted average remaining vesting period of 2.5 years.

1998 Employee Stock Purchase Plan

In 1998, the Board of Directors and the stockholders approved the implementation of an Employee Stock Purchase Plan (the Purchase Plan), and, as amended in May 2006, have reserved a total of 2.45 million shares of Class A common stock for issuance thereunder. The Purchase Plan expires December 31, 2012. The Purchase Plan is intended to qualify as an Employee Stock Purchase Plan under Section 423 of the Internal Revenue Code of 1986, as amended, and is administered by the Compensation Committee of the Board. Eligible employees are entitled to defer up to 10% of their base pay for the purchase of stock up to \$25,000 of fair market value of our Class A common stock annually. Prior to April 1, 2005, the purchase price for shares purchased under the Purchase Plan was 85% of the lesser of the fair market value at the beginning or end of the purchase period. Beginning April 1, 2005, the purchase price is equal to 85% of the fair market value at the end of the purchase period. During the first six months of 2006, a total of 101,119 shares were purchased under the Purchase Plan at a weighted average price of \$28.16 per share, which represented a weighted average discount from the fair market value of \$4.95 per share. As of June 30, 2006, 883,341 shares remained available for purchase under the Purchase Plan.

Stock-Based Compensation

We estimate the fair value of stock options using the Black-Scholes valuation model. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock options. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

Beginning April 1, 2005, compensation expense related to our Purchase Plan is calculated based on the 15% discount from the per share market price on the date of grant. Prior to April 1, 2005, it was calculated using the Black-Scholes valuation model. Compensation expense related to non-vested stock is based on the intrinsic value on the date of grant as if the stock is vested. Compensation expense related to nonqualified stock options was valued using the Black-Scholes valuation model with following assumptions:

Three and Six Months Ended June 30,	2006	2005	
Employee Stock Purchase Plan(1)			
Risk-free interest rates		2.32	%
Dividend yield		1.23	%
Expected lives		3 months	
Volatility		28.18	%
Discount for post vesting restrictions		0.0	%
Option Plans			
Risk-free interest rates(2)	4.77	% 3.58% - 3.71	%
Dividend yield(3)	1.51	% 1.16% - 1.20	%
Expected term(4)	4.7 5.3 years	5.4 years	
Volatility(5)	35.31	% 41.92% - 42.04	%
Discount for post vesting restrictions	0.0	% 0.0	%

-
- (1) There are no values for the employee stock purchase plan for 2006 since there is no longer a look-back period and the related compensation cost is equal to the intrinsic value of the 15% discount on the day of purchase.
- (2) The risk-free interest rate for each grant is based on the U.S. Treasury yield curve in effect at the time of grant for a period equal to the expected term of the stock option.
- (3) The dividend yield is calculated as a ratio of annualized expected dividend per share to the market value of our common stock on the date of grant.
- (4) The expected term is calculated based on the observed and expected time to post-vesting exercise behavior of separate identifiable employee groups.
- (5) The expected volatility is estimated based on a weighted average of historical volatility of our common stock.

We amortize stock-based compensation on a straight-line basis over the vesting period of the individual award with estimated forfeitures considered. Shares to be issued upon the exercise of stock options will come from newly issued shares.

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Certain information regarding our stock-based compensation was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Weighted average grant-date per share fair value of share options granted	\$	\$	\$ 10.93	\$ 10.69
Per share intrinsic value of non-vested stock granted	32.50	26.85	31.73	27.54
Weighted average per share discount for compensation expense recognized under the Purchase Plan	4.52	4.31	4.84	4.84
Total intrinsic value of share options exercised	127,000	114,000	1.0 million	1.2 million
Fair value of non-vested shares that vested during the period	142,000	86,000	142,000	86,000
Stock-based compensation recognized in results of operations (all as a component of selling, general and administrative expense)	1.0 million	203,000	1.7 million	278,000
Tax benefit recognized in statement of operations	179,000	80,000	253,000	109,000
Cash received from options exercised and shares purchased under all share-based arrangements	1.7 million	1.7 million	3.8 million	4.3 million
Tax deduction realized related to stock options exercised	105,000	67,000	420,000	362,000

Prior to the adoption of SFAS No. 123R, excess tax benefits realized upon the exercise of stock options were classified as an operating cash flow. SFAS No. 123R requires that these excess tax benefits be reclassified in the statements of cash flows as a cash flow from financing activities. For the three and six-month periods ended June 30, 2006, the amount of excess tax benefits that were shown as a financing activity was \$51,000 and \$366,000, respectively.

The following reconciles what certain operating results would have been without the effects of applying SFAS No. 123R in the three and six-month periods ended June 30, 2006 (in thousands, except per share amounts):

	Three Months Ended June 30, 2006		Six Months Ended June 30, 2006	
	As Reported (Restated)	Pro Forma without effects of applying SFAS No. 123R	As Reported (Restated)	Pro Forma without effects of applying SFAS No. 123R
Income from continuing operations before income taxes	\$ 20,648	\$ 21,537	\$ 38,169	\$ 39,621
Net income	11,891	12,658	21,259	22,576
Cash flow from operating activities	n/a	n/a	(14,839)	(14,473)
Cash flow from financing activities	n/a	n/a	45,632	45,266
Basic earnings per share	0.61	0.65	1.09	1.16
Diluted earnings per share	0.56	0.59	1.00	1.06

Note 8. Discontinued Operations

We continually monitor the performance of each of our dealerships and make determinations to sell based primarily on return on capital criteria. When a dealership meets the criteria of held for sale, as defined in SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the results of operations are reclassified into discontinued operations. All dealerships included in discontinued operations have been, or will be, eliminated from our on-going operations upon completion of the sale. We anticipate the completion of the sale for each dealership to occur within 12 months from the date of determination.

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During the first six months of 2006, we disposed of two of our dealerships that were held for sale at December 31, 2005 and, at June 30, 2006, no dealerships remained available for sale. Certain financial information related to discontinued operations was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenue	\$ 2,642	\$ 12,235	\$ 11,248	\$ 27,920
Pre-tax loss	(204)	(715)	(2,254)	(1,544)
Gain on disposal of discontinued operations, net of tax				36
Amount of goodwill and other intangible assets disposed of	1,606	4,406	3,552	4,406

The pre-tax loss in the six months ended June 30, 2006 included legal settlements related to dealerships in California that were sold in prior years.

Interest expense is allocated to stores classified as discontinued operations for actual flooring interest expense directly related to the new vehicles in the store. Interest expense related to our used vehicle line of credit is allocated based on total used vehicle inventory of the store, and interest expense related to our equipment line of credit is allocated based on the amount of fixed assets.

Assets held for sale included the following (in thousands):

	June 30, 2006	December 31, 2005
Inventories	\$	\$ 22,703
Property, plant and equipment		817
Goodwill		2,368
Other intangible assets		1,523
	\$	\$ 27,411

Liabilities held for sale of \$22.4 million at December 31, 2005 represented new vehicle flooring notes payable related to the dealerships held for sale.

Note 9. New Accounting Pronouncements

FASB Interpretation No. 48

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes , which is an interpretation of FASB Statement No. 109, Accounting for Income Taxes. Interpretation No. 48 applies to all tax positions accounted for under SFAS No. 109. The interpretation applies to situations where the uncertainty is to the timing of the deduction, the amount of the deduction, or the validity of the deduction. Interpretation No. 48 is effective as of the beginning of the first fiscal year beginning after December 15, 2006 (January 1, 2007 for calendar-year companies). At adoption, companies must adjust their financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Positions that meet this criterion should be measured using the largest benefit that is more than 50 percent likely to be realized. The necessary adjustment should be recorded directly to the beginning balance of retained earnings in the period of adoption and reported as a change in accounting principle. Retrospective application is prohibited. The impact of adopting Interpretation No. 48 on the financial statements is not fully known or estimable, however, it is expected to have no effect on results of operations or cash flow.

EITF Issue No. 06-3

Emerging Issues Task Force (EITF) Issue 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation), requires us to disclose our accounting policy for any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction (i.e., sales, use, value added) on a gross (included in revenues and costs) or net (excluded from revenues) basis.

EITF Issue 06-3 is effective for periods beginning after December 15, 2005, with earlier application permitted. We account for such taxes on a net basis.

SFAS No. 156

In March 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. SFAS No. 156 amends SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, with respect to accounting for separately recognized servicing assets and servicing liabilities. SFAS No. 156 is effective for fiscal years that begin after September 15, 2006, with early adoption permitted as of the beginning of an entity s fiscal year. We do not have any servicing assets or servicing liabilities and, accordingly, the adoption of SFAS No. 156 will not have any effect on our results of operations, financial condition or cash flows.

SFAS No. 155

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No 133 and 140. SFAS No. 155 resolves implementation issues addressed in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS No. 155 is effective for fiscal years that begin after September 15, 2006, with early adoption permitted as of the beginning of an entity s fiscal year. We do not have any beneficial interests in securitized financial assets and, accordingly, the adoption of SFAS No. 155 will not have any effect on our results of operations, financial condition or cash flows.

EITF 04-13

In September 2005, the Emerging Issues Task Force (EITF) issued EITF 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty, which clarifies accounting when two or more inventory purchase and sales transactions with the same counterparty should be viewed as a single exchange transaction, subject to Accounting Principles Board Issue No. 29, Accounting for Non-Monetary Transactions. EITF 04-13 is required for interim or annual reporting periods beginning after March 15, 2006. Accordingly, we adopted EITF 04-13 effective April 1, 2006. The adoption of EITF 04-3 did not have a significant impact on our results of operations, financial condition or cash flows.

Note 10. Reclassifications

Certain amounts in the prior period financial statements have been reclassified to conform to the current period presentation.

Note 11. Subsequent Events

Acquisition

In August 2006, we acquired the Ukiah Dodge Chrysler Jeep store in Ukiah, California. The store has anticipated annualized revenues of \$10 million. The store was renamed Lithia Chrysler Jeep Dodge of Ukiah.

Dividend

In July 2006, we announced a dividend on our Class A and Class B common stock of \$0.14 per share for the second quarter of 2006. The dividend, which totaled approximately \$2.8 million, was paid on August 4, 2006 to shareholders of record on July 21, 2006. The \$0.14 dividend represents a 17% increase over the \$0.12 dividend paid in each of the prior four quarters.

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

Forward Looking Statements and Risk Factors

Some of the statements in this Form 10-Q/A constitute forward-looking statements. In some cases, you can identify forward-looking statements by terms such as may, will, should, expect, plan, intend, forecast, anticipate, believe, estimate, predict, potential, and other comparable terminology. The forward-looking statements contained in this Form 10-Q/A involve known and unknown risks, uncertainties and situations that may cause our actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these statements. Some of the important factors that could cause actual results to differ from our expectations are discussed in Item 1A to our 2005 Form 10-K, which was filed with the Securities and Exchange Commission on March 8, 2006. These risk factors have not significantly changed since the filing of the 2005 Form 10-K.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements.

Overview

We are restating our previously reported financial information the quarters ended June 30, 2006 and 2005 to correct an error in those financial statements relating to our derivative accounting under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. In addition, we are restating for other errors that were previously deemed to be immaterial.

We account for our derivative financial instruments in accordance with SFAS No. 133 as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities-an amendment of FASB Statement No. 133 and SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities (collectively, the Standards). The Standards require that all derivative instruments (including certain derivative instruments embedded in other contracts) be recorded on the balance sheet as either an asset or liability measured at its fair value, and that changes in the derivatives fair value be recognized currently in earnings unless specific hedge accounting criteria are met. From inception of the hedging program, we applied a method of cash flow hedge accounting under SFAS No. 133 to account for the interest rate swap transactions that allowed us to assume the effectiveness of such transactions (the so-called short-cut method). We recently concluded that the interest rate swap transactions did not qualify for the short-cut method in prior periods because of the prepayment clauses in the debt agreements. Furthermore, although management believes that the interest rate swaps would have qualified for hedge accounting under SFAS No. 133, hedge accounting under SFAS No. 133 is not allowed retrospectively because the hedge documentation was not in place at the inception of the hedge. Eliminating the application of cash flow hedge accounting reverses the fair value adjustments that were made on our balance sheet in other comprehensive income into floorplan interest expense on our income statement.

Although the swaps do not retrospectively qualify for hedge accounting under SFAS No. 133, there is no effect on cash flows from operating, investing or financing activities for these changes. The effectiveness of the swaps as hedge transactions has not been affected by these changes in accounting treatment.

We are a leading operator of automotive franchises and retailer of new and used vehicles and services. As of August 7, 2006, we offered 25 brands of new vehicles in 97 stores in the Western United States and over the Internet. As of August 7, 2006, we operated 16 stores in Oregon, 14 in Texas, 13 in California, 12 in Washington, 8 in Idaho, 7 in Colorado, 7 in Alaska, 7 in Montana, 6 in Nevada, 3 in Nebraska, 2 in South Dakota, 1 in New Mexico and 1 in Wisconsin. We sell new and

used cars and light trucks; sell replacement parts; provide vehicle maintenance, warranty, paint and repair services; and arrange related financing, service contracts, protection products and credit insurance for our automotive customers.

We currently achieve gross profit margins above industry averages by selling a higher ratio of retail used vehicles to new vehicles and by arranging finance and extended warranty contracts for a greater percentage of our customers.

Our acquisition model is focused on acquiring average performing new vehicle franchised stores and then integrating and improving them. Our goal is to maximize the operations of all four departments of every store we acquire. We have had success with this strategy since our initial public offering in 1996. While our strategy has not changed since 1996, our ability to integrate and improve the stores that we acquire has increased dramatically. We have also developed a better process for identifying acquisition targets that fit our operating model. Our cash position, substantial lines of credit, plus an experienced and well-trained staff are all available to facilitate our continued growth as the opportunities develop.

In keeping with this model, we acquired four stores in the first six months of 2006 with total estimated annual revenues of approximately \$160 million and have a number of acquisitions expected to close during the remainder of 2006.

Although manufacturer incentives have been lower in 2006 than in the comparable 2005 periods, we expect that manufacturers will continue to offer incentives on new vehicle sales during the remainder of 2006 through a combination of repricing strategies, rebates, lease programs, early lease cancellation programs and low interest rate loans to consumers. To complement the manufacturers incentive strategy, we employ a volume-based strategy for our new vehicle sales.

We are currently working on several initiatives that we expect will improve our operations in future periods. Such initiatives include the following:

- our Customer Centric Sales Process, which will help us leverage the benefits of our Lithia Store Management System (LSMS) that allows us to track advertising and increase the productivity of the sales staff by providing daily work plans and focused training. Under this program, our showrooms will have interactive personal computers, which will allow the salesperson to quickly and efficiently enter data and interact with the customer to speed up the sales process. We rolled out this program in all of our California stores during May and June 2006, with positive results;
- our Finance and Insurance (F&I) Certification Program for our F&I managers;
- improving the functionality of our centralized inventory control process;
- our Internet initiative, which involves developing a centralized department that will be staffed 24 hours a day, seven days a week with brand specialists capable of communicating with customers by phone or live chat;
- IT initiatives related to automating our offices, centralizing certain office functions and establishing independent used vehicle operations; and
- our Assured Used Vehicle buying program and our independent used vehicle strategy. We began our Assured Used Vehicle buying program in the Tri-Cities, Abilene and Reno markets during the second quarter of 2006, with positive results. We expect to have our first independent used vehicle outlet operating by late spring or early summer 2007.

Results of Continuing Operations

Certain revenue, gross profit margin and gross profit information by product line was as follows:

Three Months Ended June 30, 2006	Percent of Total Revenues	Gross Margin	Percent of Total Gross Profit	
New vehicle	58.6	% 7.3	% 25.1	%
Used vehicle(1)	27.3	13.7	22.0	
Finance and insurance(2)	3.9	100.0	22.7	
Service, body and parts	10.1	50.3	29.9	
Fleet and other	0.1	45.4	0.3	

Three Months Ended June 30, 2005 (Restated)	Percent of Total Revenues	Gross Margin	Percent of Total Gross Profit	
New vehicle	58.4	% 7.8	% 27.1	%
Used vehicle(1)	26.8	13.8	21.9	
Finance and insurance(2)	3.6	100.0	21.4	
Service, body and parts	10.0	49.3	29.3	
Fleet and other	1.2	4.7	0.3	

Six Months Ended June 30, 2006	Percent of Total Revenues	Gross Margin	Percent of Total Gross Profit	
New vehicle	57.9	% 7.6	% 25.5	%
Used vehicle(1)	27.7	13.7	22.0	
Finance and insurance(2)	3.8	100.0	21.9	
Service, body and parts	10.5	49.6	30.3	
Fleet and other	0.1	37.4	0.3	

Six Months Ended June 30, 2005 (Restated)	Percent of Total Revenues	Gross Margin	Percent of Total Gross Profit	
New vehicle	56.6	% 8.0	% 26.1	%
Used vehicle(1)	28.2	13.7	22.4	
Finance and insurance(2)	3.7	100.0	21.2	
Service, body and parts	10.6	49.0	30.0	
Fleet and other	0.9	6.5	0.3	

(1) Includes retail and wholesale used vehicles.

(2) Reported net of anticipated cancellations.

The following table sets forth selected condensed financial data, expressed as a percentage of total revenues for the periods indicated.

	Three Months Ended June 30, 2006(1)		2005(1)		Six Months Ended June 30, 2006(1)		2005(1)	
	(Restated)		(Restated)		(Restated)		(Restated)	
Revenues:								
New vehicle	58.6	%	58.4	%	57.9	%	56.6	%
Used vehicle	27.3		26.8		27.7		28.2	
Finance and insurance	3.9		3.6		3.8		3.7	
Service, body and parts	10.1		10.0		10.5		10.6	
Fleet and other	0.1		1.2		0.1		0.9	
Total revenues	100.0	%	100.0	%	100.0	%	100.0	%
Gross profit	17.0		16.9		17.2		17.3	
Selling, general and administrative expenses	12.7		12.4		13.1		12.9	
Depreciation and amortization	0.5		0.4		0.5		0.5	

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Income from operations	3.8		4.0		3.7		3.9
Floorplan interest expense	1.0		1.0		0.9		0.7
Other interest expense	0.4		0.4		0.4		0.4
Other income, net	0.0		0.0		0.0		0.0
Income from continuing operations before taxes	2.4		2.6		2.4		2.8
Income tax expense	1.0		1.0		1.0		1.1
Income from continuing operations	1.4	%	1.6	%	1.4	%	1.7

(1) The percentages may not add due to rounding.

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The following tables set forth the changes in our operating results from continuing operations in the three and six-month periods ended June 30, 2006 compared to the three and six-month periods ended June 30, 2005:

(Dollars in thousands)	Three Months Ended		Increase (Decrease)	%	
	June 30, 2006 (Restated)	2005 (Restated)		Increase (Decrease)	Increase (Decrease)
Revenues:					
New vehicle	\$ 496,121	\$ 438,375	\$ 57,746	13.2	%
Used vehicle	230,909	200,769	30,140	15.0	
Finance and insurance	32,776	27,204	5,572	20.5	
Service, body and parts	85,736	75,417	10,319	13.7	
Fleet and other	939	9,064	(8,125)	(89.6))
Total revenues	846,481	750,829	95,652	12.7	
Cost of sales	702,256	623,817	78,439	12.6	
Gross profit	144,225	127,012	17,213	13.6	
Selling, general and administrative	107,536	93,323	14,213	15.2	
Depreciation and amortization	4,212	3,406	806	23.7	
Income from operations	32,477	30,283	2,194	7.2	
Floorplan interest expense	(8,502)	(7,865)	637	8.1	
Other interest expense	(3,641)	(3,036)	605	19.9	
Other income, net	314	247	67	27.1	
Income from continuing operations before taxes	20,648	19,629	1,019	5.2	
Income tax expense	8,706	7,781	925	11.9	
Income from continuing operations	\$ 11,942	\$ 11,848	\$ 94	0.8	%

	Three Months Ended		Increase (Decrease)	%	
	June 30, 2006	2005		Increase (Decrease)	Increase (Decrease)
New units sold	18,276	15,601	2,675	17.1	%
Average selling price per new vehicle	\$ 27,146	\$ 28,099	\$ (953)	(3.4))
Used units sold	18,178	16,304	1,874	11.5	
Average selling price per used vehicle	\$ 12,703	\$ 12,314	\$ 389	3.2	
Finance and insurance sales per retail unit	\$ 1,088	\$ 1,038	\$ 50	4.8	

(Dollars in thousands)	Six Months Ended		Increase (Decrease)	%	
	June 30, 2006 (Restated)	2005 (Restated)		Increase (Decrease)	Increase (Decrease)
Revenues:					
New vehicle	\$ 923,871	\$ 797,994	\$ 125,877	15.8	%
Used vehicle	439,987	398,091	41,896	10.5	
Finance and insurance	60,330	51,820	8,510	16.4	
Service, body and parts	168,209	149,682	18,527	12.4	
Fleet and other	2,269	12,168	(9,899)	(81.4))
Total revenues	1,594,666	1,409,755	184,911	13.1	
Cost of sales	1,319,660	1,165,610	154,050	13.2	
Gross profit	275,006	244,145	30,861	12.6	
Selling, general and administrative	208,253	182,455	25,798	14.1	
Depreciation and amortization	8,258	6,794	1,464	21.5	
Income from operations	58,495	54,896	3,599	6.6	
Floorplan interest expense	(14,096)	(9,633)	4,463	46.3	
Other interest expense	(6,972)	(5,841)	1,131	19.4	
Other income, net	742	531	211	39.7	
Income from continuing operations before taxes	38,169	39,953	(1,784)	(4.5))
Income tax expense	15,538	15,673	(135)	(0.9))

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Income from continuing operations	\$ 22,631	\$ 24,280	\$ (1,649)	(6.8)%
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	Six Months Ended		Increase (Decrease)	% Increase (Decrease)
	June 30, 2006	2005		
New units sold	33,517	28,465	5,052	17.7 %
Average selling price per new vehicle	\$ 27,564	\$ 28,034	\$ (470)	(1.7)
Used units sold	34,469	32,668	1,801	5.5
Average selling price per used vehicle	\$ 12,765	\$ 12,186	\$ 579	4.7
Finance and insurance sales per retail unit	\$ 1,075	\$ 1,039	\$ 36	3.5

Revenues

Total revenues increased 12.7% and 13.1%, respectively, in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005, as a result of acquisitions, as well as a 7.6% and a 7.4% increase, respectively, in same-store sales, excluding fleet. We believe that our strong operating systems, integrated store network and regional market focus contributed to our same-store sales increases, especially in the new vehicle sales. During the first six months of 2006, we focused on new vehicle sales to gain market share and create long-term parts and services business, which resulted in a 6.6% and an 8.8% increase, respectively, in same-store new vehicle retail sales in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005 and compared to an approximately 5.1% and 2.3% decrease, respectively, in the industry during the same periods. These industry figures include a large number of fleet sales, so industry retail figures were down substantially more. Improvements in same-store used vehicle sales resulted from strong inventories of good quality used vehicles, which resulted, in part, from trade-ins related to our increased new vehicle sales. The improvements in finance and insurance same store sales resulted primarily from the unit increases in sales of both new and used vehicles during the 2006 periods compared to the 2005 periods.

Same-store sales percentage increases were as follows:

	Three months ended June 30, 2006 vs. three months ended June 30, 2005		Six months ended June 30, 2006 vs. six months ended June 30, 2005	
New vehicle retail, excluding fleet	6.6	%	8.8	%
Used vehicles, including wholesale	9.2		4.7	
Finance and insurance	14.3		9.5	
Service, body and parts	7.5		6.3	
Total sales, excluding fleet	7.6		7.4	

Same-store sales are calculated by dealership comparing only those dealerships with operations in both comparative periods.

Penetration rates for certain products were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Finance and insurance	78 %	77 %	79 %	78 %
Service contracts	42	42	42	43
Lifetime oil change and filter	39	39	39	39

Gross Profit

Gross profit increased \$17.2 million and \$30.9 million, respectively, in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005 due to increased total revenues. Our gross profit margins by business lines were as follows:

	Three Months Ended June 30, 2006 (Restated)		2005		Basis Point Change*
New vehicle	7.3	%	7.8	%	(50)bp
Retail used vehicle	15.8		15.9		(10)
Wholesale used vehicle	2.8		3.9		(110)
Finance and insurance	100.0		100.0		
Service, body and parts	50.3		49.3		100
Overall	17.0		16.9		10

	Six Months Ended June 30, 2006 (Restated)		2005		Basis Point Change*
New vehicle	7.6	%	8.0	%	(40)bp
Retail used vehicle	15.6		15.7		(10)
Wholesale used vehicle	3.9		4.1		(20)
Finance and insurance	100.0		100.0		
Service, body and parts	49.6		49.0		60
Overall	17.2		17.3		(10)

* bp stands for basis points (one hundred basis points equals one percent).

The decreases in new vehicle gross profit margin were due to our focus on selling volume and gaining market share in the first half of 2006.

The decreases in wholesale used vehicle gross profit margin were due to wholesale market conditions and a focus on retailing more used vehicles and bringing in trade-ins nearer to market value. We dispose of these units by using centralized control, holding our own local used vehicle auctions and managing the disposal of units at larger third party auctions.

The increases in service, body and parts gross profit margin were due to our continued focus on service advisor training, which has led to gains in the sale of higher margin service items, as well as a number of pricing and cost saving initiatives.

The decline in the overall gross profit margin during the six-month period ended June 30, 2006 compared to the same period of 2005 was primarily due to our focus on increased new vehicle sales, which carry a lower margin than the other business lines.

Selling, General and Administrative Expense

Selling, general and administrative expense (SG&A) includes salaries and related personnel expenses, facility lease expense, advertising (net of manufacturer cooperative advertising credits), legal, accounting, professional services and general corporate expenses.

Selling, general and administrative expense increased \$14.2 million and \$25.8 million, respectively, in the three and six-month periods ended June 30, 2006 compared to same periods of 2005. The increases in dollars spent were primarily due to increased selling, or variable, expenses related to the increase in acquisition revenues and the number of locations. Also, SG&A in the three and six-month periods ended June 30, 2006 included \$1.0 million and \$1.7 million, respectively, of stock-based compensation compared to \$0.2 million and \$0.3 million, respectively, in the same periods of 2005, due to the adoption of SFAS No. 123R. In addition, the three and six-month periods ended June 30, 2006 included expenses for certain initiatives that we expect will lead to operating efficiencies in future periods as discussed in Overview above. After salaries and wages, the next four largest expense categories, sales compensation, payroll taxes, rent and advertising, all improved or were flat as a

percentage of gross profit in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005, despite the increases in the number of vehicles sold.

Depreciation and Amortization

Depreciation and amortization increased \$0.8 million and \$1.5 million, respectively, in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005 due to the addition of property and equipment primarily related to our acquisitions, as well as leasehold improvements to existing facilities.

Income from Operations

Operating margins declined by 20 basis points in both the three and six-month periods ended June 30, 2006 to 3.8% and 3.7%, respectively, from 4.0% and 3.9%, respectively, in the comparable periods of 2005. The decreases were due primarily to the increased SG&A as discussed above.

Floorplan Interest Expense

Floorplan interest expense increased \$0.6 million and \$4.5 million, respectively, in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005. Changes in the average outstanding balances of \$128.8 million and \$94.9 million, respectively, resulted in increases of \$1.4 million and \$2.0 million, respectively. In addition, increases in the average interest rate on our floorplan facilities resulted in increases of \$2.5 million and \$4.4 million, respectively. These increases were partially offset by decreases of \$3.3 million and \$1.9 million, respectively, related to our interest rate swaps.

Other Interest Expense

Other interest expense includes interest on our senior subordinated convertible notes, debt incurred related to acquisitions, real estate mortgages, our used vehicle line of credit and equipment related notes.

Other interest expense increased \$0.6 million and \$1.1 million, respectively, in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005. Changes in the weighted average interest rate on our debt in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005 increased other interest expense by approximately \$0.2 million and \$0.5 million, respectively, and changes in the average outstanding balances resulted in increases of approximately \$0.4 million and \$0.6 million, respectively. Interest expense related to the \$85.0 million of senior subordinated convertible notes that were issued in May 2004 totals approximately \$765,000 per quarter, which consists of \$611,000 of contractual interest and \$154,000 of amortization of debt issuance costs.

Income Tax Expense

Our effective tax rate was 42.2% and 40.7%, respectively, in the three and six-month periods ended June 30, 2006 compared to 39.6% and 39.2%, respectively, in the comparable periods of 2005. Our tax rate in the six months ended June 30, 2006 included the effect of a discrete change in our tax reserves, which occurred in the first quarter of 2006. We expect our effective tax rate to be approximately 39% to 40% for the remainder of 2006. Our effective tax rate may be affected in the future by the mix of asset acquisitions compared to corporate acquisitions, as well as by the mix of states where our stores are located.

Income from Continuing Operations

Income from continuing operations as a percentage of revenue decreased in the three and six-month periods ended June 30, 2006 compared to the same periods of 2005 as a result of the increased SG&A and increased interest expense as discussed above.

Discontinued Operations

We continually monitor the performance of each of our dealerships and make determinations to sell based primarily on return on capital criteria. When a dealership meets the criteria of held for sale, as defined in SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the results of operations are reclassified into discontinued operations. All dealerships included in discontinued operations have been, or will be, eliminated from our on-going operations upon completion of the sale. We anticipate the completion of the sale for each dealership to occur within 12 months from the date of determination.

During the first six months of 2006, we disposed of two of our dealerships that were held for sale at December 31, 2005 and, at June 30, 2006, no dealerships remained available for sale. Certain financial information related to discontinued operations was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenue	\$ 2,642	\$ 12,235	\$ 11,248	\$ 27,920
Pre-tax loss	(204)	(715)	(2,254)	(1,544)
Gain on disposal of discontinued operations, net of tax				36
Amount of goodwill and other intangible assets disposed of	1,606	4,406	3,552	4,406

The pre-tax loss in the six months ended June 30, 2006 included legal settlements related to dealerships in California that were sold in prior years.

Interest expense is allocated to stores classified as discontinued operations for actual flooring interest expense directly related to the new vehicles in the store. Interest expense related to our used vehicle line of credit is allocated based on total used vehicle inventory of the store, and interest expense related to our equipment line of credit is allocated based on the amount of fixed assets.

Seasonality and Quarterly Fluctuations

Historically, our sales have been lower in the first and fourth quarters of each year due to consumer purchasing patterns during the holiday season, inclement weather in certain of our markets and the reduced number of business days during the holiday season. As a result, financial performance is expected to be lower during the first and fourth quarters than during the second and third quarters of each fiscal year. We believe that interest rates, levels of consumer debt, consumer confidence and manufacturer sales incentives, as well as general economic conditions, also contribute to fluctuations in sales and operating results. Acquisitions have also been a contributor to fluctuations in our operating results from quarter to quarter.

Liquidity and Capital Resources

Our principal needs for capital resources are to finance acquisitions and capital expenditures, as well as for working capital and the funding of our cash dividend payments. We have relied primarily upon internally generated cash flows from operations, borrowings under our credit agreements and the proceeds from public equity and private debt offerings to finance operations and expansion. We believe that our available cash, cash equivalents, available lines of credit and cash flows from operations will be sufficient to meet our anticipated operating expenses, capital requirements, projected acquisitions and current level of cash dividends for at least the next 24 months from June 30, 2006.

Our inventories increased to \$882.0 million at June 30, 2006 from \$606.0 million at December 31, 2005 due primarily to additional new vehicle inventories acquired to meet our historically stronger sales demand during the third quarter of the year. In addition, as we did in the first quarter of 2006, we took on additional new vehicle inventories during the second quarter of 2006 in order to receive additional

manufacturer incentives. Our days supply of new vehicles declined by approximately 10 days at June 30, 2006 compared to December 31, 2005, but was 21 days above our average historical June 30 balances. We expect to sell down our excess new vehicle inventory during the third and fourth quarters of 2006 in order to be at more normalized levels by the end of 2006.

Our focus on new vehicle unit sales in the first half of 2006 led to more trade-ins, which resulted in increased used vehicle inventories as well. As a result, our days supply of used vehicles increased by approximately six days at June 30, 2006 compared to December 31, 2005. Used vehicle inventories at June 30, 2006 were three days above average levels for June 30. We believe that our inventory of good-quality used vehicles, which were purchased at favorable prices, will benefit our used vehicle business in the coming quarters.

Our new and used flooring notes payable increased to \$781.1 million at June 30, 2006 from \$530.5 million at December 31, 2005 to finance the increased inventory levels. New vehicles are financed at approximately 100% and used vehicles are financed at approximately 80% of cost. Used vehicles are financed as needed, utilizing our used vehicle flooring credit facility with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation.

Our Board of Directors declared dividends of \$0.12 per share on our Class A and Class B common stock, which were paid in March and May of 2006, and totaled approximately \$2.3 million and \$2.4 million, respectively. In addition, our Board of Directors approved a 17% increase in our second quarter 2006 dividend to \$0.14 per share on our Class A and Class B common stock, which was paid in August 2006 and totaled approximately \$2.8 million. We anticipate recommending to the Board of Directors the approval of a cash dividend each quarter.

In June 2000, our Board of Directors authorized the repurchase of up to 1,000,000 shares of our Class A common stock. Through June 30, 2006, we have purchased a total of 60,231 shares under this program and may continue to do so from time to time in the future as conditions warrant. The recent change in the tax law tends to equalize the benefits of dividends and share repurchases as a means to return capital or earnings to shareholders. As a result, we believe it is now advantageous to shareholders to have a dividend in place. With the dividend, we are able to offer an immediate and tangible return to our shareholders without reducing our already limited market float, which occurs when we repurchase shares. However, when we believe that our common stock is significantly undervalued and repurchases present an attractive use of our capital, we would expect to make strategic repurchases.

We have a working capital and used vehicle flooring credit facility with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation, totaling up to \$150 million, which expires May 1, 2008. This credit facility is cross-collateralized and secured by cash and cash equivalents, new and used vehicles on a subordinated basis to the extent not specifically financed by other lenders, parts inventories, accounts receivable, intangible assets and equipment. We pledged to DaimlerChrysler Services and Toyota Motor Credit the stock of all of our dealership subsidiaries except entities operating BMW, Honda, Nissan or Toyota stores. The commitments under this credit agreement may be withdrawn under various events of default or certain changes in control.

The financial covenants in our agreement with DaimlerChrysler Services and Toyota Motor Credit require us to maintain compliance with, among other things, (i) a specified current ratio; (ii) a specified fixed charge coverage ratio; (iii) a specified interest coverage ratio; (iv) a specified adjusted leverage ratio; and (v) certain working capital levels. At June 30, 2006, we were in compliance with all of the covenants of this agreement.

Ford Motor Credit, General Motors Acceptance Corporation and Volkswagen Credit have agreed to floor all of our new vehicles for their respective brands with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation serving as the primary lenders for substantially all other brands. These new vehicle lines are secured by new vehicle inventory of the relevant brands. Vehicles financed by lenders not directly associated with the manufacturer are classified as floorplan notes payable: non-trade

and are included as a financing activity in our statements of cash flows. Vehicles financed by lenders directly associated with the manufacturer are classified as floorplan notes payable and are included as an operating activity.

We have a credit facility with U.S. Bank N.A., which provides for a \$50.0 million revolving line of credit for leased vehicles and equipment purchases and expires May 1, 2007. The financial covenants in our agreement with U.S. Bank N.A. require us to maintain compliance with, among other things, (i) a specified current ratio; (ii) a specified fixed charge coverage ratio; (iii) a minimum total net worth; and (iv) a minimum tangible net worth. At June 30, 2006, we were in compliance with all of the covenants of this agreement. The commitments under this credit agreement may be withdrawn under various events of default or certain changes in control of Lithia.

Pursuant to our \$150 million credit agreement with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation, total dividends and repurchases of our common stock cannot exceed \$25.0 million over the term of the agreement. Through August 7, 2006, over the term of the agreement, we have paid dividends and repurchased stock totaling \$24.0 million.

We expect to be in compliance with the covenants for all of our debt agreements in the foreseeable future. In the event that we are unable to meet such requirements, and any available cure period has passed, the lender may require an acceleration of payment, increase the interest rate or limit our ability to borrow or pay cash dividends.

Interest rates on all of the above facilities ranged from 6.8% to 8.1% at June 30, 2006. Amounts outstanding on the lines at June 30, 2006, together with amounts remaining available under such lines were as follows (in thousands):

	Outstanding at June 30, 2006	Remaining Availability as of June 30, 2006
New and program vehicle lines	\$ 763,081	\$ *
Working capital and used vehicle line	18,000	132,000
Equipment/leased vehicle line	50,000	
	\$ 831,081	\$ 132,000

* There are no formal limits on the new and program vehicle lines with certain lenders.

In the third quarter of 2006, we expect to combine our \$150 million working capital and used vehicle flooring credit facility with DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation and our \$50.0 million revolving line of credit for leased vehicles and equipment purchases with U.S. Bank N.A. into a new \$225 million facility with U.S. Bank N.A., DaimlerChrysler Services North America LLC and Toyota Motor Credit Corporation. We expect that the new combined facility will increase the limit related to paying dividends and repurchasing our common stock.

We also have outstanding \$85.0 million of 2.875% senior subordinated convertible notes due 2014. We will also pay contingent interest on the notes during any six-month interest period beginning May 1, 2009, in which the trading price of the notes for a specified period of time equals or exceeds 120% of the principal amount of the notes. The notes are convertible into shares of our Class A common stock at a price of \$37.69 per share upon the satisfaction of certain conditions and upon the occurrence of certain events as follows:

- if, prior to May 1, 2009, and during any calendar quarter, the closing sale price of our common stock exceeds 120% of the conversion price for at least 20 trading days in the 30 consecutive trading days ending on the last trading day of the preceding calendar quarter;
- if, after May 1, 2009, the closing sale price of our common stock exceeds 120% of the conversion price;
- if, during the five business day period after any five consecutive trading day period in which the trading price per \$1,000 principal amount of notes for each day of such period was less than 98% of the product of the closing sale price of our common stock and the number of shares issuable upon conversion of \$1,000 principal amount of the notes;

- if the notes have been called for redemption; or
- upon certain specified corporate events.

A declaration and payment of a dividend in excess of \$0.08 per share per quarter will result in an adjustment in the conversion rate for the notes if such cumulative adjustment exceeds 1% of the current conversion rate. We declared dividends of \$0.14 per share for the quarter ended June 30, 2006 and dividends of \$0.12 per share for each of the four preceding quarters. The affect of such dividends does not yet reach the 1% threshold amount and no adjustment in the conversion rate is currently required.

The notes are redeemable at our option beginning May 6, 2009 at the redemption price of 100% of the principal amount plus any accrued interest. The holders of the notes can require us to repurchase all or some of the notes on May 1, 2009 and upon certain events constituting a fundamental change or a termination of trading. A fundamental change is any transaction or event in which all or substantially all of our common stock is exchanged for, converted into, acquired for, or constitutes solely the right to receive, consideration that is not all, or substantially all, common stock that is listed on, or immediately after the transaction or event, will be listed on, a United States national securities exchange. A termination of trading will have occurred if our common stock is not listed for trading on a national securities exchange or the Nasdaq National Market.

Our earnings to fixed charge coverage ratio, as defined in the senior subordinated convertible notes, was 2.5 for the quarter ended June 30, 2006.

Capital Commitments

We had capital commitments of \$44.4 million at June 30, 2006 for the construction of seven new facilities and additions to two existing facilities. Of the new facilities, five are replacing existing facilities. We have already incurred \$9.5 million for these projects, with an additional \$16.8 million expected to be incurred during the remainder of 2006 and the remaining \$27.6 million to be incurred in 2007 and 2008. We expect to pay for the construction out of existing cash balances until completion of the projects, at which time we anticipate securing long-term financing and general borrowings from third party lenders for 70% to 90% of the amounts expended.

We also had capital commitments of \$2.2 million for the acquisition and development of hardware and software for several information technology initiatives. We anticipate incurring these amounts during the remainder of 2006.

In addition to the above, we have approximately \$67.2 million in planned capital expenditures under consideration for various new facilities and remodeling projects. These projects are still in the planning stage or are awaiting approvals from governmental agencies or manufacturers. We feel that these projects are a critical part of our future growth strategy.

There were no significant changes to our other contractual payment obligations from those reported in our 2005 Form 10-K.

Critical Accounting Policies and Use of Estimates

Except for the addition of the Stock-Based Compensation information below, we reaffirm our critical accounting policies and use of estimates as described in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 8, 2006.

Stock-Based Compensation

On January 1, 2006, we adopted SFAS No. 123R which requires the measurement and recognition of compensation expense for all share based payment awards granted to our employees and directors, including employee stock options, non-vested stock and stock purchases related to the Purchase Plan based on the estimated fair value of the award on the grant date. Upon the adoption of SFAS No.

123R, we maintained our method of valuation for stock option awards using the Black-Scholes valuation model, which has historically been used for the purpose of providing pro-forma financial disclosures in accordance with SFAS No. 123.

The use of the Black-Scholes valuation model to estimate the fair value of stock option awards requires us to make judgments on assumptions regarding the risk-free interest rate, expected dividend yield, expected term and expected volatility over the expected term of the award. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for a period equal to the expected term of the stock option. The expected dividend yield is calculated as a ratio of annualized expected dividends per share to the market value of our common stock on the date of grant. The expected term is calculated based on the observed and expected time to post-vesting exercise behavior of separate identifiable employee groups. The expected volatility is estimated based on the historical volatility of our common stock and consideration of factors expected to impact the volatility of our stock over the term of the options.

Compensation expense is only recognized on awards that ultimately vest. Therefore, for both stock option awards and non-vested stock awards, we have reduced the compensation expense to be recognized over the vesting period for anticipated future forfeitures. Forfeiture estimates are based on historical forfeiture patterns. We update our forfeiture estimates annually and recognize any changes to accumulated compensation expense in the period of change. If actual forfeitures differ significantly from our estimates, our results of operations could be materially impacted.

Item 4. Controls and Procedures

Background

As disclosed in Amendment No. 1 to our Form 10-K, we have restated our previously issued consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 to correct an error in those financial statements relating to our derivative accounting under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133). Also, as discussed in Note 2 to the consolidated financial statements (included in Item 1), we are restating our previously reported financial information as of and for the quarters ended June 30, 2006 and 2005 to correct an error in those financial statements relating to our derivative accounting under SFAS No. 133.

During the third quarter of 2006, we, in consultation with our independent registered public accounting firm, identified that our application of, and documentation related to, the short-cut method under SFAS No. 133 for our derivative instruments was incorrect. From inception of the hedging program, we applied a method of cash flow hedge accounting under SFAS No. 133 to account for the interest rate swap transactions that allowed us to assume the effectiveness of such transactions. We have determined that the prepayment clauses in the debt agreements, which had not been identified by us or by our accounting experts at implementation, disqualified us from being able to avoid periodic testing of effectiveness under SFAS no. 133. We are not permitted to retroactively apply an appropriate method of qualifying for hedge accounting treatment for these instruments and, as a result, the changes in the fair value of these derivative instruments during their term will be reflected as a net non-cash gain/loss in flooring interest expense rather than in other comprehensive income in the balance sheet. Following our discovery of the errors in the application and documentation of hedge accounting under SFAS No. 133, we initiated a comprehensive review of all of our determinations and documentation related to hedge accounting under the short cut method for our interest rate swaps, as well as our related processes and procedures.

Disclosure Controls and Procedures

We initially evaluated our disclosure controls and procedures (as such term is defined under Rule 13a-15(e) of the Exchange Act) as of the end of the period covered by this report under the direction and with the participation of our Chief Executive Officer and Chief Financial Officer. Based

on that evaluation, our Chief Executive Officer and Chief Financial Officer initially concluded that our disclosure controls and procedures were effective as of June 30, 2006.

In connection with the aforementioned restatement of financial statements, under the direction of our Chief Executive Officer and Chief Financial Officer, we reevaluated our disclosure controls and procedures and concluded that our disclosure controls and procedures were not effective as of June 30, 2006 due to a material weakness in internal control over financial reporting with respect to hedge accounting for interest rate swaps.

Remediation of Material Weakness

To remediate the material weakness described above and enhance our internal control over financial reporting, subsequent to the filing of this Form 10-Q/A, management will implement the following changes:

- Improve training and education and understanding of hedge accounting requirements in accordance with generally accepted accounting principles for all relevant personnel involved in derivatives transactions.
- Revise our documentation to qualify for hedge accounting in accordance with generally accepted accounting principles with the assistance of outside experts that have been engaged. This includes ongoing monitoring and review to ensure the continuing qualification of hedge accounting.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the above evaluation that occurred during the fiscal quarter ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 6. Exhibits

The following exhibits are filed herewith and this list is intended to constitute the exhibit index:

- 3.1 Restated Articles of Incorporation of Lithia Motors, Inc., as amended May 13, 1999 (filed as Exhibit 3.1 to Form 10-K filed March 30, 2000 and incorporated herein by reference).
- 3.2 Bylaws (filed as Exhibit 3.2 to Form S-1, Registration Statement No. 333-14031, as declared effective by the Securities and Exchange Commission on December 18, 1996 and incorporated herein by reference).
 - 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
 - 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
 - 32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.
 - 32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: December 15, 2006

LITHIA MOTORS, INC.

By */s/* JEFFREY B. DEBOER
Jeffrey B. DeBoer
Senior Vice President and
Chief Financial Officer
(Principal Financial Officer)

By */s/* LINDA A. GANIM
Linda A. Ganim
Vice President and Chief Accounting Officer
(Principal Accounting Officer)