

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2022.

or

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

For the transition period from _____ to _____

Commission File Number 1-475

A. O. Smith Corporation

(Exact name of registrant as specified in its charter)

Delaware
(State of Incorporation)

11270 West Park Place, Milwaukee, Wisconsin
(Address of Principal Executive Office)

39-0619790
(I.R.S. Employer
Identification No.)

53224-9508
(Zip Code)

(414) 359-4000
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Trading Symbol	Name of Each Exchange on Which Registered
Common Stock (par value \$1.00 per share)	AOS	New York Stock Exchange

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 has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated Filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. Yes No

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

Class A Common Stock Outstanding as of October 26, 2022 - 25,905,876 shares

Common Stock Outstanding as of October 26, 2022 - 126,869,651 shares

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PART I - FINANCIAL INFORMATION
ITEM 1 - FINANCIAL STATEMENTS

A. O. SMITH CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
(dollars in millions, except for per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Net sales	\$ 874.2	\$ 914.6	\$ 2,817.8	\$ 2,543.4
Cost of products sold	569.2	574.3	1,836.8	1,593.1
Gross profit	305.0	340.3	981.0	950.3
Selling, general and administrative expenses	155.5	177.6	502.0	517.2
Interest expense	2.4	1.0	6.0	2.9
Other expense (income), net	2.4	(4.7)	6.4	(13.6)
Earnings before provision for income taxes	144.7	166.4	466.6	443.8
Provision for income taxes	34.9	34.8	110.8	96.3
Net Earnings	<u>\$ 109.8</u>	<u>\$ 131.6</u>	<u>\$ 355.8</u>	<u>\$ 347.5</u>
Net Earnings Per Share of Common Stock ⁽¹⁾	<u>\$ 0.71</u>	<u>\$ 0.83</u>	<u>\$ 2.29</u>	<u>\$ 2.17</u>
Diluted Net Earnings Per Share of Common Stock ⁽¹⁾	<u>\$ 0.71</u>	<u>\$ 0.82</u>	<u>\$ 2.27</u>	<u>\$ 2.15</u>
Dividends Per Share of Common Stock	<u>\$ 0.28</u>	<u>\$ 0.26</u>	<u>\$ 0.84</u>	<u>\$ 0.78</u>

⁽¹⁾ Earnings per share amounts are calculated discretely and, therefore, may not add up to the total due to rounding.

A. O. SMITH CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS
(dollars in millions)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Net earnings	\$ 109.8	\$ 131.6	\$ 355.8	\$ 347.5
Other comprehensive (loss) earnings				
Foreign currency translation adjustments	(28.9)	(2.4)	(52.9)	1.1
Unrealized gains (losses) on cash flow derivative instruments, less related income tax (provision) benefit of \$(1.1) and \$(1.6) in 2022, \$(0.1) and \$0.2 in 2021	3.5	0.4	5.0	(0.7)
Adjustment to pension liability, less related income tax provision of \$(1.3) and \$(3.8) in 2022, \$(1.2) and \$(3.8) in 2021	3.7	3.9	11.2	11.5
Comprehensive Earnings	<u>\$ 88.1</u>	<u>\$ 133.5</u>	<u>\$ 319.1</u>	<u>\$ 359.4</u>

See accompanying notes to unaudited condensed consolidated financial statements.

A. O. SMITH CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in millions)

	(unaudited) September 30, 2022	December 31, 2021
Assets		
Current Assets		
Cash and cash equivalents	\$ 358.8	\$ 443.3
Marketable securities	58.3	188.1
Receivables	564.2	634.4
Inventories	525.6	447.7
Other current assets	62.7	39.1
Total Current Assets	1,569.6	1,752.6
Property, plant and equipment	1,339.3	1,343.2
Less accumulated depreciation	(755.7)	(736.5)
Net property, plant and equipment	583.6	606.7
Goodwill	619.3	627.8
Other intangibles	349.8	364.8
Operating lease assets	31.3	32.5
Other assets	78.3	90.0
Total Assets	<u>\$ 3,231.9</u>	<u>\$ 3,474.4</u>
Liabilities		
Current Liabilities		
Trade payables	\$ 595.6	\$ 745.9
Accrued payroll and benefits	71.0	113.4
Accrued liabilities	163.8	181.8
Product warranties	63.7	70.9
Debt due within one year	6.8	6.8
Total Current Liabilities	900.9	1,118.8
Long-term debt	281.0	189.9
Product warranties	113.5	113.5
Long-term operating lease liabilities	23.5	22.3
Other liabilities	165.2	197.7
Total Liabilities	1,484.1	1,642.2
Stockholders' Equity		
Class A Common Stock, \$5 par value: authorized 27,000,000 shares; issued, 26,050,642 and 26,104,441	130.3	130.5
Common Stock, \$1 par value: authorized 240,000,000 shares; issued 164,656,952 and 164,603,153	164.7	164.7
Capital in excess of par value	554.9	545.2
Retained earnings	3,051.1	2,826.6
Accumulated other comprehensive loss	(368.1)	(331.4)
Treasury stock at cost	(1,785.1)	(1,503.4)
Total Stockholders' Equity	1,747.8	1,832.2
Total Liabilities and Stockholders' Equity	<u>\$ 3,231.9</u>	<u>\$ 3,474.4</u>

See accompanying notes to unaudited condensed consolidated financial statements.

A. O. SMITH CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in millions)
(unaudited)

	Nine Months Ended September 30,	
	2022	2021
Operating Activities		
Net earnings	\$ 355.8	\$ 347.5
Adjustments to reconcile net earnings to cash provided by (used in) operating activities:		
Depreciation and amortization	56.5	58.0
Stock based compensation expense	10.4	10.3
Net changes in operating assets and liabilities:		
Current assets and liabilities	(212.6)	(20.8)
Noncurrent assets and liabilities	4.6	(18.2)
Cash Provided by Operating Activities	214.7	376.8
Investing Activities		
Capital expenditures	(50.9)	(45.3)
Acquisitions of businesses	(8.0)	(9.0)
Investments in marketable securities	(35.3)	(160.1)
Net proceeds from sale of marketable securities	152.5	79.1
Cash Provided by (Used in) Investing Activities	58.3	(135.3)
Financing Activities		
Long-term debt incurred (repaid)	94.6	(6.8)
Common stock repurchases	(282.0)	(212.0)
Net (payments) proceeds from stock option activity	(1.6)	15.7
Dividends paid	(131.1)	(125.4)
Cash Used in Financing Activities	(320.1)	(328.5)
Effect of exchange rate changes on cash and cash equivalents	(37.4)	—
Net decrease in cash and cash equivalents	(84.5)	(87.0)
Cash and cash equivalents - beginning of period	443.3	573.1
Cash and Cash Equivalents - End of Period	\$ 358.8	\$ 486.1

See accompanying notes to unaudited condensed consolidated financial statements.

A. O. SMITH CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(dollars in millions)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Class A Common Stock				
Balance at the beginning of period	\$ 130.5	\$ 130.6	\$ 130.5	\$ 130.8
Conversion of Class A Common Stock	(0.2)	—	(0.2)	(0.2)
Balance at end of period	<u>\$ 130.3</u>	<u>\$ 130.6</u>	<u>\$ 130.3</u>	<u>\$ 130.6</u>
Common Stock				
Balance at the beginning of period	\$ 164.7	\$ 164.7	\$ 164.7	\$ 164.6
Conversion of Class A Common Stock	—	\$ —	—	\$ 0.1
Balance at end of period	<u>\$ 164.7</u>	<u>\$ 164.7</u>	<u>\$ 164.7</u>	<u>\$ 164.7</u>
Capital in Excess of Par Value				
Balance at the beginning of period	\$ 553.1	\$ 535.0	\$ 545.2	\$ 520.4
Conversion of Class A Common Stock	0.2	—	0.2	0.2
Issuance of share units	—	(0.2)	(6.0)	(5.6)
Vesting of share units	—	(0.1)	(2.4)	(1.9)
Stock based compensation expense	1.2	1.0	10.1	9.3
Exercises of stock options	0.4	0.5	0.8	7.5
Stock incentives	—	0.3	7.0	6.6
Balance at end of period	<u>\$ 554.9</u>	<u>\$ 536.5</u>	<u>\$ 554.9</u>	<u>\$ 536.5</u>
Retained Earnings				
Balance at the beginning of period	\$ 2,984.6	\$ 2,641.6	\$ 2,826.6	\$ 2,509.6
Net earnings	109.8	131.6	355.8	347.5
Dividends on stock	(43.3)	(41.5)	(131.3)	(125.4)
Balance at end of period	<u>\$ 3,051.1</u>	<u>\$ 2,731.7</u>	<u>\$ 3,051.1</u>	<u>\$ 2,731.7</u>
Accumulated Other Comprehensive Loss (see Note 16)	<u>\$ (368.1)</u>	<u>\$ (309.3)</u>	<u>\$ (368.1)</u>	<u>\$ (309.3)</u>
Treasury Stock				
Balance at the beginning of period	\$ (1,694.0)	\$ (1,344.4)	\$ (1,503.4)	\$ (1,155.9)
Exercise of stock options	0.5	0.4	(2.4)	8.0
Stock incentives and directors' compensation	—	0.1	0.3	0.3
Shares repurchased	(91.6)	(13.9)	(282.0)	(212.0)
Vesting of share units	—	0.1	2.4	1.9
Balance at end of period	<u>\$ (1,785.1)</u>	<u>\$ (1,357.7)</u>	<u>\$ (1,785.1)</u>	<u>\$ (1,357.7)</u>
Total Stockholders' Equity	<u>\$ 1,747.8</u>	<u>\$ 1,896.5</u>	<u>\$ 1,747.8</u>	<u>\$ 1,896.5</u>

See accompanying notes to unaudited condensed consolidated financial statements.

A. O. SMITH CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2022
(unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2022 are not necessarily indicative of the results expected for the full year. It is suggested the accompanying condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2021 filed with the SEC on February 11, 2022.

Recent Accounting Pronouncement

In November 2021, the Financial Accounting Standards Board (FASB) amended ASC 832, *Government Assistance* (issued under Accounting Standards Update (ASU) 2021-10, "Disclosures by Business Entities about Government Assistance"). This amendment requires disclosures that are expected to increase the transparency of transactions with a government accounted for by applying a grant or contribution accounting model by analogy, including (1) the types of transactions, (2) the accounting for those transactions, and (3) the effect of those transactions on an entity's financial statements. The Company adopted the amendment on January 1, 2022, and the adoption of ASU 2021-10 is not expected to materially impact its annual disclosures, consolidated balance sheets, statements of earnings or statements of cash flows.

2. Revenue Recognition

Substantially all of the Company's sales are from contracts with customers for the purchase of its products. Contracts and customer purchase orders are used to determine the existence of a sales contract. Shipping documents are used to verify shipment. For substantially all of its products, the Company transfers control of products to the customer at the point in time when title and risk are passed to the customer, which generally occurs upon shipment of the product. Each unit sold is considered an independent, unbundled performance obligation. The Company's sales arrangements do not include other performance obligations that are material in the context of the contract.

The nature, timing and amount of revenue for a respective performance obligation are consistent for each customer. The Company measures the sales transaction price based upon the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. Sales and value added taxes are excluded from the measurement of the transaction price. The Company's payment terms for the majority of its customers are 30 to 90 days from shipment.

Additionally, certain customers in China pay the Company prior to the shipment of products resulting in a customer deposits liability of \$103.8 million and \$155.2 million at September 30, 2022 and December 31, 2021, respectively. Customer deposit liabilities are short term in nature, recognized into revenue within one year of receipt, and recorded in Trade payables within the condensed consolidated balance sheets. The Company assesses the collectability of customer receivables based on the creditworthiness of a customer as determined by credit checks and analysis, as well as the customer's payment history. In determining the allowance for credit losses, the Company also considers various factors including the aging of customer accounts and historical write-offs. In addition, the Company monitors other risk factors including forward-looking information when establishing adequate allowances for credit losses, which reflects the current estimate of credit losses expected to be incurred over the life of the receivables. The Company's allowance for credit losses was \$10.1 million at September 30, 2022 and \$9.5 million at December 31, 2021.

Rebates and incentives are based on pricing agreements and are tied to sales volume. The amount of revenue is reduced for variable consideration related to customer rebates which are calculated using expected values and are based on program specific factors such as expected rebate percentages based on expected volumes. In situations where the customer has the right to return eligible products, the Company reduces revenue for its estimates of expected product returns, which are primarily based on an analysis of historical experience. Changes in such accruals may be required if actual sales volume differs from estimated sales volume or if future returns differ from historical experience. Shipping and handling costs billed to customers are included in net sales and the related costs are included in cost of products sold and are activities performed to fulfill the promise to transfer products.

2. Revenue Recognition (continued)

Disaggregation of Net Sales

The Company is comprised of two reporting segments: North America and Rest of World. The Rest of World segment is primarily comprised of China, Europe and India. Both segments manufacture and market comprehensive lines of residential and commercial gas, heat pump and electric water heaters, boilers, tanks and water treatment products. Both segments primarily manufacture and market in their respective regions of the world.

As each segment manufactures and markets products in its respective region of the world, the Company has determined that geography is the primary factor in reporting its sales. The Company further disaggregates its North America segment sales by major product line as each of North America's major product lines is sold through distinct distribution channels and these product lines may be impacted differently by certain economic factors. Within the Rest of World segment, particularly in China and India, the Company's major customers purchase across the Company's product lines, utilizing the same distribution channels regardless of product type. In addition, the impact of economic factors is unlikely to be differentiated by product line in the Rest of World segment.

The North America segment's major product lines are defined as the following:

Water heaters The Company's water heaters are open water heating systems that heat potable water. Typical applications for water heaters include residences, restaurants, hotels, office buildings, laundries, car washes and small businesses. The Company sells residential and commercial water heater products and related parts through its wholesale distribution channel, which includes more than 1,100 independent wholesale plumbing distributors. The Company also sells residential water heaters and related parts through retail and maintenance, repair and operations (MRO) channels. A significant portion of the Company's water heater sales in the North America segment is derived from the replacement of existing products.

Boilers The Company's boilers are closed loop water heating systems used primarily for space heating or hydronic heating. The Company's boilers are primarily used in applications in commercial settings for hospitals, schools, hotels and other large commercial buildings while residential boilers are used in homes, apartments and condominiums. The Company's boiler distribution channel is comprised primarily of manufacturer representative firms, with the remainder of its boilers distributed through wholesale channels. The Company's boiler sales in the North America segment are derived from a combination of replacement of existing products and new construction.

Water treatment products The Company's water treatment products range from point-of-entry water softeners, solutions for problem well water, and whole-home water filtration products to on-the-go filtration bottles and point-of-use carbon and reverse osmosis products. Typical applications for the Company's water treatment products include residences, restaurants, hotels and offices. The Company sells water treatment products through its retail and wholesale distribution channels, similar to water heater products and related parts. The Company's water treatment products are also sold through independent water quality dealers as well as directly to consumers including through internet sales channels. A portion of the Company's sales of water treatment products in the North America segment is comprised of replacement filters.

The following table disaggregates the Company's net sales by segment. As described above, the Company's North America segment sales are further disaggregated by major product line. In addition, the Company's Rest of World segment sales are disaggregated by China and all other Rest of World:

(dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
North America				
Water heaters and related parts	\$ 525.6	\$ 549.0	\$ 1,755.3	\$ 1,504.8
Boilers and related parts	75.5	59.6	203.4	161.6
Water treatment products and related parts	51.8	49.6	168.4	148.3
Total North America	652.9	658.2	2,127.1	1,814.7
Rest of World				
China	\$ 194.3	\$ 228.8	\$ 624.1	\$ 666.8
All other Rest of World	35.9	34.3	92.0	81.8
Total Rest of World	230.2	263.1	716.1	748.6
Inter-segment sales	(8.9)	(6.7)	(25.4)	(19.9)
Total Net Sales	\$ 874.2	\$ 914.6	\$ 2,817.8	\$ 2,543.4

3. Acquisitions

On October 19, 2021, the Company acquired 100 percent of the shares and related assets of Giant Factories, Inc. (Giant), a Canada-based manufacturer of residential and commercial water heaters for \$198.6 million, net of cash acquired. The Company paid \$2.5 million of the purchase price in the second quarter of 2022 as a result of final working capital adjustments. The Company incurred acquisition costs of approximately \$1.3 million in 2021.

Under the Giant purchase agreement, approximately \$8 million of the purchase price was set aside as an escrow to satisfy any potential obligations of the former owners of Giant, should they arise. The allocation of the purchase price to goodwill decreased by \$2.3 million in the second quarter of 2022 due to the net impact of a measurement period adjustment, primarily related to income tax matters, partially offset by the final working capital adjustment. The purchase price allocation remains preliminary and subject to final valuation adjustments that will be completed within the one year period following the acquisition date. The addition of Giant increased the Company's North America market penetration, created additional capacity and enhanced the Company's distribution capabilities. Giant is included in the North America segment.

The following table summarizes the preliminary allocation of fair value of the assets acquired and liabilities assumed at the date of acquisition. Of the \$53.8 million of acquired identifiable intangible assets, \$43.9 million was assigned to trademarks that are not subject to amortization and \$9.2 million was assigned to customer relationships which are amortized over 22 years, and the remaining \$0.7 million was assigned to non-compete agreements which are amortized over five years. The excess of the acquisition purchase price over the fair value assigned to the assets acquired and liabilities assumed was recorded as goodwill.

The following table summarizes the estimated fair values of Giant's assets acquired and liabilities assumed at the date of acquisition:

October 19, 2021 (dollars in millions)

Current assets, net of cash acquired	\$	60.1
Property, plant and equipment		55.8
Intangible assets		53.8
Goodwill		77.6
Total assets acquired		<u>247.3</u>
Current liabilities		(39.2)
Long Term liabilities		(9.5)
Net assets acquired	\$	<u>198.6</u>

During the second quarter of 2022, the Company acquired a privately-held water treatment company. The Company paid an aggregate cash purchase price of \$5.5 million, net of cash acquired. The addition of the company acquired expands the Company's water treatment platform and is included in the North America segment for reporting purposes.

As required under ASC 805 *Business Combinations*, results of operations have been included in the Company's consolidated financial statements from the date of their acquisition.

During the third quarter of 2022, the Company incurred \$4.3 million of expenses and related income tax benefit of \$1.1 million associated with a terminated acquisition. These expenses were related to the due diligence of a prospective acquisition target and recorded within selling, general and administrative expenses in the condensed consolidated statement of operations.

4. Leases

The Company's lease portfolio consists of operating leases for buildings and equipment, such as forklifts and copiers, primarily in the United States and China. The Company defines a lease as a contract that gives the Company the right to control the use of a physical asset for a stated term. The Company pays the lessor for that right, with a series of payments defined in the contract and a corresponding right of use operating lease asset and liability are recorded. The Company has elected not to record leases with an initial term of 12 months or less on its condensed consolidated balance sheet. To determine balance sheet amounts, required legal payments are discounted using the Company's incremental borrowing rate as of the inception of the lease. The incremental borrowing rate is the rate of interest that the Company would incur if it were to borrow, on a collateralized basis, an amount equal to the value of the leased item over a similar term, in a similar economic environment. Variable lease components not based on an index or rate are excluded from the measurement of the lease asset and liability and expensed as incurred for all asset classes.

Certain leases include one or more options to renew or terminate. Renewal terms can extend the lease term from one to five years and options to terminate can be effective within one year. The exercise of lease renewal or termination is at the

4. Leases (continued)

Company's discretion and when it is determined to be reasonably certain to renew or terminate, the option is reflected in the measurement of lease asset and liability. The Company's lease agreements do not contain any material residual value guarantees or material restrictive covenants or material subleases. Cash flows associated with leases are materially consistent with the expense recorded in the condensed consolidated statement of earnings.

Supplemental balance sheet information related to leases is as follows:

<u>(dollars in millions)</u>	September 30, 2022	December 31, 2021
Liabilities		
Short term: Accrued liabilities	\$ 9.4	\$ 11.7
Long term: Operating lease liabilities	23.5	22.3
Total operating lease liabilities	\$ 32.9	\$ 34.0
Less: Rent incentives and deferrals	(1.6)	(1.5)
Assets		
Operating lease assets	\$ 31.3	\$ 32.5

<u>Lease Term and Discount Rate</u>	September 30, 2022
Weighted-average remaining lease term	6.4 years
Weighted-average discount rate	3.07 %

The components of lease expense were as follows:

<u>(dollars in millions)</u>		Three months ended September 30,	
Lease Expense	Classification	2022 ⁽¹⁾	2021 ⁽²⁾
Operating lease expense	Cost of products sold	\$ 0.7	\$ 0.9
	Selling, general and administrative expenses	4.1	4.2

⁽¹⁾ 2022 includes short-term and variable lease expenses of \$0.5 million and \$0.8 million, respectively.

⁽²⁾ 2021 includes short-term and variable lease expenses of \$0.6 million and \$0.6 million, respectively.

<u>(dollars in millions)</u>		Nine Months Ended September 30,	
Lease Expense	Classification	2022 ⁽¹⁾	2021 ⁽²⁾
Operating lease expense	Cost of products sold	\$ 2.7	\$ 2.9
	Selling, general and administrative expenses	12.4	12.3

⁽¹⁾ 2022 includes short-term and variable lease expenses of \$1.6 million and \$2.5 million, respectively.

⁽²⁾ 2021 includes short-term and variable lease expenses of \$1.6 million and \$1.8 million, respectively.

4. Leases (continued)

Maturities of lease liabilities were as follows:

<u>(dollars in millions)</u>	September 30, 2022
2022	\$ 2.6
2023	9.3
2024	7.7
2025	5.1
2026	3.2
After 2026	9.3
Total lease payments	37.2
Less: Imputed interest	(4.3)
Present value of operating lease liabilities	<u>\$ 32.9</u>

5. Inventories

The following table presents the components of the Company's inventory balances:

<u>(dollars in millions)</u>	September 30, 2022	December 31, 2021
Finished products	\$ 188.0	\$ 190.2
Work in process	49.9	42.0
Raw materials	360.8	286.3
Inventories, at FIFO cost	598.7	518.5
LIFO reserve	(73.1)	(70.8)
Inventories, at LIFO cost	<u>\$ 525.6</u>	<u>\$ 447.7</u>

6. Product Warranties

The Company offers warranties on the sales of certain of its products with terms that are consistent with the market and records an accrual for the estimated future claims. The increase in the reserve for product warranties as of September 30, 2022 compared to September 30, 2021 was primarily due to increased steel prices and the acquisition of Giant. Refer to Note 3, "Acquisitions", for additional information regarding the acquisition of Giant.

The following table presents the Company's warranty liability activity:

<u>(dollars in millions)</u>	Three Months Ended September 30,	
	2022	2021
Balance at July 1,	\$ 180.0	\$ 144.9
Expense	14.0	18.5
Claims settled	(16.8)	(11.9)
Balance at September 30,	<u>\$ 177.2</u>	<u>\$ 151.5</u>

<u>(dollars in millions)</u>	Nine Months Ended September 30,	
	2022	2021
Balance at January 1,	\$ 184.4	\$ 142.3
Expense	42.6	46.4
Claims settled	(49.8)	(37.2)
Balance at September 30,	<u>\$ 177.2</u>	<u>\$ 151.5</u>

7. Debt

In 2021, the Company renewed and amended its \$500 million multi-year multi-currency revolving credit agreement with a new expiration date of April 1, 2026. The facility has an accordion provision that allows it to be increased up to \$850 million if certain conditions (including lender approval) are satisfied. Borrowings under bank credit lines and commercial paper borrowings are supported by a \$500 million revolving credit agreement. As a result of the long-term nature of this facility, the Company's commercial paper and credit line borrowings are classified as long-term debt at September 30, 2022. At its option, the Company either maintains cash balances or pays fees for bank credit and services. The facility requires the Company to maintain two financial covenants, a leverage ratio test and an interest coverage test. The Company was in compliance with the covenants as of September 30, 2022.

8. Earnings per Share of Common Stock

The numerator for the calculation of basic and diluted earnings per share is net earnings. The following table sets forth the computation of basic and diluted weighted-average shares used in the earnings per share calculations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Denominator for basic earnings per share - weighted average shares	154,197,072	159,188,790	155,625,624	160,310,548
Effect of dilutive stock options and share units	877,790	1,439,558	1,037,520	1,396,538
Denominator for diluted earnings per share	155,074,862	160,628,348	156,663,144	161,707,086

9. Stock Based Compensation

The Company adopted the A. O. Smith Combined Incentive Compensation Plan (the Incentive Plan) effective January 1, 2007. The Incentive Plan was most recently reapproved by stockholders on April 15, 2020. The Incentive Plan is a continuation of the A. O. Smith Combined Executive Incentive Compensation Plan which was originally approved by stockholders in 2002. The number of shares available for granting of options or share units at September 30, 2022 was 7,134,900. Upon stock option exercise or share unit vesting, shares are issued from treasury stock.

Total stock based compensation expense recognized in the three months ended September 30, 2022 and 2021 was \$1.4 million and \$1.4 million, respectively. Total stock based compensation expense recognized in the nine months ended September 30, 2022 and 2021 was \$10.4 million and \$10.3 million, respectively.

Stock Options

The stock options granted in the nine months ended September 30, 2022 and 2021 have three year pro rata vesting from the date of grant. Stock options are issued at exercise prices equal to the fair value of the Company's Common Stock on the date of grant. For active employees, all options granted in 2022 and 2021 expire ten years after the date of grant. The Company's stock options are expensed ratably over the three year vesting period; however, included in the stock option expense for the nine months ended September 30, 2022 and 2021 was expense associated with the accelerated vesting of stock option awards for certain employees who either are retirement eligible or become retirement eligible during the vesting period. Stock based compensation expense attributable to stock options in the three months ended September 30, 2022 and 2021 was \$0.5 million and \$0.5 million, respectively. Stock based compensation expense attributable to stock options in the nine months ended September 30, 2022 and 2021 was \$5.0 million and \$4.6 million, respectively.

9. Stock Based Compensation (continued)

Changes in options, all of which relate to the Company's Common Stock, were as follows for the nine months ended September 30, 2022:

	Weighted- Avg. Per Share Exercise Price	Number of Options	Average Remaining Contractual Life	Aggregate Intrinsic Value (dollars in millions)
Outstanding at January 1, 2022	\$ 47.73	2,252,498		
Granted	74.11	322,460		
Exercised	38.31	(45,751)		
Forfeited	61.09	(17,383)		
Outstanding at September 30, 2022	51.19	2,511,824	7 years	\$ 9.9
Exercisable at September 30, 2022	46.89	1,703,369	6 years	\$ 8.4

The weighted-average fair value per option at the date of grant during the nine months ended September 30, 2022 and 2021 using the Black-Scholes option-pricing model was \$17.57 and \$14.03, respectively. Assumptions were as follows:

	Nine Months Ended September 30,	
	2022	2021
Expected life (years)	5.7	5.8
Risk-free interest rate	1.9 %	1.2 %
Dividend yield	1.5 %	1.6 %
Expected volatility	26.8 %	27.4 %

The expected lives of options for purposes of these models are based on historical exercise behavior. The risk-free interest rates for purposes of these models are based on the U.S. Treasury yield curve in effect on the date of grant for the respective expected lives of the option. The expected dividend yields for purposes of these models are based on the dividends paid in the preceding four quarters divided by the grant date market value of the Common Stock. The expected volatility for purposes of these models are based on the historical volatility of the Common Stock.

Restricted Stock and Share Units

Participants may also be awarded shares of restricted stock or share units under the Incentive Plan. Share units vest three years after the date of grant. The Company granted 94,604 and 104,223 share units under the Incentive Plan in the nine months ended September 30, 2022 and 2021, respectively.

The share units were valued at \$6.9 million and \$6.4 million at the date of issuance in 2022 and 2021, respectively, based on the price of the Company's Common Stock at the date of grant. The share units are recognized as compensation expense ratably over the three-year vesting period; however, included in share unit expense in the three and nine months ended September 30, 2022 and 2021 was expense associated with accelerated vesting of restricted stock and share unit awards for certain employees who either are retirement eligible or will become retirement eligible during the vesting period. Stock based compensation expense attributable to share units of \$1.0 million and \$0.9 million was recognized in the three months ended September 30, 2022 and 2021, respectively. Stock based compensation expense attributable to share units of \$5.5 million and \$5.7 million was recognized in the nine months ended September 30, 2022 and 2021, respectively. Certain non-U.S.-based employees receive the cash value of the share price at the vesting date in lieu of shares. Unvested cash-settled awards are remeasured at each reporting period.

9. Stock Based Compensation (continued)

A summary of share unit activity under the Incentive Plan is as follows for the nine months ended September 30, 2022:

	Number of Units	Weighted-Average Grant Date Value
Issued and unvested at January 1, 2022	421,138	\$ 47.28
Granted	94,604	73.41
Vested	(126,631)	49.49
Forfeited	(8,439)	56.31
Issued and unvested at September 30, 2022	<u>380,672</u>	<u>52.92</u>

10. Pensions

The following table presents the components of the Company's net pension expense (income):

(dollars in millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Service cost	\$ 0.4	\$ 0.4	\$ 1.1	\$ 1.2
Interest cost	3.6	3.5	10.9	10.7
Expected return on plan assets	(5.4)	(11.9)	(16.1)	(35.9)
Amortization of unrecognized loss	5.1	5.2	15.3	15.6
Amortization of prior service cost	(0.1)	(0.1)	(0.3)	(0.3)
Defined benefit plan expense (income)	<u>\$ 3.6</u>	<u>\$ (2.9)</u>	<u>\$ 10.9</u>	<u>\$ (8.7)</u>

The service cost component of net periodic benefit cost is presented within cost of products sold and selling, general and administrative expenses within the condensed consolidated statements of earnings while the other components of pension expense (income) are reflected in other expense (income). The Company was not required to and did not make a contribution to its U.S. pension plan in 2021. The Company is not required to make a contribution in 2022.

In 2021, the Company's Board of Directors approved the termination of the Company's largest defined benefit pension plan (the Plan) representing over 95 percent of the Company's pension plan liabilities with a termination date of December 31, 2021. In April 2022, the Plan received a determination letter from the IRS that allowed the Company to proceed with the termination process for the Plan. In 2022, the Company expects to annuitize the remaining pension liability. The Plan settlement, which the Company expects to complete in the fourth quarter of 2022, will accelerate the recognition of approximately \$445 million of non-cash, pre-tax pension expenses.

11. Segment Results

The Company is comprised of two reporting segments: North America and Rest of World. The Rest of World segment is primarily comprised of China, Europe and India. Both segments manufacture and market comprehensive lines of residential and commercial gas and electric water heaters, boilers, tanks, and water treatment products. Both segments primarily manufacture and market in their respective regions of the world. The following table presents the Company's segment results:

(dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Net sales				
North America	\$ 652.9	\$ 658.2	\$ 2,127.1	\$ 1,814.7
Rest of World	230.2	263.1	716.1	748.6
Inter-segment	(8.9)	(6.7)	(25.4)	(19.9)
	<u>\$ 874.2</u>	<u>\$ 914.6</u>	<u>\$ 2,817.8</u>	<u>\$ 2,543.4</u>
Segment earnings				
North America ⁽¹⁾⁽²⁾	\$ 141.8	\$ 151.8	\$ 453.5	\$ 423.9
Rest of World	21.8	26.8	64.7	60.9
Inter-segment	—	(0.1)	(0.1)	(0.1)
	<u>163.6</u>	<u>178.5</u>	<u>518.1</u>	<u>484.7</u>
Corporate expense ⁽³⁾⁽⁴⁾	(16.5)	(11.1)	(45.5)	(38.0)
Interest expense	(2.4)	(1.0)	(6.0)	(2.9)
Earnings before income taxes	144.7	166.4	466.6	443.8
Provision for income taxes	34.9	34.8	110.8	96.3
Net earnings	<u>\$ 109.8</u>	<u>\$ 131.6</u>	<u>\$ 355.8</u>	<u>\$ 347.5</u>
⁽¹⁾ includes pension expense (income) of:	\$ 2.6	\$ (2.6)	\$ 7.8	\$ (7.8)
⁽²⁾ includes legal judgment income of:	(11.5)	—	(11.5)	—
⁽³⁾ includes terminated acquisition-related expenses of:	4.3	—	4.3	—
⁽⁴⁾ includes pension expense (income) of:	0.4	(0.6)	1.1	(1.7)

12. Fair Value Measurements

ASC 820, *Fair Value Measurements*, among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring basis or nonrecurring basis. ASC 820 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions. Assets and liabilities measured at fair value are based on the market approach which are prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

The following table presents assets (liabilities) measured at fair value on a recurring basis (dollars in millions):

Fair Value Measurement Using	September 30, 2022	December 31, 2021
Quoted prices in active markets for identical assets (Level 1)	\$ 58.3	\$ 188.1
Significant other observable inputs (Level 2)	7.9	(0.7)

Items measured at fair value were comprised of the Company's marketable securities (Level 1) and derivative instruments (Level 2). There were no changes in the Company's valuation techniques used to measure fair values on a recurring basis during the nine months ended September 30, 2022.

13. Derivative Instruments

The Company utilizes certain derivative instruments to enhance its ability to manage currency exposure as well as raw materials price risk. Derivative instruments are entered into for periods consistent with the related underlying exposures and do not constitute positions independent of those exposures. The Company does not enter into contracts for speculative purposes. The contracts are executed with major financial institutions with no credit loss anticipated for failure of the counterparties to perform.

Cash Flow Hedges

With the exception of its net investment hedges, the Company designates all of its hedging instruments as cash flow hedges. For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), gains or losses on the derivative instrument are reported as a component of other comprehensive loss, net of tax, and are reclassified into earnings in the same line item associated with the forecasted transaction and in the same period or periods during which the hedged transaction affects earnings.

Foreign Currency Forward Contracts

The Company is exposed to foreign currency exchange risk as a result of transactions in currencies other than the functional currency of certain subsidiaries. The Company utilizes foreign currency forward purchase and sale contracts to manage the volatility associated with foreign currency purchases, sales and certain intercompany transactions in the normal course of business. Principal currencies for which the Company utilizes foreign currency forward contracts include the British pound, Canadian dollar, Euro and Mexican peso.

Gains and losses on these instruments are recorded in accumulated other comprehensive loss, net of tax, until the underlying transaction is recorded in earnings. When the hedged item is realized, gains or losses are reclassified from accumulated other comprehensive loss to the consolidated statement of earnings. The assessment of effectiveness for forward contracts is based on changes in the forward rates. These hedges have been determined to be effective. The majority of the amounts in accumulated other comprehensive loss for cash flow hedges are expected to be reclassified into earnings within one year.

The following table summarizes, by currency, the contractual amounts of the Company's foreign currency forward contracts that are designated as cash flow hedges:

(dollars in millions)

	September 30, 2022		December 31, 2021	
	Buy	Sell	Buy	Sell
Canadian dollar	\$ —	\$ 111.2	\$ —	\$ 113.4
Euro	29.7	—	24.2	—
Mexican peso	12.5	—	23.8	—
Total	\$ 42.2	\$ 111.2	\$ 48.0	\$ 113.4

Net Investment Hedges

The Company enters into certain foreign currency forward contracts to hedge the exposure to a portion of the Company's net investments in certain non-U.S. subsidiaries against the effect of exchange rate fluctuations on the translation of foreign currency balances to the U.S. dollar. For the derivative instruments that are designated and qualify as net investment hedges, gains and losses are reported in other comprehensive loss where they offset gains and losses recorded on the Company's net investments in its non-U.S. subsidiaries. These hedges are determined to be effective. The Company recognized zero and \$1.4 million of after-tax gains associated with hedges of net investments in non-U.S. subsidiaries in currency translation adjustment in other comprehensive loss in the three and nine months ended September 30, 2022, respectively. The Company recognized zero and \$(0.1) million of after-tax losses associated with hedges of a net investment in non-U.S. subsidiaries in currency translation adjustment in other comprehensive loss in both the three and nine months ended September 30, 2021, respectively. The contractual amount of the Company's foreign currency forward contracts that are designated as net investment hedges is zero as of September 30, 2022.

13. Derivative Instruments (continued)

The following tables present the impact of derivative contracts on the Company's financial statements.

Fair value of derivatives designated as hedging instruments under ASC 815:

(dollars in millions)	Balance Sheet Location	September 30, 2022	December 31, 2021
Foreign currency contracts	Other current assets	\$ 10.4	\$ 1.7
	Accrued liabilities	(2.9)	(1.6)
Total derivatives designated as hedging instruments		\$ 7.5	\$ 0.1

The effect of cash flow hedges on the condensed consolidated statement of earnings:

Three Months Ended September 30 (dollars in millions):

<u>Derivatives in ASC 815 cash flow hedging relationships</u>	Amount of gain recognized in other comprehensive loss on derivatives		Location of gain reclassified from accumulated other comprehensive loss into earnings	Amount of gain reclassified from accumulated other comprehensive loss into earnings	
	2022	2021		2022	2021
Foreign currency contracts	\$ 5.7	\$ 0.6	Cost of products sold	\$ 1.0	\$ 0.2

Nine Months Ended September 30 (dollars in millions):

<u>Derivatives in ASC 815 cash flow hedging relationships</u>	Amount of gain (loss) recognized in other comprehensive loss on derivatives		Location of gain (loss) reclassified from accumulated other comprehensive loss into earnings	Amount of gain (loss) reclassified from accumulated other comprehensive loss into earnings	
	2022	2021		2022	2021
Foreign currency contracts	\$ 8.5	\$ (1.9)	Cost of products sold	\$ 1.8	\$ (0.9)

Balance Sheet Hedges

Foreign Exchange Contracts

The Company periodically enters into foreign exchange contracts to mitigate the foreign currency volatility relative to certain intercompany loans. These foreign exchange contracts did not qualify for hedge accounting in accordance with ASC 815 and as such were marked to market through earnings. The fair value of the foreign exchange contracts was an asset of \$0.4 million as of September 30, 2022. The fair value of the foreign exchange contracts was a liability of \$0.8 million as of December 31, 2021 and recorded in Accrued liabilities within the consolidated balance sheet.

The following table summarizes the contractual amounts of the Company's foreign exchange contracts that are designated as balance sheet hedges:

(dollars in millions)	September 30, 2022		December 31, 2021	
	Buy	Sell	Buy	Sell
Canadian dollar	\$ —	\$ 96.2	\$ —	\$ 125.6

13. Derivative Instruments (continued)

The amounts recognized within the consolidated statements of earnings related to the Company's foreign exchange contracts are set forth below.

Three Months Ended September 30 (dollars in millions):

Derivatives not designated as hedging instruments:	Location of loss within the consolidated statements of earnings	2022	2021
Foreign exchange contracts	Other expense (income) - net	\$ 0.4	\$ —

Nine Months Ended September 30 (dollars in millions):

Derivatives not designated as hedging instruments:	Location of loss within the consolidated statements of earnings	2022	2021
Foreign exchange contracts	Other expense (income) - net	\$ 1.5	\$ —

14. Income Taxes

The Company's effective income tax rate for the three and nine months ended September 30, 2022 was 24.1 percent and 23.7 percent, respectively. The Company estimates that its annual effective income tax rate for the full year 2022 will be between approximately 23.5 and 24.0 percent. The effective income tax rate for the three and nine months ended September 30, 2021 was 20.9 percent and 21.7 percent, respectively. The change in the effective income tax rate for the three and nine months ended September 30, 2022 compared to the effective income tax rate for the three and nine months ended September 30, 2021 was primarily due to a non-recurring favorable tax impact recorded in 2021 of \$4.2 million related to amending a previously filed tax return and a change in geographical earnings mix.

As of September 30, 2022, the Company had \$14.3 million of unrecognized tax benefits of which \$0.5 million would affect its effective income tax rate if recognized. The Company recognizes potential interest and penalties related to unrecognized tax benefits as a component of income tax expense. The Company's U.S. federal income tax returns for 2017-2022 are subject to audit. The Company is subject to state and local income tax audits for tax years 2008-2022. The Company is subject to non-U.S. income tax examinations for years 2015-2022.

15. Commitments and Contingencies

The Company maintains a commercial relationship with a supply-chain service provider (the Provider) in connection with the Company's business in China. In this capacity, the Provider offers order-entry, warehousing and logistics support. The Provider also offers asset-backed financing to certain of the Company's distributors in China to facilitate their working capital needs. To facilitate its financing support business, the Provider has collateralized lending facilities in place with multiple Chinese banks under which the Company has agreed to repurchase inventory if both requested by the banks and certain defined conditions are met, primarily related to the aging of the distributors' notes.

The Provider is required to indemnify the Company for any losses the Company would incur in the event of an inventory repurchase under these arrangements. Potential losses under the repurchase arrangements represent the difference between the repurchase price and net proceeds from the resale of product plus costs incurred in the process, less related distributor rebates.

Before considering any reduction of distributor rebate accruals of \$1.4 million and \$3.9 million as of September 30, 2022 and December 31, 2021, respectively, and from the resale of the related inventory, the gross amount the Company would be obligated to repurchase, which would be contingent on the default of all of the outstanding loans, was approximately \$2.4 million as of September 30, 2022 and \$7.2 million as of December 31, 2021. The Company's reserves for estimated losses under repurchase arrangements were immaterial as of September 30, 2022 and December 31, 2021.

On September 28, 2022, the Company received a cash judgment of \$11.5 million from a competitor of our North America segment related to its infringement of one of the Company's patents. The terms of the judgment resulted in pre-tax income of \$11.5 million that is recorded as an offset to selling, general and administrative expenses and a related tax expense of \$2.9 million.

16. Changes in Accumulated Other Comprehensive Loss by Component

Changes to accumulated other comprehensive loss by component are as follows:

(dollars in millions)	Three Months Ended September 30,	
	2022	2021
Cumulative foreign currency translation		
Balance at beginning of period	\$ (68.7)	\$ (44.6)
Other comprehensive loss before reclassifications	(28.9)	(2.4)
Balance at end of period	(97.6)	(47.0)
Unrealized net gain (loss) on cash flow derivatives		
Balance at beginning of period	2.1	(0.5)
Other comprehensive gain before reclassifications	4.3	0.5
Realized gains on derivatives reclassified to cost of products sold (net of income tax provision of \$0.2 and \$0.1 in 2022 and 2021, respectively)	(0.8)	(0.1)
Balance at end of period	5.6	(0.1)
Pension liability		
Balance at beginning of period	(279.8)	(266.1)
Amounts reclassified from accumulated other comprehensive loss: ⁽¹⁾	3.7	3.9
Balance at end of period	(276.1)	(262.2)
Accumulated other comprehensive loss, end of period	\$ (368.1)	\$ (309.3)
⁽¹⁾ Amortization of pension items:		
Actuarial losses	\$ 5.1 ⁽²⁾	\$ 5.2 ⁽²⁾
Prior year service cost	(0.1) ⁽²⁾	(0.1) ⁽²⁾
	5.0	5.1
Income tax benefit	(1.3)	(1.2)
Reclassification net of income tax benefit	\$ 3.7	\$ 3.9

⁽²⁾ These accumulated other comprehensive loss components are included in the computation of net periodic pension cost. See Note 10 - Pensions for additional details.

16. Changes in Accumulated Other Comprehensive Loss by Component (continued)

Changes to accumulated other comprehensive loss by component are as follows:

(dollars in millions)	Nine Months Ended September 30,	
	2022	2021
Cumulative foreign currency translation		
Balance at beginning of period	\$ (44.7)	\$ (48.1)
Other comprehensive (loss) income before reclassifications	(52.9)	1.1
Balance at end of period	(97.6)	(47.0)
Unrealized net gain (loss) on cash flow derivatives		
Balance at beginning of period	0.6	0.6
Other comprehensive gain (loss) before reclassifications	6.4	(1.4)
Realized (gains) losses on derivatives reclassified to cost of products sold (net of income tax provision (benefit) of \$0.4 and \$(0.2) in 2022 and 2021, respectively)	(1.4)	0.7
Balance at end of period	5.6	(0.1)
Pension liability		
Balance at beginning of period	(287.3)	(273.7)
Amounts reclassified from accumulated other comprehensive loss: ⁽¹⁾	11.2	11.5
Balance at end of period	(276.1)	(262.2)
Accumulated other comprehensive loss, end of period	<u>\$ (368.1)</u>	<u>\$ (309.3)</u>
⁽¹⁾ Amortization of pension items:		
Actuarial losses	\$ 15.3 ⁽²⁾	\$ 15.6 ⁽²⁾
Prior year service cost	(0.3) ⁽²⁾	(0.3) ⁽²⁾
	15.0	15.3
Income tax benefit	(3.8)	(3.8)
Reclassification net of income tax benefit	<u>\$ 11.2</u>	<u>\$ 11.5</u>

⁽²⁾ These accumulated other comprehensive loss components are included in the computation of net periodic pension cost. See Note 10 - Pensions for additional details.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Our company is comprised of two reporting segments: North America and Rest of World. Our Rest of World segment is primarily comprised of China, Europe and India. Both segments manufacture and market comprehensive lines of residential and commercial gas, heat pump and electric water heaters, boilers, tanks, and water treatment products. Both segments primarily manufacture and market in their respective region of the world.

We continue to seek acquisitions that enable geographic growth, expand our core business, and establish adjacencies. Consistent with this strategy, we acquired Giant Factories, Inc. (Giant), a Canada-based manufacturer of residential and commercial water heaters, in October 2021 using a combination of debt and cash. The acquisition fits squarely in our core capabilities, supplements our presence in Canada and enhances our capacity and distribution in the region. Giant contributed \$25.3 million and \$88.1 million of net sales in the third quarter and first nine months of 2022, respectively. Refer to Note 3, "Acquisitions" for additional information. We also continue to look for opportunities to add to our existing operations demonstrated by our previous introductions of water treatment products in India and range hoods and cooktops in China.

Our global supply chain management team continued to navigate through supply chain and logistics challenges in the first nine months of 2022. We have seen supply constraints for certain components and raw materials used in our operations, limited container and trucking capacity, and port congestion and delays. While we continued to see improvement in our supply chain as we closed out the third quarter, challenges still persist. In addition, while steel markets moderated in the first nine months of 2022, commodity prices and availability remain volatile. We remain in close contact with our suppliers and logistics providers to troubleshoot, manage and resolve bottlenecks, as the environment remains unpredictable.

In our North America segment, after approximately eight percent growth in 2021, we expect residential industry water heater volumes will be down approximately 12 to 13 percent in 2022 compared with 2021 as we believe that industry demand will normalize to more historical growth rates. We saw greater than anticipated softness in residential water heater order rates in the third quarter of 2022 as we believe our customers right-sized their inventories in response to our lead times returning to pre-pandemic levels after being elevated due to COVID-19-related supply chain constraints. While we expect quarter-over-quarter improvement in the fourth quarter, we expect North America residential water heater volume softness will persist through the remainder of the 2022. We believe that commercial water heater industry unit volumes will decline approximately 15 percent in 2022 compared to 2021 primarily due to weakness in the commercial electric water heaters greater than 55 gallons product category. We expect commercial gas water heater unit volumes to be flat to slightly down. We expect net sales in 2022 will benefit from our 2021 price increases, which had a cumulative effect on our water heater prices of approximately 50 percent. We expect to see an approximately 25 percent increase in our net sales of boilers in 2022 compared to 2021 driven by increased pricing in response to higher input costs coupled with higher demand. We anticipate net sales of our North America water treatment products, inclusive of acquisitions, will increase approximately 10 percent in 2022, compared to 2021, primarily driven by higher consumer demand for our point of use and point of entry water treatment systems.

In our Rest of World segment, after strong growth in 2021, we expect 2022 net sales in China will be flat to slightly down in local currency compared with 2021. Our business in China continues to be negatively impacted by the COVID-19 pandemic. To slow the spread of COVID-19 in China, targeted shutdowns began in certain cities late in the first quarter of 2022 and persisted through the first nine months of the year. The situation remains unpredictable.

Combining all of these factors, we expect our consolidated net sales to increase between five and seven percent in 2022, which includes our acquisition of Giant adding approximately \$100 million in incremental net sales. This guidance excludes the potential impacts from future acquisitions and assumes the COVID-19 related shutdowns in China remain at current levels throughout the rest of the year and do not significantly impact our operations or our employees, customers or suppliers.

Results of Operations

(dollars in millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Net sales	\$ 874.2	\$ 914.6	\$ 2,817.8	\$ 2,543.4
Cost of products sold	569.2	574.3	1,836.8	1,593.1
Gross profit	305.0	340.3	981.0	950.3
<i>Gross profit margin %</i>	34.9 %	37.2 %	34.8 %	37.4 %
Selling, general and administrative expenses	155.5	177.6	502.0	517.2
Interest expense	2.4	1.0	6.0	2.9
Other expense (income) - net	2.4	(4.7)	6.4	(13.6)
Earnings before provision for income taxes	144.7	166.4	466.6	443.8
Provision for income taxes	34.9	34.8	110.8	96.3
Net Earnings	\$ 109.8	\$ 131.6	\$ 355.8	\$ 347.5

Our net sales in the third quarter of 2022 were \$874.2 million, or 4.4 percent lower than 2021 third quarter net sales of \$914.6 million. Net sales in the first nine months of 2022 were \$2,817.8 million, or approximately 11 percent higher than \$2,543.4 million in the same period last year. Compared to the prior year quarter, our net sales decrease was primarily driven by lower residential water heater volumes in North America, which more than offset inflation-related pricing actions implemented in 2021. Our net sales increase in the first nine months of 2022 was primarily driven by inflation-related pricing actions and partially offset by lower residential water heater volumes in North America and lower net sales in China. In addition, our net sales in China were negatively impacted by approximately \$12 million in the third quarter and first nine months of 2022 due to the depreciation of the Chinese currency against the U.S. dollar. Our acquisition of Giant added \$25.3 million and \$88.1 million of incremental net sales in the third quarter and first nine months of 2022, respectively.

Our gross profit margin in the third quarter of 2022 was 34.9 percent compared to gross profit margin of 37.2 percent in the prior-year period. Gross profit margin in the first nine months of 2022 was 34.8 percent compared to the gross profit margin of 37.4 percent in the first nine months of 2021. The lower gross profit margins in the third quarter and first nine months of 2022 compared to the same periods last year were primarily due to higher steel and other material costs and production inefficiencies, which outpaced our pricing actions.

Selling, general, and administrative (SG&A) expenses in the third quarter of 2022 decreased by \$22.1 million compared to the third quarter of 2021. SG&A expenses decreased by \$15.2 million in the first nine months of 2022 compared to the prior year period. The decrease in SG&A expenses in the third quarter of 2022 was primarily due to the recognition of an \$11.5 million judgment against a competitor related to its infringement of one of our patents, partially offset by \$4.3 million of expenses associated with a terminated acquisition and lower selling expenses. The decrease in SG&A expenses in the first nine months of 2022 was primarily due to the judgment discussed above, lower management incentive expenses, and lower engineering costs in China, partially offset by increased selling expenses on higher net sales and the terminated acquisition expenses discussed above.

Interest expense in the third quarter of 2022 was \$2.4 million compared to \$1.0 million in the same period last year. Interest expense in the first nine months of 2022 was \$6.0 million compared to \$2.9 million in the same period the previous year. The increase in interest expense in the third quarter and first nine months of 2022 compared to the same periods last year was primarily due to higher debt levels.

Other expense was \$2.4 million in the third quarter of 2022 compared to other income of \$(4.7) million in the third quarter of 2021. Other expense was \$6.4 million in the first nine months of 2022 compared to other income of \$(13.6) million in the first nine months of 2021. Pension expense in the third quarter of 2022 was \$3.6 million compared to pension income of \$(2.9) million in the third quarter of 2021. Pension expense in the first nine months of 2022 was \$10.9 million compared to pension income of \$(8.7) million in the first nine months of 2021.

In 2021, our Board of Directors approved the termination of our largest defined benefit pension plan (the Plan), representing over 95 percent of our pension plan liabilities with a termination date of December 31, 2021. In April 2022, we received a determination letter from the IRS that allowed us to proceed with the termination process for the Plan. In 2022, we expect to annuitize the remaining Plan pension liability. The Plan settlement, which we expect to complete in the fourth quarter of 2022, will accelerate the recognition of approximately \$445 million of non-cash, pre-tax pension expenses, or approximately \$1.73

per share after tax. In addition, to protect the Plan's funded status, the Plan transferred a significant portion of its assets to lower risk investments in 2021. The impact of this transition resulted in a lower expected rate of return on pension investments and accordingly, higher pension expenses in 2022 compared to previous years. The service cost component of our pension income is reflected in cost of products sold and SG&A expenses. All other components of our pension expense (income) are reflected in other expense (income).

Our pension costs and credits are developed from actuarial valuations. The valuations reflect key assumptions regarding, among other things, discount rates, expected return on plan assets, retirement ages, and years of service. We consider current market conditions, including changes in interest rates, in making these assumptions. Our assumption for the expected rate of return on plan assets is 3.00 percent in 2022 compared to 6.25 percent in 2021. The discount rate used to determine net periodic pension costs increased to 2.72 percent in 2022 from 2.45 percent in 2021.

Our effective income tax rates for the third quarter and first nine months of 2022 were 24.1 percent and 23.7 percent, respectively. Our effective income tax rates for the third quarter and first nine months of 2021 were 20.9 percent and 21.7 percent, respectively. Our effective income tax rates in the third quarter and first nine months of 2022 were higher than our effective income tax rates in the same periods of 2021 primarily due to a non-recurring \$4.2 million favorable tax impact recorded in the prior year periods related to amending a previously filed tax return and a change in geographic earnings mix. We estimate our annual effective income tax rate for the full year of 2022 will be between 23.5 and 24.0 percent.

We are providing non-U.S. Generally Accepted Accounting Principles (GAAP) measures (adjusted earnings, adjusted EPS, adjusted segment earnings and adjusted corporate expense) that exclude the impact of pension settlement expenses as well as legal judgment income, expenses associated with a terminated acquisition and non-operating pension income and expenses. Reconciliations from GAAP measures to non-GAAP measures are provided below. We believe that the measures of adjusted earnings, adjusted EPS, adjusted segment earnings and adjusted corporate expense provide useful information to investors about our performance and allow management and our investors to better understand our performance between periods without regard to items that we do not consider to be a component of our core operating performance.

North America Segment

(dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Net Sales	\$ 652.9	\$ 658.2	\$ 2,127.1	\$ 1,814.7
Segment Earnings	141.8	151.8	453.5	423.9
Segment margin	21.7 %	23.1 %	21.3 %	23.4 %

Net sales in our North America segment were \$652.9 million in the third quarter of 2022 or \$5.3 million lower than net sales of \$658.2 million in the third quarter of 2021. Net sales in the first nine months of 2022 were \$2,127.1 million or \$312.4 million higher than net sales of \$1,814.7 million in the same period last year. Lower net sales in the third quarter of 2022 were primarily driven by lower residential water heater volumes which more than offset price increases implemented in 2021, largely on water heaters, which were in response to rising material and other input costs. The increased net sales in the first nine months of 2022 compared to the prior year period were primarily driven by the price increases discussed above which were partially offset by lower residential water heater volumes. In addition, our acquisition of Giant added \$25.3 million and \$88.1 million of incremental net sales in the third quarter and first nine months of 2022, respectively.

North America segment earnings were \$141.8 million in the third quarter of 2022, a decrease of approximately seven percent compared to segment earnings of \$151.8 million in the third quarter of 2021. Segment earnings during the first nine months of 2022 were \$453.5 million, an increase of approximately seven percent compared to segment earnings of \$423.9 million during the first nine months of 2021. Segment margins were 21.7 percent and 23.1 percent in the third quarter of 2022 and 2021, respectively. Segment margins were 21.3 percent and 23.4 percent during the first nine months of 2022 and 2021, respectively. Lower segment earnings in the third quarter of 2022 compared to the third quarter of 2021 were primarily due to lower residential water heater volumes, higher material costs, and production inefficiencies, partially offset by price increases implemented in 2021 as discussed above and the \$11.5 million patent infringement judgment referenced above. Higher segment earnings in the first nine months of 2022 compared to the prior year period were primarily due to the price increases and the judgment referenced above, partially offset by higher material and logistics costs. Segment margin was lower in the third quarter and the first nine months of 2022 primarily due to an overall increase in costs, including production inefficiencies, outpacing pricing actions.

Adjusted segment earnings and adjusted segment margin in the third quarter of 2022 were \$132.9 million and 20.4 percent, respectively. Adjusted segment earnings and adjusted segment margin in the third quarter of 2021 were \$149.2 million and 22.7

percent, respectively. Adjusted segment earnings and adjusted segment margin in the first nine months of 2022 were \$449.8 million and 21.1 percent, respectively. Adjusted segment earnings and adjusted segment margin in the first nine months of 2021 were \$416.1 million and 22.9 percent, respectively. We estimate our 2022 North America adjusted segment margin will be approximately 21.5 percent, excluding legal judgment income and pension expense.

Adjusted segment earnings and adjusted segment margin in the third quarter of 2022 and 2021 exclude \$2.6 million and (\$2.6) million of pension expense (income), respectively, and the recognition of the \$11.5 million patent infringement judgment. Adjusted segment earnings and adjusted segment margin in the first nine months of 2022 and 2021 exclude \$7.8 million and (\$7.8) million of pension expense (income), respectively, and the recognition of the \$11.5 million patent infringement judgment.

Rest of World Segment

(dollars in millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Net Sales	\$ 230.2	\$ 263.1	\$ 716.1	\$ 748.6
Segment Earnings	21.8	26.8	64.7	60.9
Segment margin	9.5 %	10.2 %	9.0 %	8.1 %

Net sales in the Rest of World segment were \$230.2 million in the third quarter of 2022, or \$32.9 million lower than net sales of \$263.1 million in the third quarter of 2021. Net sales during the first nine months of 2022 were \$716.1 million, or \$32.5 million lower than net sales of \$748.6 million during the first nine months ended of 2021. Net sales in China decreased approximately 15 percent in U.S. dollar terms and 10 percent in local currency in the third quarter of 2022 and approximately six percent in U.S. dollar terms and five percent in local currency in the first nine months of 2022 compared to the same period last year. Lower net sales in China in the third quarter and first nine months of 2022 were primarily driven by lower consumer demand due to COVID-19 related shutdowns. In addition, our net sales in this segment were negatively impacted by approximately \$16 million and \$22 million in the third quarter and first nine months, respectively of 2022 compared to the same periods last year, due to the depreciation of foreign currencies compared to the U.S. dollar. Net sales in India increased approximately 16 percent in the third quarter of 2022 on strong demand for our water heater and water treatment products compared to the prior year quarter.

Rest of World segment earnings were \$21.8 million in the third quarter of 2022, compared to \$26.8 million in the third quarter of 2021. Segment earnings during the first nine months of 2022 were \$64.7 million, compared to \$60.9 million during the nine months of 2021. Segment margins were 9.5 percent and 10.2 percent in the third quarter of 2022 and 2021, respectively. Segment margins were 9.0 percent and 8.1 percent during the first nine months of 2022 and 2021, respectively.

Lower segment earnings in the third quarter of 2022, were driven by lower volumes in China, partially offset by lower selling and advertising expenses. The decline in segment operating margin in the third quarter of 2022 was primarily due the impact of negative currency, partially offset by the increase in China operating margins. Higher segment earnings and margin in the first nine months of 2022 compared to the prior year period were primarily driven by favorable mix and lower engineering, advertising and selling expenses in China. We expect the full-year segment margin to be approximately 10 percent in 2022.

Outlook

We expect our consolidated net sales to increase between five and seven percent in 2022, which includes our acquisition of Giant adding approximately \$100 million in incremental net sales. Our expected higher net sales are driven by pricing actions implemented in 2021 in North America, partially offset by lower volumes of residential water heaters in North America. We expect to achieve full-year earnings of between \$1.29 and \$1.39 per share and adjusted earnings of between \$3.05 and \$3.15 per share. Our 2022 guidance excludes the potential impacts from future acquisitions and assumes the COVID-19 related shutdowns in China remain at current levels throughout the rest of the year and do not significantly impact our operations or our employees, customers or suppliers.

Liquidity & Capital Resources

Our working capital was \$668.7 million at September 30, 2022, and higher compared with \$633.8 million at December 31, 2021. A majority of the increase in working capital was driven by lower accounts payable and payroll-related accruals and higher inventory balances than at December 31, 2021, due to higher levels of safety stock on higher cost inventory which were partially offset by lower accounts receivable, and cash balances. In addition, cash balances as of September 30, 2022 were negatively impacted by \$37.4 million due to the effects of changes in foreign currency during the year. In the first nine months of 2022, we repatriated approximately \$120 million of cash from our foreign subsidiaries. We used the proceeds to pay down outstanding debt balances.

(dollars in millions)	Nine Months Ended September 30,	
	2022	2021
Cash provided by operating activities	\$ 214.7	\$ 376.8
Cash provided by (used in) investing activities	58.3	(135.3)
Cash used in financing activities	(320.1)	(328.5)

Cash provided by operating activities in the first nine months of 2022 was \$214.7 million compared with \$376.8 million in the same period last year. Cash provided by higher earnings in the first nine months of 2022 compared with the prior year was more than offset by lower customer deposits in China, higher incentive payments in 2022 due to record 2021 net sales and earnings, and additional working capital cash outlays for higher levels of safety stock on higher cost inventory. Our free cash flow in the first nine months of 2022 and 2021 was \$163.8 million and \$331.5 million, respectively. We expect free cash flow to be between \$400 million to \$425 million in 2022. Free cash flow is a non-GAAP measure and is described in more detail in the Non-GAAP Measures section below.

Capital expenditures totaled \$50.9 million in the first nine months of 2022, compared with \$45.3 million in the same period last year. We project 2022 capital expenditures will be between \$70 and \$75 million, and full-year depreciation and amortization expense will be approximately \$80 million.

In 2021, we renewed and amended our \$500 million revolving credit facility, which now expires on April 1, 2026. The renewed and amended facility, with a group of nine banks, has an accordion provision that allows it to be increased up to \$850 million if certain conditions (including lender approval) are satisfied. Borrowing rates under the facility are determined by our leverage ratio. The facility requires us to maintain two financial covenants, a leverage ratio test and an interest coverage test, and we were in compliance with the covenants as of September 30, 2022, and expect to be in compliance for the foreseeable future.

The facility backs up commercial paper and credit line borrowings. At September 30, 2022, we had \$152.1 million outstanding under the facility and an available borrowing capacity of \$347.9 million. We believe the combination of available borrowing capacity and operating cash flows will provide sufficient funds to finance our existing operations for the foreseeable future.

Our total debt increased by \$94.6 million in the first nine months of 2022 and was primarily due to repurchases of our common stock. Our leverage, as measured by the ratio of total debt to total capitalization, was 14.1 percent at September 30, 2022, compared with 9.7 percent at December 31, 2021.

Our U.S. pension plans continues to meet all funding requirements under ERISA regulations. We were not required to make a contribution to our pension plan in 2021. We forecast that we will not be required to make a contribution to the plan in 2022, and we do not plan to make any voluntary contributions in 2022.

In the first quarter of 2022, our Board of Directors approved adding 3,500,000 shares of common stock to our existing discretionary share repurchase authority. Under our share repurchase program, we may purchase our common stock through a combination of a Rule 10b5-1 automatic trading plan and discretionary purchases in accordance with applicable securities laws. The stock repurchase authorization remains effective until terminated by our Board of Directors, which may occur at any time, subject to the parameters of any Rule 10b5-1 automatic trading plan that we may then have in effect. During the first nine months of 2022, we repurchased 4,472,500 shares of our stock at a total cost of \$282.0 million. At September 30, 2022, we had 2,553,857 shares remaining on the share repurchase authority. Depending on factors such as stock price, working capital requirements, and alternative investment opportunities, we expect to spend approximately \$400 million on stock repurchases in 2022 through a combination of our Rule 10b5-1 automatic trading plan and open market repurchases.

On October 12, 2022, our Board of Directors declared a regular quarterly cash dividend of \$0.30 per share on our Common Stock and Class A common stock, which represents an increase over the amount per share of our most recent dividend. The dividend is payable on November 15, 2022, to shareholders of record on October 31, 2022.

Non-GAAP Financial Information

We provide non-GAAP measures of free cash flow, adjusted earnings, adjusted EPS, adjusted segment earnings and adjusted corporate expense. We define free cash flow as cash provided by operating activities less capital expenditures. Our adjusted earnings, adjusted EPS, adjusted segment earnings and adjusted corporate expenses excludes the impact of pension settlement expenses, non-operating pension income and expenses, legal judgment income, and expenses associated with terminated acquisition costs.

We believe that free cash flow provides useful additional information concerning cash flow available to meet future debt service obligations and working capital requirements. We believe that the measure of adjusted earnings, adjusted EPS, adjusted segment earnings and adjusted corporate expense provides useful information to investors about our performance and allows management and our investors to better understand our performance between periods without regard to items we do not consider to be a component of our core operating performance.

A. O. SMITH CORPORATION
Adjusted Earnings and Adjusted EPS
(dollars in millions, except per share data)
(unaudited)

The following is a reconciliation of net earnings and diluted EPS to adjusted earnings (non-GAAP) and adjusted EPS (non-GAAP):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2022	2021	2022	2021
Net Earnings (GAAP)	\$ 109.8	\$ 131.6	\$ 355.8	\$ 347.5
Legal judgment income, before tax	(11.5)	—	(11.5)	—
Pension expense (income), before tax	3.0	(3.2)	8.9	(9.5)
Terminated acquisition-related expenses, before tax	4.3	—	4.3	—
Tax effect on above items	1.0	0.8	(0.4)	2.4
Adjusted Earnings (non-GAAP)	<u>\$ 106.6</u>	<u>\$ 129.2</u>	<u>\$ 357.1</u>	<u>\$ 340.4</u>
Diluted EPS (GAAP)⁽¹⁾	\$ 0.71	\$ 0.82	\$ 2.27	\$ 2.15
Legal judgment income per diluted share, before tax	(0.07)	—	(0.07)	—
Pension expense (income) per diluted share, before tax	0.02	(0.02)	0.06	(0.06)
Terminated acquisition-related expenses per diluted share, before tax	0.03	—	0.03	—
Tax effect on above items per diluted share	—	0.01	(0.01)	0.02
Adjusted EPS (non-GAAP)⁽¹⁾	<u>\$ 0.69</u>	<u>\$ 0.81</u>	<u>\$ 2.28</u>	<u>\$ 2.11</u>

⁽¹⁾ Earnings per share amounts are calculated discretely and, therefore, may not add up to the total due to rounding.

A. O. SMITH CORPORATION
Adjusted Segment Earnings
(dollars in millions)
(unaudited)

The following is a reconciliation of reported segment earnings to adjusted segment earnings (non-GAAP):

	Three Months Ended September 30,		Nine Months Ended, September 30,	
	2022	2021	2022	2021
Segment Earnings (GAAP)				
North America	\$ 141.8	\$ 151.8	\$ 453.5	\$ 423.9
Rest of World	21.8	26.8	64.7	60.9
Inter-segment earnings elimination	—	(0.1)	(0.1)	(0.1)
Total Segment Earnings (GAAP)	<u>\$ 163.6</u>	<u>\$ 178.5</u>	<u>\$ 518.1</u>	<u>\$ 484.7</u>
Adjustments:				
North America	\$ (8.9)	\$ (2.6)	\$ (3.7)	\$ (7.8)
Rest of World	—	—	—	—
Inter-segment earnings elimination	—	—	—	—
Total Adjustments	<u>\$ (8.9)</u>	<u>\$ (2.6)</u>	<u>\$ (3.7)</u>	<u>\$ (7.8)</u>
Adjusted Segment Earnings (non-GAAP)				
North America	\$ 132.9	\$ 149.2	\$ 449.8	\$ 416.1
Rest of World	21.8	26.8	64.7	60.9
Inter-segment earnings elimination	—	(0.1)	(0.1)	(0.1)
Total Adjusted Segment Earnings (non-GAAP)	<u>\$ 154.7</u>	<u>\$ 175.9</u>	<u>\$ 514.4</u>	<u>\$ 476.9</u>
Additional Information				
Adjustments: North America Segment				
Pension expense (income), before tax	\$ 2.6	\$ (2.6)	\$ 7.8	\$ (7.8)
Legal judgment income, before tax	(11.5)	—	(11.5)	—
Total Adjustments	<u>\$ (8.9)</u>	<u>\$ (2.6)</u>	<u>\$ (3.7)</u>	<u>\$ (7.8)</u>

A. O. SMITH CORPORATION
Adjusted Corporate Expense
(dollars in millions)
(unaudited)

The following is a reconciliation of reported Corporate Expense to adjusted Corporate Expense (non-GAAP):

	Three Months Ended September 30,		Nine Months Ended, September 30,	
	2022	2021	2022	2021
Corporate Expense (GAAP)	\$ (16.5)	\$ (11.1)	\$ (45.5)	\$ (38.0)
Adjustments:				
Corporate pension expense (income)	0.4	(0.6)	1.1	(1.7)
Terminated acquisition-related expenses	4.3	—	4.3	—
Corporate Expense (non-GAAP)	<u>\$ (11.8)</u>	<u>\$ (11.7)</u>	<u>\$ (40.1)</u>	<u>\$ (39.7)</u>

A. O. SMITH CORPORATION
Free Cash Flow
(dollars in millions)
(unaudited)

The following is a reconciliation of reported cash flow from operating activities to free cash flow (non-GAAP):

	Nine Months Ended, September 30,	
	2022	2021
Cash provided by operating activities (GAAP)	\$ 214.7	\$ 376.8
Less: Capital expenditures	(50.9)	(45.3)
Free cash flow (non-GAAP)	<u>\$ 163.8</u>	<u>\$ 331.5</u>

A. O. SMITH CORPORATION
2022 Adjusted EPS Guidance and 2021 Adjusted EPS
(unaudited)

The following is a reconciliation of diluted EPS to adjusted EPS (non-GAAP) (all items are net of tax):

	2022 Guidance	2021
Diluted EPS (GAAP)	\$ 1.29 - 1.39	\$ 3.02
Estimated pension settlement charge	1.73 ⁽¹⁾	—
Pension expense (income)	0.06 ⁽²⁾	(0.06) ⁽³⁾
Legal judgment income	(0.05)	—
Terminated acquisition-related expenses	0.02	—
Adjusted EPS (non-GAAP)	<u>\$ 3.05 - 3.15</u>	<u>\$ 2.96</u>

⁽¹⁾ Includes pre-tax pension settlement charges of \$378.3 million and \$66.7 million, within the North America segment and Corporate expenses, respectively.

⁽²⁾ Includes pre-tax pension expense of \$10.5 million and \$1.3 million, within the North America segment and Corporate expenses, respectively.

⁽³⁾ Includes pre-tax pension income of \$10.5 million and \$2.6 million, within the North America segment and Corporate expenses, respectively.

Critical Accounting Policies

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the U.S., which requires the use of estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements. The critical accounting policies that we believe could have the most significant effect on our reported results or require complex judgment by management are contained in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of our Annual Report on Form 10-K for the year ended December 31, 2021. We believe that at September 30, 2022, there was no material change to this information.

Recent Accounting Pronouncement

Refer to *Recent Accounting Pronouncement* in Note 1 – Basis of Presentation in the notes to our condensed consolidated financial statements included in Part 1 Financial Information.

Forward Looking Statements

This filing contains statements that the Company believes are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally can be identified by the use of words such as "may," "will," "expect," "intend," "estimate," "anticipate," "believe," "forecast," "continue," "guidance", "outlook" or words of similar meaning. All forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated as of the date of this filing. Important factors that could cause actual results to differ materially from these expectations include, among other things, the following: further softening in U.S. residential water heater demand resulting primarily from channel inventory destocking; negative impacts to the Company, particularly the demand for its products, resulting from global inflationary pressures or a potential recession in one or more of the markets in which the Company participates; the Company's ability to continue to obtain commodities, components, parts and accessories on a timely basis through its supply chain and at expected costs; negative impacts to demand for the Company's products, particularly commercial products, and to its operations and workforce as a result of the severity and duration of the COVID-19 pandemic; further weakening in U.S. residential or commercial construction or instability in the Company's replacement markets; inability of the Company to implement or maintain pricing actions; an uneven recovery of the Chinese economy or decline in the growth rate of consumer spending or housing sales in China; negative impact to the Company's business in China as a result of future COVID-19 related shutdowns there; negative impact to the Company's businesses from international tariffs, trade disputes and geopolitical differences, including the conflict in Ukraine; potential weakening in the high-efficiency boiler segment in the U.S.; substantial defaults in payment by, material reduction in purchases by or the loss, bankruptcy or insolvency of a major customer; foreign currency fluctuations; the Company's inability to successfully integrate or achieve its strategic objectives resulting from acquisitions; competitive pressures on the Company's businesses; the impact of potential information technology or data security breaches; changes in government regulations or regulatory requirements; and adverse developments in general economic, political and business conditions in key regions of the world. Forward-looking statements included in this filing are made only as of the date of this filing, and the Company is under no obligation to update these statements to reflect subsequent events or circumstances. All subsequent written and oral forward-looking statements attributed to the Company, or persons acting on its behalf, are qualified entirely by these cautionary statements.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As is more fully described in our Annual Report on Form 10-K for the year ended December 31, 2021, we are exposed to various types of market risks, including currency and certain commodity risks. Our quantitative and qualitative disclosures about market risk have not materially changed since that report was filed. We monitor our currency and commodity risks on a continuous basis and generally enter into forward and futures contracts to minimize these exposures. The majority of the contracts are for periods of less than one year. Our Company does not engage in speculation in our derivative strategies. It is important to note that gains and losses from our forward and futures contract activities are offset by changes in the underlying costs of the transactions being hedged.

ITEM 4 - CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (Exchange Act). Based upon this evaluation of these disclosure controls and procedures, our principal executive officer and principal financial officer concluded that the disclosure controls and procedures were effective as of September 30, 2022 to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported,

within the time period specified in the SEC rules and forms, and to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.

Changes in internal control over financial reporting

There have been no changes in our internal control over financial reporting during the quarter ended September 30, 2022 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

During the third quarter of 2022, the Company reached a judgment against a competitor related to the infringement of one of the Company's patents. Other than this judgment, there have been no material changes in the legal and environmental matters discussed in Part 1, Item 3 and Note 16 of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2021.

ITEM 1A RISK FACTORS

There have been no material changes from the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2021, except for the addition of the risk factors set forth below:

■ *The outbreak of hostilities in Ukraine may exacerbate certain risks we face*

Russia's invasion of Ukraine and the global response, including the imposition of sanctions by the European Union, the United States and other countries, could create or exacerbate risks facing our business. While we do not have a physical presence in Russia or Ukraine, we have evaluated our operations, vendor contracts and customer arrangements, and at present we do not expect the conflict to directly have a material and adverse effect on our financial condition or results of operations. However, further escalation of geopolitical tensions related to the military conflict, including increased trade barriers or restrictions on global trade, could result in, among other things, cyberattacks, supply disruptions, significant volatility in commodity prices and availability, supply of energy resources, lower consumer demand, changes to foreign exchange rates and financial and capital markets. These risks and others described more fully in our Annual Report could be exacerbated by this military conflict. The extent and duration of the military action, sanctions and resulting market disruptions could be significant and could potentially have substantial impact on the global economy and our business for an unknown period of time.

■ *The global coronavirus (COVID-19) pandemic, or other global public health pandemics, could have a material adverse effect on our business, results of operations and financial condition*

Our business, results of operations and financial condition may be adversely affected if a global public health pandemic, including the current COVID-19 pandemic, interferes with the ability of our employees, suppliers, and customers to perform our and their respective responsibilities and obligations relative to the conduct of our business and operations. The COVID-19 pandemic has significantly impacted economic activity and markets around the world, and it could have a material negative impact on our business and operations in numerous ways, including but not limited to those outlined below:

- The risk that we, or our employees, suppliers or customers may be prevented from conducting business activities for an indefinite period of time, including shutdowns that may be requested or mandated by governmental authorities
- Restrictions on shipping products from certain jurisdictions where they are produced or into certain jurisdictions where customers are located.
- Inability to meet our customers' needs and achieve cost targets due to increased logistics costs, longer shipment times, and disruptions in our manufacturing and supply arrangements caused by the loss or disruption of essential manufacturing and supply elements, such as raw materials or other finished product components, transportation, workforce or other manufacturing and distribution capability.
- Failure of third parties on which we rely, including our suppliers, distributors, contractors and commercial banks, to meet their obligations to us, or significant disruptions in their ability to do so, which may be caused by their own financial or operational difficulties, workforce disruptions, or mandated shutdowns by governmental authorities, may adversely impact our operations.
- Significant reductions in demand, particularly for our commercial products, or significant volatility in demand and a global economic recession that could reduce demand for our products, resulting from actions taken by governments, businesses, and/or the general public in an effort to limit exposure to and spreading of such infectious diseases, such as

travel restrictions, quarantines, and business shutdowns or slowdowns. In addition, there is risk that the commercial sector, such as the restaurant and hospitality industries in which we have customers, will experience long-term shifts in consumer behavior which could negatively impact demand or capacity and may not return to pre-pandemic levels.

- Manufacturing plant inefficiencies due to safety and preventative health measures that we have implemented in our plants to prevent the spread of COVID-19.
- Deterioration of worldwide capital, credit, and financial markets that could limit our ability to obtain external financing to fund our operations and capital expenditures.

The extent to which the COVID-19 pandemic, or other outbreaks of disease or similar public health threats, materially and adversely impacts our business, results of operations and financial condition remains uncertain and will depend on future developments. Such developments may include the geographic spread and duration of the virus, periodic surges of the virus, the severity of the virus and the actions that may be taken by various governmental authorities and other third parties in response to the outbreak. In the first nine months of 2022, a number of municipal governments in China imposed shutdowns to prevent further spread of COVID-19. These shutdowns may continue or recur during the foreseeable future and could have a material negative impact on our business and operations there.

In addition, we cannot predict how quickly, and to what extent, normal economic and operating conditions can resume throughout the world, and the resumption of normal business operations may be delayed or constrained by lingering effects of the COVID-19 pandemic on our suppliers, third-party service providers, and/or customers.

ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In the first quarter of 2022, our Board of Directors approved adding 3,500,000 shares of common stock to the existing discretionary share repurchase authority. Under the share repurchase program, the Common Stock may be purchased through a combination of Rule 10b5-1 automatic trading plan and discretionary purchases in accordance with applicable securities laws. The number of shares purchased and the timing of the purchases will depend on a number of factors, including share price, trading volume and general market conditions, as well as working capital requirements, general business conditions and other factors, including alternative investment opportunities. The stock repurchase authorization remains effective until terminated by our Board of Directors which may occur at any time, subject to the parameters of any Rule 10b5-1 automatic trading plan that we may then have in effect. In the third quarter of 2022, we repurchased 1,604,000 shares at an average price of \$57.09 per share and at a total cost of \$91.6 million. As of September 30, 2022, there were 2,553,857 shares remaining on the existing repurchase authorization.

ISSUER PURCHASES OF EQUITY SECURITIES

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares that may yet be Purchased Under the Plans or Programs</u>
July 1 - July 31, 2022	500,000	\$ 57.02	500,000	3,657,857
August 1 - August 31, 2022	453,000	62.04	453,000	3,204,857
September 1 - September 30, 2022	651,000	53.69	651,000	2,553,857

ITEM 6 - EXHIBITS

Refer to the Exhibit Index on page 32 of this report.

INDEX TO EXHIBITS

<u>Exhibit Number</u>	<u>Description</u>
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
32.1	Written Statement of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Written Statement of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101	The following materials from A. O. Smith Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2022 are filed herewith, formatted in XBRL (Extensive Business Reporting Language): (i) the Condensed Consolidated Statement of Earnings for the three and nine months ended September 30, 2022 and 2021, (ii) the Condensed Consolidated Statement of Comprehensive Earnings for the three and nine months ended September 30, 2022 and 2021, (iii) the Condensed Consolidated Balance Sheets as of September 30, 2022, and December 31, 2021 (iv) the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2022 and 2021 (v) the Condensed Consolidated Statement of Stockholders' Equity for the three and nine months ended September 30, 2022 and 2021 (vi) the Notes to Condensed Consolidated Financial Statements.

SIGNATURES

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

A. O. SMITH CORPORATION

October 28, 2022

/s/ Benjamin A. Otchere

Benjamin A. Otchere
Vice President and Controller

/s/ Charles T. Lauber

Charles T. Lauber
Executive Vice President and Chief Financial Officer

Exhibit 31.1

CERTIFICATION

I, Kevin J. Wheeler, certify that:

1. I have reviewed this quarterly report on Form 10-Q of A. O. Smith Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

October 28, 2022

/s/ Kevin J. Wheeler

Kevin J. Wheeler

Chairman, President and Chief Executive Officer

Exhibit 31.2

CERTIFICATION

I, Charles T. Lauber, certify that;

1. I have reviewed this quarterly report on Form 10-Q of A. O. Smith Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

October 28, 2022

/s/ Charles T. Lauber

Charles T. Lauber

Executive Vice President and Chief Financial Officer

Exhibit 32.1

Written Statement of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, the undersigned certifies that to the best of my knowledge:

- (1) the Quarterly Report on Form 10-Q of A. O. Smith Corporation for the quarter ended September 30, 2022 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of A. O. Smith Corporation.

October 28, 2022

/s/ Kevin J. Wheeler

Kevin J. Wheeler

Chairman, President and Chief Executive Officer

Exhibit 32.2

Written Statement of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, the undersigned certifies that to the best of my knowledge:

- (1) the Quarterly Report on Form 10-Q of A. O. Smith Corporation for the quarter ended September 30, 2022 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of A. O. Smith Corporation.

October 28, 2022

/s/ Charles T. Lauber

Charles T. Lauber

Executive Vice President and Chief Financial Officer