

MUELLER INDUSTRIES INC
Form 10-Q
July 26, 2017
INDEX

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

FORM 10-Q

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

For the quarterly period ended July 1, 2017 Commission file number 1-6770

MUELLER INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

Delaware 25-0790410

(State or other jurisdiction (I.R.S. Employer
of incorporation or organization) Identification No.)

8285 Tournament Drive, Suite 150
Memphis, Tennessee 38125
(Address of principal executive offices) (Zip Code)

(901) 753-3200
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

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.

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The number of shares of the Registrant's common stock outstanding as of July 21, 2017 was 57,627,171.

INDEX

MUELLER INDUSTRIES, INC.

FORM 10-Q

For the Quarterly Period Ended July 1, 2017

As used in this report, the terms “Company,” “Mueller,” and “Registrant” mean Mueller Industries, Inc. and its consolidated subsidiaries taken as a whole, unless the context indicates otherwise.

INDEX

	Page Number
<u>Part I. Financial Information</u>	
<u>Item 1. – Financial Statements (Unaudited)</u>	
<u>a.) Condensed Consolidated Statements of Income</u>	<u>3</u>
<u>b.) Condensed Consolidated Statements of Comprehensive Income</u>	<u>4</u>
<u>c.) Condensed Consolidated Balance Sheets</u>	<u>5</u>
<u>d.) Condensed Consolidated Statements of Cash Flows</u>	<u>6</u>
<u>e.) Notes to Condensed Consolidated Financial Statements</u>	<u>7</u>
<u>Item 2. – Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>21</u>
<u>Item 3. – Quantitative and Qualitative Disclosures About Market Risk</u>	<u>30</u>
<u>Item 4. – Controls and Procedures</u>	<u>32</u>
<u>Part II. Other Information</u>	
<u>Item 1. – Legal Proceedings</u>	<u>32</u>
<u>Item 1A – Risk Factors</u>	<u>32</u>
<u>Item 2. – Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>33</u>
<u>Item 5. -- Other Information</u>	<u>33</u>
<u>Item 6. – Exhibits</u>	<u>34</u>
<u>Signatures</u>	<u>35</u>

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

MUELLER INDUSTRIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(In thousands, except per share data)	For the Quarter Ended		For the Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Net sales	\$614,266	\$544,071	\$1,192,186	\$1,076,880
Cost of goods sold	524,311	456,060	1,012,738	902,702
Depreciation and amortization	8,595	9,061	16,950	17,981
Selling, general, and administrative expense	34,557	34,514	70,088	70,294
Operating income	46,803	44,436	92,410	85,903
Interest expense	(6,442)	(1,692)	(8,973)	(3,540)
Other income, net	231	515	782	760
Income before income taxes	40,592	43,259	84,219	83,123
Income tax expense	(12,650)	(14,005)	(24,579)	(28,126)
(Loss) income from unconsolidated affiliates, net of tax	(109)	(995)	(1,352)	1,927
Consolidated net income	27,833	28,259	58,288	56,924
Net income attributable to noncontrolling interests	(200)	(462)	(668)	(497)
Net income attributable to Mueller Industries, Inc.	\$27,633	\$27,797	\$57,620	\$56,427
Weighted average shares for basic earnings per share	56,906	56,511	56,843	56,489
Effect of dilutive stock-based awards	511	418	585	456
Adjusted weighted average shares for diluted earnings per share	57,417	56,929	57,428	56,945
Basic earnings per share	\$0.49	\$0.49	\$1.01	\$1.00
Diluted earnings per share	\$0.48	\$0.49	\$1.00	\$0.99
Dividends per share	\$0.100	\$0.100	\$8.200	\$0.175

See accompanying notes to condensed consolidated financial statements.

INDEX

MUELLER INDUSTRIES, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (Unaudited)

(In thousands)	For the Quarter Ended		For the Six Months Ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Consolidated net income	\$27,833	\$28,259	\$58,288	\$56,924
Other comprehensive income (loss), net of tax:				
Foreign currency translation	906	(10,186)	8,116	(11,297)
Net change with respect to derivative instruments and hedging activities, net of tax of \$(89), \$(266), \$(185), \$(487)	261	700	317	1,294
Net change in pension and postretirement obligation adjustments, net of tax of \$172, \$(522), \$183, \$(920)	(405)	1,530	(365)	2,702
Attributable to unconsolidated affiliates, net of tax of \$(704), \$(812), \$199, \$(812)	1,247	1,438	(351)	1,438
Other, net	(236)	9	(380)	23
Total other comprehensive income (loss), net	1,773	(6,509)	7,337	(5,840)
Consolidated comprehensive income	29,606	21,750	65,625	51,084
Comprehensive (income) loss attributable to noncontrolling interests	(386)	123	(1,503)	862
Comprehensive income attributable to Mueller Industries, Inc.	\$29,220	\$21,873	\$64,122	\$51,946

See accompanying notes to condensed consolidated financial statements.

INDEX

MUELLER INDUSTRIES, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)

(In thousands, except share data)	July 1, 2017	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 167,555	\$ 351,317
Accounts receivable, less allowance for doubtful accounts of \$834 in 2017 and \$637 in 2016	287,829	256,291
Inventories	252,799	242,013
Other current assets	35,568	44,702
Total current assets	743,751	894,323
Property, plant, and equipment, net	284,594	295,231
Goodwill, net	137,085	123,993
Intangible assets, net	36,332	36,168
Investment in unconsolidated affiliates	75,208	77,110
Other assets	20,294	20,651
Total assets	\$ 1,297,264	\$ 1,447,476
Liabilities		
Current liabilities:		
Current portion of debt	\$ 14,583	\$ 13,655
Accounts payable	105,880	103,175
Accrued wages and other employee costs	30,894	35,121
Other current liabilities	67,841	67,041
Total current liabilities	219,198	218,992
Long-term debt, less current portion	489,043	213,709
Pension liabilities	14,823	14,890
Postretirement benefits other than pensions	16,793	16,383
Environmental reserves	20,859	21,208
Deferred income taxes	19,351	19,573
Other noncurrent liabilities	11,191	6,284
Total liabilities	791,258	511,039
Equity		
Mueller Industries, Inc. stockholders' equity:		
Preferred stock - \$1.00 par value; shares authorized 5,000,000; none outstanding	—	—
Common stock - \$.01 par value; shares authorized 100,000,000; issued 80,183,004; outstanding 57,624,926 in 2017 and 57,395,209 in 2016	802	802
Additional paid-in capital	274,750	273,345
Retained earnings	727,110	1,141,831
Accumulated other comprehensive loss	(60,454	) (66,956)

Edgar Filing: MUELLER INDUSTRIES INC - Form 10-Q

Treasury common stock, at cost	(448,837)	(450,338)
Total Mueller Industries, Inc. stockholders' equity	493,371	898,684
Noncontrolling interests	12,635	37,753
Total equity	506,006	936,437
Commitments and contingencies	—	—
Total liabilities and equity	\$1,297,264	\$1,447,476

See accompanying notes to condensed consolidated financial statements.

5

INDEX

MUELLER INDUSTRIES, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)

(In thousands)	For the Six Months Ended	
	July 1, 2017	July 2, 2016
Cash flows from operating activities		
Consolidated net income	\$58,288	\$56,924
Reconciliation of consolidated net income to net cash provided by operating activities:		
Depreciation and amortization	17,093	18,162
Stock-based compensation expense	3,692	2,874
Loss (income) from unconsolidated affiliates	1,352	(1,927)
Gain on sale of business	(1,631)	—
Loss (gain) on disposals of assets	81	(555)
Gain on sales of securities	(611)	—
Impairment charges	411	—
Deferred income taxes	3	3,548
Income tax benefit from exercise of stock options	—	(186)
Changes in assets and liabilities, net of businesses acquired and sold:		
Receivables	(47,108)	(52,334)
Inventories	(10,874)	1,176
Other assets	(4,723)	17,009
Current liabilities	(1,262)	(1,314)
Other liabilities	(1,086)	(1,440)
Other, net	(1,078)	(72)
Net cash provided by operating activities	12,547	41,865
Cash flows from investing activities		
Capital expenditures	(11,908)	(10,248)
Acquisition of businesses, net of cash acquired	(18,419)	(20,533)
Proceeds from sale of business, net of cash sold	17,483	—
Net withdrawals from restricted cash balances	4,650	1,508
Investment in unconsolidated affiliates	(1,617)	—
Proceeds from sales of assets	1,363	1,482
Proceeds from sales of securities	1,787	—
Net cash used in investing activities	(6,661)	(27,791)
Cash flows from financing activities		
Dividends paid to stockholders of Mueller Industries, Inc.	(185,539)	(9,887)
Dividends paid to noncontrolling interests	(2,909)	—
Issuance of long-term debt	—	2,000
(Repayment) issuance of debt by consolidated joint ventures, net	(3,320)	4,426
Net cash (used) received to settle stock-based awards	(785)	326
Repayments of long-term debt	(611)	(500)
Income tax benefit from exercise of stock options	—	186

Net cash used in financing activities	(193,164)	(3,449)
Effect of exchange rate changes on cash	3,516	(2,308)
(Decrease) increase in cash and cash equivalents	(183,762)	8,317
Cash and cash equivalents at the beginning of the period	351,317	274,844
Cash and cash equivalents at the end of the period	\$167,555	\$283,161

See accompanying notes to condensed consolidated financial statements. Refer to Note 2 for discussion of significant noncash financing activities.

6

INDEX

MUELLER INDUSTRIES, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

General

Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) have been condensed or omitted. Results of operations for the interim periods presented are not necessarily indicative of results which may be expected for any other interim period or for the year as a whole. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K, including the annual financial statements incorporated therein.

The accompanying unaudited interim financial statements include all normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented herein. The first half of 2017 contained 26 weeks, while the first half of 2016 contained 27 weeks.

Note 1 – Earnings per Common Share

Basic per share amounts have been computed based on the average number of common shares outstanding. Diluted per share amounts reflect the increase in average common shares outstanding that would result from the assumed exercise of outstanding stock options and vesting of restricted stock awards, computed using the treasury stock method. Approximately four thousand and 418 thousand stock-based awards were excluded from the computation of diluted earnings per share for the quarters ended July 1, 2017 and July 2, 2016, respectively, because they were antidilutive.

Note 2 – Special Dividend

On March 9, 2017, the Company distributed a special dividend of \$3.00 in cash and \$5.00 in principal amount of the Company's 6% Subordinated Debentures (Debentures) due March 1, 2027 for each share of common stock outstanding. Interest on the Debentures is payable semiannually on September 1 and March 1, commencing September 1, 2017. At issuance, the Debentures were recorded at their estimated fair value. The fair value of the Debentures was estimated based on quoted market prices for the same or similar issues, the current rates offered to the Company for debt of the same remaining maturities, or the use of market standard models. The carrying value of the Debentures approximate fair value at July 1, 2017.

The Debentures are subordinated to all other funded debt of the Company and are callable, in whole or in part, at any time at the option of the Company, subject to declining call premiums during the first five years. The Debentures also grant each holder the right to require the Company to repurchase such holder's Debentures in the event of a change in control at declining repurchase premiums during the first five years. The Debentures may be redeemed, subject to the conditions set forth above, at the following redemption price (expressed as a percentage of principal amount) plus any accrued but unpaid interest to, but excluding, the redemption date:

If redeemed during the 12-month period beginning March 9:

Year	Redemption Price
2017	106%
2018	105

2019	104
2020	103
2021	102
2022 and thereafter	100

The effect of the special dividend was a decrease in stockholders' equity of approximately \$458.7 million, an increase in long-term debt of approximately \$284.5 million, and a decrease in cash of approximately \$174.2 million.

INDEX

Note 3 – Acquisitions and Dispositions

Acquisitions

On May 31, 2017, the Company entered into a share purchase agreement pursuant to which the Company acquired all of the outstanding shares of Pexcor Manufacturing Company Inc. (Pexcor) and Heatlink Group Inc. (Heatlink) for approximately \$18.5 million, net of working capital adjustments. The total purchase price consisted of \$16.3 million in cash at closing and a contingent consideration arrangement which requires the Company to pay the former owners up to \$2.2 million based on EBITDA growth of the acquired companies. Pexcor and Heatlink, based out of Calgary, Canada, produce and sell a complete line of products for PEX plumbing and radiant systems. These businesses complement the Company's existing businesses within the Piping Systems segment.

The fair value of the assets acquired totaled \$10.6 million, consisting primarily of inventories of \$4.7 million, accounts receivable of \$2.9 million, property, plant, and equipment of \$2.0 million, other current assets of \$0.5 million, and other assets of \$0.5 million. The fair value of the liabilities assumed totaled \$3.9 million, consisting primarily of accounts payable of \$3.6 million and other liabilities of \$0.3 million. Of the remaining purchase price, \$11.8 million was allocated to non-deductible goodwill and intangible assets. The purchase price allocation is provisional as of July 1, 2017 and subject to change upon completion of the final valuation of the long-lived assets, working capital, and contingent consideration during the measurement period.

On April 26, 2016, the Company entered into an agreement pursuant to which the Company acquired a 60 percent equity interest in Jungwoo Metal Ind. Co., LTD (Jungwoo-Mueller) for approximately \$20.5 million in cash. Jungwoo-Mueller, which manufactures copper-based pipe joining products, is headquartered in Seoul, South Korea and serves markets worldwide. This business complements the Company's existing copper fittings business in the Piping Systems segment and is reported in the Company's Condensed Consolidated Financial Statements one month in arrears.

The fair value of the assets acquired totaled \$49.0 million, consisting primarily of property, plant, and equipment of \$24.2 million, inventories of \$17.6 million, accounts receivable of \$5.6 million, other current assets of \$1.4 million, and deferred tax assets of \$0.2 million. The fair value of the liabilities assumed totaled \$17.9 million, consisting primarily of long-term debt of \$8.7 million, accounts payable of \$7.3 million, pension liabilities of \$0.8 million, other current liabilities of \$0.5 million, and other liabilities of \$0.6 million. Of the remaining purchase price, \$1.0 million was allocated to non-deductible goodwill and intangible assets. The noncontrolling interest in Jungwoo-Mueller is \$11.6 million. The valuation of the business has been finalized. Changes to the purchase price allocation from the amounts presented in the Company's 2016 Annual Report on Form 10-K were immaterial.

Dispositions

On June 21, 2017, the Company entered into a definitive equity transfer agreement with Jiangsu Xingrong Hi-Tech Co. Ltd. and Jiangsu Baiyang Industries Co. Ltd. (Baiyang), together, the minority partners in Mueller-Xingrong (the Company's Chinese joint venture), pursuant to which the Company sold its 50.5 percent equity interest in Mueller-Xingrong to Baiyang for approximately \$18.3 million. Mueller-Xingrong manufactures engineered copper tube primarily for air-conditioning applications in China and was included in the Piping Systems segment. Mueller-Xingrong reported net sales of \$67.3 million and net losses of \$9 thousand in the first half of 2017 compared to net sales of \$69.6 million and net income of \$426 thousand in the first half of 2016. The carrying value of the assets disposed totaled \$56.7 million, consisting primarily of accounts receivable, inventories, and long-lived assets. The carrying value of the liabilities disposed (consisting primarily of current debt and accounts payable), noncontrolling interest, and amounts recognized in accumulated other comprehensive income (AOCI) totaled \$36.2 million. Since the disposal constituted a complete liquidation of the Company's investment in a foreign entity, the Company removed

from AOCI and recognized a cumulative translation gain of \$3.8 million. As a result of the disposal, the Company recognized a net gain on the sale of this business of \$1.6 million as a reduction of selling, general, and administrative expense in the Condensed Consolidated Financial Statements.

Note 4 –Segment Information

Each of the Company’s reportable segments is composed of certain operating segments that are aggregated primarily by the nature of products offered as follows:

Piping Systems

Piping Systems is composed of the following operating segments: Domestic Piping Systems Group, Great Lakes Copper, Pexcor & Heatlink, European Operations, Trading Group, and Jungwoo-Mueller (the Company’s South Korean joint venture). The Domestic Piping Systems Group manufactures copper tube and fittings, plastic fittings, and line sets. These products are

INDEX

manufactured in the U.S., sold in the U.S, and exported to markets worldwide. Outside the U.S., Great Lakes Copper manufactures copper tube and line sets and sells the products primarily in the U.S. and Canada, Pexcor & Heatlink produce a complete line of products for PEX plumbing and radiant systems in Canada, and the European Operations manufacture copper tube in the U.K. which is sold primarily in Europe. The Trading Group manufactures pipe nipples and imports and resells brass and plastic plumbing valves, malleable iron fittings, faucets, and plumbing specialty products in the U.S. and Mexico. Jungwoo-Mueller manufactures copper-based joining products that are sold worldwide. The Piping Systems segment's products are sold primarily to plumbing, refrigeration, and air-conditioning wholesalers, hardware wholesalers and co-ops, building product retailers, and air-conditioning original equipment manufacturers (OEMs).

The Company disposed of Mueller-Xingrong (the Company's Chinese joint venture) on June 21, 2017. This business manufactures engineered copper tube primarily for air-conditioning applications in China.

Industrial Metals

Industrial Metals is composed of the following operating segments: Brass Rod & Copper Bar Products, Impacts & Micro Gauge, and Brass Value-Added Products. These businesses manufacture brass rod, impact extrusions, and forgings, as well as a wide variety of end products including plumbing brass, automotive components, valves, fittings, and gas assemblies. These products are manufactured in the U.S. and sold primarily to OEMs in the U.S., many of which are in the industrial, construction, heating, ventilation, and air-conditioning, plumbing, and refrigeration markets.

Climate

Climate is composed of the following operating segments: Refrigeration Products, Fabricated Tube Products, Westermeyer, and Turbotec. These domestic businesses manufacture and fabricate valves, assemblies, high pressure components, and coaxial heat exchangers primarily for the heating, ventilation, air-conditioning, and refrigeration markets in the U.S.

Summarized segment information is as follows:

(In thousands)	For the Quarter Ended July 1, 2017				Total
	Piping Systems	Industrial Metals	Climate	Corporate and Eliminations	
Net sales	\$422,844	\$154,504	\$36,636	\$ 282	\$614,266
Cost of goods sold	364,261	132,972	27,449	(371)	524,311
Depreciation and amortization	5,591	1,904	615	485	8,595
Selling, general, and administrative expense	18,410	2,864	2,456	10,827	34,557
Operating income	34,582	16,764	6,116	(10,659)	46,803
Interest expense					(6,442)
Other income, net					231
Income before income taxes					\$40,592

INDEX

Segment information (continued):

(In thousands)	For the Quarter Ended July 2, 2016					Total
	Piping Systems	Industrial Metals	Climate	Corporate and Eliminations		
Net sales	\$388,662	\$127,737	\$31,359	\$ (3,687	)	\$544,071
Cost of goods sold	333,356	104,874	22,448	(4,618	)	456,060
Depreciation and amortization	5,787	2,120	618	536		9,061
Selling, general, and administrative expense	16,560	3,619	2,456	11,879		34,514
Operating income	32,959	17,124	5,837	(11,484	)	44,436
Interest expense						(1,692)
Other income, net						515
Income before income taxes						\$43,259
	For the Six Months Ended July 1, 2017					
(In thousands)	Piping Systems	Industrial Metals	Climate	Corporate and Eliminations		Total
Net sales	\$821,619	\$304,341	\$70,915	\$ (4,689	)	\$1,192,186
Cost of goods sold	708,907	257,015	53,013	(6,197	)	1,012,738
Depreciation and amortization	10,933	3,802	1,244	971		16,950
Selling, general, and administrative expense	36,831	6,094	4,932	22,231		70,088
Operating income	64,948	37,430	11,726	(21,694	)	92,410
Interest expense						(8,973)
Other income, net						782
Income before income taxes						\$84,219

INDEX

Segment information (continued):

(In thousands)	For the Six Months Ended July 2, 2016					Total
	Piping Systems	Industrial Metals	Climate	Corporate and Eliminations		
Net sales	\$757,552	\$262,258	\$62,065	\$ (4,995	)	\$1,076,880
Cost of goods sold	647,148	214,103	46,153	(4,702	)	902,702
Depreciation and amortization	11,436	4,255	1,217	1,073		17,981
Selling, general, and administrative expense	34,850	6,864	4,979	23,601		70,294
Operating income	64,118	37,036	9,716	(24,967	)	85,903
Interest expense						(3,540
Other income, net						760
Income before income taxes						\$83,123

Note 5 – Inventories

(In thousands)	July 1, 2017	December 31, 2016
Raw materials and supplies	\$65,739	\$ 57,387
Work-in-process	30,677	42,227
Finished goods	162,789	149,288
Valuation reserves	(6,406)	(6,889)
Inventories	\$252,799	\$ 242,013

Note 6 – Derivative Instruments and Hedging Activities

The Company's earnings and cash flows are subject to fluctuations due to changes in commodity prices, foreign currency exchange rates, and interest rates. The Company uses derivative instruments such as commodity futures contracts, foreign currency forward contracts, and interest rate swaps to manage these exposures.

All derivatives are recognized in the Condensed Consolidated Balance Sheets at their fair value. On the date the derivative contract is entered into, it is either a) designated as a hedge of (i) a forecasted transaction or the variability of cash flow to be paid (cash flow hedge) or (ii) the fair value of a recognized asset or liability (fair value hedge), or b) not designated in a hedge accounting relationship, even though the derivative contract was executed to mitigate an economic exposure (economic hedge), as the Company does not enter into derivative contracts for trading purposes. Changes in the fair value of a derivative that is qualified, designated and highly effective as a cash flow hedge are recorded in stockholders' equity within AOCI, to the extent effective, until they are reclassified to earnings in the same period or periods during which the hedged transaction affects earnings. Changes in the fair value of a derivative that is qualified, designated and highly effective as a fair value hedge, along with the gain or loss on the hedged recognized asset or liability that is attributable to the hedged risk, are recorded in current earnings. Changes in the fair value of undesignated derivatives executed as economic hedges and the ineffective portion of designated derivatives

are reported in current earnings.

The Company documents all relationships between derivative instruments and hedged items, as well as the risk-management objective and strategy for undertaking various hedge transactions. This process includes linking all derivative instruments that are designated as fair value hedges to specific assets and liabilities in the Condensed Consolidated Balance Sheets and linking cash flow hedges to specific forecasted transactions or variability of cash flow.

11

INDEX

The Company also assesses, both at the hedge's inception and on an ongoing basis, whether the designated derivative instruments that are used in hedging transactions are highly effective in offsetting changes in cash flows or fair values of hedged items. When a derivative instrument is determined not to be highly effective as a hedge or the underlying hedged transaction is no longer probable of occurring, hedge accounting is discontinued prospectively in accordance with the derecognition criteria for hedge accounting.

Commodity Futures Contracts

Copper and brass represent the largest component of the Company's variable costs of production. The cost of these materials is subject to global market fluctuations caused by factors beyond the Company's control. The Company occasionally enters into forward fixed-price arrangements with certain customers; the risk of these arrangements is generally managed with commodity futures contracts. These futures contracts have been designated as cash flow hedges.

At July 1, 2017, the Company held open futures contracts to purchase approximately \$14.3 million of copper over the next 11 months related to fixed price sales orders. The fair value of those futures contracts was a \$254 thousand net gain position, which was determined by obtaining quoted market prices (level 1 within the fair value hierarchy). In the next 12 months, the Company will reclassify into earnings realized gains or losses relating to cash flow hedges. At July 1, 2017, this amount was approximately \$169 thousand of deferred net gains, net of tax.

The Company may also enter into futures contracts to protect the value of inventory against market fluctuations. At July 1, 2017, the Company held open futures contracts to sell approximately \$31.8 million of copper over the next six months related to copper inventory. The fair value of those futures contracts was a \$457 thousand net loss position, which was determined by obtaining quoted market prices (level 1 within the fair value hierarchy).

Interest Rate Swap

On February 20, 2013, the Company entered into a two-year forward-starting interest rate swap agreement with an effective date of January 12, 2015, and an underlying notional amount of \$200.0 million, pursuant to which the Company receives variable interest payments based on one-month LIBOR and pays fixed interest at a rate of 1.4 percent. Based on the Company's current variable premium pricing on its revolving credit facility, the all-in fixed rate is 2.95 percent. The interest rate swap will mature on December 11, 2017, and is structured to offset the interest rate risk associated with the Company's floating-rate, LIBOR-based Credit Agreement. The swap was designated and accounted for as a cash flow hedge at inception. During the fourth quarter of 2016, the Company discontinued hedge accounting prospectively.

The fair value of the interest rate swap is estimated based on the present value of the difference between expected cash flows calculated at the contracted interest rate and the expected cash flows at the current market interest rate using observable benchmarks for LIBOR forward rates at the end of the period (level 2 within the fair value hierarchy). Interest payable and receivable under the swap agreement is accrued and recorded as an adjustment to interest expense. The fair value of the interest rate swap was a \$99 thousand loss position at July 1, 2017, and there was \$256 thousand of deferred losses, net of tax, included in AOCI that are expected to be reclassified into interest expense over the term of the interest rate swap.

The Company presents its derivative assets and liabilities in the Condensed Consolidated Balance Sheets on a net basis by counterparty. The following table summarizes the location and fair value of the derivative instruments and disaggregates the net derivative assets and liabilities into gross components on a contract-by-contract basis:

INDEX

(In thousands)	Asset Derivatives		Fair Value		Liability Derivatives		Fair Value	
	Balance Sheet Location		July	December	Balance Sheet Location	July 1,	December	
			1,	31, 2016		2017	31, 2016	
Commodity contracts - gains	Other current assets	\$372	\$ 1,013	Other current liabilities	\$—	\$ 564		
Commodity contracts - losses	Other current assets	(118)	(148)	Other current liabilities	(457)	(920)		
Interest rate swap	Other current assets	—	—	Other current liabilities	(99)	(787)		
Total derivatives ⁽¹⁾		\$254	\$ 865				\$(556)	