

STARRETT L S CO  
Form 10-Q  
May 02, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended                      March 31, 2018

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              1-367

**THE L. S. STARRETT COMPANY**

(Exact name of registrant as specified in its charter)

MASSACHUSETTS

(State or other jurisdiction of incorporation or organization)

04-1866480

(I.R.S. Employer Identification No.)

121 CRESCENT STREET, ATHOL, MASSACHUSETTS 01331-1915

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code 978-249-3551

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, or a smaller reporting company. See definition of

“accelerated filer,”  
“large accelerated  
filer” and “smaller  
reporting company”  
in Rule 12b-2 of the  
Exchange  
Act. (Check One):

Large Accelerated  
Filer    Accelerated  
Filer  
      Non-Accelerated  
Filer    Smaller  
Reporting Company

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

Common Shares outstanding as of April 30, 2018

Class A Common Shares            6,272,716

Class B Common Shares            744,656



THE L. S. STARRETT COMPANY

CONTENTS

|  | Page<br>No. |
|--|-------------|
| Part I. Financial Information:   |             |
| Item 1. Financial Statements   |             |
| Consolidated Balance Sheets – March 31, 2018 (unaudited) and June 30, 2017   | 3           |
| Consolidated Statements of Operations – three and nine months ended March 31, 2018 and March 31, 2017 (unaudited)                  | 4           |
| Consolidated Statements of Comprehensive Income (Loss) – three and nine months ended March 31, 2018 and March 31, 2017 (unaudited) | 5           |
| Consolidated Statements of Stockholders' Equity – nine months ended March 31, 2018 (unaudited)                                     | 6           |
| Consolidated Statements of Cash Flows - nine months ended March 31, 2018 and March 31, 2017 (unaudited)                            | 7           |
| Notes to Unaudited Consolidated Financial Statements   | 8-16        |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations                                      | 16-19       |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk   | 19          |
| Item 4. Controls and Procedures  | 19          |
| Part II. Other Information:  |             |
| Item 1A. Risk Factors  | 20          |
| Exhibits   | 21          |

Item  
6.

SIGNATURES

22

2

---

**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

## THE L. S. STARRETT COMPANY

## Consolidated Balance Sheets

(in thousands except share data)

|   | 03/31/2018<br>(unaudited) | 06/30/2017 |
|---|---------------------------|------------|
| <b>ASSETS</b>   |                           |            |
| Current assets:   |                           |            |
| Cash  | \$ 15,444                 | \$ 14,607  |
| Accounts receivable (less allowance for doubtful accounts of \$1,164 and \$946, respectively) | 31,684                    | 30,425     |
| Inventories   | 63,799                    | 58,097     |
| Prepaid expenses and other current assets   | 7,546                     | 6,994      |
| Total current assets  | 118,473                   | 110,123    |
| Property, plant and equipment, net  | 38,659                    | 39,345     |
| Taxes receivable  | 1,888                     | 2,627      |
| Deferred tax assets, net  | 18,523                    | 26,032     |
| Intangible assets, net  | 9,452                     | 9,868      |
| Goodwill  | 4,668                     | 4,668      |
| Other assets  | 2                         | 2          |
| Total assets  | \$ 191,665                | \$ 192,665 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                           |            |
| Current liabilities:  |                           |            |
| Current maturities of long-term debt  | \$ 4,681                  | \$ 11,514  |
| Accounts payable  | 10,464                    | 8,366      |
| Accrued expenses  | 6,328                     | 5,424      |
| Accrued compensation  | 4,597                     | 5,435      |
| Total current liabilities   | 26,070                    | 30,739     |
| Other tax obligations   | 2,889                     | 3,645      |
| Long-term debt, net of current portion  | 17,736                    | 6,095      |

Edgar Filing: STARRETT L S CO - Form 10-Q

|   |            |            |
|---|------------|------------|
| Postretirement benefit and pension obligations  | 56,258     | 58,571     |
| Other non-current liabilities   | 1,650      | 1,589      |
| Total liabilities   | 104,603    | 100,639    |
| Stockholders' equity:   |            |            |
| Class A Common stock \$1 par (20,000,000 shares authorized; 6,272,716 outstanding at March 31, 2018 and 6,267,603 outstanding at June 30, 2017) | 6,273      | 6,268      |
| Class B Common stock \$1 par (10,000,000 shares authorized; 745,216 outstanding at March 31, 2018 and 761,588 outstanding at June 30, 2017)     | 745        | 762        |
| Additional paid-in capital  | 55,562     | 55,579     |
| Retained earnings   | 73,543     | 79,402     |
| Accumulated other comprehensive loss  | (49,061 )  | (49,985 )  |
| Total stockholders' equity  | 87,062     | 92,026     |
| Total liabilities and stockholders' equity  | \$ 191,665 | \$ 192,665 |

See Notes to Unaudited Consolidated Financial Statements



## THE L. S. STARRETT COMPANY

## Consolidated Statements of Operations

(in thousands except per share data) (unaudited)

|   | 3 Months Ended |            | 9 Months Ended |            |
|---|----------------|------------|----------------|------------|
|   | 03/31/2018     | 03/31/2017 | 03/31/2018     | 03/31/2017 |
| Net sales   | \$54,834       | \$ 50,670  | \$158,776      | \$ 152,770 |
| Cost of goods sold  | 36,762         | 36,191     | 108,235        | 107,555    |
| Gross margin  | 18,072         | 14,479     | 50,541         | 45,215     |
| % of Net sales  | 33.0 %         | 28.6 %     | 31.8 %         | 29.6 %     |
| Selling, general and administrative expenses                        | 15,859         | 15,326     | 47,435         | 45,689     |
| Restructuring charges   | -              | 6          | -              | 400        |
| Operating income (loss)   | 2,213          | (853 )     | 3,106          | (874 )     |
| Other income (expense)  | 124            | (391 )     | 968            | (466 )     |
| Gain on sale of building  | -              | -          | -              | 3,089      |
| Income (loss) before income taxes                                   | 2,337          | (1,244 )   | 4,074          | 1,749      |
| Income tax expense (benefit)  | 700            | (458 )     | 8,532          | 713        |
| Net income (loss)   | \$1,637        | \$ (786 )  | \$(4,458 )     | \$ 1,036   |
| Basic income (loss) per share                                       | \$0.23         | \$ (0.11 ) | \$(0.64 )      | \$ 0.15    |
| Diluted income (loss) per share                                     | \$0.23         | \$ (0.11 ) | \$(0.64 )      | \$ 0.15    |
| Weighted average outstanding shares used in per share calculations: |                |            |                |            |
| Basic   | 7,018          | 7,058      | 7,012          | 7,046      |
| Diluted   | 7,036          | 7,058      | 7,012          | 7,078      |
| Dividends per share   | \$-            | \$ 0.10    | \$0.20         | \$ 0.30    |

See Notes to Unaudited Consolidated Financial Statements



THE L. S. STARRETT COMPANY

Consolidated Statements of Comprehensive Income (Loss)

(in thousands) (unaudited)

|  | 3 Months Ended |            | 9 Months Ended |            |
|--|----------------|------------|----------------|------------|
|  | 03/31/2018     | 03/31/2017 | 03/31/2018     | 03/31/2017 |
| Net income (loss)  | \$1,637        | \$ (786 )  | \$(4,458)      | \$ 1,036   |
| Other comprehensive income (loss):   |                |            |                |            |
| Currency translation gain (loss)   | 321            | 1,456      | 1,006          | (300 )     |
| Pension and postretirement plans, net of tax of \$0, \$0, \$0, and \$3,958, respectively | (28 )          | (45 )      | (82 )          | 6,377      |
| Other comprehensive income (loss)  | 293            | 1,411      | 924            | 6,077      |
| Total comprehensive income (loss)  | \$1,930        | \$ 625     | \$(3,534)      | \$ 7,113   |

See Notes to Unaudited Consolidated Financial Statements

## THE L. S. STARRETT COMPANY

## Consolidated Statements of Stockholders' Equity

For the Nine Months Ended March 31, 2018

(in thousands except per share data) (unaudited)

|                                   | <b>Common<br/>Stock</b>            |                    | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Loss</b> | <b>Total</b> |
|-----------------------------------|------------------------------------|--------------------|---|------------------------------|---|--------------|
|                                   | <b>Outstanding<br/>Class<br/>A</b> | <b>Class<br/>B</b> |   |                              |   |              |
| Balance June 30, 2017             | \$6,268                            | \$762              | \$ 55,579                                 | \$ 79,402                    | \$ (49,985)   | ) \$92,026   |
| Total comprehensive income (loss) | -                                  | -                  | -   | (4,458 )                     | 924   | (3,534 )     |
| Dividends (\$0.20 per share)      | -                                  | -                  | -   | (1,401 )                     | -   | (1,401 )     |
| Repurchase of shares              | (58 )                              | (6 )               | (487 )                                    | -                            | -   | (551 )       |
| Issuance of stock                 | 21                                 | 13                 | 244                                       | -                            | -   | 278          |
| Stock-based compensation          | 18                                 | -                  | 226                                       | -                            | -   | 244          |
| Conversion                        | 24                                 | (24 )              | -   | -                            | -   | -            |
| Balance March 31, 2018            | \$6,273                            | \$745              | \$ 55,562                                 | \$ 73,543                    | \$ (49,061)   | ) \$87,062   |

Accumulated balance consists of:

|  |              |
|--|--------------|
| Translation loss                               | \$ (42,317 ) |
| Pension and postretirement plans, net of taxes | (6,744 )     |
|  | \$ (49,061 ) |

See Notes to Unaudited Consolidated Financial Statements

## THE L. S. STARRETT COMPANY

## Consolidated Statements of Cash Flows

(in thousands) (unaudited)

9 Months Ended  
03/31/2018 03/31/2017

## Cash flows from operating activities:

|   |           |          |
|---|-----------|----------|
| Net income (loss)                                   | \$(4,458) | \$ 1,036 |
| Non-cash operating activities:                      |           |          |
| Gain on sale of building                            | -         | (3,089 ) |
| Depreciation  | 4,163     | 4,020    |
| Amortization  | 1,490     | 1,280    |
| Stock-based compensation                            | 244       | 320      |
| Net long-term tax obligations                       | 32        | (31 )    |
| Deferred taxes                                      | 7,649     | 702      |
| Postretirement benefit and pension obligations      | 439       | 1,916    |
| (Income) loss from equity method investment         | -         | 223      |
| Working capital changes:                            |           |          |
| Accounts receivable                                 | (254 )    | 6,200    |
| Inventories   | (4,720 )  | (2,184 ) |
| Other current assets                                | (474 )    | (1,501 ) |
| Other current liabilities                           | 1,007     | (1,790 ) |
| Prepaid pension expense                             | (3,541 )  | (4,303 ) |
| Other   | 63        | 222      |
| Net cash provided by (used in) operating activities | 1,640     | 3,021    |
| Cash flows from investing activities:               |           |          |
| Business acquisition, net of cash acquired          | -         | (1,324 ) |
| Additions to property, plant and equipment          | (3,250 )  | (3,478 ) |
| Software development                                | (1,014 )  | (750 )   |
| Proceeds from sale of building                      | -         | 3,321    |
| Net cash provided by (used in) investing activities | (4,264 )  | (2,231 ) |
| Cash flows from financing activities:               |           |          |
| Proceeds from borrowings                            | 6,845     | -        |
| Debt repayments                                     | (2,037 )  | (1,151 ) |
| Proceeds from common stock issued                   | 278       | 242      |
| Shares repurchased                                  | (551 )    | (51 )    |

Edgar Filing: STARRETT L S CO - Form 10-Q

|   |          |           |   |
|---|----------|-----------|---|
| Dividends paid                                      | (1,401)  | (2,113)   | ) |
| Net cash provided by (used in) financing activities | 3,134    | (3,073)   | ) |
| Effect of exchange rate changes on cash             | 327      | (450)     | ) |
| Net increase (decrease) in cash                     | 837      | (2,733)   | ) |
| Cash, beginning of period                           | 14,607   | 19,794    |   |
| Cash, end of period                                 | \$15,444 | \$ 17,061 |   |
| Supplemental cash flow information:                 |          |           |   |
| Interest paid                                       | \$479    | \$ 474    |   |
| Income taxes paid, net                              | 175      | (213)     | ) |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Notes to Unaudited Consolidated Financial Statements

March 31, 2018

**Note 1: Basis of Presentation and Summary of Significant Account Policies**

The unaudited interim financial statements as of and for the *nine* months ended *March 31, 2018* have been prepared by The L.S. Starrett Company (the "Company") in accordance with accounting principles generally accepted in the United States of America for interim financial reporting. Accordingly, they do *not* include all of the information and notes required by generally accepted accounting principles for complete financial statements. These unaudited financial statements, which, in the opinion of management, reflect all adjustments (including normal recurring adjustments) necessary for a fair presentation, should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form *10-K* for the year ended *June 30, 2017*. Operating results are *not* necessarily indicative of the results that *may* be expected for any future interim period or for the entire fiscal year.

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect amounts reported in the consolidated financial statements and accompanying notes. Note 2 to the Company's Consolidated Financial Statements included in the Annual Report on Form *10-K* for the year ended *June 30, 2017* describes the significant accounting policies and methods used in the preparation of the consolidated financial statements.

**Note 2: Recent Accounting Pronouncements**

In *May 2014*, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") *2014-09*, "Revenues from Contracts with Customers (Topic 606)," which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The standard requires entities to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The new guidance also includes a cohesive set of disclosure requirements intended to provide users of financial statements comprehensive information about the nature, amounts, timing and uncertainty of revenue and cash flows arising from a company's contracts with customers. ASU *2014-09* defines a *five*-step process to achieve this core principle and in doing so, it is possible that more

judgment and estimates *may* be required within the revenue recognition process than are required under existing guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to separate performance obligations, among others. The new standard will be effective for the Company beginning *July 1, 2018*. The FASB issued *four* subsequent standards in *2016* containing implementation guidance related to the new standard. These standards provide additional guidance related to principal versus agent considerations, licensing, and identifying performance obligations. Additionally, these standards provide narrow-scope improvements and practical expedients as well as technical corrections and improvements.

The guidance permits *two* methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the modified retrospective method). The Company will be adopting the standard using the modified retrospective method effective *July 1, 2018*.

The Company expects to complete our implementation procedures with respect to the new revenue recognition standard during the *fourth* quarter of fiscal year *2018*. While the Company continues to assess the impact of the new standard, it should be noted that revenues are primarily generated from the sale of finished products to customers, and that sales predominantly contain a single delivery element and that revenue is recognized at a single point in time when ownership, risks and rewards transfer. The timing of revenue recognition for these product sales is *not* materially impacted by the new standard. However, the Company is utilizing a comprehensive approach to assess the impact of the guidance on its current contract portfolio by reviewing its current accounting policies and practices to identify potential differences that would result from applying the new requirements to the Company's revenue contracts, including evaluation of performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price, allocating the transaction price to each separate performance obligation and accounting treatment of costs to obtain and fulfill contracts. While certain differences *may* arise specifically related to variable consideration and consideration payable to a customer, the Company does *not* expect these differences to materially impact our consolidated financial statements. In addition, the Company is currently analyzing our internal control over financial reporting framework to determine if controls should be added or modified as a result of adopting this standard, and reviewing the tax impact, if any, the adoption of the new standard *may* have. The Company also expects that the adoption of the new standard will result in expanded and disaggregated disclosure requirements.



In *February 2016*, the FASB issued ASU No. 2016-02, "Leases (Topic 842)". The ASU requires that organizations that lease assets recognize assets and liabilities on the balance sheet for the rights and obligations created by those leases. The ASU will affect the presentation of lease related expenses on the income statement and statement of cash flows and will increase the required disclosures related to leases. This ASU is effective for fiscal years beginning after *December 15, 2018*, including interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the impact of ASU No. 2016-02 on its consolidated financial statements. It is expected that a key change upon adoption will be the balance sheet recognition of leased assets and liabilities and that any changes in income statement recognition will *not* be material.

In *October 2016*, the FASB issued ASU No. 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory", which is intended to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. This update removes the current exception in GAAP prohibiting entities from recognizing current and deferred income tax expenses or benefits related to transfer of assets, other than inventory, within the consolidated entity. The current exception to defer the recognition of any tax impact on the transfer of inventory within the consolidated entity until it is sold to a *third* party remains unaffected. The amendments in this update are effective for public entities for annual reporting periods beginning after *December 15, 2017*. Early adoption is permitted. The adoption of ASU No. 2016-16 is *not* expected to have a material impact on the Company's consolidated financial statements.

In *January 2017*, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805) - Clarifying the Definition of a Business", with the objective to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets versus businesses. The amendments in ASU 2017-01 provide a screen to determine when a set of assets and activities is *not* a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is *not* a business. This screen is expected to reduce the number of transactions that need to be further evaluated. If the screen is *not* met, the amendments in ASU 2017-01 (i) require that to be considered a business, a set of assets and liabilities acquired must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output; and (ii) remove the evaluation of whether a market participant could replace missing elements. The amendments in this ASU are effective for annual and interim periods beginning after *December 15, 2017* and should be applied prospectively. Early adoption is permitted for transactions for which the acquisition date occurs before the issuance date of ASU 2017-01, only when the transaction has *not* been reported in financial statements that have been issued or made available for issuance. The adoption of ASU No. 2017-01 is *not* expected to have a material impact on the Company's consolidated financial statements.

In *January 2017*, the FASB issued ASU No. 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment". Under the new guidance, if a reporting unit's carrying value amount exceeds its fair value, an entity will record an impairment charge based on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. The standard eliminates the requirement to calculate goodwill impairment using Step 2, which calculates an impairment charge by comparing the implied fair value of goodwill with its carrying amount. The standard does *not* change the guidance on completing Step 1 of the goodwill impairment test. The amendments in this ASU are effective for annual and interim periods beginning after *December 15, 2019* and should be applied prospectively for annual and any interim goodwill impairment tests. Early adoption is permitted for

entities for interim or annual goodwill impairment tests performed on testing dates after *January 1, 2017*. The Company is currently evaluating the impact of the update on its consolidated financial statements.

In *February 2018*, the FASB issued ASU No. 2018-02, “Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income”. For deferred tax items recognized in Accumulated Other Comprehensive Income (AOCI), changes in tax rates can leave amounts “stranded” in AOCI. Under ASU 2018-02, FASB has given companies an option to reclassify the stranded tax effects resulting from the tax law and tax rate changes under the Tax Cuts and Jobs Act of 2017 from AOCI to retained earnings. This guidance is effective for fiscal years beginning after *December 15, 2018* and requires companies to disclose whether they are or are *not* opting to reclassify the income tax effects from the new 2017 tax act. Early adoption is permitted. The Company is currently evaluating the impact of this update on its consolidated financial statements.

In *February 2018*, the FASB issued ASU 2018-05, “Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118”. This update codified the guidance provided in SAB 118 on applying ASC 740, Income Taxes, if the accounting for certain income tax effects of the Tax Cuts and Jobs Act of 2017 is incomplete when the financial statements are issued for a reporting period. This update was effective upon issuance. Therefore, the Company has applied the guidance in this update within our consolidated financial statements for the quarter ended *March 31, 2018*. See Note 9: “Income Taxes”, of this Form 10-Q for more information on the adoption of this guidance.

### Note 3: Stock-based Compensation

On *September 5, 2012*, the Board of Directors adopted The L.S. Starrett Company *2012* Long Term Incentive Plan (the "*2012* Stock Plan"). The *2012* stock plan was approved by shareholders on *October 17, 2012*, and the material terms of its performance goals were recently re-approved by shareholders at the Company's Annual Meeting held on *October 18, 2017*. The *2012* Stock Plan permits the granting of the following types of awards to officers, other employees and non-employee directors: stock options; restricted stock awards; unrestricted stock awards; stock appreciation rights; stock units including restricted stock units; performance awards; cash-based awards; and awards other than previously described that are convertible or otherwise based on stock. The *2012* Stock Plan provides for the issuance of up to *500,000* shares of common stock.

Options granted vest in periods ranging from *one* year to *three* years and expire *ten* years after the grant date. Restricted stock units ("RSU") granted generally vest from *one* year to *three* years. Vested restricted stock units will be settled in shares of common stock. As of *March 31, 2018*, there were *20,000* stock options and *140,802* restricted stock units outstanding. In addition, there were *297,033* shares available for grant under the *2012* Stock Plan as of *March 31, 2018*.

For stock option grants the fair value of each grant is estimated at the date of grant using the Binomial Options pricing model. The Binomial Options pricing model utilizes assumptions related to stock volatility, the risk-free interest rate, the dividend yield, and employee exercise behavior. Expected volatilities utilized in the model are based on the historic volatility of the Company's stock price. The risk free interest rate is derived from the U.S. Treasury Yield curve in effect at the time of the grant. The expected life is determined using the average of the vesting period and contractual term of the options (Simplified Method).

*No* stock options were granted during the *nine* months ended *March 31, 2018* and *2017*.

The weighted average contractual term for stock options outstanding as of *March 31, 2018* was *4.75* years. The aggregate intrinsic value of stock options outstanding as of *March 31, 2018* was less than *\$0.1* million. Stock options exercisable as of *March 31, 2018* were *20,000*. In recognizing stock compensation expense for the *2012* Stock Incentive Plan, management has estimated that there will be *no* forfeitures of options.

The Company accounts for stock options and RSU awards by recognizing the expense of the grant date fair value ratably over vesting periods generally ranging from *one* year to *three* years. The related expense is included in selling, general and administrative expenses.

There were 62,000 RSU awards with a fair value of \$7.22 per RSU granted during the *nine* months ended *March 31, 2018*. There were 14,400 RSUs settled, and 12,433 RSUs forfeited during the *nine* months ended *March 31, 2018*. The aggregate intrinsic value of RSU awards outstanding as of *March 31, 2018* was \$1.0 million. As of *March 31, 2018* all vested awards had been issued and settled.

On *February 5, 2013*, the Board of Directors adopted The L.S. Starrett Company 2013 Employee Stock Ownership Plan (the “2013 ESOP”). The purpose of the plan is to supplement existing Company programs through an employer funded individual account plan dedicated to investment in common stock of the Company, thereby encouraging increased ownership of the Company while providing an additional source of retirement income. The plan is intended as an employee stock ownership plan within the meaning of Section 4975 (e) (7) of the Internal Revenue Code of 1986, as amended. U.S. employees who have completed a year of service are eligible to participate.

Compensation expense related to all stock based plans for the *nine* month periods ended *March 31, 2018* and *2017* was \$0.2 million, and \$0.3 million respectively. As of *March 31, 2018*, there was \$1.5 million of total unrecognized compensation costs related to outstanding stock-based compensation arrangements. Of this cost, \$1.4 million relates to performance based RSU grants that are *not* expected to be awarded. The remaining \$0.1 million is expected to be recognized over a weighted average period of 2.0 years.

#### **Note 4: Inventories**

ASU No. 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory", specifies that when an entity measures inventory at the lower of cost or market that “market” is defined as “net realizable value,” or the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The adoption of ASU No. 2015-11 on July 1, 2017 did *not* have a material impact on our consolidated financial statements.

Inventories consist of the following (in thousands):

|                                     | 03/31/2018 | 6/30/2017 |
|-------------------------------------|------------|-----------|
| Raw material and supplies           | \$ 26,098  | \$ 26,293 |
| Goods in process and finished parts | 19,788     | 16,419    |
| Finished goods                      | 43,910     | 41,591    |
|                                     | 89,796     | 84,303    |
| LIFO Reserve                        | (25,997 )  | (26,206 ) |
|                                     | \$ 63,799  | \$ 58,097 |

LIFO inventories were \$8.4 million and \$7.7 million at *March 31, 2018* and *June 30, 2017*, respectively, such amounts being approximately \$26.0 million and \$26.2 million, respectively, less than if determined on a FIFO basis. The use of LIFO, as compared to FIFO, resulted in a \$0.2 million decrease in cost of sales for the *nine* months ended *March 31, 2018* compared to a \$1.5 million decrease in cost of sales for the *nine* months ended *March 31, 2017*.

#### Note 5: Business Acquisition

In fiscal 2010, the Company entered into an agreement with a private software company to invest \$1.5 million in exchange for a 36% equity interest therein. In the *third* quarter of fiscal 2017, the Company entered into a new agreement to invest an additional \$3.6 million for an additional 64% of equity in the company. The Company paid \$1.8 million in cash at closing and is obligated to pay an additional \$1.8 million in cash *three* years subsequent to closing (discounted to \$1.6 million on the purchase date). In addition, the agreement provides for the former owners to receive a 30% share of operating profits of the business over the next *three* years so long as they remain employed by the Company. The Company has accrued for such profit sharing as an expense based on results of operations since the date of acquisition.

The acquisition has been accounted for as a business combination and the financial results of the company have been included in our consolidated financial statements since the date of acquisition. Under the acquisition method of accounting, the purchase price was allocated to net tangible and intangible assets based upon their estimated fair values as of the acquisition date.

The table below presents the allocation of the purchase price to the acquired net assets (in thousands):

|  |         |
|--|---------|
| Cash                                   | \$509   |
| Accounts receivable                    | 273     |
| Inventories                            | 243     |
| Other current assets                   | 18      |
| Deferred software development costs    | 2,520   |
| Intangible Assets                      | 1,220   |
| Goodwill                               | 1,634   |
| Fixed assets                           | 47      |
| Deferred tax liability                 | (1,090) |
| Accounts payable & current liabilities | (80 )   |
| Purchase Price (1)                     | \$5,294 |

(1)  $\$1,833 + 1,555$  (\$1.8 million discounted at 5%) = \$3,388 purchase price divided by 64% = \$5.294 million.

Pro-forma financial information has *not* been presented for this acquisition because it is *not* considered material to the Company's financial position or results of operations.

#### **Note 6: Goodwill and Intangible Assets**

The Company's acquisition of Bytewise in 2011 and the private software company in 2017 resulted in the recognition of goodwill totaling \$4.7 million. Under ASU 2011-08, the Company is required, on a set date, to annually assess its goodwill in order to determine whether or *not* it is more likely than *not* that the fair value of the reporting unit's goodwill exceeded its carrying amount. Determining the fair value of a reporting unit is subjective and requires the use of significant estimates and assumptions.

For Bytewise, the annual assessment date was *October 1, 2017*. The Company performed a quantitative analysis in accordance with ASU 2011-08 for its annual assessment (commonly referred to as “Step One”). With the assistance of an independent *third-party* valuation specialist, the Company estimated the fair value using an income approach based on the present value of future cash flows. The Company believes this approach yields the most appropriate evidence of fair value. The Company also utilized the comparable company multiples method and market transaction fair value method to validate the fair value amount obtained using the income approach. The key assumptions utilized in the discounted cash flow model included estimates of future cash flows from operating activities offset by estimated capital expenditures of the reporting unit, the estimated terminal value for the reporting unit, a discount rate based on a weighted average cost of capital, and an assessment of current market capitalization.

Under the quantitative analysis, the *2017* fair value assessment of the Bytewise goodwill exceeded the carrying amount by approximately *81.1%*. Therefore *no* goodwill impairment was determined to exist. If future results significantly vary from current estimates, related projections, or business assumptions in the future due to changes in industry or market conditions, the Company *may* be required to record impairment charges.

The Company performed a qualitative analysis in accordance with ASU 2011-08 for its *February 1, 2018* annual assessment of goodwill (commonly referred to as “Step Zero”) associated with its purchase of the private software company. From a qualitative perspective, in evaluating whether it is more likely than *not* that the fair value of a reporting unit exceeds its carrying amount, relevant events and circumstances are taken into account, with greater weight assigned to events and circumstances that most affect the fair value or the carrying amounts of its assets. Items that were considered included, but were *not* limited to, the following: macroeconomic conditions, industry and market conditions, cost factors, overall financial performance and changes in management or key personnel. After assessing these and other factors the Company determined that it was more likely than *not* that the fair value of this reporting unit exceeded its carrying amount as of *February 1, 2018*.

Amortizable intangible assets consist of the following (in thousands):

|                            | 03/31/2018 | 6/30/2017 |
|----------------------------|------------|-----------|
| Non-compete agreement      | \$ 600     | \$ 600    |
| Trademarks and trade names | 2,070      | 2,070     |
| Completed technology       | 2,358      | 2,358     |
| Customer relationships     | 5,580      | 5,580     |
| Software development       | 7,197      | 6,184     |
| Other intangible assets    | 325        | 325       |
| Total                      | 18,130     | 17,117    |
| Accumulated amortization   | (8,678 )   | (7,249 )  |
| Total net balance          | \$ 9,452   | \$ 9,868  |

Amortizable intangible assets are being amortized on a straight-line basis over the period of expected economic benefit.

The estimated useful lives of the intangible assets subject to amortization range between 5 years for software development and 20 years for some trademark and trade name assets.

The estimated aggregate amortization expense for the remainder of fiscal 2018 and for each of the next *five* years and thereafter, is as follows (in thousands):

|                          |       |
|--------------------------|-------|
| 2018 (Remainder of year) | \$578 |
| 2019                     | 2,210 |
| 2020                     | 1,687 |
| 2021                     | 1,284 |
| 2022                     | 1,051 |
| 2023                     | 708   |
| Thereafter               | 1,934 |

**Note 7: Pension and Post-retirement Benefits**

The Company has *two* defined benefit pension plans, *one* for U.S. employees and another for U.K. employees. The U.K. plan was closed to new entrants in fiscal 2009. The Company has a postretirement medical and life insurance benefit plan for U.S. employees. The Company also has defined contribution plans.

On *December 21, 2016*, the Company amended the U.S. defined benefit pension plan to freeze benefit accruals effective *December 31, 2016*. Consequently, the Plan is closed to new participants and current participants will *no* longer earn additional benefits after *December 31, 2016*.



The amendment of the defined benefit pension plan triggered a pension curtailment which required a re-measurement of the Plan's benefit obligation as of *December 31, 2016*. The re-measurement resulted in a decrease in the benefit obligation of approximately \$6.9 million primarily due to an increase in the discount rate from 3.77% to 4.31%, with an additional \$4.2 million decrease resulting from the impact of the curtailment. These reductions in the Plan's benefit obligation were recorded as other comprehensive income, net of taxes.

Net periodic benefit costs for all of the Company's defined benefit pension plans consist of the following (in thousands):

|                                | Three Months Ended |            | Nine Months Ended |            |
|--------------------------------|--------------------|------------|-------------------|------------|
|                                | 03/31/2018         | 03/31/2017 | 03/31/2018        | 03/31/2017 |
| Service cost                   | \$-                | \$ -       | \$-               | \$ 1,405   |
| Interest cost                  | 1,531              | 1,574      | 4,560             | 4,659      |
| Expected return on plan assets | (1,300)            | (1,284 )   | (3,876)           | (3,878 )   |
| Amortization of net loss       | 5                  | 6          | 17                | 102        |
|                                | \$236              | \$ 296     | \$701             | \$ 2,288   |

Net periodic benefit costs for the Company's Postretirement Medical Plan consists of the following (in thousands):

|                                      | Three Months |            | Nine Months |            |
|--------------------------------------|--------------|------------|-------------|------------|
|                                      | Ended        | Ended      | Ended       | Ended      |
|                                      | 03/31/2018   | 03/31/2017 | 03/31/2018  | 03/31/2017 |
| Service cost                         | \$21         | \$ 23      | \$64        | \$ 70      |
| Interest cost                        | 69           | 67         | 203         | 203        |
| Amortization of prior service credit | (134)        | (168 )     | (403)       | (505 )     |
| Amortization of net loss             | 24           | 30         | 74          | 90         |
|                                      | \$(20 )      | \$ (48 )   | \$(62 )     | \$ (142 )  |

For the *nine* month period ended *March 31, 2018*, the Company contributed \$2.8 million to the U.S. and \$0.8 million to the UK pension plans. The Company estimates that it will contribute an additional \$1.2 million for the remainder of fiscal 2018.

The Company's pension plans use fair value as the market-related value of plan assets and recognize net actuarial gains or losses in excess of *ten* percent (*10%*) of the greater of the market-related value of plan assets or of the plans' projected benefit obligation in net periodic (benefit) cost as of the plan measurement date. Net actuarial gains or losses that are less than *10%* of the thresholds noted above are accounted for as part of the accumulated other comprehensive loss.

#### Note 8: Debt

Debt is comprised of the following (in thousands):

|   | 03/31/2018 | 6/30/2017 |
|---|------------|-----------|
| <u>Short-term and current maturities</u>            |            |           |
| Loan and Security Agreement                         | \$ 1,669   | \$ 11,514 |
| Other Loans   | 3,012      | -         |
| <u>Long-term debt</u>                               |            |           |
| Loan and Security Agreement, net of current portion | 17,736     | 6,095     |
|   | \$ 22,417  | \$ 17,609 |

The Company amended its Loan and Security Agreement, which includes a Line of Credit and a Term Loan, in *January 2018*. Borrowings under the Line of Credit *may not* exceed \$23.0 million. The Line of Credit has an interest rate of LIBOR plus *1.5%*, and expires on *April 30, 2021*. The effective interest rate on the Line of Credit under the Loan and Security Agreement for the *nine* months ended *March 31, 2018* and *2017* was *3.2%* and *2.5%*, respectively. As of *March 31, 2018*, \$12.9 million was outstanding on the Line of Credit.

Availability under the Line of Credit is subject to a borrowing base comprised of accounts receivable and inventory. The Company believes that the borrowing base will consistently produce availability under the Line of Credit in excess of \$23.0 million. A *0.25%* commitment fee is charged on the unused portion of the Line of Credit.

The obligations under the Credit Facility are unsecured. In the event of certain triggering events, such obligations would become secured by the assets of the Company's domestic subsidiaries. A triggering event occurs when the Company fails to achieve any of the financial covenants noted below in consecutive quarters.

The material financial covenants of the amended Loan and Security Agreement are: 1) funded debt to EBITDA, excluding non-cash and retirement benefit expenses ("maximum leverage"), *not* to exceed 2.25 to 1.00, 2) annual capital expenditures *not* to exceed \$15.0 million, 3) maintain a Debt Service Coverage Rate of a minimum of 1.25 to 1.00, and 4) maintain consolidated cash plus liquid investments of *not* less than \$10.0 million at any time. As of *March 31, 2018*, the Company was in compliance with all the financial debt covenants related to its Loan and Security Agreement. The Company was *not* in compliance with *one* of its non-financial covenants related to additional borrowings made in *December*, but the waiver received in *January 2018* was granted until *June 30, 2018*. The Company expects to be in compliance with this covenant prior to the waiver expiration.

On *November 22, 2011*, in conjunction with the Bytewise acquisition, the Company entered into a \$15.5 million term loan (the "Term Loan") under the then existing Loan and Security Agreement. The Term Loan is a *ten* year loan bearing a fixed interest rate of 4.5% and is payable in fixed monthly payments of principal and interest of \$160,640. The Term Loan had a balance of \$6.5 million at *March 31, 2018*.

In *December 2017*, the Company's Brazilian subsidiary entered into *two* short-term loans with local banks in order to support the Company's strategic initiatives. The loans backed by the entity's US dollar denominated export receivables were made with Santander Bank and Bradesco Bank and totaled \$3.5 million. The Santander loan of \$1.5 million has a term of 180 days and a rate of 4.19% and the Bradesco loan of \$2.0 million has a term of 360 days and a rate of 4.75%. As of *March 31, 2018*, the outstanding balance on these loans was \$3.0 million.

#### **Note 9: Income Taxes**

The Company is subject to U.S. federal income tax and various state, local, and foreign income taxes in numerous jurisdictions. The Company's domestic and foreign tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to the Company's interpretation of applicable tax laws in the jurisdictions in which it files.

The Company provides for income taxes on an interim basis based on an estimate of the effective tax rate for the year. This estimate is reassessed on a quarterly basis. Discrete tax items are accounted for in the quarterly period in which they occur.

On *December 22, 2017*, the Tax Cuts and Jobs Act was signed into law in the United States. This law made numerous changes to federal taxation in the U.S., including a reduction in the federal corporate tax rate to *21%* and a *one-time* tax on historical foreign earnings that had *not* yet been repatriated. The effect of the tax rate change is that the Company's federal tax rate is reduced to a blended rate of *28%* from the previous rate of *34%* for fiscal *2018*, and then will further reduce to the enacted *21%* in Fiscal *2019* and beyond. In addition, there are also a number of other changes primarily related to U.S. taxation of income earned by foreign subsidiaries and on transactions with those subsidiaries. As a result of this legislation, in the quarter ended *December 31, 2017*, the Company performed an initial assessment of the impact of tax reform and has taken a charge to tax expense of *\$7.3* million to reflect the estimated impact of the tax rate reduction on its deferred tax assets. The Company has estimated the overall federal tax impact for the *one* time transition tax to be zero. Further guidance from the Department of Treasury and various state taxing authorities as well as year-end financial data is required, however, before the various tax calculations can be considered complete.

The Company is reviewing all aspects of the tax law change and, other than the reduced tax rate on earnings going forward, which will provide a favorable benefit, the Company does *not* believe the other provisions will have a significant impact to tax expense. The Company will continue to measure the impact of these provisions and will record any changes in subsequent quarters when information and guidance becomes available.

The tax expense for the *third* quarter of fiscal *2018* was *\$0.7* million on profit before tax of *\$2.3* million for an effective tax rate of *30.0%*. The effective tax rate for the *third* quarter of fiscal *2017* was *36.8%*. For the *first nine* months of fiscal *2018*, tax expense was *\$8.5* million on profit before tax of *\$4.1* million for an effective tax rate of *209%*. Before the tax charge related to new tax legislation, tax expense was *\$1.3* million or *31.5%* of pre-tax income. For the *first nine* months of fiscal *2017*, the effective tax rate was *40.8%*.

The tax expense in the *third* quarter of fiscal *2018* was increased by a nominal amount of discrete items primarily related to interest charges on tax liabilities and an increase in the valuation allowance for state tax loss carryforwards which were mostly offset by the benefit from a reduced liability for uncertain tax positions net of the reduction in the receivable for a competent authority review. In prior quarters, there were net discrete charges of *\$7.2* million including discrete charges for the impact of the tax law change referred to above, the impact of tax deductions on stock grants which were less than the book deductions, and interest on tax liabilities; these were partly offset by discrete tax benefits for research credits in the U.K., the use of carryforward tax losses in the U.K. and the impact of provision to return adjustments. The tax expense in the *third* quarter of fiscal *2017* was increased by less than *\$0.1* million for interest expense on uncertain tax positions and for the *first nine* months of fiscal *2017*, it was increased by *\$0.3* million primarily for the impact of a tax rate change in the U.K. applied to the deferred tax asset balance.

U.S. Federal tax returns through fiscal 2014 are generally *no* longer subject to review by tax authorities; however, tax loss carryforwards from years before fiscal 2015 are still subject to adjustment. As of *March 31, 2018*, the Company has substantially resolved all open income tax audits and there were *no* other local or federal income tax audits in progress. In international jurisdictions including Australia, Brazil, Canada, China, Germany, Mexico, New Zealand, Singapore and the UK, which comprise a significant portion of the Company's operations, the years that *may* be examined vary by country. The Company's most significant foreign subsidiary in Brazil is subject to audit for the calendar years 2012 - 2017. During the next *twelve* months, it is possible there will be a reduction of \$0.2 million in long term tax obligations due to the expiration of the statute of limitations on prior year tax returns.

Accounting for income taxes requires estimates of future benefits and tax liabilities. Due to the temporary differences in the timing of recognition of items included in income for accounting and tax purposes, deferred tax assets or liabilities are recorded to reflect the impact arising from these differences on future tax payments. With respect to recorded tax assets, the Company assesses the likelihood that the asset will be realized by addressing the positive and negative evidence to determine whether realization is more likely than *not* to occur. If realization is in doubt because of uncertainty regarding future profitability, the Company provides a valuation allowance related to the asset to the extent that it is more likely than *not* that the deferred tax asset will *not* be realized. Should any significant changes in the tax law or the estimate of the necessary valuation allowance occur, the Company would record the impact of the change, which could have a material effect on the Company's financial position.

*No* valuation allowance has been recorded for the Company's domestic deferred tax assets related to temporary differences in items included in taxable income. The Company continues to believe that due to forecasted future taxable income and certain tax planning strategies available, it is more likely than *not* that it will be able to utilize the tax benefit provided by those differences. In the U.S., a partial valuation allowance has been provided for foreign tax credit carryforwards due to the uncertainty of generating sufficient foreign source income to utilize those credits in the future. In certain other countries where Company operations are in a loss position, the deferred tax assets for tax loss carryforwards and other temporary differences are fully offset by a valuation allowance.

#### **Note 10: Contingencies**

The Company is involved in certain legal matters which arise in the normal course of business. These matters are *not* expected to have a material impact on the Company's financial condition, results of operations or cash flows.

In the *second* quarter of this year, the Company's Brazilian subsidiary received a favorable ruling on an old tax dispute related to the Brazilian Program of Social Integration (PIS) taxes. This ruling resulted in the recognition of other income of approximately \$1.0 million, and was awarded in the form of tax credits to be used to offset future tax payments.

**Note 11: Segment Information**

The segment information and the accounting policies of each segment are the same as those described in the notes to the consolidated financial statements entitled “Financial Information by Segment & Geographic Area” included in our Annual Report on Form 10-K for the year ended *June 30, 2017*. The Company’s business is aggregated into *two* reportable segments based on geography of operations: North American Operations and International Operations. Segment income is measured for internal reporting purposes by excluding corporate expenses which are included in unallocated in the table below. Other income and expense, including interest income and expense, the gain on the sale of a building in fiscal 2017, and income taxes are excluded entirely from the table below. There were *no* significant changes in the segment operations or in the segment assets from the Annual Report. Financial results for each reportable segment are as follows (in thousands):

|   | <b>North<br/>American<br/>Operations</b> | <b>International<br/>Operations</b> | <b>Unallocated</b> | <b>Total</b> |
|---|--|-------------------------------------|--------------------|--------------|
| <b><u>Three Months ended March 31, 2018</u></b> |  |                                     |                    |              |
| Sales <sup>1</sup>                              | \$ 34,119                                | \$ 20,715                           | \$ -               | \$54,834     |
| Operating Income (Loss)                         | \$ 2,831                                 | \$ 629                              | \$ (1,247 )        | \$2,213      |
| <b><u>Three Months ended March 31, 2017</u></b> |  |                                     |                    |              |
| Sales <sup>2</sup>                              | \$ 31,791                                | \$ 18,879                           | \$ -               | \$50,670     |
| Operating Income (Loss)                         | \$ 1,563                                 | \$ (693 )                           | \$ (1,723 )        | \$(853 )     |

<sup>1</sup> Excludes \$1,527 of North American segment intercompany sales to the International segment, and \$3,602 of International segment intercompany sales to the North American segment.

<sup>2</sup> Excludes \$1,493 of North American segment intercompany sales to the International segment, and \$2,536 of International segment intercompany sales to the North American segment.

|  | <b>North<br/>American<br/>Operations</b> | <b>International<br/>Operations</b> | <b>Unallocated</b> | <b>Total</b> |
|--|--|-------------------------------------|--------------------|--------------|
| <b><u>Nine Months ended March 31, 2018</u></b> |  |                                     |                    |              |
| Sales <sup>1</sup>                             | \$ 94,937                                | \$ 63,839                           | \$ -               | \$158,776    |
| Operating Income (Loss)                        | \$ 5,545                                 | \$ 1,629                            | \$ (4,068)         | ) \$3,106    |
| <b><u>Nine Months ended March 31, 2017</u></b> |  |                                     |                    |              |
| Sales <sup>2</sup>                             | \$ 92,345                                | \$ 60,425                           | \$ -               | \$152,770    |
| Operating Income (Loss)                        | \$ 4,520                                 | \$ (143)                            | ) \$ (5,251)       | ) \$(874 )   |

<sup>1</sup> Excludes \$4,804 of North American segment intercompany sales to the International segment, and \$10,290 of International segment intercompany sales to the North American segment.

<sup>2</sup> Excludes \$6,189 of North American segment intercompany sales to the International segment, and \$8,585 of International segment intercompany sales to the North American segment.

#### **Note 12: Facility Closure**

This footnote was previously reported as a “subsequent event” in the fiscal 2018 *second* quarter 10-Q report.

The Company decided in *January 2018* to vacate its facility in Mt. Airy, North Carolina, and move current operations to a smaller building. While *no* definitive date for this move has been set yet, the Company anticipates that the move will happen within the next 12 months. The Company incurred a \$4.1 million impairment charge in fiscal 2016, when the majority of the plant’s operations were relocated to the Company’s Brazilian production facility. As of *December 31, 2017*, the carrying value of the building is \$2.0 million, and the Company believes that the current fair value exceeds the carrying value. During the current quarter, the Company sold the inventory and equipment related to *one* of the product lines impacted by this decision. This sale resulted in a \$0.1 million increase in income before tax.

**ITEM 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**RESULTS OF OPERATIONS**

**Three months Ended March 31, 2018 and March 31, 2017**

**Overview**

The Company continued to experience healthy demand globally, which translated into revenue increases based upon improved fulfillment rates for precision hand tools, growth in high-end metrology products and an economic recovery in Brazil.

Net sales were \$54.8 million in fiscal 2018, an increase of \$4.1 million or 8% from \$50.7 million in fiscal 2017. North America and International improved \$2.3 million and \$1.8 million, respectively. Operating income was \$2.2 million, an increase of \$3.1 million due to a \$3.6 million increase in gross margin offset by a \$0.5 million increase in selling, general and administrative expenses.



### **Net Sales**

North American sales increased \$2.3 million or 7% from \$31.8 million in fiscal 2017 to \$34.1 million in fiscal 2018 as the result of a 9% growth in precision hand tools and a 13% improvement in high-end metrology equipment.

International sales increased \$1.8 million or 10% from \$18.9 million in fiscal 2017 to \$20.7 million in fiscal 2018 due to a 13% gain in Brazil shipments.

### **Gross Margin**

Gross margin increased \$3.6 million or 25% from 29% of sales in fiscal 2017 to 33% of sales in fiscal 2018.

North American gross margins increased \$1.9 million from \$8.8 million or 28% of sales in fiscal 2017 to \$10.7 million or 31% of sales in fiscal 2018 due to higher sales volume of precision hand tools and a favorable products mix of increased sales of high-end metrology equipment.

International gross margins increased \$1.6 million from 30% of sales in fiscal 2017 to 35% of sales in fiscal 2018 based upon higher sales volume from Brazil.

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses increased \$0.5 million or 3% from \$15.3 million in fiscal 2017 to \$15.8 million in fiscal 2018.

North American expenses, including Corporate, increased \$0.2 million from \$9.0 million in fiscal 2017 to \$9.2 million in fiscal 2018 as increased research and development spending on high-end metrology more than offset reduced professional fees.

International expenses increased \$0.3 million or 5% due principally to higher professional consulting fees related to the previously announced saw consolidation.

### **Other Income (Expense)**

Other income increased \$0.5 million from a \$0.4 million loss in fiscal 2017 to a \$0.1 million gain in 2018 principally as a result of a loss related to an acquisition investment in fiscal 2017 compared to a gain on sales of equipment in fiscal 2018.

### **Income Taxes**

The tax expense for the third quarter of fiscal 2018 was \$0.7 million on pre-tax income of \$2.3 million for an effective rate of 30%. The effective tax rate for the third quarter of fiscal 2017 was 37%. The passage of the Tax Cuts and Jobs Act in December 2017 reduced the federal tax rate in the U.S. to 21% effective January 1, 2018; the impact of this change reduced the Company's fiscal 2018 federal tax rate to 28%. The tax expense for the third quarter of fiscal 2018 and 2017 is slightly lower than the normalized combined federal and state tax rate of 31% in fiscal 2018 and 40% in fiscal 2017 due to profits in foreign jurisdictions subject to a lower tax rate.

### **Net Income**

The Company recorded net income of \$1.6 million or \$0.23 per share in the third quarter of fiscal 2018 compared to net loss of \$0.8 million or \$0.11 per share in fiscal 2017 principally due to higher sales and improved gross margins.

### **Nine months Ended March 31, 2018 and March 31, 2017**

### **Overview**

Net sales were \$158.8 million in fiscal 2018, an increase \$6.0 million or 4% from \$152.8 million in fiscal 2017. Operating income was \$3.1 million, an increase of \$4.0 million, as a result of a \$5.3 million improvement in gross margins offset by a \$1.3 million increase in selling, general and administrative expenses, including \$0.4 million in restructuring charges in fiscal 2017.



**Net Sales**

North American sales increased \$2.6 million or 3% from \$92.3 million in fiscal 2017 to \$94.9 million in fiscal 2018 led by gains in higher-end metrology.

International sales increased \$3.4 million or 6% from \$60.4 million in fiscal 2017 to \$63.8 million in fiscal 2018 based upon strong organic growth in Brazil.

**Gross Margin**

Gross margin increased \$5.3 million or 12% and improved to 32% of sales in fiscal 2018 from 30% of sales in fiscal 2017.

North American gross margins increased \$2.6 million or 10% in fiscal 2018 compared to fiscal 2017 due to increased sales of high margin capital equipment.

International gross margins increased \$2.7 million based upon increased volume and improved margins in Brazil.

**Selling, General and Administrative Expenses**

Selling, general and administrative expense increased \$1.7 million or 4% from \$45.7 million in fiscal 2017 to \$47.4 million in fiscal 2018.

North American expenses, including Corporate, increased \$0.9 million or 3% due to increased research and development spending on high-end metrology and the full year impact of the expenses from the acquired software company.

International expenses increased \$0.8 million or 4% due to higher professional fees related to the previously announced saw consolidation.

### **Other Income (Expense)**

Other income declined \$1.7 million, as a \$3.1 million gain on the sale of the Canadian warehouse in fiscal 2017 more than offset a \$1.4 million favorable legal settlement in Brazil in fiscal 2018.

### **Income Taxes**

The tax expense for the first three quarters of fiscal 2018 was \$8.5 million on pre-tax income of \$4.1 million for an effective rate of 209%. The tax expense includes a charge of \$7.3 million resulting from the impact of the Tax Cuts and Jobs Act passed in December 2017. Without that charge, tax expense was \$1.3 million or 31.5% of pre-tax income. The effective tax rate for the first three quarters of fiscal 2017 was 41%. In addition to the impact of the new tax law, there were discrete items decreasing tax expense by \$0.1 million in the first three quarters of fiscal 2018 and increasing tax expense by \$0.3 million in the first three quarters of fiscal 2017.

The passage of the Tax Cuts and Jobs Act in December 2017 reduced the federal tax rate in the U.S. to 21% effective January 1, 2018; the impact of this change reduced the Company's fiscal 2018 federal tax rate to 28% and to 21% thereafter. Also included in the Act was a provision to tax a portion of cumulative foreign earnings not yet repatriated. Tax expense included a charge of \$7.3 million in December for a reduction of the deferred tax asset due to the change in tax rates enacted in the United States. The impact due to the tax on cumulative foreign earnings is not expected to be material due to the use of foreign tax credits. In fiscal 2019 and future years, the Company expects to benefit from the lower U.S. tax rate.

### **Net Income**

The Company recorded net loss of \$4.5 million or \$0.64 per share for the first three quarters of fiscal 2018 compared to net income of \$1.0 million or \$0.15 per share in fiscal 2017. This was principally due to a higher effective tax rate related to the new tax legislation enacted in December 2017, and its impact on the Company's deferred tax assets.

**LIQUIDITY AND CAPITAL RESOURCES**

| Cash flows (in thousands)                       | Nine Months Ended |             |
|---|-------------------|-------------|
|   | 03/31/2018        | 03/31/2017  |
| Cash provided by (used in) operating activities | \$1,640           | \$ 3,021    |
| Cash provided by (used in) investing activities | (4,264)           | (2,231 )    |
| Cash provided by (used in) financing activities | 3,134             | (3,073 )    |
| Effect of exchange rate changes on cash         | 327               | (450 )      |
| Net increase (decrease) in cash                 | \$837             | \$ (2,733 ) |

Fiscal 2018 net cash flow for the nine months ended March 31, 2018 of \$0.8 million increased \$3.5 million compared to a \$2.7 million decrease for the nine months ended March 31, 2017 as a \$6.8 million increase in borrowings more than offset reduced cash from operations and higher long-term debt payments.

**Liquidity and Credit Arrangements**

The Company believes it maintains sufficient liquidity and has the resources to fund its operations. In addition to its cash, the Company maintains a \$23 million line of credit in connection with its Loan and Security Agreement, of which, \$12.9 million was outstanding as of March 31, 2018. Availability under the agreement is further reduced by open letters of credit totaling \$0.9 million. The Loan and Security Agreement contains financial covenants with respect to leverage, tangible net worth, and interest coverage, and also contains customary affirmative and negative covenants, including limitations on indebtedness, liens, acquisitions, asset dispositions and fundamental corporate changes, and certain customary events of default. As of March 31, 2018, the Company was in compliance with all its financial covenants, but was not in compliance with the non-financial covenant related to additional borrowings. The waiver received in January for this instance of non-compliance was granted until June 30, 2018, at which time the Company expects to be in compliance with this covenant. The Loan and Security Agreement was amended on January 30, 2018 to extend the Line of Credit for an additional three years until April 30, 2021.

The effective interest rate on the borrowings under the Loan and Security Agreement during the nine months ended March 31, 2018 and 2017 was 3.2% and 2.5% respectively.

**OFF-BALANCE SHEET ARRANGEMENTS**

The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

There have been no material changes in quantitative and qualitative disclosures about market risk from what was reported in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2017.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company's management, under the supervision and with the participation of the Company's President and Chief Executive Officer and Chief Financial Officer, has evaluated the Company's disclosure controls and procedures as of March 31, 2018, and they have concluded that our disclosure controls and procedures were effective as of such date. All information required to be filed in this report was recorded, processed, summarized and reported within the time period required by the rules and regulations of the Securities and Exchange Commission, and such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2018, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective.

There have been no changes in internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting during the quarter ended March 31, 2018.

**PART II. OTHER INFORMATION**

**ITEM 1A. RISK FACTORS**

**SAFE HARBOR STATEMENT**

**UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

This Quarterly Report on Form 10-Q contains forward-looking statements about the Company's business, competition, sales, expenditures, foreign operations, plans for reorganization, interest rate sensitivity, debt service, liquidity and capital resources, and other operating and capital requirements. In addition, forward-looking statements may be included in future Company documents and in oral statements by Company representatives to securities analysts and investors. The Company is subject to risks that could cause actual events to vary materially from such forward-looking statements. You should carefully review and consider the information regarding certain factors which could materially affect our business, financial condition or future results set forth under Item 1A. "Risk Factors" in our Form 10-K for the year ended June 30, 2017. There have been no material changes from the factors disclosed in our Form 10-K for the year ended June 30, 2017.



**ITEM 6. EXHIBITS**

31a Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

31b Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

32 Certifications of the Principal Executive Officer and the Principal Financial Officer pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

The following materials from The L. S. Starrett Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2018 are furnished herewith, formatted in XBRL (Extensible Business Reporting Language): (i) the 101 Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Income (Loss), (iv) the Consolidated Statement of Stockholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) Notes to Consolidated Financial Statements, tagged as blocks of text.

**SIGNATURES**

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

THE L. S. STARRETT COMPANY

(Registrant)

Date May 2, 2018 /S/R. Douglas A. Starrett  
Douglas A. Starrett - President and CEO (Principal Executive Officer)

Date May 2, 2018 /S/R. Francis J. O'Brien  
Francis J. O'Brien - Treasurer and CFO (Principal Accounting Officer)