MATERION Corp
Form 10-Q
October 27, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016

¨ 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 001-15885
MATERION CORPORATION
(Exact name of Registrant as specified in charter)

Ohio	34-1919973
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6070 Parkland Blvd., Mayfield Heights, Ohio	44124
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code:
216-486-4200
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No þ
As of October 21, 2016 there were 19,937,862 common shares, no par value, outstanding.

PART I FINANCIAL INFORMATION
MATERION CORPORATION AND SUBSIDIARIES

Item 1. Financial Statements
The consolidated financial statements of Materion Corporation and its subsidiaries for the third quarter and nine months ended September 30, 2016 are as follows:

Consolidated Statements of Income - Third quarter and nine months ended September 30, 2016 and October 2, 2015	2
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Materion Corporation and Subsidiaries
Consolidated Statements of Income
(Unaudited)

(Thousands, except per share amounts)	Third Quarter Ended		Nine Months Ended	
	Sept. 30, 2016	Oct. 2, 2015	Sept. 30, 2016	Oct. 2, 2015
Net sales	$249,619	$244,354	$734,906	$811,233
Cost of sales	198,864	200,351	595,488	663,548
Gross margin	50,755	44,003	139,418	147,685
Selling, general, and administrative expense	34,177	29,051	97,101	101,578
Research and development expense	3,237	2,501	9,860	9,435
Other—net	3,190	1,590	8,997	(532)
Operating profit	10,151	10,861	23,460	37,204
Interest expense—net	490	586	1,417	1,893
Income before income taxes	9,661	10,275	22,043	35,311
Income tax expense	1,616	2,883	3,081	9,868
Net income	$8,045	$7,392	$18,962	$25,443
Basic earnings per share:				
Net income per share of common stock	$0.40	$0.37	$0.95	$1.26
Diluted earnings per share:				
Net income per share of common stock	$0.40	$0.36	$0.94	$1.24
Cash dividends per share	$0.095	$0.090	$0.280	$0.265
Weighted-average number of shares of common stock outstanding:				
Basic	19,957	20,087	19,996	20,128
Diluted	20,192	20,383	20,209	20,458

Refer to Notes to Consolidated Financial Statements.

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Materion Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income
(Unaudited)

	Third Quarter Ended		Nine Months Ended	
	Sept. 30,	Oct. 2,	Sept. 30,	Oct. 2,
(Thousands)	2016	2015	2016	2015
Net income	$8,045	$7,392	$18,962	$25,443
Other comprehensive income:				
Foreign currency translation adjustment	467	359	2,918	(895)
Derivative and hedging activity, net of tax	132	(1,177)	(489)	(1,778)
Pension and post-employment benefit adjustment, net of tax	673	901	2,923	2,705
Other comprehensive income	1,272	83	5,352	32
Comprehensive income	$9,317	$7,475	$24,314	$25,475

Refer to Notes to Consolidated Financial Statements.

Materion Corporation and Subsidiaries
Consolidated Balance Sheets

(Thousands)	(Unaudited) Sept. 30, 2016	Dec. 31, 2015
Assets		
Current assets		
Cash and cash equivalents	$ 15,806	$ 24,236
Accounts receivable	118,826	97,236
Inventories	210,213	211,820
Prepaid expenses	13,871	12,799
Total current assets	358,716	346,091
Long-term deferred income taxes	26,655	25,743
Property, plant, and equipment	862,474	833,834
Less allowances for depreciation, depletion, and amortization	(602,084)	(570,205)
Property, plant, and equipment—net	260,390	263,629
Intangible assets	10,706	13,389
Other assets	4,925	6,716
Goodwill	86,725	86,725
Total Assets	$ 748,117	$ 742,293
Liabilities and Shareholders’ Equity		
Current liabilities		
Short-term debt	$ 12,803	$ 8,990
Accounts payable	32,941	31,888
Salaries and wages	23,637	27,494
Other liabilities and accrued items	24,275	22,035
Income taxes	3,851	2,373
Unearned revenue	1,152	3,695
Total current liabilities	98,659	96,475
Other long-term liabilities	17,893	18,435
Retirement and post-employment benefits	84,003	92,794
Unearned income	42,515	45,953
Long-term income taxes	1,179	1,293
Deferred income taxes	142	110
Long-term debt	3,776	4,276
Shareholders’ equity		
Serial preferred stock	—	—
Common stock	212,168	208,967
Retained earnings	513,020	499,659
Common stock in treasury	(153,899)	(148,559)
Accumulated other comprehensive loss	(75,353)	(80,705)
Other equity transactions	4,014	3,595
Total shareholders' equity	499,950	482,957
Total Liabilities and Shareholders’ Equity	$ 748,117	$ 742,293

Refer to Notes to Consolidated Financial Statements.

Materion Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

(Thousands)	Nine Months Ended Sept. 30, 2016	Oct. 2, 2015
Cash flows from operating activities:		
Net income	$18,962	$25,443
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation, depletion, and amortization	34,379	28,462
Amortization of deferred financing costs in interest expense	417	497
Stock-based compensation expense	2,880	4,518
(Gain) loss on sale of property, plant, and equipment	(601)	310
Deferred income tax (benefit) expense	(676)	3,841
Changes in assets and liabilities net of acquired assets and liabilities:		
Decrease (increase) in accounts receivable	(19,781)	(1,583)
Decrease (increase) in inventory	3,294	9,928
Decrease (increase) in prepaid and other current assets	(956)	(1,965)
Increase (decrease) in accounts payable and accrued expenses	(2,207)	(19,299)
Increase (decrease) in unearned revenue	(2,546)	(773)
Increase (decrease) in interest and taxes payable	898	896
Increase (decrease) in long-term liabilities	(9,320)	(5,175)
Other-net	1,611	(256)
Net cash provided by operating activities	26,354	44,844
Cash flows from investing activities:		
Payments for purchase of property, plant, and equipment	(20,052)	(24,085)
Payments for mine development	(8,934)	(16,972)
Proceeds from sale of property, plant, and equipment	1,366	43
Net cash used in investing activities	(27,620)	(41,014)
Cash flows from financing activities:		
Proceeds from issuance of short-term debt, net	3,777	14,152
Proceeds from issuance of long-term debt	10,000	53,990
Repayment of long-term debt	(10,517)	(46,275)
Principal payments under capital lease obligations	(549)	(582)
Cash dividends paid	(5,601)	(5,331)
Deferred financing costs	(1,000)	—
Repurchase of common stock	(3,798)	(7,129)
Net cash (used in) provided by financing activities	(7,688)	8,825
Effects of exchange rate changes	524	(979)
Net change in cash and cash equivalents	(8,430)	11,676
Cash and cash equivalents at beginning of period	24,236	13,150
Cash and cash equivalents at end of period	$15,806	$24,826

Refer to Notes to Consolidated Financial Statements.

Materion Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note A — Accounting Policies
(Dollars in thousands)
Basis of Presentation: In management’s opinion, the accompanying consolidated financial statements of Materion Corporation and its subsidiaries (the Company) contain all of the adjustments necessary to present fairly the financial position, results of operations, and cash flows for the interim periods reported. All adjustments were of a normal and recurring nature. Certain amounts in prior years have been reclassified to conform to the 2016 consolidated financial statement presentation.
These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's 2015 Annual Report on Form 10-K. The interim period results are not necessarily indicative of the results to be expected for the full year.
New Pronouncements Adopted: In April 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2015-03, Simplifying the Presentation of Debt Issuance Costs, which requires companies to present debt issuance costs associated with a debt liability as a deduction from the carrying amount of that debt liability on the balance sheet rather than being capitalized as an asset. The Company adopted this ASU effective January 1, 2016, and applied the new guidance on a retrospective basis, which resulted in a decrease to Intangible assets, Short-term debt, and Long-term debt, at December 31, 2015, of $347, $8, and $339, respectively.
In July 2015, the FASB issued ASU 2015-11, Simplifying the Measurement of Inventory. Inventory within the scope of this update is required to be measured at the lower of its cost or net realizable value, with net realizable value being the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This ASU is effective prospectively for fiscal years and interim periods beginning after December 15, 2016, with early adoption permitted. We early adopted this ASU effective January 1, 2016. The adoption did not have a material effect on the consolidated financial statements.
New Pronouncements Issued: In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which impacts several aspects of accounting for share-based payment transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Under the new standard, income tax benefits and deficiencies are to be recognized as income tax expense or benefit in the income statement, and the tax effects of exercised or vested awards will be treated as discrete items in the reporting period in which they occur. An entity will also recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the reporting period. Excess tax benefits will be classified, along with other income tax cash flows, as an operating activity. In regard to forfeitures, the entity may make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or account for forfeitures as they occur. The ASU, which is required to be applied on a modified retrospective basis, will be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2016, with early adoption permitted. The Company is currently evaluating the impact of adopting this new guidance on the consolidated financial statements.
In February 2016, the FASB issued ASU 2016-02, Leases, which eliminates the off-balance-sheet accounting for leases. The new guidance will require lessees to report their operating leases as both an asset and liability on the balance sheet and disclose key information about leasing arrangements. The ASU, which is required to be applied on a modified retrospective basis, will be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact of adopting this new guidance on the consolidated financial statements.
In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes previous revenue recognition guidance. The new standard requires that a company recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration the Company expects to receive

in exchange for those goods or services. Companies will need to use more judgment and estimates than under the guidance currently in effect, including estimating the amount of variable revenue to recognize over each identified performance obligation. Additional disclosures will be required to help users of financial statements understand the nature, amount, and timing of revenue and cash flows arising from contracts. This ASU is effective beginning in fiscal year 2018 with a provision for early adoption in 2017. The standard can be adopted either retrospectively or as a cumulative-effect adjustment as of the date of adoption. The Company is currently evaluating the impact of adopting this new guidance on the consolidated financial statements.

Materion Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

No other recently issued or effective ASUs had, or are expected to have, a material effect on the Company's results of operations, financial condition, or liquidity.

Note B — Segment Reporting

(Thousands)	Performance Alloys and Composites	Advanced Materials	Other Other [1]	Other Corporate [2]	Other Subtotal	Total
Third Quarter 2016						
Net sales	$ 103,699	$ 107,250	$ 38,670	$ —	$ 38,670	$ 249,619
Intersegment sales [3]	47	21,505	—	—	—	21,552
Value-added sales	87,247	45,960	25,803	(2,009)	23,794	157,001
Operating profit (loss)	4,357	8,245	3,432	(5,883)	(2,451)	10,151
Third Quarter 2015						
Net sales	$ 93,566	$ 113,635	$ 37,142	$ 11	$ 37,153	$ 244,354
Intersegment sales [3]	191	15,316	—	—	—	15,507
Value-added sales	79,596	44,520	25,671	(948)	24,723	148,839
Operating profit (loss)	4,547	6,950	2,273	(2,909)	(636)	10,861
First Nine Months 2016						
Net sales	$ 292,024	$ 328,927	$ 113,955	$ —	$ 113,955	$ 734,906
Intersegment sales [3]	226	54,110	—	—	—	54,336
Value-added sales	248,799	135,019	75,548	(4,573)	70,975	454,793
Operating profit (loss)	6,103	20,748	9,803	(13,194)	(3,391)	23,460
First Nine Months 2015						
Net sales	$ 304,507	$ 394,922	$ 112,024	$ (220)	$ 111,804	$ 811,233
Intersegment sales [3]	733	48,830	—	—	—	49,563
Value-added sales	256,697	142,952	75,438	(1,258)	74,180	473,829
Operating profit (loss)	20,677	23,289	4,512	(11,274)	(6,762)	37,204

(1) Other represents the Precision Coatings group, which is a business included in the Other reportable segment.
(2) Costs associated with the Company's unallocated corporate functions have been shown separately to better illustrate the financial information for the businesses within the Other reportable segment.
(3) Intersegment sales are eliminated in consolidation.

Materion Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note C — Other-net

Other-net (income) expense for the third quarter and first nine months of 2016 and 2015 is summarized as follows:

	Third Quarter Ended		Nine Months Ended	
	Sept. 30,	Oct. 2,	Sept. 30,	Oct. 2,
(Thousands)	2016	2015	2016	2015
Foreign currency exchange/translation loss (gain)	$336	$(1,256)	$977	$(4,569)
Amortization of intangible assets	1,148	1,256	3,444	3,769
Metal consignment fees	1,665	1,686	4,851	5,554
Net loss (gain) on disposal of fixed assets	94	2	(601)	310
Recovery from insurance	—	—	—	(3,800)
Legal recoveries	—	(500)	—	(1,825)
Other items	(53)	402	326	29
Total	$3,190	$1,590	$8,997	$(532)

Note D — Income Taxes

The Company recorded income tax expense of $1.6 million in the third quarter of 2016, an effective tax rate of 16.7% against income before income taxes, and income tax expense of $2.9 million in the third quarter of 2015, with an effective tax rate of 28.1% against income before income taxes.

In the first nine months of 2016, income tax expense of $3.1 million was calculated using an effective tax rate of 14.0%, while income tax expense of $9.9 million in the first nine months of 2015 was calculated using an effective tax rate of 27.9%.

The Company recorded discrete items in the first nine months of 2016, resulting in a net tax benefit of $1.0 million, primarily due to international tax planning initiatives. The difference between the statutory and effective rates in the third quarter and first nine months of both years was primarily due to these discrete items, the impact of percentage depletion, the foreign rate differential, and other items. The research and development credit also had a favorable effect on the Company's 2016 effective tax rate.

Materion Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note E — Earnings Per Share
The following table sets forth the computation of basic and diluted EPS:

	Third Quarter Ended		Nine Months Ended	
(Thousands, except per share amounts)	Sept. 30, 2016	Oct. 2, 2015	Sept. 30, 2016	Oct. 2, 2015
Numerator for basic and diluted EPS:				
Net income	$8,045	$7,392	$18,962	$25,443
Denominator:				
Denominator for basic EPS:				
Weighted-average shares outstanding	19,957	20,087	19,996	20,128
Effect of dilutive securities:				
Stock appreciation rights	70	123	66	174
Restricted stock units	82	113	86	103
Performance-based restricted stock units	83	60	61	53
Diluted potential common shares	235	296	213	330
Denominator for diluted EPS:				
Adjusted weighted-average shares outstanding	20,192	20,383	20,209	20,458
Basic EPS	$0.40	$0.37	$0.95	$1.26
Diluted EPS	$0.40	$0.36	$0.94	$1.24

Stock appreciation rights (SARs) totaling 982,588 and 487,248 for the quarters ended September 30, 2016 and October 2, 2015, respectively, and 993,418 and 379,676 for the nine months ended September 30, 2016 and October 2, 2015, respectively, were excluded from the dilution calculation as their effect would have been anti-dilutive.

Note F — Depreciation and Amortization
The Company received an aggregate of $63.5 million from the U.S. Department of Defense (DoD) in previous periods for reimbursement of the DoD's share of the cost of the equipment in property, plant, and equipment, and the reimbursements are reported as unearned income, a liability on the Consolidated Balance Sheets. The equipment was placed in service during 2012, and its full cost is being depreciated in accordance with Company policy. The unearned income liability is being reduced ratably with the depreciation expense recorded over the life of the equipment.
In the first nine months of 2016 and 2015, the depreciation expense reimbursed for this equipment was $3.4 million and $4.7 million, respectively. Accordingly, in the first nine months of 2016 and 2015, unearned income was reduced by $3.4 million and $4.7 million, respectively, with the offset recorded as a credit to cost of sales. Depreciation, depletion, and amortization expense on the Consolidated Statements of Cash Flows is shown net of the reduction in unearned income.

Materion Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note G — Inventories

Inventories on the Consolidated Balance Sheets are summarized as follows:

(Thousands)	Sept. 30, 2016	Dec. 31, 2015
Raw materials and supplies	$35,792	$37,463
Work in process	176,763	180,458
Finished goods	41,896	38,135
Subtotal	$254,451	$256,056
Less: LIFO reserve balance	44,238	44,236
Inventories	$210,213	$211,820

The liquidation of last in, first out (LIFO) inventory layers did not impact cost of sales in the third quarter of 2016 and reduced cost of sales by $0.5 million in the third quarter of 2015. In the first nine months of 2016 and 2015, cost of sales was reduced by $3.2 million and $2.4 million, respectively.

Note H — Pensions and Other Post-employment Benefits

The following is a summary of the net periodic benefit cost for the third quarter and first nine months of 2016 and 2015 for the domestic pension plans (which include the defined benefit pension plan and the supplemental retirement plans) and the domestic retiree medical plan.

	Pension Benefits Third Quarter Ended		Other Benefits Third Quarter Ended	
(Thousands)	Sept. 30, 2016	Oct. 2, 2015	Sept. 30, 2016	Oct. 2, 2015
Components of net periodic benefit cost				
Service cost	$1,946	$2,231	$26	$29
Interest cost	2,595	2,500	140	139
Expected return on plan assets	(3,488)	(3,354)	—	—
Amortization of prior service benefit	(115)	(113)	(374)	(374)
Amortization of net loss	1,431	1,820	—	—
Net periodic benefit cost (benefit)	$2,369	$3,084	$(208)	$(206)

	Pension Benefits Nine Months Ended		Other Benefits Nine Months Ended	
(Thousands)	Sept. 30, 2016	Oct. 2, 2015	Sept. 30, 2016	Oct. 2, 2015
Components of net periodic benefit cost				
Service cost	$5,838	$6,692	$77	$87
Interest cost	7,785	7,500	422	415
Expected return on plan assets	(10,464)	(10,062)	—	—
Amortization of prior service benefit	(345)	(337)	(1,122)	(1,122)
Amortization of net loss	4,292	5,459	—	—
Net periodic benefit cost (benefit)	$7,106	$9,252	$(623)	$(620)

The Company made contributions to the domestic defined benefit pension plan of $12.0 million and $8.0 million in the first nine months of 2016 and 2015, respectively.

Materion Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note I — Accumulated Other Comprehensive Income

Changes in the components of accumulated other comprehensive income, including the amounts reclassified, for the third quarter and first nine months of 2016 and 2015 are as follows:

(Thousands)	Gains and Losses on Cash Flow Hedges	Pension and Post-Employment Benefits	Foreign Currency Translation	Total
Balance at July 1, 2016	$958	$ (74,546)	$ (3,037)	$(76,625)
Other comprehensive income (loss) before reclassifications	(126)	—	467	341
Amounts reclassified from accumulated other comprehensive income	336	1,015	—	1,351
Net current period other comprehensive income before tax	210	1,015	467	1,692
Deferred taxes on current period activity	78	342	—	420
Net current period other comprehensive income after tax	132	673	467	1,272
Balance at September 30, 2016	$1,090	$ (73,873)	$ (2,570)	$(75,353)
Balance at July 3, 2015	$2,977	$ (79,858)	$ (5,407)	$(82,288)
Other comprehensive income (loss) before reclassifications	(447)	—	359	(88)
Amounts reclassified from accumulated other comprehensive income	(1,423)	1,396	—	(27)
Net current period other comprehensive income (loss) before tax	(1,870)	1,396	359	(115)
Deferred taxes on current period activity	(693)	495	—	(198)
Net current period other comprehensive income (loss) after tax	(1,177)	901	359	83
Balance at October 2, 2015	$1,800	$ (78,957)	$ (5,048)	$(82,205)
Balance at December 31, 2015	$1,579	$ (76,796)	$ (5,488)	$(80,705)
Other comprehensive income (loss) before reclassifications	(1,571)	—	2,918	1,347
Amounts reclassified from accumulated other comprehensive income	793	3,045	—	3,838
Net current period other comprehensive income (loss) before tax	(778)	3,045	2,918	5,185
Deferred taxes on current period activity	(289)	122	—	(167)
Net current period other comprehensive income (loss) after tax	(489)	2,923	2,918	5,352
Balance at September 30, 2016	$1,090	$ (73,873)	$ (2,570)	$(75,353)
Balance at December 31, 2014	$3,578	$ (81,662)	$ (4,153)	$(82,237)
Other comprehensive income (loss) before reclassifications	2,198	14	(895)	1,317
Amounts reclassified from accumulated other comprehensive income	(5,021)	4,186	—	(835)
Net current period other comprehensive income (loss) before tax	(2,823)	4,200	(895)	482
Deferred taxes on current period activity	(1,045)	1,495	—	450
Net current period other comprehensive income (loss) after tax	(1,778)	2,705	(895)	32
Balance at October 2, 2015	$1,800	$ (78,957)	$ (5,048)	$(82,205)

Reclassifications from accumulated other comprehensive income of gains and losses on foreign currency cash flow hedges are recorded in Other-net in the Consolidated Statements of Income. Refer to Note L for additional details on cash flow hedges.

Reclassifications from accumulated other comprehensive income for pension and post-employment benefits are included in the computation of the net periodic pension and post-employment benefit expense. Refer to Note H for additional details on pension and post-employment expenses.

Materion Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

Note J — Stock-based Compensation Expense

Stock-based compensation expense, which includes awards settled in shares and in cash, was $2.1 million and $4.4 million in the third quarter and first nine months of 2016, respectively, compared to $0.5 million and $5.9 million in the same periods of 2015.

The Company granted 221,065 SARs to certain employees during the first nine months of 2016. The weighted-average exercise price per share and weighted-average fair value per share of the SARs granted during the nine months ended September 30, 2016 were $25.19 and $8.07, respectively. The Company estimated the fair value of the SARs using the following assumptions in the Black-Scholes model:

Risk-free interest rate	1.25%
Dividend yield	1.4 %
Volatility	38.0%
Expected term (in years)	5.7

The Company granted 69,212 stock-settled restricted stock units (RSUs) and 28,180 cash-settled RSUs to certain employees and non-employee directors during the first nine months of 2016. The Company measures the fair value of stock-settled RSUs based on the closing market price of a share of Materion common stock on the date of the grant. The weighted-average fair value per share was $25.96 for stock-settled RSUs granted during the nine months ended September 30, 2016. Cash-settled RSUs are accounted for as liability-based compensation awards and adjusted based on the closing price of Materion's common stock over the vesting period of three years.

The Company granted stock-settled and cash-settled performance-based restricted stock units (PRSUs) to certain employees in the first nine months of 2016. The weighted-average fair value of the stock-settled PRSUs was $22.77 per share and will be expensed over the vesting period of three years. The liability for cash-settled PRSUs is re-measured at fair value each reporting period, and the expense is recorded accordingly. The final payout to the employees for all PRSUs will be based upon the Company's return on invested capital and the total return to shareholders over the vesting period relative to a peer group's performance over the same period.

At September 30, 2016, unearned compensation cost related to the unvested portion of all stock-based awards was approximately $5.9 million, and is expected to be recognized over the remaining vesting period of the respective grants.

Note K — Fair Value of Financial Instruments

The Company measures and records financial instruments at fair value. A fair value hierarchy is used for those instruments measured at fair value that distinguishes between assumptions based on market data (observable inputs) and the Company's assumptions (unobservable inputs). The hierarchy consists of three levels:

Level 1 — Quoted market prices in active markets for identical assets and liabilities;

Level 2 — Inputs other than Level 1 inputs that are either directly or indirectly observable; and

Level 3 — Unobservable inputs developed using estimates and assumptions developed by the Company, which reflect those that a market participant would use.

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The following table summarizes the financial instruments measured at fair value in the Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015:

(Thousands)	Total Carrying Value in the Consolidated Balance Sheets		Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)	
	2016	2015	2016	2015	2016	2015	2016	2015
Financial Assets								
Deferred compensation investments	$1,699	$2,524	$1,699	$2,503	$—	$21	$ —	$ —
Foreign currency forward contracts	64	462	—	—	64	462	—	—
Total	$1,763	$2,986	$1,699	$2,503	$64	$483	$ —	$ —
Financial Liabilities								
Deferred compensation liability	$1,699	$2,524	$1,699	$2,503	$—	$21	$ —	$ —
Foreign currency forward contracts	560	180	—	—	560	180	—	—
Total	$2,259	$2,704	$1,699	$2,503	$560	$201	$ —	$ —

The Company uses a market approach to value the assets and liabilities for financial instruments in the table above. Outstanding contracts are valued through models that utilize market observable inputs, including both spot and forward prices, for the same underlying currencies and metals. The carrying values of the other working capital items and debt in the Consolidated Balance Sheet approximate fair values as of September 30, 2016 and December 31, 2015.

Note L — Derivative Instruments and Hedging Activity

The Company uses derivative contracts to hedge portions of its foreign currency exposures and may also use derivatives to hedge a portion of its precious metal exposures. The objectives and strategies for using derivatives in these areas are as follows:

Foreign Currency. The Company sells a portion of its products to overseas customers in their local currencies, primarily the euro and yen. The Company secures foreign currency derivatives, mainly forward contracts and options, to hedge these anticipated sales transactions. The purpose of the hedge program is to protect against the reduction in the dollar value of foreign currency sales from adverse exchange rate movements. Should the dollar strengthen significantly, the decrease in the translated value of the foreign currency sales should be partially offset by gains on the hedge contracts. Depending upon the methods used, hedge contracts may limit the benefits from a weakening U.S. dollar.

The use of forward contracts locks in a firm rate and eliminates any downside risk from an adverse rate movement as well as any benefit from a favorable rate movement. The Company may from time to time choose to hedge with options or a tandem of options, known as a collar. These hedging techniques can limit or eliminate the downside risk but can allow for some or all of the benefit from a favorable rate movement to be realized. Unlike a forward contract, a premium is paid for an option; collars, which are a combination of a put and call option, may have a net premium but can be structured to be cash neutral. The Company will primarily hedge with forward contracts due to the relationship between the cash outlay and the level of risk.

The use of foreign currency derivative contracts is governed by policies approved by the Audit Committee of the Board of Directors. A team consisting of senior financial managers reviews the estimated exposure levels, as defined by budgets, forecasts, and other internal data, and determines the timing, amounts, and instruments to use to hedge that exposure within the confines of the policy. Management analyzes the effective hedged rates and the actual and projected gains and losses on the hedging transactions against the program objectives, targeted rates, and levels of risk assumed. Hedge contracts are typically layered in at different times for a specified exposure period in order to minimize the impact of rate movements.

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Precious Metals. The Company maintains the majority of its precious metal production requirements on consignment in order to reduce its working capital investment and the exposure to metal price movements. When a precious metal product is fabricated and ready for shipment to the customer, the metal is purchased out of consignment at the current market price. The price paid by the Company forms the basis for the price charged to the customer. This methodology allows for changes in either direction in the market prices of the precious metals used by the Company to be passed through to the customer, and reduces the impact changes in prices could have on the Company's margins and operating profit. The consigned metal is owned by financial institutions that charge the Company a financing fee based upon the current value of the metal on hand.

In certain instances, a customer may want to establish the price for the precious metal at the time the sales order is placed rather than at the time of shipment. Setting the sales price at a different date than when the material would be purchased potentially creates an exposure to movements in the market price of the metal. Therefore, in these limited situations, the Company may elect to enter into a forward contract to purchase precious metal. The forward contract allows the Company to purchase metal at a fixed price on a specific future date. The price in the forward contract serves as the basis for the price to be charged to the customer. By doing so, the selling price and purchase price are matched, and the Company's price exposure is reduced.

The Company refines precious metal-containing materials for its customers and typically will purchase the refined metal from the customer at current market prices. In limited circumstances, the customer may want to fix the price to be paid at the time of the order as opposed to when the material is refined. The customer may also want to fix the price for a set period of time. The Company may then elect to enter into a hedge contract, either a forward contract or a swap, to fix the price for the estimated quantity of metal to be purchased, thereby reducing the exposure to adverse movements in the price of the metal.

The Company may from time to time elect to purchase precious metal and hold in inventory rather than on consignment due to potential credit line limitations or other factors. These purchases are typically held for a short duration. A forward contract will be secured at the time of the purchase to fix the price to be used when the metal is transferred back to the consignment line, thereby limiting any price exposure during the time when the metal was owned.

The Company will only enter into a derivative contract if there is an underlying identified exposure. Contracts are typically held until maturity. The Company does not engage in derivative trading activities and does not use derivatives for speculative purposes. The Company only uses currency hedge contracts that are denominated in the same currency as the underlying exposure and precious metal hedge contracts denominated in the same metal as the underlying exposure.

All derivatives are recorded on the balance sheet at fair value. If the derivative is designated and effective as a cash flow hedge, changes in the fair value of the derivative are recognized in other comprehensive income (OCI) until the hedged item is recognized in earnings. The ineffective portion of a derivative’s fair value, if any, is recognized in earnings immediately. If a derivative is not a hedge, changes in the fair value are adjusted through income. The fair values of the outstanding derivatives are recorded on the balance sheet as assets (if the derivatives are in a gain position) or liabilities (if the derivatives are in a loss position). The fair values will also be classified as short-term or long-term depending upon their maturity dates.

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Materion Corporation and Subsidiaries
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The following table summarizes the notional amount and the fair value of the Company's outstanding derivatives and balance sheet classification as of September 30, 2016 and December 31, 2015:

(Thousands)	September 30, 2016 Notional Amount	September 30, 2016 Fair Value	December 31, 2015 Notional Amount	December 31, 2015 Fair Value
Prepaid expenses				
Foreign currency forward contracts - yen	$—	$—	$5,138	$60
Foreign currency forward contracts - euro	8,549	64	18,181	402
	8,549	64	23,319	462
Other liabilities and accrued items				
Foreign currency forward contracts - yen	4,320	(461)	5,102	(94)
Foreign currency forward contracts - euro	4,443	(99)	10,514	(86)
	8,763	(560)	15,616	(180)
Total	$17,312	$(496)	$38,935	$282

All of these contracts were designated and effective as cash flow hedges. No ineffectiveness expense was recorded in the third quarter or first nine months of 2016 or 2015.

Changes in the fair value of outstanding cash flow hedges recorded in OCI for the first nine months of 2016 and 2015 totaled a decrease of $1.6 million and an increase of $2.2 million, respectively. The Company expects to relieve substantially the entire balance in OCI as of September 30, 2016 to the Consolidated Statements of Income during the twelve-month period beginning October 1, 2016. Refer to Note I for additional OCI details.

Note M — Contingencies

Materion Brush Inc., one of the Company's wholly-owned subsidiaries, is a defendant from time to time in proceedings where the plaintiffs allege they have contracted chronic beryllium disease (CBD) or related ailments as a result of exposure to beryllium. The Company will record a reserve for CBD or other litigation when a loss from either settlement or verdict is probable and estimable. Claims filed by third-party plaintiffs may be covered by insurance subject to deductibles which vary based on when the exposure occurred. Reserves are recorded for asserted claims only, and defense costs are expensed as incurred. One CBD case that was outstanding at the end of the second quarter of 2016 was settled during the third quarter of 2016. The settlement of this case has been fully reflected in the Company's financial statements and is not material to the Company's consolidated financial statements. One CBD case that had been on appeal was remanded to the trial court and was outstanding as of the end of the third quarter of 2016. The Company does not expect the resolution of this matter to have a material impact on the consolidated financial statements.

The Company has an active environmental compliance program and records reserves for the probable cost of identified environmental remediation projects. The reserves are established based upon analyses conducted by the Company's engineers and outside consultants and are adjusted from time to time based upon ongoing studies, the difference between actual and estimated costs, and other factors. The reserves may also be affected by rulings and negotiations with regulatory agencies. The undiscounted reserve balance was $6.0 million at September 30, 2016 and $5.7 million at December 31, 2015. Environmental projects tend to be long term, and the final actual remediation costs may differ from the amounts currently recorded.

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

OVERVIEW

We are an integrated producer of high-performance advanced engineered materials used in a variety of electrical, electronic, sensing, thermal, and structural applications. Our products are sold into numerous end markets, including consumer electronics,

industrial components, medical, automotive electronics, defense, telecommunications infrastructure, energy, commercial aerospace, science, services, and appliance.

RESULTS OF OPERATIONS

Third Quarter

	Third Quarter Ended			
(Thousands, except per share data)	Sept. 30, 2016	Oct. 2, 2015	$ Change	% Change
Net sales	$249,619	$244,354	$5,265	2 %
Value-added sales	157,001	148,839	8,162	5 %
Gross margin	50,755	44,003	6,752	15 %
Gross margin as a % of value-added sales	32 %	30 %	N/A	N/A
Selling, general, and administrative (SG&A) expense	34,177	29,051	5,126	18 %
SG&A expense as a % of value-added sales	22 %	20 %	N/A	N/A
Research and development (R&D) expense	3,237	2,501	736	29 %
R&D expense as a % of value-added sales	2 %	2 %	N/A	N/A
Other—net	3,190	1,590	1,600	101 %
Operating profit	10,151	10,861	(710)	(7)%
Interest expense—net	490	586	(96)	(16)%
Income before income taxes	9,661	10,275	(614)	(6)%
Income tax expense	1,616	2,883	(1,267)	(44)%
Net income	$8,045	$7,392	$653	9 %
Diluted earnings per share	$0.40	$0.36	$0.04	11 %

N/A = Not Applicable

Net sales of $249.6 million in the third quarter of 2016 were $5.2 million higher than the $244.4 million recorded in the third quarter of 2015. The increase in net sales in the third quarter of 2016 was due to higher sales volume and the impact of pass-through precious metal and copper prices. Sales volume was higher primarily due to increased shipments of raw material beryllium hydroxide and stronger demand in the consumer electronics and telecom infrastructure end markets, partially offset by unfavorable product mix. Changes in precious metal and copper prices favorably impacted net sales in the third quarter of 2016 by $14.1 million when compared to the third quarter of 2015.

Value-added sales is a non-GAAP measure that removes the impact of pass-through metal costs and allows for analysis without the distortion of the movement or volatility in metal prices. Internally, we manage our business on this basis, and a reconciliation of net sales to value-added sales is included herein. Value-added sales of $157.0 million in the third quarter of 2016 increased $8.2 million, or 5% compared to the third quarter of 2015. Value-added sales to the consumer electronics end market, which accounted for 29% of our total value-added sales, increased $7.2 million year-over-year. Shipments of raw material beryllium hydroxide during the third quarter of 2016 also increased value-added sales by approximately $3.0 million compared to the third quarter of 2015. These increases were offset by weakness in the industrial components and defense end markets, which lowered value-added sales by $5.1 million.

Gross margin in the third quarter of 2016 was $50.8 million, or $6.8 million above the $44.0 million gross margin recorded during the third quarter of 2015. Expressed as a percentage of value-added sales, gross margin increased from 30% in the third quarter of 2015 to 32% in the third quarter of 2016. The increase in gross margin was primarily due to higher sales volume, improved manufacturing yields, and favorable price and product mix.

SG&A expense was $34.2 million in the third quarter of 2016, or $5.1 million higher than $29.1 million in the third quarter of 2015. The increase in SG&A expense was due primarily to higher stock-based and annual incentive compensation expense of $4.1 million primarily driven by stock price fluctuation and financial performance.

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R&D expense consists primarily of direct personnel costs for pre-production evaluation and testing of new products, prototypes, and applications. R&D expense was flat as a percentage of value-added sales at approximately 2% in the third quarter of both 2016 and 2015.

Other-net was $3.2 million of expense in the third quarter of 2016, or a $1.6 million increase from the third quarter of 2015. Other-net in the third quarter of 2015 included foreign currency exchange gains of $1.3 million due primarily to the maturity of foreign currency forward contracts compared to a foreign currency exchange loss of $0.3 million in the third quarter of 2016. Additionally, Other-net in the third quarter of 2015 included a gain of $0.5 million related to a favorable legal settlement. Refer to Note C to the Consolidated Financial Statements for details of the major components within Other-net.

Interest expense-net was $0.5 million in the third quarter of 2016 and $0.6 million in the third quarter of 2015 due to lower average debt outstanding.

Income tax expense for the third quarter of 2016 was $1.6 million versus $2.9 million in the third quarter of 2015. The effective tax rate for the third quarter of 2016 was 16.7% compared to an effective tax rate of 28.1% in the prior-year period. The effects of discrete items, percentage depletion, the foreign rate differential, and other items were the primary factors for the difference between the effective and statutory rates in the third quarter of 2016 and 2015. The R&D tax credit also had a favorable effect on the Company's third quarter 2016 effective tax rate.

Nine Months

	Nine Months Ended			
(Thousands, except per share data)	Sept. 30, 2016	Oct. 2, 2015	$ Change	% Change
Net sales	$734,906	$811,233	$(76,327)	(9)%
Value-added sales	454,793	473,829	(19,036)	(4)%
Gross margin	139,418	147,685	(8,267)	(6)%
Gross margin as a % of value-added sales	31%	31%	N/A	N/A
SG&A expense	97,101	101,578	(4,477)	(4)%
SG&A expense as a % of value-added sales	21%	21%	N/A	N/A
R&D expense	9,860	9,435	425	5%
R&D expense as a % of value-added sales	2%	2%	N/A	N/A
Other—net	8,997	(532)	9,529	(1,791)%
Operating profit	23,460	37,204	(13,744)	(37)%
Interest expense—net	1,417	1,893	(476)	(25)%
Income before income taxes	22,043	35,311	(13,268)	(38)%
Income tax expense	3,081	9,868	(6,787)	(69)%
Net income	$18,962	$25,443	$(6,481)	(25)%
Diluted earnings per share	$0.94	$1.24	$(0.30)	(24)%

N/A = Not Applicable

Net sales of $734.9 million in the first nine months of 2016 were $76.3 million lower than the $811.2 million recorded in the first nine months of 2015. The decrease in net sales in the first nine months of 2016 was primarily due to lower sales volume. Sales volume was lower primarily due to decreased shipments of raw material beryllium hydroxide, weaker demand in the oil and gas sector of the energy end market, and weakness in the industrial components and automotive electronics end markets. These decreases were partially offset by changes in precious metal and copper prices, which favorably impacted net sales in the first nine months of 2016 by approximately $8.2 million when compared to the first nine months of 2015.

Value-added sales of $454.8 million in the first nine months of 2016 decreased $19.0 million, or 4% compared to the first nine months of 2015. Value-added sales to the consumer electronics end market, our largest end market accounting for approximately 28% of our total value-added sales in the first nine months of 2016, were up slightly compared to the first nine months of 2015. In addition, value-added sales to the defense end market increased $7.2 million year-over-year. These increases were more than offset by decreased shipments of raw material beryllium hydroxide of $8.1 million and lower value-added sales in several end markets. The industrial components and automotive electronics end market sales, which collectively accounted for 23% of our total value-added sales in the first nine months of 2016, decreased $12.0 million compared to the first nine months of 2015.

Gross margin in the first nine months of 2016 was $139.4 million, or $8.3 million below the $147.7 million gross margin recorded during the first nine months of 2015. The decrease in gross margin was primarily due to a combination of lower sales volume and unfavorable product mix.

SG&A expense was $97.1 million in the first nine months of 2016, or $4.5 million lower than $101.6 million in the first nine months of 2015. The decrease in SG&A expense was primarily due to a $2.6 million reduction in stock-based and annual incentive compensation expense driven by stock price fluctuation and financial performance as compared to the prior-year period. In addition, selling expenses were also lower due to the decrease in sales volume.

R&D expense was flat as a percentage of value-added sales at approximately 2% in the first nine months of both 2016 and 2015.

Other-net was $9.0 million of expense in the first nine months of 2016 as compared to $0.5 million of income in the first nine months of 2015. Other-net in the first nine months of 2015 included foreign currency exchange gains of $4.6 million compared to a foreign currency exchange loss of $1.0 million in the first nine months of 2016. Additionally, Other-net in the first nine months of 2015 included recognized gains of $5.6 million from settlement agreements on insurance and legal claims in connection with construction of our beryllium pebble facility in Elmore, Ohio. Refer to Note C to the Consolidated Financial Statements for details of the major components within Other-net.

Interest expense-net was $1.4 million in the first nine months of 2016 and $1.9 million in the first nine months of 2015 due to lower average debt outstanding.

Income tax expense for the first nine months of 2016 was $3.1 million versus $9.9 million in the first nine months of 2015. The effective tax rates for the first nine months of 2016 and 2015 were 14.0% and 27.9%, respectively. The effects of discrete items, percentage depletion, the foreign rate differential, and other items were the primary factors for the difference between the effective and statutory rates in the first nine months of 2016 and 2015. The R&D tax credit also had a favorable effect on the Company's effective tax rate in the first nine months of 2016.

Value-Added Sales - Reconciliation of Non-GAAP Measure

A reconciliation of net sales to value-added sales, a non-GAAP measure, for each reportable segment and for the total Company for the third quarter and first nine months of 2016 and 2015 is as follows:

	Third Quarter Ended		Nine Months Ended	
(Thousands)	Sept. 30, 2016	Oct. 2, 2015	Sept. 30, 2016	Oct. 2, 2015
Net sales				