

TORO CO
Form 10-Q
June 05, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended May 3, 2013

THE TORO COMPANY

(Exact name of registrant as specified in its charter)

Delaware
(State of Incorporation)

1-8649
(Commission File Number)

41-0580470
(I.R.S. Employer Identification Number)

8111 Lyndale Avenue South

Bloomington, Minnesota 55420

Telephone number: (952) 888-8801

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

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

Edgar Filing: TORO CO - Form 10-Q

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

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

The number of shares of Common Stock outstanding as of May 28, 2013 was 57,508,343.

Table of Contents

THE TORO COMPANY

INDEX TO FORM 10-Q

	Page Number
<u>PART I.</u>	
<u>FINANCIAL INFORMATION:</u>	
<u>Item 1.</u>	
<u>Financial Statements</u>	
<u>Condensed Consolidated Statements of Earnings (Unaudited) Three and Six Months Ended May 3, 2013 and May 4, 2012</u>	3
<u>Condensed Consolidated Statements of Comprehensive Income (Unaudited) Three and Six Months Ended May 3, 2013 and May 4, 2012</u>	4
<u>Condensed Consolidated Balance Sheets (Unaudited) May 3, 2013, May 4, 2012, and October 31, 2012</u>	5
<u>Condensed Consolidated Statements of Cash Flows (Unaudited) Six Months Ended May 3, 2013 and May 4, 2012</u>	6
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7-15
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16-26
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	26-27
<u>Item 4.</u>	
<u>Controls and Procedures</u>	27
<u>PART II.</u>	
<u>OTHER INFORMATION:</u>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	27
<u>Item 1A.</u>	
<u>Risk Factors</u>	28
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	28
<u>Item 6.</u>	
<u>Exhibits</u>	29
<u>Signatures</u>	30

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****THE TORO COMPANY AND SUBSIDIARIES****Condensed Consolidated Statements of Earnings (Unaudited)****(Dollars and shares in thousands, except per share data)**

	Three Months Ended		Six Months Ended	
	May 3, 2013	May 4, 2012	May 3, 2013	May 4, 2012
Net sales	\$ 704,486	\$ 691,485	\$ 1,149,147	\$ 1,115,320
Cost of sales	452,185	456,063	731,029	733,247
Gross profit	252,301	235,422	418,118	382,073
Selling, general, and administrative expense	134,830	128,922	254,443	241,552
Operating earnings	117,471	106,500	163,675	140,521
Interest expense	(4,149)	(4,165)	(8,398)	(8,593)
Other income, net	2,995	2,057	4,438	2,550
Earnings before income taxes	116,317	104,392	159,715	134,478
Provision for income taxes	37,915	35,574	49,917	45,737
Net earnings	\$ 78,402	\$ 68,818	\$ 109,798	\$ 88,741
Basic net earnings per share of common stock	\$ 1.35	\$ 1.15	\$ 1.88	\$ 1.48
Diluted net earnings per share of common stock	\$ 1.32	\$ 1.13	\$ 1.85	\$ 1.46
Weighted-average number of shares of common stock outstanding Basic	58,132	59,878	58,308	59,933
Weighted-average number of shares of common stock outstanding Diluted	59,257	60,960	59,444	60,961

See accompanying notes to condensed consolidated financial statements.

Table of Contents**THE TORO COMPANY AND SUBSIDIARIES****Condensed Consolidated Statements of Comprehensive Income (Unaudited)****(Dollars in thousands)**

	Three Months Ended		Six Months Ended	
	May 3, 2013	May 4, 2012	May 3, 2013	May 4, 2012
Net earnings	\$ 78,402	\$ 68,818	\$ 109,798	\$ 88,741
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	(1,168)	(705)	546	(1,755)
Derivative instruments, net of tax of \$1,030, \$(440), \$634, and \$548, respectively	1,482	(748)	674	937
Other comprehensive income (loss), net	314	(1,453)	1,220	(818)
Comprehensive income	\$ 78,716	\$ 67,365	\$ 111,018	\$ 87,923

See accompanying notes to condensed consolidated financial statements.

Table of Contents**THE TORO COMPANY AND SUBSIDIARIES****Condensed Consolidated Balance Sheets (Unaudited)**

(Dollars in thousands)

	May 3, 2013	May 4, 2012	October 31, 2012
ASSETS			
Cash and cash equivalents	\$ 80,341	\$ 82,572	\$ 125,856
Receivables, net	307,770	272,819	147,410
Inventories, net	309,998	250,804	251,117
Prepaid expenses and other current assets	30,434	23,281	24,437
Deferred income taxes	62,768	62,209	63,314
Total current assets	791,311	691,685	612,134
Property, plant, and equipment	703,104	669,159	683,107
Less accumulated depreciation	526,044	484,539	502,584
	177,060	184,620	180,523
Other assets	25,381	25,190	18,477
Goodwill	92,049	91,988	92,000
Other intangible assets, net	29,153	35,871	32,065
Total assets	\$ 1,114,954	\$ 1,029,354	\$ 935,199
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current portion of long-term debt	\$ 250	\$ 1,858	\$ 1,858
Short-term debt		7	
Accounts payable	203,710	196,382	124,806
Accrued liabilities	294,648	278,491	251,458
Total current liabilities	498,608	476,738	378,122
Long-term debt, less current portion	223,513	223,701	223,482
Deferred revenue	10,605	9,347	11,143
Deferred income taxes	2,898	1,380	2,280
Other long-term liabilities	6,287	7,614	7,770
Stockholders' equity:			
Preferred stock, par value \$1.00 per share, authorized 1,000,000 voting and 850,000 non-voting shares, none issued and outstanding			
Common stock, par value \$1.00 per share, authorized 175,000,000 shares as of May 3, 2013 and 100,000,000 shares as of May 4, 2012 and October 31, 2012; issued and outstanding 57,615,679 shares as of May 3, 2013, 58,827,322 shares as of May 4, 2012, and 58,266,482 shares as of October 31, 2012	57,616	58,827	58,266
Retained earnings	324,181	259,391	264,110
Accumulated other comprehensive loss	(8,754)	(7,644)	(9,974)
Total stockholders' equity	373,043	310,574	312,402
Total liabilities and stockholders' equity	\$ 1,114,954	\$ 1,029,354	\$ 935,199

See accompanying notes to condensed consolidated financial statements.

Table of Contents**THE TORO COMPANY AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows (Unaudited)****(Dollars in thousands)**

	Six Months Ended	
	May 3, 2013	May 4, 2012
Cash flows from operating activities:		
Net earnings	\$ 109,798	\$ 88,741
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Noncash income from finance affiliate	(3,532)	(2,802)
Provision for depreciation and amortization	26,890	25,664
Stock-based compensation expense	5,336	5,031
Decrease (increase) in deferred income taxes	281	(396)
Other	81	(121)
Changes in operating assets and liabilities, net of effect of acquisitions:		
Receivables, net	(160,534)	(126,215)
Inventories, net	(59,082)	(21,270)
Prepaid expenses and other assets	(3,486)	(5,066)
Accounts payable, accrued liabilities, deferred revenue, and other long-term liabilities	120,896	125,929
Net cash provided by operating activities	36,648	89,495
Cash flows from investing activities:		
Purchases of property, plant, and equipment	(19,508)	(21,905)
Proceeds from asset disposals	73	96
Contributions to finance affiliate, net	(4,669)	(3,559)
Acquisitions, net of cash acquired	-	(9,663)
Net cash used in investing activities	(24,104)	(35,031)
Cash flows from financing activities:		
Repayments of short-term debt	(415)	(922)
Repayments of long-term debt	(1,548)	(1,670)
Excess tax benefits from stock-based awards	4,577	6,879
Proceeds from exercise of stock options	6,573	13,268
Purchases of Toro common stock	(50,499)	(56,067)
Dividends paid on Toro common stock	(16,364)	(13,228)
Net cash used in financing activities	(57,676)	(51,740)
Effect of exchange rates on cash and cash equivalents	(383)	(1,038)
Net (decrease) increase in cash and cash equivalents	(45,515)	1,686
Cash and cash equivalents as of the beginning of the fiscal period	125,856	80,886
Cash and cash equivalents as of the end of the fiscal period	\$ 80,341	\$ 82,572
Supplemental disclosures of cash flow information:		
Long-term debt issued in connection with an acquisition	\$	\$ 100

See accompanying notes to condensed consolidated financial statements.

Table of Contents

THE TORO COMPANY AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements (Unaudited)

May 3, 2013

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all the information and notes required by U.S. generally accepted accounting principles (U.S. GAAP) for complete financial statements. Unless the context indicates otherwise, the terms company and Toro refer to The Toro Company and its consolidated subsidiaries. In the opinion of management, the unaudited condensed consolidated financial statements include all adjustments, consisting primarily of recurring accruals, considered necessary for a fair presentation of the financial position and results of operations. Since the company's business is seasonal, operating results for the six months ended May 3, 2013 cannot be annualized to determine the expected results for the fiscal year ending October 31, 2013.

The company's fiscal year ends on October 31, and quarterly results are reported based on three-month periods that generally end on the Friday closest to the quarter end. For comparative purposes, however, the company's second and third quarters always include exactly 13 weeks of results so that the quarter end date for these two quarters is not necessarily the Friday closest to the calendar month end.

For further information, refer to the consolidated financial statements and notes included in the company's Annual Report on Form 10-K for the fiscal year ended October 31, 2012. The policies described in that report are used for preparing quarterly reports.

Common Shares Authorized

On March 12, 2013, following approval by the company's shareholders at its 2013 annual meeting of shareholders, the company amended its Restated Certificate of Incorporation by filing a Certificate of Amendment to Restated Certificate of Incorporation with the Secretary of State of Delaware to increase the number of authorized shares of common stock from 100,000,000 to 175,000,000.

Stock Split

On May 24, 2012, the company announced that its Board of Directors declared a two-for-one stock split of the company's common stock, effected in the form of a 100 percent stock dividend. The stock split was distributed or paid on June 29, 2012, to shareholders of record as of June 15, 2012. Earnings and dividends declared per share and weighted-average shares outstanding are presented in this report after the effect of the two-for-one stock split. The two-for-one stock split is also reflected in the share amounts in all periods presented in this report.

Accounting Policies

In preparing the consolidated financial statements in conformity with U.S. GAAP, management must make decisions that impact the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures, including disclosures of contingent assets and liabilities. Such decisions include the selection of the appropriate accounting principles to be applied and the assumptions on which to base accounting estimates. Estimates are used in determining, among other items, sales promotions and incentives accruals, incentive compensation accruals, inventory valuation, warranty reserves, earnout liabilities, allowance for doubtful accounts, pension and postretirement accruals, self-insurance accruals, useful lives for tangible and intangible assets, and future cash flows associated with impairment testing for goodwill and other long-lived assets. These estimates and assumptions are based on management's best estimates and judgments at the time they are made. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors that management believes to be reasonable under the circumstances, including the current economic environment. Management adjusts such estimates and assumptions when facts and circumstances dictate. As future events and their effects cannot be determined with certainty, actual amounts could differ significantly from those estimated at the time the consolidated financial statements are prepared. Changes in those estimates will be reflected in the consolidated financial statements in future periods.

Table of Contents**Stock-Based Compensation***Stock Option Awards*

Under the company's incentive plan, stock options are granted with an exercise price equal to the closing price of the company's common stock on the date of grant, as reported by the New York Stock Exchange. Options are generally granted to officers, other employees, and non-employee members of the company's Board of Directors on an annual basis in the first quarter of the company's fiscal year. Options generally vest one-third each year over a three-year period and have a ten-year term. Other options granted to certain non-officer employees vest in full on the three-year anniversary of the date of grant and have a ten-year term. Compensation expense equal to the grant date fair value is generally recognized for these awards over the vesting period. Stock options granted to officers and other employees are subject to accelerated expensing if the option holder meets the retirement definition set forth in the plan. In that case, the fair value of the options is expensed in the fiscal year of grant because the option holder must be employed as of the end of the fiscal year in which the options are granted in order for the options to continue to vest following retirement. Similarly, if a non-employee director has served on the company's Board of Directors for ten full fiscal years or more, the awards vest immediately upon retirement, and therefore, the fair value of the options granted is fully expensed on the date of the grant.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes valuation method with the assumptions noted in the table below. The expected life is a significant assumption as it determines the period for which the risk-free interest rate, volatility, and dividend yield must be applied. The expected life is the average length of time in which officers, other employees, and non-employee directors are expected to exercise their stock options, which is primarily based on historical experience. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. Expected volatilities are based on the movement of the company's common stock over the most recent historical period equivalent to the expected life of the option. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury rate over the expected life at the time of grant. Dividend yield is estimated over the expected life based on the company's dividend policy, historical cash dividends paid, expected future cash dividends, and expected changes in the company's stock price.

The following table illustrates the assumptions for options granted in the following fiscal periods.

	Fiscal 2013	Fiscal 2012
Expected life of option in years	6	6
Expected volatility	35.18% - 35.19%	34.87% - 35.02%
Weighted-average volatility	35.19%	35.01%
Risk-free interest rate	0.88%	1.20%
Expected dividend yield	1.04% - 1.07%	1.31% - 1.40%
Weighted-average dividend yield	1.07%	1.32%
Grant date per share weighted-average fair value	\$13.03	\$8.56

Performance Share Awards

The company grants performance share awards to executive officers and other employees under which they are entitled to receive shares of the company's common stock contingent on the achievement of performance goals of the company, which are generally measured over a three-year

period. The number of shares of common stock a participant receives will be increased (up to 200 percent of target levels) or reduced (down to zero) based on the level of achievement of performance goals and will vest at the end of a three-year period. Performance share awards are granted on an annual basis in the first quarter of the company's fiscal year. Compensation expense is recognized for these awards on a straight-line basis over the vesting period based on the per share fair value as of the date of grant and the probability of achieving each performance goal. The per share fair value of performance share awards granted during the first quarter of each of fiscal 2013 and 2012 was \$42.06 and \$28.24, respectively. No performance share awards were granted during the second quarter of fiscal 2013 or 2012.

Restricted Stock and Restricted Stock Unit Awards

Under the company's incentive plan, restricted stock and restricted stock unit awards are generally granted to certain non-officer employees. Occasionally, restricted stock or restricted stock unit awards may be granted in connection with hiring, mid-year promotions, leadership transition, or retention. In fiscal 2013, the company began granting restricted stock unit awards. Restricted stock and restricted stock unit awards generally vest one-third each year over a three-year period or vest in full on the three-year anniversary of the date of grant. Compensation expense equal to the grant date fair value, which is equal to the closing price of the company's common stock on the date of grant multiplied by the number of shares subject to the restricted stock and restricted stock unit awards, is recognized for these awards over the vesting period. The per share weighted-average fair value of restricted stock awards granted during the first six months of fiscal 2013 and 2012 was \$42.50 and \$30.70, respectively.

Table of Contents**Per Share Data**

Reconciliations of basic and diluted weighted-average shares of common stock outstanding are as follows:

(Shares in thousands)	Three Months Ended		Six Months Ended	
	May 3, 2013	May 4, 2012	May 3, 2013	May 4, 2012
<i>Basic</i>				
Weighted-average number of shares of common stock	58,132	59,878	58,260	59,921
Assumed issuance of contingent shares			48	12
Weighted-average number of shares of common stock and assumed issuance of contingent shares	58,132	59,878	58,308	59,933
<i>Diluted</i>				
Weighted-average number of shares of common stock and assumed issuance of contingent shares	58,132	59,878	58,308	59,933
Effect of dilutive securities	1,125	1,082	1,136	1,028
Weighted-average number of shares of common stock, assumed issuance of contingent shares, and effect of dilutive securities	59,257	60,960	59,444	60,961

Options to purchase an aggregate of 361,651 and 285,668 shares of common stock outstanding during the second quarter of fiscal 2013 and 2012, respectively, were excluded from the diluted net earnings per share calculation because their exercise prices were greater than the average market price of the company's common stock during the same respective periods. Options to purchase an aggregate of 306,491 and 469,242 shares of common stock outstanding during the year-to-date periods through the second quarter of fiscal 2013 and 2012, respectively, were excluded from the diluted net earnings per share calculations because their exercise prices were greater than the average market price of the company's common stock during the same respective periods.

Inventories

Inventories are valued at the lower of cost or net realizable value, with cost determined by the last-in, first-out (LIFO) method for most inventories and first-in, first-out (FIFO) method for all other inventories. The company establishes a reserve for excess, slow-moving, and obsolete inventory that is equal to the difference between the cost and estimated net realizable value for that inventory. These reserves are based on a review and comparison of current inventory levels to the planned production, as well as planned and historical sales of the inventory.

Inventories were as follows:

(Dollars in thousands)	May 3, 2013	May 4, 2012	October 31, 2012
Raw materials and work in process	\$ 94,219	\$ 100,167	\$ 91,465
Finished goods and service parts	279,586	211,638	223,459
Total FIFO value	373,805	311,805	314,924

Edgar Filing: TORO CO - Form 10-Q

Less: adjustment to LIFO value		63,807		61,001		63,807
Total	\$	309,998	\$	250,804	\$	251,117

Goodwill

The changes in the net carrying amount of goodwill for the first six months of fiscal 2013 were as follows:

(Dollars in thousands)		Professional Segment		Residential Segment		Total
Balance as of October 31, 2012	\$	80,984	\$	11,016	\$	92,000
Translation adjustments		20		29		49
Balance as of May 3, 2013	\$	81,004	\$	11,045	\$	92,049

Table of Contents**Other Intangible Assets**

The components of other amortizable intangible assets were as follows:

(Dollars in thousands) May 3, 2013	Estimated Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net
Patents	1.5-13	\$ 9,593	\$ (8,302)	\$ 1,291
Non-compete agreements	1.5-10	6,304	(4,076)	2,228
Customer-related	1.5-13	8,272	(4,212)	4,060
Developed technology	1.5-10	27,704	(11,813)	15,891
Trade names	1.5-5	1,515	(713)	802
Other		800	(800)	
Total amortizable		54,188	(29,916)	24,272
Non-amortizable - trade names		4,881		4,881
Total other intangible assets, net		\$ 59,069	\$ (29,916)	\$ 29,153

October 31, 2012	Estimated Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net
Patents	1.5-13	\$ 9,593	\$ (8,031)	\$ 1,562
Non-compete agreements	1.5-10	6,303	(3,656)	2,647
Customer-related	1.5-13	8,312	(3,826)	4,486
Developed technology	1.5-10	27,727	(10,196)	17,531
Trade names	1.5-5	1,515	(557)	958
Other		800	(800)	
Total amortizable		54,250	(27,066)	27,184
Non-amortizable - trade names		4,881		4,881
Total other intangible assets, net		\$ 59,131	\$ (27,066)	\$ 32,065

Amortization expense for intangible assets during the first six months of fiscal 2013 was \$3.0 million. Estimated amortization expense for the remainder of fiscal 2013 and succeeding fiscal years is as follows: fiscal 2013 (remainder), \$2.8 million; fiscal 2014, \$5.3 million; fiscal 2015, \$5.1 million; fiscal 2016, \$4.6 million; fiscal 2017, \$3.7 million; fiscal 2018, \$1.7 million; and after fiscal 2018, \$1.1 million.

Investment in Joint Venture

In fiscal 2009, the company and TCF Inventory Finance, Inc. (TCFIF), a subsidiary of TCF National Bank, established Red Iron Acceptance, LLC (Red Iron), a joint venture in the form of a Delaware limited liability company that provides inventory financing, including floor plan and open account receivable financing, to distributors and dealers of the company's products in the U.S. and to select distributors of the company's products in Canada. In fiscal 2012, the company and TCFIF entered into amendments to certain of the agreements pertaining to Red Iron, among other things, to extend the initial term of Red Iron until October 31, 2017, subject to unlimited automatic two-year extensions thereafter. Either the company or TCFIF may elect not to extend the initial term or any subsequent term by giving one-year notice to the other party of its intention not to extend the term. Additionally, in connection with the joint venture, the company and an affiliate of TCFIF entered into an arrangement to provide inventory financing to dealers of the company's products in Canada.

Edgar Filing: TORO CO - Form 10-Q

The company owns 45 percent of Red Iron and TCFIF owns 55 percent of Red Iron. The company accounts for its investment in Red Iron under the equity method of accounting. Each of the company and TCFIF contributed a specified amount of the estimated cash required to enable Red Iron to purchase the company's inventory financing receivables and to provide financial support for Red Iron's inventory financing programs. Red Iron borrows the remaining requisite estimated cash utilizing a \$450 million secured revolving credit facility established under a credit agreement between Red Iron and TCFIF. The company's total investment in Red Iron as of May 3, 2013 was \$20.7 million. The company has not guaranteed the outstanding indebtedness of Red Iron. The company has agreed to repurchase products repossessed by Red Iron and the TCFIF Canadian affiliate, up to a maximum aggregate amount of \$7.5 million in a calendar year. In addition, the company has provided recourse to Red Iron for certain outstanding receivables, which amounted to a maximum amount of \$0.5 million as of May 3, 2013.

Under the repurchase agreement between Red Iron and the company, Red Iron provides financing for certain dealers and distributors. These transactions are structured as an advance in the form of a payment by Red Iron to the company on behalf of

Table of Contents

a distributor or dealer with respect to invoices financed by Red Iron. These payments extinguish the obligation of the dealer or distributor to make payment to the company under the terms of the applicable invoice. Under separate agreements between Red Iron and the dealers and distributors, Red Iron provides loans to the dealers and distributors for the advances paid by Red Iron to the company. The net amount of new receivables financed for dealers and distributors under this arrangement for the six months ended April 30, 2013 and April 30, 2012 was \$639.6 million and \$615.2 million, respectively.

As of April 30, 2013, Red Iron's total assets were \$406.5 million and total liabilities were \$360.5 million.

Warranty Guarantees

The company's products are warranted to ensure customer confidence in design, workmanship, and overall quality. Warranty coverage is for specified periods of time and on select products' hours of usage, and generally covers parts, labor, and other expenses for non-maintenance repairs. Warranty coverage generally does not cover operator abuse or improper use. An authorized company distributor or dealer must perform warranty work. Distributors and dealers submit claims for warranty reimbursement and are credited for the cost of repairs, labor, and other expenses as long as the repairs meet prescribed standards. Warranty expense is accrued at the time of sale based on the estimated number of products under warranty, historical average costs incurred to service warranty claims, the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, and other minor factors. Special warranty reserves are also accrued for major rework campaigns. The company sells extended warranty coverage on select products for a prescribed period after the factory warranty period expires.

Warranty provisions, claims, changes in estimates, and additions from acquisitions for the first six months of fiscal 2013 and 2012 were as follows:

(Dollars in thousands)	Six Months Ended	
	May 3, 2013	May 4, 2012
Beginning balance	\$ 69,848	\$ 62,730
Warranty provisions	23,478	22,263
Warranty claims	(14,651)	(13,573)
Changes in estimates	(579)	1,461
Additions from acquisitions		200
Ending balance	\$ 78,096	\$ 73,081

Segment Data

The presentation of segment information reflects the manner in which management organizes segments for making operating decisions and assessing performance. On this basis, the company has determined it has three reportable business segments: Professional, Residential, and Distribution. The Distribution segment, which consists of company-owned domestic distributorships, has been combined with the company's corporate activities and elimination of intersegment revenues and expenses that is shown as "Other" in the following tables due to the insignificance of the segment.

Edgar Filing: TORO CO - Form 10-Q

The following table shows the summarized financial information concerning the company's reportable segments:

(Dollars in thousands)

Three months ended May 3, 2013	Professional	Residential	Other	Total
Net sales	\$ 496,436	\$ 201,390	\$ 6,660	\$ 704,486
Intersegment gross sales	11,318	121	(11,439)	
Earnings (loss) before income taxes	112,275	24,679	(20,637)	116,317

Three months ended May 4, 2012	Professional	Residential	Other	Total
Net sales	\$ 455,945	\$ 231,897	\$ 3,643	\$ 691,485
Intersegment gross sales	14,056	128	(14,184)	
Earnings (loss) before income taxes	98,701	28,518	(22,827)	104,392

Six months ended May 3, 2013	Professional	Residential	Other	Total
Net sales	\$ 825,580	\$ 322,337	\$ 1,230	\$ 1,149,147
Intersegment gross sales	26,773	205	(26,978)	
Earnings (loss) before income taxes	173,013	36,833	(50,131)	159,715
Total assets	653,514	256,412	205,028	1,114,954

Table of Contents

Six months ended May 4, 2012	Professional	Residential	Other	Total
Net sales	\$ 739,779	\$ 369,505	\$ 6,036	\$ 1,115,320
Intersegment gross sales	19,122	(88)	(19,034)	
Earnings (loss) before income taxes	140,792	41,126	(47,440)	134,478
Total assets	598,357	239,385	191,612	1,029,354

The following table summarizes the components of the loss before income taxes included in Other shown above:

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	May 3, 2013	May 4, 2012	May 3, 2013	May 4, 2012
Corporate expenses	\$ (20,635)	\$ (21,721)	\$ (42,319)	\$ (41,191)
Interest expense, net	(4,149)	(4,165)	(8,398)	(8,593)
Other	4,147	3,059	586	2,344
Total	\$ (20,637)	\$ (22,827)	\$ (50,131)	\$ (47,440)

Derivative Instruments and Hedging Activities

The company is exposed to foreign currency exchange rate risk arising from transactions in the normal course of business, such as sales to third party customers, sales and loans to wholly owned foreign subsidiaries, foreign plant operations, and purchases from suppliers. The company actively manages the exposure of its foreign currency exchange rate market risk by entering into various hedging instruments, authorized under company policies that place controls on these activities, with counterparties that are highly rated financial institutions. The company's hedging activities primarily involve the use of forward currency contracts and cross currency swaps that are intended to offset intercompany loan exposures. The company uses derivative instruments only in an attempt to limit underlying exposure from foreign currency exchange rate fluctuations and to minimize earnings and cash flow volatility associated with foreign currency exchange rate changes. Decisions on whether to use such contracts are primarily based on the amount of exposure to the currency involved and an assessment of the near-term market value for each currency. The company's policy does not allow the use of derivatives for trading or speculative purposes. The company also has made an accounting policy election to use the portfolio exception with respect to measuring counterparty credit risk for derivative instruments, and to measure the fair value of a portfolio of financial assets and financial liabilities on the basis of the net open risk position with each counterparty. The company's primary foreign currency exchange rate exposures are with the Euro, the Australian dollar, the Canadian dollar, the British pound, the Mexican peso, the Japanese yen, the Chinese Yuan, and the Romanian New Leu against the U.S. dollar, as well as the Romanian New Leu against the Euro.

Cash flow hedges. The company recognizes all derivative instruments as either assets or liabilities at fair value on the consolidated balance sheet and formally documents relationships between cash flow hedging instruments and hedged transactions, as well as its risk-management objective and strategy for undertaking hedge transactions. This process includes linking all derivatives to the forecasted transactions, such as sales to third parties and foreign plant operations. Changes in fair values of outstanding cash flow hedge derivatives, except the ineffective portion, are recorded in other comprehensive income (OCI), until net earnings is affected by the variability of cash flows of the hedged transaction. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in net earnings. The consolidated statement of earnings classification of effective hedge results is the same as that of the underlying exposure. Results of hedges of sales and foreign plant operations are recorded in net sales and cost of sales, respectively, when the underlying hedged transaction affects net earnings. The maximum amount of time the company hedges its exposure to the variability in future cash flows for forecasted trade sales and purchases is two years. Results of hedges of intercompany loans are recorded in other income, net as an offset to the remeasurement of the foreign loan balance.

The company formally assesses, at a hedge's inception and on an ongoing basis, whether the derivatives that are designated as hedges have been highly effective in offsetting changes in the cash flows of the hedged transactions and whether those derivatives may be expected to remain highly effective in future periods. When it is determined that a derivative is not, or has ceased to be, highly effective as a hedge, the company discontinues hedge accounting prospectively. When the company discontinues hedge accounting because it is no longer probable, but it is still reasonably possible that the forecasted transaction will occur by the end of the originally expected period or within an additional two-month period of time thereafter, the gain or loss on the derivative remains in accumulated other comprehensive loss (AOCL) and is reclassified to net earnings when the forecasted transaction affects net earnings. However, if it is probable that a forecasted transaction will not occur by the end of the originally specified time period or within an additional two-month period of time thereafter, the gains and losses that were in AOCL are recognized immediately in net earnings. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the company carries the derivative at its fair value on the consolidated balance sheet, recognizing future changes in the fair value in other income, net. For the second quarter of fiscal 2013, there were immaterial losses on contracts reclassified into earnings as

Edgar Filing: TORO CO - Form 10-Q

Table of Contents

a result of the discontinuance of cash flow hedges. As of May 3, 2013, the notional amount outstanding of forward contracts designated as cash flow hedges was \$42.5 million. Additionally, the company has one cross currency interest rate swap instrument outstanding as of May 3, 2013 for a fixed pay notional of 36.6 million Romanian New Leu and receive floating notional of 8.5 million Euro.

Derivatives not designated as hedging instruments. The company also enters into foreign currency contracts that include forward currency contracts and cross currency swaps to mitigate the change in fair value of specific assets and liabilities on the consolidated balance sheet. These contracts are not designated as hedging instruments. Accordingly, changes in the fair value of hedges of recorded balance sheet positions, such as cash, receivables, payables, intercompany notes, and other various contractual claims to pay or receive foreign currencies other than the functional currency, are recognized immediately in other income, net, on the consolidated statements of earnings together with the transaction gain or loss from the hedged balance sheet position.

The following table presents the fair value of the company's derivatives and consolidated balance sheet location.

(Dollars in thousands)	Asset Derivatives				Liability Derivatives			
	May 3, 2013		May 4, 2012		May 3, 2013		May 4, 2012	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives Designated as Hedging Instruments								
Forward currency contracts	Prepaid expenses	\$ 2,027	Prepaid expenses	\$ 759	Accrued liabilities	\$ 478	Accrued liabilities	\$
Cross currency swaps	Prepaid expenses		Prepaid expenses		Accrued liabilities	598	Accrued liabilities	
Derivatives Not Designated as Hedging Instruments								
Forward currency contracts	Prepaid expenses	241	Prepaid expenses	1,318	Accrued liabilities	763	Accrued liabilities	339
Cross currency swaps	Prepaid expenses	189	Prepaid expenses		Accrued liabilities		Accrued liabilities	
Total Derivatives		\$ 2,457		\$ 2,077		\$ 1,839		\$ 339

The following table presents the impact of derivative instruments on the consolidated statements of earnings for the company's derivatives designated as cash flow hedging instruments for the three and six months ended May 3, 2013 and May 4, 2012, respectively.

(Dollars in thousands)	Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)		Location of Gain (Loss) Reclassified from AOCL into Income (Effective Portion)	Gain (Loss) Recognized from AOCL into Income (Effective Portion)		Location of Gain (Loss) Recognized in Income on Derivatives (Ineffective Portion and excluded from Effectiveness Testing)	Gain (Loss) Recognized in Income on Derivatives (Ineffective Portion and Excluded from Effectiveness Testing)	
	May 3,	May 4,		May 3,	May 4,		May 3,	May 4,

Edgar Filing: TORO CO - Form 10-Q

For the three months ended	2013	2012		2013	2012		2013	2012
Forward currency contracts	\$ 1,523	\$ (870)	Net sales	\$ (796)	\$ 1,265	Other income, net	\$ 133	\$ 281
Forward currency contracts	363	120	Cost of sales	177	(214)			
Cross currency contracts	(406)		Other income, net	(292)				
Total	\$ 1,480	\$ (750)		\$ (911)	\$ 1,051			

For the six months ended	May 3, 2013	May 4, 2012		May 3, 2013	May 4, 2012		May 3, 2013	May 4, 2012
Forward currency contracts	\$ 674	\$ 241	Net sales	\$ (1,342)	\$ 1,705	Other income, net	\$ 701	\$ 203
Forward currency contracts	601	692	Cost of sales	241	(646)			
Cross currency contracts	(605)		Other income, net	(839)				
Total	\$ 670	\$ 933		\$ (1,940)	\$ 1,059			

As of May 3, 2013, the company expects to reclassify approximately \$0.7 million of gains from AOCL to earnings during the next 12 months.

Table of Contents

The following table presents the impact of derivative instruments on the consolidated statements of earnings for the company's derivatives not designated as hedging instruments.

(Dollars in thousands)	Location of Gain (Loss) Recognized in Net Earnings	Gain (Loss) Recognized in Net Earnings			
		Three Months Ended		Six Months Ended	
		May 3, 2013	May 4, 2012	May 3, 2013	May 4, 2012
Forward currency contracts	Other income, net	\$ 2,394	\$ 158	\$ (960)	\$ 4,506
Cross currency swaps	Other income, net	342		(181)	
		\$ 2,736	\$ 158	\$ (1,141)	\$ 4,506

Fair Value Measurements

The company categorizes its assets and liabilities into one of three levels based on the assumptions (inputs) used in valuing the asset or liability. Estimates of fair value for financial assets and financial liabilities are based on the framework established in the accounting guidance for fair value measurements. The framework defines fair value, provides guidance for measuring fair value and requires certain disclosures. The framework discusses valuation techniques such as the market approach (comparable market prices), the income approach (present value of future income or cash flow), and the cost approach (cost to replace the service capacity of an asset or replacement cost). The framework utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Level 1 provides the most reliable measure of fair value, while Level 3 generally requires significant management judgment. The three levels are defined as follows:

Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs reflecting management's assumptions about the inputs used in pricing the asset or liability.

Cash and cash equivalents are valued at their carrying amounts in the consolidated balance sheets, which are reasonable estimates of their fair value due to their short-term maturities. Forward currency contracts are valued based on observable market transactions of forward currency prices and spot currency rates as of the reporting date. The fair value of cross currency contracts is determined using discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs such as interest rates and foreign currency exchange rates. In addition, credit valuation adjustments, which consider the impact of any credit enhancements to the contracts such as collateral postings, thresholds, mutual puts, and guarantees, are incorporated in the fair values to account for potential nonperformance risk. The unfunded deferred compensation liability is primarily subject to changes in fixed-income investment contracts based on current yields. For accounts receivable and accounts payable, carrying amounts are a reasonable estimate of fair value given their short-term nature.

Edgar Filing: TORO CO - Form 10-Q

Assets and liabilities measured at fair value on a recurring basis, as of May 3, 2013, May 4, 2012, and October 31, 2012 are summarized below:

(Dollars in thousands)				
May 3, 2013	Fair Value	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 80,341	\$ 80,341	\$	
Forward currency contracts	2,268		2,268	
Cross currency contracts	189		189	
Total assets	\$ 82,798	\$ 80,341	\$ 2,457	
Liabilities:				
Forward currency contracts	\$ 1,241		\$ 1,241	
Cross currency contracts	598		598	
Deferred compensation liabilities	3,180		3,180	
Total liabilities	\$ 5,019		\$ 5,019	

Edgar Filing: TORO CO - Form 10-Q

Table of Contents

May 4, 2012	Fair Value	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 82,572	\$ 82,572		
Forward currency contracts	2,077		2,077	
Total assets	\$ 84,649	\$ 82,572	\$ 2,077	
Liabilities:				
Forward currency contracts	\$ 339		\$ 339	
Deferred compensation liabilities	3,928		3,928	
Total liabilities	\$ 4,267		\$ 4,267	

October 31, 2012	Fair Value	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 125,856	\$ 125,856		
Forward currency contracts	995		995	
Cross currency contracts	1,046		1,046	
Total assets	\$ 127,897	\$ 125,856	\$ 2,041	
Liabilities:				
Forward currency contracts	\$ 2,114		\$ 2,114	
Deferred compensation liabilities	3,547		3,547	
Total liabilities	\$ 5,661		\$ 5,661	

There were no transfers between Level 1 and Level 2 during the three and six months ended May 3, 2013 and May 4, 2012, or the twelve months ended October 31, 2012.

Contingencies

Litigation

General. The company is party to litigation in the ordinary course of business. Litigation occasionally involves claims for punitive as well as compensatory damages arising out of use of the company's products. Although the company is self-insured to some extent, the company maintains insurance against certain product liability losses. The company is also subject to litigation and administrative and judicial proceedings with respect to claims involving asbestos and the discharge of hazardous substances into the environment. Some of these claims assert damages and liability for personal injury, remedial investigations or clean up and other costs and damages. The company is also typically involved in commercial disputes, employment disputes, and patent litigation cases in which it is asserting or defending against patent infringement claims. To prevent possible infringement of the company's patents by others, the company periodically reviews competitors' products. To avoid potential liability with respect to others' patents, the company regularly reviews certain patents issued by the United States Patent and Trademark Office (USPTO) and foreign patent offices. Management believes these activities help minimize its risk of being a defendant in patent infringement litigation.

Canadian Lawnmower Engine Horsepower Marketing and Sales Practices Litigation. In March 2010, individuals who claim to have purchased lawnmowers in Canada filed class action litigation against the company and other defendants that, similar to the class action litigation previously filed by plaintiffs in the United States and settled by the company pursuant to a settlement agreement that became final in February 2011, (i) contains allegations under applicable Canadian law that the horsepower labels on the products the plaintiffs purchased were inaccurate, (ii) seeks certification of a class of all persons in Canada who, beginning January 1, 1994 purchased a lawnmower containing a gas

Edgar Filing: TORO CO - Form 10-Q

combustible engine up to 30 horsepower that was manufactured or sold by the company and other defendants, and (iii) seeks under applicable Canadian law unspecified compensatory and punitive damages, attorneys' costs and fees, and equitable relief.

Management continues to evaluate this Canadian litigation and, in the event the company is unable to favorably resolve this litigation, while management does not currently believe that this litigation would have a material adverse effect on the company's annual consolidated operating results or financial condition, an unfavorable resolution or outcome could be material to the company's consolidated operating results for a particular period.

Subsequent Events

The company evaluated all subsequent events and concluded that no additional subsequent events have occurred that would require recognition in the consolidated financial statements or disclosure in the notes to the consolidated financial statements.

Table of Contents

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Nature of Operations

The Toro Company is in the business of designing, manufacturing, and marketing professional turf maintenance equipment and services, landscape equipment and lighting, turf irrigation systems, agricultural micro-irrigation systems, rental and construction equipment, and residential yard and snow removal products. We sell our products worldwide through a network of distributors, dealers, hardware retailers, home centers, mass retailers, and over the Internet. Our businesses are organized into three reportable business segments: Professional, Residential, and Distribution. Our Distribution segment, which consists of our company-owned domestic distributorships, has been combined with our corporate activities and is shown as Other. Our emphasis is to provide innovative, well-built, and dependable products supported by an extensive service network. A significant portion of our revenues has historically been, and we expect will continue to be, attributable to new and enhanced products. We define new products as those introduced in the current and previous two fiscal years.

This Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) should be read in conjunction with the MD&A included in Part II, Item 7 of our Annual Report on Form 10-K for the fiscal year ended October 31, 2012.

RESULTS OF OPERATIONS

Overview

Our results for the second quarter of fiscal 2013 were positive with a net sales increase of 1.9 percent and a net earnings increase of 13.9 percent, each as compared to the second quarter of fiscal 2012. Year-to-date net earnings increased 23.7 percent in fiscal 2013 compared to the same period in the prior fiscal year on a net sales increase of 3.0 percent. Sales for our professional segment increased 8.9 percent in the second quarter of fiscal 2013 compared to the second quarter of fiscal 2012 due to strong pre-season demand for our landscape contractor equipment resulting from customer optimism for the upcoming selling season and newly introduced products, increased shipments of golf and grounds equipment in Europe and Asia, higher sales of our micro-irrigation products from continued market growth and demand for our drip irrigation solutions in agricultural markets, and price increases on some products. For the year-to-date period of fiscal 2013, professional segment net sales were up 11.6 percent also due to strong demand in our first quarter of fiscal 2013 for products manufactured prior to the phase in of applicable Tier 4 emission requirements that resulted in price increases for such products. Additionally, increased sales and demand in the rental market, as well as incremental net sales from acquisitions, contributed to our professional segment net sales growth in fiscal 2013. Residential segment sales were down 13.2 percent and 12.8 percent for our second quarter and year-to-date periods of fiscal 2013, respectively, compared to the same periods in the prior fiscal year due to lower shipments and demand for walk power mowers and riding products primarily from unfavorable weather conditions this year compounded by favorable early spring weather conditions in 2012. Additionally, lower shipments of snow thrower products due to the lack of snowfall for the winter of 2012/2013 during the primary selling season contributed to the decrease of our residential segment net sales for the year-to-date comparison, which was somewhat offset by higher sales of Pope products in Australia due to increased demand for irrigation products as a result of drought conditions. Our net earnings growth in the second quarter and year-to-date periods of fiscal 2013 resulted primarily from an improvement of our gross margin rate of 180 basis points and 210 basis points for the second quarter and year-to-date periods of fiscal 2013, respectively, compared to the same periods last fiscal year, higher sales volumes, and a decrease in our tax rate due to the retroactive reenactment of the domestic research and development tax credit in our first quarter of fiscal 2013. However, our selling, general, and administrative (SG&A) expense as a percentage of net sales was up by 50 basis points and 40 basis points in the second quarter and year-to-date periods of fiscal 2013, respectively, compared to the same periods last fiscal year.

Edgar Filing: TORO CO - Form 10-Q

Although our overall financial condition remains strong, our inventory levels increased 23.6 percent as of the end of the second quarter of fiscal 2013 compared to the end of the second quarter of fiscal 2012 as we built inventory in anticipation of strong demand for products impacted by Tier 4 emissions requirements, and higher residential segment inventory levels due to lower sales volumes. Our receivables increased 12.8 percent, as of the end of the second quarter of fiscal 2013 compared to the end of the second quarter of fiscal 2012 due to a higher proportion of sales that were not financed with Red Iron. We increased our second quarter cash dividend by 27.3 percent from \$0.11 to \$0.14 per share compared to the quarterly cash dividend paid in the second quarter of fiscal 2012.

Our multi-year initiative, Destination 2014 will take us to our centennial in 2014 and into our second century. This is our third year of this four-year initiative, which is intended to focus our efforts on driving our legacy of excellence through building caring relationships and engaging in innovation. Through our Destination 2014 initiative financial goals, we strive to achieve \$100 million in organic revenue growth each fiscal year and 12 percent operating earnings as a percentage of net sales by the end

Table of Contents

of fiscal 2014. We define organic revenue growth as the increase in net sales, less net sales from acquisitions that occurred in the most recent four quarters.

In January 2013, we entered into an agreement to acquire a Chinese micro-irrigation company, subject to applicable regulatory approvals and other customary closing conditions. We expect to close the transaction by the end of fiscal 2013.

Our financial results for the first half of fiscal 2013 were solid, and we are optimistic about the remainder of the fiscal year. Our continued focus is on generating customer demand and aggressively driving retail sales for our innovative products, while keeping production closely aligned with expected shipment volumes. We will continue to keep a cautionary eye on the global economic environment, retail demand, field inventory levels, commodity prices, weather conditions, competitive actions, expenses, and other factors identified below under the heading

Forward-Looking Information, which could cause our actual results to differ from our anticipated outlook.

Net Earnings

Net earnings for the second quarter of fiscal 2013 were \$78.4 million, or \$1.32 per diluted share, compared to \$68.8 million, or \$1.13 per diluted share, for the second quarter of fiscal 2012, resulting in a net earnings per diluted share increase of 16.8 percent. Year-to-date net earnings in fiscal 2013 were \$109.8 million, or \$1.85 per diluted share, compared to \$88.7 million, or \$1.46 per diluted share, in the same comparable period last fiscal year, resulting in a net earnings per diluted share increase of 26.7 percent. The primary factors contributing to our earnings improvements were an increase in our gross margin rate, higher sales volumes, and a decrease in our effective tax rate, somewhat offset by an increase in SG&A expense. In addition, second quarter and year-to-date fiscal 2013 net earnings per diluted share were benefited by approximately \$0.03 per share and \$0.05 per share, respectively, compared to the same periods in fiscal 2012, as a result of reduced shares outstanding from repurchases of our common stock.

The following table summarizes the major operating costs and other income as a percentage of net sales:

	Three Months Ended		Six Months Ended	
	May 3, 2013	May 4, 2012	May 3, 2013	May 4, 2012
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	(64.2)	(66.0)	(63.6)	(65.7)
Gross margin	35.8	34.0	36.4	34.3
SG&A expense	(19.1)	(18.6)	(22.1)	(21.7)
Operating earnings	16.7	15.4	14.3	12.6
Interest expense	(0.6)	(0.6)	(0.7)	(0.7)
Other income, net	0.4	0.3	0.4	0.2
Provision for income taxes	(5.4)	(5.1)	(4.4)	(4.1)
Net earnings	11.1%	10.0%	9.6%	8.0%

Net Sales

Edgar Filing: TORO CO - Form 10-Q

Worldwide consolidated net sales for the second quarter of fiscal 2013 were \$704.5 million, up 1.9 percent compared to the second quarter of fiscal 2012. For the year-to-date period of fiscal 2013, net sales were \$1,149.1 million, up 3.0 percent from the same period in the prior fiscal year. Worldwide professional segment net sales were up 8.9 percent and 11.6 percent for the second quarter and year-to-date periods of fiscal 2013, respectively, compared to the same periods in the prior fiscal year. Sales for our professional segment increased due to strong pre-season demand for our landscape contractor equipment resulting from customer optimism for the upcoming selling season and newly introduced products, increased shipments of golf and grounds equipment in Europe and Asia, higher sales of our micro-irrigation products from continued market growth and demand for our drip irrigation solutions in agricultural markets, and price increases on some products. For the year-to-date period of fiscal 2013, professional segment net sales were up also due to strong demand in our first quarter of fiscal 2013 for products manufactured prior to the phase in of applicable Tier 4 emission requirements that resulted in price increases for such products. Specifically, additional Tier 4 emission requirements began to phase in for our products manufactured after January 1, 2013, having diesel engines greater than 25 but less than 75 horsepower. As a result, during the first quarter of 2013, we implemented price increases for our products subject to such Tier 4 emission requirements in order to cover the additional cost associated with the new technologies. Consequently, our professional segment net sales in the first quarter of fiscal 2013 were significantly higher than we experienced in the past or expect to experience in the future, except as may potentially be realized in connection with the phase in of additional future requirements. The result was strong demand prior to price increases going into effect for products now subject to Tier 4 emission requirements. Additionally, increased sales and demand in the rental market, as well as incremental net sales from acquisitions of \$3.2 million and \$6.4 million for the second quarter and year-to-

Table of Contents

date periods of fiscal 2013, respectively, contributed to our professional segment net sales growth. Residential segment net sales were down 13.2 percent and 12.8 percent for the second quarter and year-to-date periods of fiscal 2013, respectively, compared to the same periods in the prior fiscal year due to lower shipments and demand for walk power mowers and riding products primarily from unfavorable weather conditions this year compounded by favorable early spring weather conditions in 2012. Additionally, lower shipments of snow thrower products due to the lack of snowfall for the winter of 2012/2013 during the primary selling season contributed to the decrease of our residential segment net sales for the year-to-date comparison, which was somewhat offset by higher sales of Pope products in Australia due to increased demand for irrigation products as a result of drought conditions. International net sales were up 7.4 percent and 1.9 percent for the second quarter and year-to-date periods of fiscal 2013, respectively, compared to the same periods in the prior fiscal year due to increased shipments of golf and grounds equipment in Europe and Asia. However, changes in currency exchange rates resulted in a reduction of our net sales of approximately \$4.3 million and \$4.7 million for the second quarter and year-to-date periods of fiscal 2013, respectively. Field inventory levels were up as of the end of the second quarter of fiscal 2013 compared to the end of the second quarter of fiscal 2012 due to increased orders from strong demand prior to price increases going into effect for products subject to Tier 4 emission requirements, as well as a late start to spring, whereas last year we experienced strong preseason demand from early spring weather conditions.

Gross Profit

As a percentage of net sales, gross profit for the second quarter of fiscal 2013 increased 180 basis points to 35.8 percent compared to 34.0 percent in the second quarter of fiscal 2012. Gross profit as a percent of net sales for the year-to-date period of fiscal 2013 increased 210 basis points to 36.4 percent compared to 34.3 percent for the year-to-date period of fiscal 2012. These improvements were primarily due to a higher proportionate share of product sales that carry higher average gross margins, price increases on some products, cost reduction efforts, and slightly lower commodity prices, somewhat offset by changes in currency exchange rates that hampered our gross margin growth rate.

Selling, General, and Administrative Expense

SG&A expense increased \$5.9 million, or 4.6 percent, for the second quarter of fiscal 2013 compared to the second quarter of fiscal 2012 and increased \$12.9 million, or 5.3 percent, for the year-to-date period of fiscal 2013 compared to the year-to-date period of fiscal 2012. As a percentage of net sales, SG&A expense increased 50 basis points and 40 basis points for the second quarter and year-to-date periods of fiscal 2013, respectively, compared to the same periods in the prior fiscal year. These increases were primarily attributable to incremental SG&A costs from acquisitions of approximately \$2 million and \$4 million for the second quarter and year-to-date periods of fiscal 2013, respectively, an increase in warehousing expenses related to our new distribution facility in Ankeny, Iowa, plus higher inventory levels, an increase in engineering from investments in new product development, and higher health insurance expense. These increases were somewhat offset by a decline in product liability expense from favorable claims experience and a decrease in incentive compensation expense.

Interest Expense

Interest expense for the second quarter and year-to-date periods of fiscal 2013 decreased slightly, by 0.4 percent and 2.3 percent, respectively, compared to the same periods last fiscal year due to lower average debt levels.

Other Income, Net

Other income, net for the second quarter and year-to-date periods of fiscal 2013 increased \$0.9 million and \$1.9 million, respectively, compared to the same periods last fiscal year primarily due to higher income from our equity investment in Red Iron and a decrease in foreign currency exchange rate losses.

Provision for Income Taxes

The effective tax rate for the second quarter of fiscal 2013 was 32.6 percent compared to 34.1 percent for the second quarter of fiscal 2012. The effective tax rate for the year-to-date periods of fiscal 2013 and 2012 was 31.3 percent and 34.0 percent, respectively. The reductions in the effective tax rate were primarily the result of the retroactive reenactment of the domestic research and development tax credit.

Table of Contents**BUSINESS SEGMENTS**

As described previously, we operate in three reportable business segments: Professional, Residential, and Distribution. Our Distribution segment, which consists of our company-owned domestic distributorships, has been combined with our corporate activities and elimination of intersegment revenues and expenses that is shown as Other in the following tables. Operating earnings for our Professional and Residential segments are defined as operating earnings plus other income, net. Operating loss for Other includes operating earnings (loss), corporate activities, other income, net, and interest expense.

The following table summarizes net sales by segment:

(Dollars in thousands)	Three Months Ended			
	May 3, 2013	May 4, 2012	\$ Change	% Change
Professional	\$ 496,436	\$ 455,945	\$ 40,491	8.9%
Residential	201,390	231,897	(30,507)	(13.2)
Other	6,660	3,643	3,017	82.8
Total*	\$ 704,486	\$ 691,485	\$ 13,001	1.9%
* Includes international sales of:	\$ 212,005	\$ 197,386	\$ 14,619	7.4%

(Dollars in thousands)	Six Months Ended			
	May 3, 2013	May 4, 2012	\$ Change	% Change
Professional	\$ 825,580	\$ 739,779	\$ 85,801	11.6%
Residential	322,337	369,505	(47,168)	(12.8)
Other	1,230	6,036	(4,806)	(79.6)
Total*	\$ 1,149,147	\$ 1,115,320	\$ 33,827	3.0%
* Includes international sales of:	\$ 353,596	\$ 346,848	\$ 6,748	1.9%

The following table summarizes segment earnings (loss) before income taxes:

(Dollars in thousands)	Three Months Ended			
	May 3, 2013	May 4, 2012	\$ Change	% Change
Professional	\$ 112,275	\$ 98,701	\$ 13,574	13.8%
Residential	24,679	28,518	(3,839)	(13.5)
Other	(20,637)	(22,827)	2,190	9.6
Total	\$ 116,317	\$ 104,392	\$ 11,925	11.4%

(Dollars in thousands)	Six Months Ended			
	May 3, 2013	May 4, 2012	\$ Change	% Change
Professional	\$ 173,013	\$ 140,792	\$ 32,221	22.9%

Edgar Filing: TORO CO - Form 10-Q

Residential	36,833	41,126	(4,293)	(10.4)
Other	(50,131)	(47,440)	(2,691)	(5.7)
Total	\$ 159,715	\$ 134,478	\$ 25,237	18.8%

Table of Contents

Professional

Net Sales. Worldwide net sales for the professional segment in the second quarter and year-to-date periods of fiscal 2013 increased 8.9 percent and 11.6 percent, respectively, compared to the same periods in the prior fiscal year. Sales for our professional segment were up due to strong pre-season demand for our landscape contractor equipment resulting from customer optimism for the upcoming selling season and newly introduced products, increased shipments of golf and grounds equipment in Europe and Asia, higher sales of our micro-irrigation products from continued market growth and demand, as well as additional manufacturing capacity that increased production and enabled higher sales for our drip irrigation solutions, and price increases on some products. For the year-to-date period of fiscal 2013, professional segment net sales were up also due to strong demand in our first quarter of fiscal 2013 for products manufactured prior to the phase in of applicable Tier 4 emission requirements, as previously discussed. Additionally, increased sales and demand in the rental market, as well as incremental net sales from acquisitions of \$3.2 million and \$6.4 million for the second quarter and year-to-date periods of fiscal 2013, respectively, contributed to our professional segment net sales growth. Field inventory levels were also up as of the end of the second quarter of fiscal 2013 compared to the end of the same period in the prior fiscal year due to increased orders from strong demand prior to price increases going into effect for products subject to Tier 4 emission requirements, as well as a late start to spring, whereas last year we experienced strong pre-season demand from early spring weather conditions.

Operating Earnings. Operating earnings for the professional segment in the second quarter and year-to-date periods of fiscal 2013 increased 13.8 percent and 22.9 percent, respectively, compared to the same periods in the prior fiscal year. Expressed as a percentage of net sales, professional segment operating margin increased to 22.6 percent compared to 21.6 percent in the second quarter of fiscal 2012, and fiscal 2013 year-to-date professional segment operating margin also increased to 21.0 percent compared to 19.0 percent in the same period last fiscal year. These profit improvements were attributable to higher sales volumes, an increase in gross margins primarily from the same factors discussed previously in the Gross Profit section, and lower SG&A expenses as a percentage of net sales for the year-to-date comparison due to the leveraging of fixed SG&A costs over higher sales volumes.

Residential

Net Sales. Worldwide net sales for the residential segment in the second quarter and year-to-date periods of fiscal 2013 decreased 13.2 percent and 12.8 percent, respectively, compared to the same periods in the prior fiscal year. The sales decreases were largely due to lower shipments and demand for walk power mowers and riding products primarily from unfavorable weather conditions this year compounded by favorable early spring weather conditions in 2012 that accelerated sales of residential spring products into our second quarter of fiscal 2012. For the year-to-date comparison, shipments of snow thrower products were down due to the lack of snowfall for the winter of 2012/2013 during the primary selling season, which was somewhat offset by higher sales of Pope products in Australia due to increased demand for irrigation products as a result of drought conditions in that region. Our residential segment field inventory levels were higher as of the end of the second quarter of fiscal 2013 compared to the end of our second quarter of fiscal 2012 as a result of the aforementioned lack of snowfall during the primary selling season for the winter of 2012/2013, coupled with the late start to spring in 2013.

Operating Earnings. Operating earnings for the residential segment in the second quarter and year-to-date periods of fiscal 2013 decreased 13.5 percent and 10.4 percent, respectively, compared to the same periods in the prior fiscal year due to lower sales volumes. However, expressed as a percentage of net sales, residential segment operating margin was even at 12.3 percent in both second quarters of fiscal 2013 and 2012, and fiscal 2013 year-to-date residential segment operating margin increased to 11.4 percent compared to 11.1 percent in the same period last fiscal year. The increase in operating margin for the year-to-date comparison was primarily attributable to an improvement in gross margin mainly as a result of cost reduction efforts and lower commodity costs, somewhat offset by higher SG&A expenses as a percentage of net sales due to fixed SG&A costs over lower sales volumes.

Other

Net Sales. Net sales for the other segment include sales from our wholly owned domestic distribution companies less sales from the professional and residential segments to those distribution companies. The other segment net sales for the second quarter of fiscal 2013 increased \$3.0 million compared to the second quarter of fiscal 2012 due to a decline in sales eliminated in the other segment from reduced shipments to our company-owned distribution companies. For the year-to-date period of fiscal 2013, the other segment net sales decreased \$4.8 million compared to the same period in the prior fiscal year due to strong professional segment sales in the first quarter of fiscal 2013, mainly for products manufactured prior to the phase-in of applicable Tier 4 emission requirements, as previously discussed, to our wholly owned distribution companies that are eliminated in our other segment.

Table of Contents

Operating Losses. Operating losses for the other segment decreased \$2.2 million in the second quarter of fiscal 2013 compared to the second quarter of fiscal 2012 due to a decline in product liability expense from favorable claims experience and a decrease in incentive compensation expense, somewhat offset by higher health insurance expense. For the year-to-date period of fiscal 2013 compared to the same period last fiscal year, operating losses for the other segment were up \$2.7 million primarily due to an increase in the elimination of gross profit previously recorded with respect to sales of our products to our wholly owned distribution companies as a result of higher inventory levels at those distribution companies and an increase in health insurance expense, somewhat offset by lower product liability expense and incentive compensation.

FINANCIAL POSITION

Working Capital

Throughout the second quarter of fiscal 2013, our average working capital increased mainly due to higher average inventory levels as we built inventory in anticipation of higher demand for our products prior to the phase-in of applicable Tier 4 emission requirements, as well as lower sales for our residential segment from unfavorable weather conditions. We intend to continue our efforts on efficient asset management, with a focus on minimizing the amount of working capital in the supply chain, adjusting production plans, and maintaining or improving order replenishment and service levels to end users. We define average net working capital as accounts receivable plus inventory less trade payables as a percentage of net sales for a twelve month period.

Receivables as of the end of the second quarter of fiscal 2013 increased 12.8 percent compared to the end of the second quarter of fiscal 2012 due to a higher proportion of sales that were not financed with Red Iron. Our average days sales outstanding for receivables were slightly up, to 35 days based on sales for the twelve months ended May 3, 2013, compared to 34.5 days for the twelve months ended May 4, 2012. Inventory levels as of the end of the second quarter of fiscal 2013 also increased by 23.6 percent compared to the end of the second quarter of fiscal 2012. Our inventory levels were up as we built inventory in anticipation of strong demand for products impacted by Tier 4 emissions requirements before they went into effect, as well as higher residential segment inventory levels due to lower shipments and demand from the late spring weather in 2013, whereas last fiscal year we experienced strong preseason demand as a result of favorable early spring weather conditions. In addition, accounts payable increased as of the end of our second quarter of fiscal 2013 by \$7.3 million, or 3.7 percent, driven by higher levels of inventory. The combination of these increases resulted in a higher average net working capital as a percentage of net sales for the twelve months ended May 3, 2013 of 16.3 percent compared to 14.9 percent for the twelve months ended May 4, 2012.

Liquidity and Capital Resources

Our businesses are seasonally working capital intensive and require funding for purchases of raw materials used in production, replacement parts inventory, payroll and other administrative costs, capital expenditures, establishment or construction of new facilities, expansion and upgrading of existing facilities, as well as for financing of receivables from customers that are not financed with Red Iron. We believe that our anticipated cash generated from operations, together with our fixed rate long-term debt, bank credit lines, and cash on hand will provide us with adequate liquidity to meet our anticipated operating requirements. We believe that the funds available through existing financing arrangements and forecasted cash flows will be sufficient to provide the necessary capital resources for our anticipated working capital needs, capital expenditures, investments, debt repayments, quarterly cash dividend payments, and stock repurchases for at least the next twelve months.

Edgar Filing: TORO CO - Form 10-Q

Our Board of Directors approved a cash dividend of \$0.14 per share for the second quarter of fiscal 2013 paid on April 15, 2013, which was an increase of 27.3 percent over our cash dividend of \$0.11 per share for the second quarter of fiscal 2012.

Cash Flow. We historically use more operating cash in the first half of our fiscal year than the second half of our fiscal year due to the seasonality of our business. Cash provided by operating activities for the first six months of fiscal 2013 decreased \$52.8 million compared to the first six months of fiscal 2012, mainly as a result of a higher increase in working capital requirements, primarily from higher inventory levels and receivables, somewhat offset by higher net earnings for the first half of fiscal 2013 as compared to the first half of fiscal 2012. Cash used for investing activities was down by \$10.9 million compared to the first six months of fiscal 2012, due mainly to cash utilized for acquisitions last fiscal year and lower levels of cash used for purchases of property, plant and equipment in the first half of fiscal 2013 compared to the first half of fiscal 2012. Cash used for financing activities for the first six months of fiscal 2013 was up by \$5.9 million due mainly to lower amounts of proceeds from stock option exercises and higher levels of cash paid for dividends in the first half of fiscal 2013 compared to the first half of fiscal 2012, somewhat offset by lower amounts of funds used to repurchase our common stock during the first half of fiscal 2013 compared to the first half of fiscal 2012.

Credit Lines and Other Capital Resources. Our businesses are seasonal, with accounts receivable balances historically increasing between January and April as a result of typically higher sales volumes and extended payment terms made available to our customers, and typically decreasing between May and December when payments are received. The seasonality of production

Table of Contents

and shipments causes our working capital requirements to fluctuate during the year. Seasonal cash requirements are financed from operations, cash on hand, and with short-term financing arrangements, including our \$150.0 million unsecured senior revolving credit facility that expires in July 2015. Included in our \$150.0 million revolving credit facility is a sublimit for standby letters of credit and a sublimit for swingline loans. At our election and with the approval of the named borrowers on the revolving credit facility, the aggregate maximum principal amount available under the facility may be increased by an amount up to \$100.0 million in aggregate. Funds are available under the revolving credit facility for working capital, capital expenditures, and other lawful purposes, including, but not limited to, acquisitions and stock repurchases. Interest expense on this credit line is determined based on a LIBOR rate, or other rates quoted by the Administrative Agent, Bank of America, N.A., plus a basis point spread defined in the credit agreement. In addition, our non-U.S. operations maintain unsecured short-term lines of credit in the aggregate amount of approximately \$13.5 million. These facilities bear interest at various rates depending on the rates in their respective countries of operation. As of May 3, 2013, we had no outstanding short-term debt under our credit facilities and an aggregate of \$11.3 million of outstanding letters of credit. As of May 3, 2013, we had an aggregate of \$152.2 million of unutilized availability under our credit agreements.

The revolving credit facility contains standard covenants, including, without limitation, financial covenants, such as the maintenance of minimum interest coverage and maximum debt to earnings ratios; and negative covenants, which among other things, limit loans and investments, disposition of assets, consolidations and mergers, transactions with affiliates, restricted payments, contingent obligations, liens and other matters customarily restricted in such agreements. Most of these restrictions are subject to certain minimum thresholds and exceptions. Under the revolving credit facility, we are not limited to payments of cash dividends and stock repurchases as long as our debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) ratio from the previous quarter compliance certificate is less than or equal to 2.75; however, we are limited to \$50 million per fiscal year if our debt to EBITDA ratio from the previous quarter compliance certificate is greater than 2.75. As of May 3, 2013, we were not limited to payments of cash dividends and stock repurchases as our debt to EBITDA ratio was below 2.75. We were also in compliance with all covenants related to our credit agreement for our revolving credit facility as of May 3, 2013, and we expect to be in compliance with all covenants during the remainder of fiscal 2013. If we were out of compliance with any debt covenant required by this credit agreement following the applicable cure period, the banks could terminate their commitments unless we could negotiate a covenant waiver from the banks. In addition, our long-term senior notes and debentures could become due and payable if we were unable to obtain a covenant waiver or refinance our short-term debt under our credit agreement. If our credit rating falls below investment grade and/or our average debt to EBITDA ratio rises above 2.00, the basis point spread over LIBOR, or other rates quoted by the Administrative Agent, Bank of America, N.A., we currently pay on our outstanding short-term debt under the credit agreement would increase. However, the credit commitment could not be cancelled by the banks based solely on a ratings downgrade. Our debt rating for long-term unsecured senior, non-credit enhanced debt was unchanged during the second quarter of fiscal 2013 by Standard and Poor's Ratings Group at BBB and by Moody's Investors Service at Baa3.

Customer Financing Arrangements and Contractual Obligations

In fiscal 2009, we established our Red Iron joint venture with TCFIF. The purpose of Red Iron is to provide inventory financing, including floor plan and open accounts receivable financing, to distributors and dealers of our products in the U.S. and to select distributors of our products in Canada to enable our distributors and dealers to carry representative inventories of our products. Some independent international dealers continue to finance their products with a third party finance company. This third party financing company purchased \$11.8 million of receivables from us during the first six months of fiscal 2013. As of May 3, 2013, \$10.4 million of receivables financed by the third party financing company, excluding Red Iron, were outstanding. See our most recently filed Annual Report on Form 10-K for further details regarding our customer financing arrangements and contractual obligations.

Inflation

We are subject to the effects of inflation, deflation, and changing prices. In the first six months of fiscal 2013, average prices paid for commodities and components we purchase were slightly lower compared to the average prices paid for commodities and components in the first

Edgar Filing: TORO CO - Form 10-Q

six months of fiscal 2012, which benefited our gross margin growth rate in the first half of fiscal 2013 compared to the first half of fiscal 2012. We will continue to closely follow the commodities and components that affect our product lines, and we anticipate average prices paid for commodities and components to be approximately equivalent to or slightly higher for the remainder of fiscal 2013 as compared to fiscal 2012. We expect to mitigate the impact of inflationary pressures by engaging in proactive vendor negotiations, reviewing alternative sourcing options, substituting materials, engaging in internal cost reduction efforts, and increasing prices on some of our products, all as appropriate.

Table of Contents

Critical Accounting Policies and Estimates

See our most recent Annual Report on Form 10-K for the fiscal year ended October 31, 2012 for a discussion of our critical accounting policies.

New Accounting Pronouncements to be Adopted

In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11 related to disclosures on offsetting of assets and liabilities thereby amending ASC 210, *Balance Sheet*. ASU No. 2011-11 requires us to disclose information about offsetting and related arrangements to enable users of our financial statements to understand the effect of those arrangements on our financial position. In January 2013, the FASB issued ASU No. 2013-01 which clarified that the scope of ASU No. 2011-11 only applies to derivatives accounted for in accordance with ASC 815, *Derivatives and Hedging*. We will adopt this guidance in our first quarter of fiscal 2014, as required. The adoption of this guidance is not expected to have a material impact on our consolidated financial statements.

In February 2013, FASB issued ASU No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU No. 2013-02 requires entities to disclose, for items reclassified out of accumulated other comprehensive income (loss) and into net income in their entirety, the effect of the reclassification on each affected net income line item. ASU No. 2013-02 also requires a cross reference to other required U.S. GAAP disclosures for accumulated other comprehensive income (loss) reclassification items that are not reclassified in their entirety into net income. The effective date of ASU No. 2013-02 is for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2012, and early adoption is permitted. We plan to early adopt this guidance in our fiscal 2013 fourth quarter. The adoption of this guidance is not expected to have a material impact on our consolidated financial statements.

No other new accounting pronouncement that has been issued but not yet effective for us during the second quarter of fiscal 2013 has had or is expected to have a material impact on our consolidated financial statements.

Forward-Looking Information

This Quarterly Report on Form 10-Q contains not only historical information, but also forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and that are subject to the safe harbor created by those sections. In addition, we or others on our behalf may make forward-looking statements from time to time in oral presentations, including telephone conferences and/or web casts open to the public, in press releases or reports, on our web sites, or otherwise. Statements that are not historical are forward-looking and reflect expectations and assumptions. We try to identify forward-looking statements in this report and elsewhere by using words such as expect, strive, looking ahead, outlook, forecast, optimistic, plan, anticipate, continue, estimate, believe, could, should, will, would, may, possible, likely, intend, and similar expressions and by using future dates. Our forward-looking statements generally relate to our future performance, including our anticipated operating results, liquidity requirements, and financial condition; our business strategies and goals; and the effect of laws, rules, regulations, new accounting pronouncements, and outstanding litigation on our business and future performance.

Edgar Filing: TORO CO - Form 10-Q

Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those projected or implied. These risks and uncertainties include factors that affect all businesses operating in a global market as well as matters specific to Toro. The following are some of the factors known to us that could cause our actual results to differ materially from what we have anticipated in our forward-looking statements:

- Economic conditions and outlook in the United States and in other countries in which we conduct business could adversely affect our net sales and earnings, which include but are not limited to recessionary conditions; slow or negative economic growth rates; the impact of state debt and sovereign debt defaults and austerity measures by certain European countries; slow down or reductions in levels of golf course development, renovation, and improvement; golf course closures; reduced levels of home ownership, construction, and sales; home foreclosures; negative consumer confidence; reduced consumer spending levels resulting from tax increases or otherwise; prolonged high unemployment rates; higher commodity and component costs and fuel prices; inflationary or deflationary pressures; reduced credit availability or unfavorable credit terms for our distributors, dealers, and end-user customers; higher short-term, mortgage, and other interest rates; and general economic and political conditions and expectations.
- Weather conditions have and may continue to reduce demand for some of our products, which may adversely affect our net sales and operating results, or may affect the timing of demand for some of our products and may adversely affect net sales and operating results in subsequent periods.
- Increases in the cost, or disruption in the availability, of raw materials, components, and parts containing various commodities that we purchase, such as steel, aluminum, fuel, resins, linerboard, copper, lead, rubber, engines, transmissions, transaxles, hydraulics, electric motors, and other commodities and components, and increases in our other costs of doing business, such as transportation costs or employee healthcare costs, including as the result of recently enacted or future healthcare laws or regulations, may adversely affect our profit margins and business.

Table of Contents

- Our professional segment net sales are dependent upon golf course revenues and the amount of investment in golf course renovations and improvements; the level of new golf course development and golf course closures; the level of homeowners who outsource their lawn care; the level of residential and commercial construction; continued acceptance of and demand for micro-irrigation solutions for agricultural markets; availability of credit to professional segment customers on acceptable terms to finance new product purchases; and the amount of government revenues, budget, and spending levels for grounds maintenance equipment; and other factors.
- Our residential segment net sales are dependent upon mass retailers and home centers, such as The Home Depot, Inc. as a major customer, the amount of product placement at retailers, consumer confidence and spending levels, and changing buying patterns of customers.
- A significant percentage of our consolidated net sales are generated outside of the United States, and we intend to continue to expand our international operations. Our international operations also require significant management attention and financial resources, expose us to difficulties presented by international economic, political, legal, accounting, and business factors; including political, economic and/or social instability in the countries in which we sell products resulting in contraction or disruption of such markets; and may not be successful or produce desired levels of net sales. In addition, a portion of our international net sales are financed by third parties. The termination of our agreements with these third parties, any material change to the terms of our agreements with these third parties or in the availability or terms of credit offered to our international customers by these third parties, or any delay in securing replacement credit sources, could adversely affect our sales and operating results.
- Fluctuations in foreign currency exchange rates could result in declines in our reported net sales and net earnings.
- Our business, properties, and products are subject to governmental regulation with which compliance may require us to incur expenses or modify our products or operations and non-compliance may expose us to penalties. Governmental regulation may also adversely affect the demand for some of our products and our operating results. The United States Environmental Protection Agency has adopted increasingly stringent engine emission regulations, including Tier 4 emission requirements applicable to diesel engines in specified horsepower ranges that are used in some of our products. Beginning January 1, 2013, such requirements expand to additional horsepower categories and, accordingly, apply to more of our products. Although we have developed plans to achieve substantial compliance with Tier 4 requirements, these plans are subject to many variables including, among others, the inability of our suppliers to provide compliant engines on a timely basis or our inability to complete the necessary engineering and testing to meet our production schedule. If we are unable to successfully execute such plans, our ability to sell our products into the market may be inhibited, which could adversely affect our competitive position and financial results. To the extent in which we are able to pass along costs we incurred related to research, development, engineering, and other costs to design Tier 4 compliant products in the form of price increases to our customers and/or our competitors implement different strategies with respect to compliance with Tier 4 requirements, we may experience lower market demand for our products that may, ultimately, adversely affect our profit margins, net sales, and overall financial results. Additionally, as customers' buying patterns change to purchasing our products in advance of price increases on compliant products, we have and may continue to experience abnormal fluctuation in sales and our financial results of any one period may not be representative of expected financial results in subsequent periods. We believe our financial results during the first quarter and year-to-date period of fiscal 2013 were positively impacted by these patterns.

As required under the Dodd-Frank Wall Street Reform and Consumer Protection Act, in August 2012 the SEC promulgated final rules regarding disclosure of the use of certain minerals, known as conflict minerals, which are mined from the Democratic Republic of the Congo and adjoining countries, as well as procedures regarding a manufacturer's efforts to prevent the sourcing of such minerals and metals produced from those minerals. These conflict minerals are commonly referred to as 3TG and include tin, tantalum, tungsten, and gold. The new rules will require us to engage in due diligence efforts for the 2013 calendar year, with initial disclosures required no later than May 31, 2014, and subsequent disclosures required no later than May 31 of each following year. We expect that we will incur additional costs and expenses, which may be significant, in order to comply with these rules. Since our supply chain is complex, ultimately we may not be able to sufficiently verify the origins for any conflict minerals and metals used in our products through the due diligence procedures that we implement, which may adversely affect our reputation with our customers, shareholders, and other stakeholders.

In addition, changes in laws and regulations also may adversely affect our operating results, including, in particular, (i) taxation changes, tax rate changes, new tax laws, revised tax law interpretations, or expiration of the domestic research and development tax credit, which individually or in combination may cause our effective tax rate to increase, or (ii) new, recently enacted or revised healthcare laws or regulations, which may

cause us to incur higher employee healthcare and other costs.

- If we are unable to continue to enhance existing products and develop and market new products that respond to customer needs and preferences and achieve market acceptance, or if we experience unforeseen product quality or other problems in the development, production, or use of new and existing products, we may experience a decrease in demand for our products, and our business could suffer.

Table of Contents

- Our reliance upon patents, trademark laws, and contractual provisions to protect our proprietary rights may not be sufficient to protect our intellectual property from others who may sell similar products. Our products may infringe the proprietary rights of others.
- We manufacture our products at and distribute our products from several locations in the United States and internationally. Any disruption at any of these facilities or our inability to cost-effectively expand existing, open and manage new facilities, including our new distribution facility in Ankeny, Iowa, and/or move production between manufacturing facilities could adversely affect our business and operating results. In fiscal 2012, we began operations at our new micro-irrigation facility in Romania. If this facility does not produce the anticipated manufacturing or operational efficiencies, or if the micro-irrigation products to be produced at this facility are not accepted into the new geographic markets at expected levels, we may not recover the costs of the new facility and our operating results may be adversely affected.
- We intend to grow our business in part through additional acquisitions and alliances, stronger customer relations, and new joint ventures and partnerships, all of which are risky and could harm our business, particularly if we are not able to successfully integrate such acquisitions and alliances, joint ventures, and partnerships. Additionally, factors could affect completion of our proposed acquisition of a micro-irrigation company in China, including whether and when the required regulatory approvals will be obtained, and whether and when other closing conditions will be satisfied.
- We rely on our management information systems for inventory management, distribution, and other key functions. If our information systems fail to adequately perform these functions, or if we experience an interruption in their operation, our business and operating results could be adversely affected.
- We face intense competition in all of our product lines with numerous manufacturers, including from some competitors that have larger operations and greater financial resources than us. We may not be able to compete effectively against competitors' actions, which could harm our business and operating results.
- We are subject to product liability claims, product quality issues, and other litigation from time to time that could adversely affect our operating results or financial condition.
- If we are unable to retain our key employees, and attract and retain other qualified personnel, we may not be able to meet strategic objectives and our business could suffer.
- As a result of our financing joint venture with TCFIF, we are dependent upon the joint venture to provide competitive inventory financing programs, including floor plan and open account receivable financing, to certain distributors and dealers of our products. Any material change in the availability or terms of credit offered to our customers by the joint venture, any termination or disruption of our joint venture relationship or any delay in securing replacement credit sources could adversely affect our net sales and operating results.
- The terms of our credit arrangements and the indentures governing our senior notes and debentures could limit our ability to conduct our business, take advantage of business opportunities, and respond to changing business, market, and economic conditions. Additionally, we are subject to counterparty risk in our credit arrangements. If we are unable to comply with the terms of our credit arrangements and indentures, especially the financial covenants, our credit arrangements could be terminated and our senior notes and debentures could become due and payable.
- Legislative enactments could impact the competitive landscape within our markets and affect demand for our products.
- Our business is subject to a number of other factors that may adversely affect our operating results, financial condition, or business, such as: our ability to achieve the revenue growth, operating earnings, and employee engagement goals of our multi-year employee initiative called Destination 2014; natural or man-made disasters or global pandemics that may result in shortages of raw materials and components, higher fuel and commodity costs, delays in shipments to customers, and an increase in insurance premiums; financial difficulties and viability of our distributors and dealers, changes in distributor ownership, changes in channel distribution of our products, relationships with our distribution channel partners, our success in partnering with new dealers, and our customers' ability to pay amounts owed to us; ability of management to adapt to unplanned events; drug cartel-related violence, which may disrupt our production activities and maquiladora operations based in Juarez, Mexico; and continued threat of terrorist acts and war that may result in heightened security and higher costs for import and export shipments of components or finished goods, reduced leisure travel, and contraction of the U.S. and world economies.

Edgar Filing: TORO CO - Form 10-Q

For more information regarding these and other uncertainties and factors that could cause our actual results to differ materially from what we have anticipated in our forward-looking statements or otherwise could materially adversely affect our business, financial condition, or operating results, see our most recently filed Annual Report on Form 10-K, Part I, Item 1A, Risk Factors.

All forward-looking statements included in this report are expressly qualified in their entirety by the foregoing cautionary statements. We wish to caution readers not to place undue reliance on any forward-looking statement which speaks only as of the date made and to recognize that forward-looking statements are predictions of future results, which may not occur as anticipated. Actual results could differ materially from those anticipated in the forward-looking statements and from historical results, due to the risks and uncertainties described above, as well as others that we may consider immaterial or do not

Table of Contents

anticipate at this time. The foregoing risks and uncertainties are not exclusive and further information concerning the company and our businesses, including factors that potentially could materially affect our financial results or condition, may emerge from time to time. We assume no obligation to update forward-looking statements to reflect actual results or changes in factors or assumptions affecting such forward-looking statements. We advise you, however, to consult any further disclosures we make on related subjects in our future Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K we file with or furnish to the Securities and Exchange Commission.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk stemming from changes in foreign currency exchange rates, interest rates, and commodity prices. We are also exposed to equity market risk pertaining to the trading price of our common stock. Changes in these factors could cause fluctuations in our earnings and cash flows. See further discussion on these market risks below.

Foreign Currency Exchange Rate Risk. In the normal course of business, we actively manage the exposure of our foreign currency exchange rate market risk by entering into various hedging instruments, authorized under company policies that place controls on these activities, with counterparties that are highly rated financial institutions. Our hedging activities involve the primary use of forward currency contracts. We also utilize cross currency swaps to offset intercompany loan exposures. We use derivative instruments only in an attempt to limit underlying exposure from currency fluctuations and to minimize earnings and cash flow volatility associated with foreign currency exchange rate changes and not for trading purposes. We are exposed to foreign currency exchange rate risk arising from transactions in the normal course of business, such as sales to third party customers, sales and loans to wholly owned foreign subsidiaries, foreign plant operations, and purchases from suppliers. Because our products are manufactured or sourced primarily from the United States and Mexico, a stronger U.S. dollar and Mexican peso generally have a negative impact on our results from operations, while a weaker dollar and peso generally have a positive effect. Our primary foreign currency exchange rate exposures are with the Euro, the Australian dollar, the Canadian dollar, the British pound, the Mexican peso, the Japanese yen, the Chinese Yuan, the Romanian New Leu against the U.S. dollar, as well as the Romanian New Leu against the Euro.

We enter into various contracts, principally forward contracts that change in value as foreign currency exchange rates change, to protect the value of existing foreign currency assets, liabilities, anticipated sales, and probable commitments. Decisions on whether to use such contracts are made based on the amount of exposures to the currency involved and an assessment of the near-term market value for each currency. Worldwide foreign currency exchange rate exposures are reviewed monthly. The gains and losses on these contracts offset changes in values of the related exposures. Therefore, changes in values of these hedge instruments are highly correlated with changes in market values of underlying hedged items both at inception of the hedge and over the life of the hedge contract. Additional information regarding gains and losses on our derivative instruments is presented in the Notes to Condensed Consolidated Financial Statements (Unaudited) in Item 1 of this Quarterly Report on Form 10-Q, in the section entitled Derivative Instruments and Hedging Activities.

The following foreign currency exchange contracts held by us have maturity dates in fiscal 2013 and 2014. All items are non-trading and stated in U.S. dollars. Some derivative instruments we enter into do not meet the cash flow hedging criteria; therefore, changes in fair value are recorded in other income, net. The average contracted rate, notional amount, pre-tax value of derivative instruments in accumulated other comprehensive loss, and fair value impact of derivative instruments in other income, net as of and for the fiscal period ended May 3, 2013 were as follows:

Dollars in thousands (except average contracted rate)	Average Contracted	Notional Amount	Value in Accumulated	Fair Value Impact
--	-----------------------	--------------------	-------------------------	----------------------

Edgar Filing: TORO CO - Form 10-Q

	Rate			Other Comprehensive Income (Loss)	(Loss) Gain
Buy US dollar/Sell Australian dollar	1.0310	\$	32,685.3	\$ 368.8	\$ (211.3)
Buy US dollar/Sell Canadian dollar	1.0197		5,148.6	(36.4)	(10.7)
Buy US dollar/Sell Euro	1.2989		76,116.0	(574.2)	(1,825.2)
Buy US dollar/Sell British pound	1.5591		13,252.0		33.6
Buy Euro/Sell US dollar	1.2780		6,651.3		189.2
Buy Mexican peso/Sell US dollar	13.2067		27,561.7	1,433.2	679.0
Buy Euro/Sell Romanian New Leu	4.4162		10,870.9	(141.7)	(567.9)
Buy Japanese Yen/Sell US dollar	96.6600		26.9		(0.2)

Our net investment in foreign subsidiaries translated into U.S. dollars is not hedged. Any changes in foreign currency exchange rates would be reflected as a foreign currency translation adjustment, a component of accumulated other comprehensive loss in stockholders' equity, and would not impact net earnings.

Table of Contents

Interest Rate Risk. Our market risk on interest rates relates primarily to LIBOR-based short-term debt from commercial banks, as well as the potential increase in fair value of long-term debt resulting from a potential decrease in interest rates. However, we do not have cash flow or earnings exposure due to market risks on long-term debt. We generally do not use interest rate swaps to mitigate the impact of fluctuations in interest rates. See our most recently filed Annual Report on Form 10-K (Item 7A Quantitative and Qualitative Disclosures about Market Risk). There has been no material change in this information.

Commodity Price Risk. Some raw materials used in our products are exposed to commodity price changes. The primary commodity price exposures are with steel, aluminum, fuel, petroleum-based resin, and linerboard. In addition, we are a purchaser of components and parts containing various commodities, including steel, aluminum, copper, lead, rubber, and others that are integrated into our end products. Further information regarding rising prices for commodities is presented in Item 2 of this Quarterly Report on Form 10-Q, in the section entitled Inflation.

We enter into fixed-price contracts for future purchases of natural gas in the normal course of operations as a means to manage natural gas price risks.

Item 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) that are designed to provide reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, we recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and we are required to apply our judgment in evaluating the cost-benefit relationship of possible internal controls. Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered in this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of such period to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that 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 disclosure. There was no change in our internal control over financial reporting that occurred during our second quarter ended May 3, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

We are a party to litigation in the ordinary course of business. Litigation occasionally involves claims for punitive as well as compensatory damages arising out of use of our products. Although we are self-insured to some extent, we maintain insurance against certain product liability losses. We are also subject to litigation and administrative and judicial proceedings with respect to claims involving asbestos and the discharge

Edgar Filing: TORO CO - Form 10-Q

of hazardous substances into the environment. Some of these claims assert damages and liability for personal injury, remedial investigations or clean-up and other costs and damages. We are also typically involved in commercial disputes, employment disputes, and patent litigation cases in the ordinary course of business. To prevent possible infringement of our patents by others, we periodically review competitors' products. To avoid potential liability with respect to others' patents, we regularly review certain patents issued by the USPTO and foreign patent offices. We believe these activities help us minimize our risk of being a defendant in patent infringement litigation. We are currently involved in patent litigation cases where we are asserting and defending against patent infringement.

For a description of our material legal proceedings, see Notes to Condensed Consolidated Financial Statements under the heading "Litigation" included in Item 1 of this Quarterly Report on Form 10-Q, which is incorporated into this Part II, Item 1 by reference.

Table of Contents**Item 1A. RISK FACTORS**

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results or could cause our actual results to differ materially from our anticipated results or other expectations, including those expressed in any forward-looking statement made in this report, are described in our most recently filed Annual Report on Form 10-K (Item 1A. Risk Factors). There has been no material change in those risk factors.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table shows our second quarter of fiscal 2013 stock repurchase activity.

Period	Total Number of Shares (or Units) Purchased (1,2,3,4)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased As Part of Publicly Announced Plans or Programs (1,2)	Maximum Number of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1,2)
February 2, 2013 through March 1, 2013	46,000	\$ 44.61	46,000	5,651,765
March 2, 2013 through March 29, 2013	1,153	46.75	1,153	5,650,612
March 30, 2013 through May 3, 2013	342,318	44.74	338,865	5,311,747
Total	389,471	\$ 44.73	386,018	

(1) On December 1, 2010, the company's Board of Directors authorized the repurchase of 6,000,000 shares of the company's common stock in open-market or in privately negotiated transactions. This program has no expiration date but may be terminated by the company's Board of Directors at any time. The company repurchased an aggregate of 386,018 shares during the period indicated above under this program. There are 311,747 shares remaining for repurchase under this program.

(2) On December 11, 2012, the company's Board of Directors authorized the repurchase of 5,000,000 shares of the company's common stock in open-market or in privately negotiated transactions. This program has no expiration date but may be terminated by the company's Board of Directors at any time. No shares were repurchased during the periods indicated above under this program.

(3) Includes 22 shares of the company's common stock surrendered by employees to satisfy minimum tax withholding obligations upon vesting of restricted stock granted under the company's incentive plan. These 22 shares were not repurchased under the company's repurchase program described in footnotes 1 and 2 above.

(4) Includes 1,122 units (shares) of the company's common stock purchased in open-market transactions at an average price of \$46.38 per share on behalf of a rabbi trust formed to pay benefit obligations of the company to participants in deferred compensation plans. These 1,122 shares were not repurchased under the company's repurchase program described in footnotes 1 and 2 above.

Table of Contents

Item 6. EXHIBITS

(a) Exhibits

- 3.1 and 4.1 Restated Certificate of Incorporation of The Toro Company (incorporated by reference to Exhibit 3.1 to Registrant's Current Report on Form 8-K dated June 17, 2008, Commission File No. 1-8649).
- 3.2 and 4.2 Certificate of Amendment to Restated Certificate of Incorporation of The Toro Company (incorporated by reference to Exhibit 3.1 to Registrant's Current Report on Form 8-K dated March 13, 2013, Commission File No. 1-8649).
- 3.3 and 4.3 Amended and Restated Bylaws of The Toro Company (incorporated by reference to Exhibit 3.2 to Registrant's Current Report on Form 8-K dated June 17, 2008, Commission File No. 1-8649).
- 4.4 Specimen Form of Common Stock Certificate (incorporated by reference to Exhibit 4(c) to Registrant's Quarterly Report on Form 10-Q for the fiscal quarter ended August 1, 2008, Commission File No. 1-8649).
- 4.5 Indenture dated as of January 31, 1997, between Registrant and First National Trust Association, as Trustee, relating to The Toro Company's 7.80% Debentures due June 15, 2027 (incorporated by reference to Exhibit 4(a) to Registrant's Current Report on Form 8-K dated June 24, 1997, Commission File No. 1-8649).
- 4.6 Indenture dated as of April 20, 2007, between Registrant and The Bank of New York Trust Company, N.A., as Trustee, relating to The Toro Company's 6.625% Notes due May 1, 2037 (incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement on Form S-3 filed with the Securities and Exchange Commission on April 23, 2007, Registration No. 333-142282).
- 4.7 First Supplemental Indenture dated as of April 26, 2007, between Registrant and The Bank of New York Trust Company, N.A., as Trustee, relating to The Toro Company's 6.625% Notes due May 1, 2037 (incorporated by reference to Exhibit 4.1 to Registrant's Current Report on Form 8-K dated April 23, 2007, Commission File No. 1-8649).
- 4.8 Form of The Toro Company 6.625% Note due May 1, 2037 (incorporated by reference to Exhibit 4.2 to Registrant's Current Report on Form 8-K dated April 23, 2007, Commission File No. 1-8649).
- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) (Section 302 of the Sarbanes-Oxley Act of 2002) (filed herewith).
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) (Section 302 of the Sarbanes-Oxley Act of 2002) (filed herewith).
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
- 101 The following financial information from The Toro Company's Quarterly Report on Form 10-Q for the quarterly period ended May 3, 2013, filed with the SEC on June 5, 2013, formatted in eXtensible Business Reporting Language (XBRL): (i) Condensed Consolidated Statements of Earnings for the three and six-month periods ended May 3, 2013 and May 4, 2012, (ii) Condensed Consolidated Statements of Comprehensive Income for the three and six-month periods ended May 3, 2013 and May 4, 2012, (iii) Condensed Consolidated Balance Sheets as of May 3, 2013, May 4, 2012, and October 31, 2012, (iv) Condensed Consolidated Statement of Cash Flows for the three and six-month periods ended May 3, 2013 and May 4, 2012, and (v) Notes to Condensed Consolidated Financial Statements.

Table of Contents

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 hereunto duly authorized.

THE TORO COMPANY

(Registrant)

Date: June 5, 2013

By /s/ Renee J. Peterson
Renee J. Peterson
Vice President, Finance
and Chief Financial Officer
(duly authorized officer and principal financial officer)