ESTERLINE TECHNOLOGIES CORP
Form 10-Q
August 03, 2018
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 June 29, 2018.

OR

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

For the transition period from to

Commission file number 1-6357

ESTERLINE TECHNOLOGIES CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	13-2595091
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

500 108th Avenue N.E., Bellevue, Washington 98004

(Address of principal executive offices)(Zip Code)

Registrant’s telephone number, including area code (425) 453-9400

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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, a smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company
Emerging growth company		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of July 31, 2018, 29,442,875 shares of the issuer's common stock were outstanding.

PART I – FINANCIAL INFORMATION

Item 1.Financial Statements

ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED BALANCE SHEET

As of June 29, 2018, and September 29, 2017

(In thousands, except share amounts)

	June 29, 2018 (Unaudited)	September 29, 2017
ASSETS		
Current Assets		
Cash and cash equivalents	$ 351,039	$ 307,826
Accounts receivable, net of allowances of $14,391 and $16,035	401,244	430,524
Inventories		
Raw materials and purchased parts	185,211	194,034
Work in progress	188,956	178,191
Finished goods	105,327	105,744
	479,494	477,969
Income tax refundable	18,503	12,814
Prepaid expenses	23,778	19,239
Other current assets	4,574	13,836
Current assets of businesses held for sale	4,052	6,501
Total Current Assets	1,282,684	1,268,709
Property, Plant and Equipment	826,642	862,715
Accumulated depreciation	509,766	514,081
	316,876	348,634
Other Non-Current Assets		
Goodwill	1,031,234	1,053,573
Intangibles, net	318,169	359,166
Deferred income tax benefits	55,532	56,793
Other assets	17,323	19,804
Non-current assets of businesses held for sale	12,632	13,334

Total Assets	$ 3,034,450	$ 3,120,013

ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED BALANCE SHEET

As of June 29, 2018, and September 29, 2017

(In thousands, except share amounts)

	June 29, 2018 (Unaudited)	September 29, 2017
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 133,470	$ 138,595
Accrued liabilities	218,953	230,007
Current maturities of long-term debt	15,245	17,424
U.S. and foreign income taxes	7,151	582
Current liabilities of businesses held for sale	3,212	7,184
Total Current Liabilities	378,031	393,792
Long-Term Liabilities		
Credit facilities	25,000	50,000
Long-term debt, net of current maturities	695,884	709,424
Deferred income tax liabilities	34,927	43,978
Pension and post-retirement obligations	65,443	66,981
Long-term U.S. income taxes payable	38,640	-
Other liabilities	17,703	18,838
Non-current liabilities of businesses held for sale	2,910	1,724
Shareholders' Equity		
Common stock, par value $.20 per share, authorized 60,000,000 shares,		
issued 33,177,952 and 33,117,473 shares	6,636	6,623
Additional paid-in capital	750,449	738,329
Treasury stock at cost, repurchased 3,737,327 and 3,135,927 shares	(351,964)	(308,514)
Retained earnings	1,671,906	1,655,187
Accumulated other comprehensive loss	(312,164)	(266,870)
Total Esterline Shareholders' Equity	1,764,863	1,824,755
Noncontrolling interests	11,049	10,521
Total Shareholders' Equity	1,775,912	1,835,276
Total Liabilities and Shareholders' Equity	$ 3,034,450	$ 3,120,013

ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED STATEMENT OF OPERATIONS AND

COMPREHENSIVE INCOME (LOSS)

For the Three and Nine Months Ended June 29, 2018, and June 30, 2017

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	June 29, 2018	June 30, 2017	June 29, 2018	June 30, 2017
Net Sales	$499,871	$504,107	$1,499,545	$1,471,654
Cost of Sales	329,951	330,408	1,017,562	977,837
	169,920	173,699	481,983	493,817
Expenses				
Selling, general & administrative	98,895	93,615	299,817	286,649
Research, development and engineering	22,830	30,190	73,397	80,937
License fee income	-	-	(5,293)	-
Loss (gain) on sale of business	(97)	-	5,213	-
Insurance recovery	-	-	-	(7,789)
Total Expenses	121,628	123,805	373,134	359,797
Operating Earnings from Continuing Operations	48,292	49,894	108,849	134,020
Interest Income	(579)	(150)	(1,326)	(346)
Interest Expense	7,902	7,299	23,673	22,645
Earnings from Continuing Operations Before Income Taxes	40,969	42,745	86,502	111,721
Income Tax Expense	11,094	10,703	66,962	23,320
Earnings from Continuing Operations Including Noncontrolling Interests	29,875	32,042	19,540	88,401
Earnings Attributable to Noncontrolling Interests	(158)	(278)	(684)	(1,069)
Earnings from Continuing Operations Attributable to Esterline, Net of Tax	29,717	31,764	18,856	87,332
Loss from Discontinued Operations Attributable to Esterline, Net of Tax	(1,894)	(815)	(2,137)	(6,185)
Net Earnings Attributable to Esterline	$27,823	$30,949	$16,719	$81,147
Earnings (Loss) Per Share Attributable to Esterline - Basic:				
Continuing operations	$1.01	$1.07	$0.63	$2.94
Discontinued operations	(0.06)	(0.03)	(0.07)	(0.21)
Earnings (Loss) Per Share	$0.95	$1.04	$0.56	$2.73

Earnings (Loss) Per Share Attributable to Esterline - Diluted:				
Continuing operations	$1.00	$1.06	$0.63	$2.92
Discontinued operations	(0.06)	(0.03)	(0.07)	(0.21)
Earnings (Loss) Per Share	$0.94	$1.03	$0.56	$2.71
Net Earnings (Loss)	$27,823	$30,949	$16,719	$81,147
Change in Fair Value of Derivative Financial Instruments	(13,588)	11,966	(20,961)	11,034
Income Tax Expense (Benefit)	(4,104)	3,575	(6,038)	3,094
	(9,484)	8,391	(14,923)	7,940
Change in Pension and Post-Retirement Obligations	1,311	536	3,172	4,132
Income Tax Expense	359	284	833	1,536
	952	252	2,339	2,596
Foreign Currency Translation Adjustment	(50,889)	46,763	(32,710)	9,926
Comprehensive Income (Loss)	$(31,598)	$86,355	$(28,575)	$101,609

ESTERLINE TECHNOLOGIES CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS

For the Nine Months Ended June 29, 2018, and June 30, 2017

(Unaudited)

(In thousands)

	June 29, 2018	June 30, 2017
Cash Flows Provided (Used) by Operating Activities		
Net earnings (loss) including noncontrolling interests	$17,403	$82,216
Adjustments to reconcile net earnings (loss) including noncontrolling interests to net cash provided (used) by operating activities:		
Depreciation and amortization	79,827	77,005
Deferred income taxes	(2,724)	(11,640)
Share-based compensation	9,424	7,549
Loss on disposal of fixed assets	2,101	-
Loss on sale of business	5,213	-
Gain on sale of discontinued operations	-	(793)
Gain (loss) on assets held for sale	780	3,537
Working capital changes:		
Accounts receivable	17,125	23,493
Inventories	(26,300)	(31,462)
Prepaid expenses	(5,254)	(4,153)
Other current assets	(956)	(263)
Accounts payable	(1,156)	3,258
Accrued liabilities	(21,891)	(13,416)
U.S. and foreign income taxes	718	(7,621)
Long-term U.S. income taxes payable	38,640	-
Other liabilities	(2,765)	2,292
Other, net	9,209	8,867
	119,394	138,869
Cash Flows Provided (Used) by Investing Activities		
Purchase of capital assets	(39,249)	(42,153)
Proceeds from sale of capital assets	434	-
Proceeds from sale of business	47,814	600
	8,999	(41,553)
Cash Flows Provided (Used) by Financing Activities		
Proceeds provided by stock issuance under employee stock plans	3,101	26,901
Withholding taxes on restricted stock units vested	(402)	(1,115)
Shares repurchased	(43,450)	-
Repayment of long-term credit facilities	(70,000)	(95,000)

Repayment of long-term debt	(10,701)	(12,872)
Proceeds from issuance of long-term credit facilities	45,000	5,000
	(76,452)	(77,086)
Effect of Foreign Exchange Rates on Cash and Cash Equivalents	(8,728)	648
Net Increase (Decrease) in Cash and Cash Equivalents	43,213	20,878
Cash and Cash Equivalents - Beginning of Year	307,826	258,520
Cash and Cash Equivalents - End of Period	$351,039	$279,398
Supplemental Cash Flow Information:		
Cash paid for interest	$25,295	$24,094
Cash paid for taxes	23,671	38,641

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ESTERLINE TECHNOLOGIES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Three and Nine Months Ended June 29, 2018, and June 30, 2017

Note 1 – Basis of Presentation

The consolidated balance sheet as of June 29, 2018, the consolidated statement of operations and comprehensive income (loss) for the three and nine months ended June 29, 2018, and June 30, 2017, and the consolidated statement of cash flows for the nine months ended June 29, 2018, and June 30, 2017, are unaudited. In the opinion of management, all of the necessary adjustments, consisting of normal recurring accruals, have been made to present fairly the financial statements referred to above in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the above statements do not include all of the footnotes required for complete financial statements. The results of operations and cash flows for the interim periods presented are not necessarily indicative of results that can be expected for the full year.

The notes to the consolidated financial statements in the Company's Annual Report on Form 10-K/A for the fiscal year ended September 29, 2017, provide a summary of significant accounting policies and additional financial information that should be read in conjunction with this Form 10-Q.

The timing of the Company's revenues is impacted by the purchasing patterns of customers and, as a result, revenues are not generated evenly throughout the year. Moreover, the Company's first fiscal quarter, October through December, includes significant holiday periods in both Europe and North America, resulting in fewer business days.

Note 2 – Recent Accounting Pronouncements

In August 2017 the Financial Accounting Standards Board ("FASB") amended its guidance on the financial reporting of hedging relationships. The new guidance eliminates the requirement to separately measure and report hedge ineffectiveness, expands permissible cash flow hedges on contractually specified components, and simplifies hedge documentation and effectiveness assessment. The guidance will be effective at the beginning of the Company's first quarter of fiscal year 2020 and will require a modified retrospective approach on existing cash flow and net investment hedges. The presentation and disclosure requirements will be applied prospectively. The Company is currently evaluating the impact this guidance will have on the Company's consolidated financial statements and the timing of adoption.

In March 2017 the FASB issued new guidance on the presentation of the net periodic cost of postretirement benefit programs. The new standard requires sponsors of defined benefit postretirement plans to present the non-service cost components of net periodic benefit cost separate from the service cost component on the income statement. The new standard also requires that the non-service cost components of net periodic benefit cost no longer be capitalized within assets. The Company is evaluating the effects the standard will have on the Company's consolidated financial statements and related disclosures beyond the change in income statement presentation. This new standard is effective for the Company in fiscal year 2019, with early adoption permitted. The Company plans to adopt the new standard in fiscal 2019.

In January 2017 the FASB issued new guidance regarding the goodwill impairment test. The new guidance eliminates the Step 2 valuation test when evaluating goodwill for impairment. The new guidance requires that an entity performs its annual or interim goodwill test by comparing the fair value of the reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The guidance is effective for the Company in fiscal year 2021, with early adoption permitted. The standard was implemented in the first quarter of fiscal 2018. There was no impact on the Company's financial statements as a result of adopting this guidance.

In October 2016 the FASB issued new guidance regarding income taxes. The new guidance will require the tax effects of intercompany transactions, other than sales of inventory, to be recognized currently, eliminating an exception under current Generally Accepted Accounting Principles (GAAP) in which the tax effects of intra-entity asset transfers are deferred until the transferred asset is sold to a third party or otherwise recovered through use. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The guidance will be effective for the Company in fiscal year 2019, with early adoption permitted. The Company plans to adopt the new standard in fiscal 2019.

In August 2016 the FASB issued new guidance addressing how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The guidance will be effective for the Company in fiscal year 2019, with early adoption permitted. The Company plans to adopt the new standard in fiscal 2019.

In June 2016 the FASB issued a new standard on the measurement of credit losses, which will impact the Company's measurement of trade receivables. The new standard replaces the current incurred loss model with a forward-looking expected loss model that is likely

to result in earlier recognition of losses. The Company is evaluating the effect the updated standard will have on the Company's consolidated financial statements and related disclosures. The new standard is effective for the Company in 2021, with early adoption permitted, but not earlier than 2020. The Company will adopt the new standard in fiscal 2020.

In February 2016 the FASB issued a new lease accounting standard, which provides revised guidance on accounting for lease arrangements by both lessors and lessees. The central requirement of the new standard is that lessees must recognize lease-related assets and liabilities for all leases with a term longer than 12 months. The Company is evaluating the effect the standard will have on the Company's consolidated financial statements and related disclosures. The new standard is effective for the Company in fiscal year 2020, with early adoption permitted. The Company will adopt the new standard in fiscal 2020.

In July 2015 the FASB issued guidance which simplifies the subsequent measurement of inventory by requiring inventory to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling price of inventory in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. This new guidance was adopted in the first quarter of fiscal 2018, with no impact to the Company's consolidated financial statements and related disclosures.

Revenue Recognition

In May 2014 the FASB issued a comprehensive new revenue recognition standard that effectively replaces all current guidance on the topic. The guidance permits the use of either a retrospective or a cumulative effect transition method.

The Company has performed a review of the new guidance against the Company's current accounting practices. The Company has reviewed a representative sample of contracts and other agreements with customers and evaluated the provisions contained within these agreements compared with the amended guidance.

This amended guidance is expected to change the revenue recognition practices for a number of revenue streams across the Company's businesses; the most significant will be for certain U.S. government contracts and certain other contracts that meet one or more of the mandatory criteria, which will move revenue recognition from a "point-in-time" basis to an "over-time" basis. The ongoing effect of recording revenue on an "over-time" basis is not expected to be materially different than under the historical guidance.

The amended guidance is also expected to change the recognition of certain development costs that are contractually guaranteed for reimbursement by our customers. Contractually guaranteed reimbursements for development efforts are currently recognized as the development activities are performed. Under the amended guidance, the contractually guaranteed reimbursement specific to the development effort will be deferred as a contract liability and recognized as revenue when future products are delivered to the customer. This requirement applies where the Company does not transfer all intellectual property rights related to the development effort to the customer or does not have an enforceable right to payment for performance completed to date. The costs associated with development effort under an arrangement with contractually guaranteed reimbursement will also be deferred, up to the amount reimbursed, and recognized through cost of goods sold as products are delivered to the customer. The ongoing effect of deferring contractually guaranteed reimbursements and the related costs until products are delivered to the customer is not expected to be materially different from the historical guidance.

The new standard also significantly enhances required disclosures regarding revenue and related assets and liabilities. The Company is in the process of implementing changes to business processes, systems and internal controls required to adopt the new accounting standard.

The updated standard becomes effective for the Company in the first quarter of fiscal 2019, with early adoption permitted. The Company expects to apply the standard using the modified retrospective approach, with a cumulative

effect adjustment recognized at the beginning of fiscal year 2019.

Note 3 – Earnings Per Share and Shareholders' Equity

Basic earnings per share is computed on the basis of the weighted average number of shares outstanding during the year. Diluted earnings per share includes the dilutive effect of stock options, restricted stock units and share units related to the Company's performance share plan to the extent that performance share plan objectives are met. Common shares issuable from stock options excluded from the calculation of diluted earnings per shares because they were anti-dilutive were 950,790 and 945,572 for the three and nine months ended June 29, 2018. Common shares issuable from stock options excluded from the calculation of diluted earnings per share because they were anti-dilutive were 605,725 and 690,475 for the three and nine months ended June 30, 2017, respectively. Shares used for calculating earnings per share are disclosed in the following table:

In Thousands	Three Months Ended		Nine Months Ended	
	June 29, 2018	June 30, 2017	June 29, 2018	June 30, 2017
Shares used for basic earnings per share	29,430	29,830	29,649	29,698
Shares used for diluted earnings per share	29,548	30,068	29,775	29,953

The authorized capital stock of the Company consists of 25,000 shares of preferred stock ($100 par value), 475,000 shares of serial preferred stock ($1.00 par value), each issuable in series, and 60,000,000 shares of common stock ($.20 par value). As of June 29, 2018, and September 29, 2017, there were no shares of preferred stock or serial preferred stock outstanding.

In June 2014 the Company's Board of Directors approved a $200 million share repurchase program. In March 2015 the Company's Board of Directors approved an additional $200 million for the share repurchase program. Under the program, the Company is authorized to repurchase up to $400 million of outstanding shares of common stock from time to time, depending on market conditions, share price and other factors. Repurchases may be made in the open market or through private transactions, in accordance with SEC requirements. The Company may enter into a Rule 10(b)5-1 plan designed to facilitate the repurchase of all or a portion of the repurchase amount. The program does not require the Company to acquire a specific number of shares. Common stock repurchased can be reissued, and accordingly, the Company accounts for repurchased stock under the cost method of accounting.

During the three months ended June 29, 2018, there were no shares repurchased. During the nine months ended June 29, 2018, the Company repurchased 601,400 shares under this program at an average price paid per share of $72.25, for an aggregate purchase price of $43.4 million. There were no shares repurchased during the three or nine months ended June 30, 2017. There have been no shares repurchased subsequent to June 29, 2018. Since the program began, the Company has repurchased 3,737,327 shares for an aggregate purchase price of $352.0 million, with $48.0 million in shares remaining available for repurchase in the future.

Changes in issued and outstanding common shares are summarized as follows:

	Year Ended

	Nine Months Ended	
	June 29, 2018	September 29, 2017
Shares Issued:		
Balance, beginning of year	33,117,473	32,564,252
Shares issued under share-based compensation plans	60,479	553,221
Balance, end of current period	33,177,952	33,117,473
Treasury Stock:		
Balance, beginning of year	(3,135,927)	(3,135,927)
Shares purchased	(601,400)	-
Balance, end of current period	(3,737,327)	(3,135,927)
Shares outstanding, end of period	29,440,625	29,981,546

The components of Accumulated Other Comprehensive Income (Loss):

In Thousands	June 29, 2018	September 29, 2017
Unrealized gain (loss) on derivative contracts	$(7,492)	$13,469
Tax effect	2,146	(3,892)
	(5,346)	9,577
Pension and post-retirement obligations	(78,610)	(81,782)
Tax effect	27,123	27,956
	(51,487)	(53,826)
Foreign currency translation adjustment	(255,331)	(222,621)
Accumulated other comprehensive income (loss)	$(312,164)	$(266,870)

Note 4 – Retirement Benefits

The Company's pension plans principally include a U.S. pension plan maintained by Esterline and a non-U.S. plan maintained by CMC Electronics, Inc. (CMC), a wholly owned subsidiary of the Company. The Company also sponsors a number of other non-U.S. defined benefit pension plans, primarily in Belgium, France and Germany. Components of periodic pension cost consisted of the following:

In Thousands	Three Months Ended		Nine Months Ended	
	June 29, 2018	June 30, 2017	June 29, 2018	June 30, 2017
Components of Net Periodic Cost				
Service cost	$3,356	$3,287	$10,125	$10,012
Interest cost	4,085	3,838	12,312	11,293
Expected return on plan assets	(6,772)	(6,241)	(20,406)	(18,796)
Amortization of prior service cost	123	114	376	343
Amortization of actuarial (gain) loss	796	1,996	2,392	5,397
Net periodic cost	$1,588	$2,994	$4,799	$8,249

The Company amortizes prior service cost and actuarial gains and losses from accumulated other comprehensive income to expense over the remaining service period.

Note 5 – Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value hierarchy has been established that prioritizes the inputs to valuation techniques used to measure fair value. An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The hierarchy of fair value measurements is described below:

Level 1 – Valuations are based on quoted prices that the Company has the ability to obtain in actively traded markets for identical assets and liabilities. Since valuations are based on quoted prices that are readily and regularly available in an active market or exchange traded market, a valuation of these instruments does not require a significant degree of judgment.

Level 2 – Valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuations are based on model-based techniques for which some or all of the assumptions are not observable and therefore obtained from indirect market information that is significant to the overall fair value measurement and which require a significant degree of management judgment.

The following table sets forth the Company's financial assets and liabilities that were measured at fair value on a recurring basis by level within the fair value hierarchy at June 29, 2018, and September 29, 2017.

In Thousands	Level 2	
	June 29, 2018	September 29, 2017
Assets:		
Derivative contracts designated as hedging instruments	$1,014	$ 13,932
Derivative contracts not designated as hedging instruments	84	284
Embedded derivatives	3,298	746
Liabilities:		
Derivative contracts designated as hedging instruments	$8,507	$ 464
Derivative contracts not designated as hedging instruments	1,440	2,440
Embedded derivatives	494	2,239

In Thousands	Level 3	
	June 29, 2018	September 29, 2017
Assets:		
Estimated value of assets held for sale	$16,684	$ 19,835
Liabilities:		
Estimated value of liabilities held for sale	$6,122	$ 8,908

The Company's embedded derivatives are the result of entering into sales or purchase contracts that are denominated in a currency other than the Company's functional currency or the supplier's or customer's functional currency. The fair value is determined by calculating the difference between quoted exchange rates at the time the contract was entered into and the period-end exchange rate. These contracts are categorized as Level 2 in the fair value hierarchy.

The Company's derivative contracts consist of foreign currency exchange contracts and, from time to time, interest rate swap agreements. These derivative contracts are over the counter, and their fair value is determined using modeling techniques that include market inputs such as interest rates, yield curves, and currency exchange rates. These contracts are categorized as Level 2 in the fair value hierarchy.

The Company's Board of Directors previously approved a plan to sell certain non-core business units. Based upon the estimated fair values, the Company adjusted the carrying value of the assets and liabilities of the businesses to fair value. Principal assumptions used in measuring the estimated value of assets and liabilities held for sale included estimated selling price of the discontinued business, discount rates, industry growth rates, and pricing of comparable transactions in the market. The valuations are categorized as Level 3 in the fair value hierarchy.

Note 6 – Derivative Financial Instruments

The Company uses derivative financial instruments in the form of foreign currency forward exchange contracts and interest rate swap contracts for the purpose of minimizing exposure to changes in foreign currency exchange rates on business transactions and interest rates, respectively. The Company's policy is to execute such instruments with banks the Company believes to be creditworthy and not to enter into derivative financial instruments for speculative purposes. These derivative financial instruments do not subject the Company to undue risk, as gains and losses on these instruments generally offset gains and losses on the underlying assets, liabilities, or anticipated transactions that are being hedged.

All derivative financial instruments are recorded at fair value in the Consolidated Balance Sheet. For a derivative that has not been designated as an accounting hedge, the change in the fair value is recognized immediately through earnings. For a derivative that has been designated as an accounting hedge of an existing asset or liability (a fair value hedge), the change in the fair value of both the derivative and underlying asset or liability is recognized immediately through earnings. For a derivative designated as an accounting hedge of an anticipated transaction (a cash flow hedge), the change in the fair value is recorded on the Consolidated Balance Sheet in Accumulated Other Comprehensive Income (AOCI) to the extent the derivative is effective in mitigating the exposure related to the anticipated transaction. The change in the fair value related to the ineffective portion of the hedge, if any, is immediately recognized in earnings. The amount recorded within AOCI is reclassified into earnings in the same period during which the underlying hedged transaction affects earnings.

The fair value of derivative instruments is presented on a gross basis, as the Company does not have any derivative contracts which are subject to master netting arrangements. The Company did not have any hedges with credit-risk-related contingent features or that required the posting of collateral as of June 29, 2018, and September 29, 2017. The cash flows from derivative contracts are recorded in operating activities in the Consolidated Statement of Cash Flows.

Foreign Currency Forward Exchange Contracts

The Company transacts business in various foreign currencies, which subjects the Company's cash flows and earnings to exposure related to changes in foreign currency exchange rates. These exposures arise primarily from purchases or sales of products and services from third parties. Foreign currency forward exchange contracts provide for the purchase or sale of foreign currencies at specified future dates at specified exchange rates, and are used to offset changes in the fair value of certain assets or liabilities or forecasted cash flows resulting from transactions denominated in foreign currencies. At June 29, 2018, and September 29, 2017, the Company had outstanding foreign currency forward exchange contracts principally to sell U.S. dollars with notional amounts of $465.9 million and $406.9 million, respectively. The notional value of our foreign currency forward contracts includes $93.0 million related to the hedge of a portion of our net monetary assets, including the embedded derivatives in our backlog. These notional values consist primarily of contracts for the British pound sterling, Canadian dollar, and European euro and are stated in U.S. dollar equivalents at spot exchange rates at the respective dates.

Interest Rate Swaps

The Company manages its exposure to interest rate risk by maintaining an appropriate mix of fixed and variable rate debt, which over time are expected to moderate the costs of debt financing. When considered necessary, the Company may use financial instruments in the form of interest rate swaps to help meet this objective.

Embedded Derivative Instruments

The Company's embedded derivatives are the result of entering into sales or purchase contracts that are denominated in a currency other than the Company's functional currency or the supplier's or customer's functional currency.

Net Investment Hedge

In April 2015 the Company issued €330.0 million in 3.625% Senior Notes due April 2023 (2023 Notes) which require semi-annual interest payments in April and October each year until maturity. The Company designated the 2023 Notes and accrued interest as a hedge of the investment of certain foreign business units. The foreign currency gain or loss that is effective as a hedge is reported as a component of AOCI in shareholders' equity. To the extent that this hedge is ineffective, the foreign currency gain or loss is recorded in earnings. There has been no ineffectiveness of the hedge since inception.

Fair Value of Derivative Instruments

Fair value of derivative instruments in the Consolidated Balance Sheet at June 29, 2018, and September 29, 2017, consisted of:

In Thousands		Fair Value	
	Classification	June 29, 2018	September 29, 2017

Foreign Currency Forward Exchange Contracts:			
	Other current assets	$1,081	$ 11,433
	Other assets	17	2,783
	Accrued liabilities	6,587	2,506
	Other liabilities	3,360	398
Embedded Derivative Instruments:			
	Other current assets	$1,776	$ 604
	Other assets	1,522	142
	Accrued liabilities	392	1,657
	Other liabilities	102	582

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The effect of derivative instruments on the Consolidated Statement of Operations and Comprehensive Income (Loss) for the three and nine months ended June 29, 2018, and June 30, 2017, consisted of:

Fair Value Hedges and Embedded Derivatives

The Company recognized the following gains (losses) on contracts designated as fair value hedges and embedded derivatives:

In Thousands	Three Months Ended		Nine Months Ended	
Gain (Loss)	June 29, 2018	June 30, 2017	June 29, 2018	June 30, 2017
Fair Value Hedges:				
Recognized in cost of sales	$(547)	$1,086	$(1,818)	$845
Recognized in selling, general & administrative	(1,652)	906	(2,666)	699
Embedded derivatives:				
Recognized in sales	$868	$(952)	$1,536	$(1,169)

Cash Flow Hedges

The Company recognized the following gains (losses) on contracts designated as cash flow hedges:

In Thousands	Three Months Ended		Nine Months Ended	
Gain (Loss)	June 29, 2018	June 30, 2017	June 29, 2018	June 30, 2017
Foreign currency forward exchange contracts:				
Recognized in AOCI (effective portion)	$(15,087)	$14,250	$(29,378)	$21,188
Reclassified from AOCI into sales	1,499	(2,284)	8,417	(10,154)

Net Investment Hedges

The Company recognized the following gains (losses) on contracts designated as net investment hedges:

In Thousands	Three Months Ended		Nine Months Ended	
Gain (Loss)	June 29, 2018	June 30, 2017	June 29, 2018	June 30, 2017
2023 Notes and Accrued Interest:				

Recognized in AOCI	$21,198	$(25,512)	$4,219	$(6,133)

During the third quarter of fiscal 2018 and 2017, the Company recorded a loss of $4.0 million and a gain of $5.3 million, respectively, on foreign currency forward exchange contracts that have not been designated as accounting hedges. During the first nine months of fiscal 2018 and 2017, the Company recorded a loss of $5.4 million and a gain of $4.7 million, respectively, on foreign currency forward exchange contracts that have not been designated as accounting hedges. These foreign currency exchange gains and losses are included in selling, general and administrative expense.

There was no significant impact to the Company's earnings related to the ineffective portion of any hedging instruments during the first nine months of fiscal 2018 and 2017. In addition, there was no significant impact to the Company's earnings when a hedged firm commitment no longer qualified as a fair value hedge or when a hedged forecasted transaction no longer qualified as a cash flow hedge during the first nine months of fiscal 2018 and 2017.

Amounts included in AOCI are reclassified into earnings when the hedged transaction settles. The Company expects to reclassify approximately $4.4 million of net loss into earnings over the next 12 months. The maximum duration of the Company's foreign currency cash flow hedge contracts at June 29, 2018, was 24 months.

Note 7 – Insurance Recovery

In fiscal 2017 the Company received a $7.8 million insurance recovery due to an energetic incident at one of its countermeasure operations, which occurred in the third quarter of fiscal 2016. Management does not anticipate additional insurance recoveries arising from this matter in fiscal 2018. The insurance recovery is reported as a separate line item on the Consolidated Statement of Operations and Comprehensive Income (Loss) and is included in Advanced Materials segment earnings.

Note 8 – License Fee Income

In January 2018 the Company granted an exclusive license to a third party to manufacture, repair and sell certain legacy avionics components for $4.5 million. In addition, the Company sold $0.4 million in inventory. The Company will be paid a 15% royalty on future sales of the licensed product. The Company recorded $2.3 million in license fee income, net of the write-off of the related intangible assets of $2.2 million in the second quarter of fiscal 2018. In December 2017 the Company granted an exclusive license to a third party to manufacture, repair and sell certain legacy control devices for $3.0 million. Additionally, the Company sold certain inventory and manufacturing equipment to the licensee for $1.0 million. The Company will be paid a 15% royalty on future sales of the licensed product. The license fee income is reported as a separate line item on the Consolidated Statement of Operations and Comprehensive Income (Loss) and is included in Avionics & Controls segment earnings.

Note 9 – Sale of Business

In March 2018 the Board of Directors approved the sale of the Kirkhill business, and on March 15, 2018, the Company sold the assets and certain liabilities of this business to TransDigm, Inc. for $50 million before selling costs. The Company incurred an estimated $5.2 million loss on sale of the business and an estimated $0.8 million gain after tax due to the release of a valuation allowance on a capital loss carryover. Based on current discontinued operations accounting guidance, the sale of the Kirkhill business does not qualify as a discontinued operation.

Note 10 – Income Taxes

The Tax Cuts and Jobs Act (the Act) was enacted on December 22, 2017. The Act reduces the U.S. federal corporate tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, and creates new taxes on certain foreign sourced earnings.

The SEC recognized that a company's review of certain income tax effects of the Act may be incomplete at the time financial statements are issued. According to FASB Accounting Standards Update No. 2018-05, if a company does not have the necessary information available for certain effects of the Act, the Company may record provisional numbers and adjust those amounts during the measurement period not to extend beyond one year.

At June 29, 2018, the Company had not completed the accounting for the tax effects of enactment of the Act; however, in certain cases, as described below, the Company made a reasonable estimate of the effects on its existing deferred tax balances and the one-time transition tax. In other cases, the Company was not able to make a reasonable estimate in the first nine months of fiscal 2018 and continued to account for those items based on its existing accounting under ASC 740, Income Taxes, and the provisions of the tax laws that were in effect immediately prior to enactment. For the items for which the Company was able to determine a reasonable estimate, the Company recognized a provisional amount of $48.6 million, which is included as a component of income tax expense from continuing operations. In all cases, the Company will continue to make and refine the calculations as additional analysis is completed. In addition, the estimates may also be affected as the Company gains a more thorough understanding of the tax law.

Provisional Amounts

U.S. Deferred Tax Assets and Liabilities

The Company remeasured its deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. However, the Company is still analyzing certain aspects of the Act and refining its calculations, including evaluation of limits on employee remuneration, which could affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the remeasurement of the deferred tax balance was $6.6 million.

Foreign Tax Effects

The one-time transition tax is based on the Company's total post-1986 earnings and profits (E&P) that the Company previously deferred from U.S. income taxes. The Company recorded a provisional amount for its one-time transition tax liability resulting in an increase in income tax expense of $42.0 million. The Company is still analyzing certain aspects of the Act and refining its calculations, which could potentially affect the measurement of these amounts, including the benefit attributable to foreign tax credits and related elections. Further, the transition tax is based in part on the amount of those earnings held in cash and other specified assets. This amount may change when the Company finalizes the calculations of post-1986 foreign E&P previously deferred from U.S. taxation and finalizes the amounts of cash or other specified assets. The Act sets certain limits that may restrict the Company's use of any foreign tax credits generated from the one-time transaction tax. As of the date of this report, management was not able to (1) determine a reasonable estimate of the tax liability for the Company's remaining outside basis; (2) complete an analysis of the Global Intangible Low Taxed Income (GILTI); or (3) evaluate how the Act will impact the Company's existing ASC 740-10-25-3 position to indefinitely reinvest unremitted foreign earnings.

The income tax rate for the third quarter of fiscal 2018 was 27.1% compared with the prior-year period of 25.0%. The difference in the effective tax rate was primarily driven by the repeal of certain benefits of foreign tax regimes, discrete tax benefits related to employee share-based payment awards, with an offset associated with a reduction in the U.S. federal statutory tax rate.

The income tax rate for the first nine months of fiscal 2018 was 77.4% mainly due to the effect of the Act. In addition, the income tax rate for the first nine months of fiscal 2018 reflected a $4.6 million tax benefit from a release of a capital loss valuation reserve due to a realized capital gain upon the sale of the Kirkhill business.

The 20.9% income tax rate in the first nine months of fiscal 2017 reflected the following items: the Company recognized $8.0 million of discrete tax benefits primarily related to a reduction of the income tax rate in France for fiscal 2020 and the early adoption of the accounting standard update for employee share-based payment awards.

By the end of fiscal 2018, it is reasonably possible that approximately $1.0 million of tax benefits that are currently unrecognized could be recognized as a result of settlement of examinations and/or the expiration of applicable statutes of limitations. The Company recognizes interest related to unrecognized tax benefits in income tax expense.

Note 11 – Debt

Long-term debt at June 29, 2018, and September 29, 2017, consisted of the following:

In Thousands	June 29, 2018	September 29, 2017
U.S. credit facility	$25,000	$50,000
U.S. Term Loan, due April 2020	215,625	225,000
3.625% Senior Notes, due April 2023	385,539	389,862
Government refundable advances	44,068	45,549
Obligation under capital leases	69,817	71,091
Debt issuance costs	(3,920)	(4,654)
	736,129	776,848
Less current maturities	15,245	17,424
Carrying amount of long-term debt	$720,884	$759,424

U.S. Credit Facility

On April 9, 2015, the Company amended its secured credit facility to extend the maturity to April 9, 2020, increase the revolving credit facility to $500 million, and provide for a delayed-draw term loan facility of $250 million, which was drawn on August 3, 2015. The Company recorded $2.3 million in debt issuance costs. The credit facility is secured by substantially all the Company's assets, and interest is based on standard inter-bank offering rates. The interest rate ranges from LIBOR plus 1.25% to LIBOR plus 2.00% depending on leverage ratios at the time the funds are drawn. At June 29, 2018, the Company had $25.0 million outstanding under the secured credit facility at an interest rate of LIBOR plus 1.50%, which was 3.6%.

U.S. Term Loan, due April 2020

On August 3, 2015, the Company borrowed $250 million under the amended secured credit facility (U.S. Term Loan, due 2020). The interest rate on the U.S. Term Loan, due 2020, ranges from LIBOR plus 1.25% to LIBOR plus 2.00%. At June 29, 2018, the interest rate was LIBOR plus 1.50%, or 3.6%. The loan amortizes at 1.25% of the original principal balance quarterly through March 2020, with the remaining balance due in April 2020.

3.625% Senior Notes, due April 2023

In April 2015 TA Mfg. Limited, a wholly owned subsidiary of the Company, issued €330.0 million in 3.625% Notes, due 2023, requiring semi-annual interest payments in April and October of each year until maturity. The notes are designated as a net investment hedge and translated to U.S. dollars each period, with the associated gains or losses recorded to AOCI. The net proceeds from the sale of the notes, after deducting $5.9 million of debt issuance costs, were $350.8 million. The 2023 Notes are general unsecured senior obligations of the Company. The 2023 Notes are unconditionally guaranteed on a senior basis by the Company and certain subsidiaries of the Company that are guarantors under the Company’s existing secured credit facility. The 2023 Notes are subject to redemption at the option of the Company, in whole or in part at redemption prices starting at 102.719% of the principal amount plus accrued interest during the period beginning April 15, 2018, and declining annually to 100% of principal and accrued interest on or after April 15, 2021.

Based on quoted market prices, the fair value of the Company’s 2023 Notes was $388.9 million and $403.2 million as of June 29, 2018, and September 29, 2017, respectively. The carrying amount of the secured credit facility and the U.S. Term Loan, due 2020,

approximate fair value. The estimate of fair value for the 2023 Notes is based on Level 2 inputs as defined in the fair value hierarchy described in Note 5.

Government Refundable Advances

Government refundable advances consist of payments received from the Canadian government to assist in research and development related to commercial aviation. The requirement to repay this advance is solely based on year-over-year commercial aviation revenue growth at CMC beginning in 2014. Imputed interest on the advance was 2.52% at June 29, 2018. The debt recognized was $44.1 million and $45.5 million at June 29, 2018, and September 29, 2017, respectively.

Obligation Under Capital Lease

The Company leases certain buildings and equipment under capital leases. The present value of the minimum capital lease payments, net of the current portion, totaled $67.6 million and $69.0 million as of June 29, 2018, and September 29, 2017, respectively.

Note 12 – Commitments and Contingencies

The Company is party to various lawsuits and claims, both as a plaintiff and defendant, and has contingent liabilities arising from the conduct of business, none of which, in the opinion of management, is expected to have a material effect on the Company's financial position or results of operations. The Company believes that it has made appropriate and adequate provisions for contingent liabilities.

On March 5, 2014, the Company entered into a Consent Agreement with the U.S. Department of State's Directorate of Defense Trade Controls Office of Defense Trade Controls Compliance (DTCC) to resolve alleged International Traffic in Arms Regulations (ITAR) civil violations. The Consent Agreement was closed in fiscal 2017.

Note 13 – Employee Stock Plans

As of June 29, 2018, the Company had three share-based compensation plans, which are described below. The compensation cost that has been charged against income for those plans was $9.4 million and $7.5 million for the first nine months of fiscal 2018 and 2017, respectively. During the first nine months of fiscal 2018 and 2017, the Company issued 60,479 and 532,491 shares, respectively, under its share-based compensation plans.

Employee Stock Purchase Plan (ESPP)

The ESPP is a "safe-harbor" designed plan whereby shares are purchased by participants at a discount of 5% of the market value on the purchase date and, therefore, compensation cost is not recorded.

Employee Sharesave Scheme

The Company offers shares under its employee sharesave scheme for U.K. employees. This plan allows participants the option to purchase shares at a 5% discount of the market price of the stock as of the beginning of the offering period. The term of these options is three years. The sharesave scheme is not a "safe-harbor" design, and therefore, compensation cost is recognized on this plan. Under the sharesave scheme, option exercise prices are equal to the fair market value of the Company's common stock on the date of grant. The Company granted 20,981 and 11,338 options in the nine months ended June 29, 2018, and June 30, 2017, respectively. The weighted-average grant date fair value of options granted during the nine months ended June 29, 2018, and June 30, 2017, was $22.67 and $24.61, respectively.

The fair value of the awards under the employee share-save scheme was estimated using a Black-Scholes pricing model which uses the assumptions noted in the following table. The risk-free rate for the contractual life of the options is based on the U.S. Treasury zero coupon issues in effect at the time of grant.

	Nine Months Ended	
	June 29, 2018	June 30, 2017
Volatility	38.89 %	35.58 %
Risk-free interest rate	1.98 %	1.75 %
Expected life (years)	3	3
Dividends	0	0

Equity Incentive Plan

Under the equity incentive plan, option exercise prices are equal to the fair market value of the Company's common stock on the date of grant. The Company granted 239,680 and 237,200 options to purchase shares in the nine months ended June 29, 2018, and June 30, 2017, respectively. The weighted-average grant date fair value of options granted during the nine months ended June 29, 2018, and June 30, 2017, was $30.80 and $32.66 per share, respectively.

The fair value of each option granted by the Company was estimated using a Black-Scholes pricing model, which uses the assumptions noted in the following table. The Company uses historical data to estimate volatility of the Company's common stock and option exercise and employee termination assumptions. The risk-free rate for the contractual life of the option is based on the U.S. Treasury zero coupon issues in effect at the time of the grant.

Nine
Months
Ended
June 29,