EASTERN CO
Form 10-Q
November 06, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2017

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: 001-35383

THE EASTERN COMPANY
(Exact name of registrant as specified in its charter)

Connecticut	06-0330020
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

112 Bridge Street, Naugatuck, Connecticut	06770
(Address of principal executive offices)	(Zip Code)

(203) 729-2255
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

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 [X] 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 [X] 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 the 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 [X]
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 [X]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding as of October 18, 2017
Common Stock, No par value	6,261,415

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

ASSETS	September 30, 2017	December 31, 2016
Current Assets		
Cash and cash equivalents	$21,194,091	$22,725,376
Marketable securities	366,554	--
Accounts receivable, less allowances: $507,000 - 2017; $430,000 - 2016	28,448,534	18,135,792
Inventories	45,207,813	34,030,286
Prepaid expenses and other assets	4,398,041	1,858,471
Total Current Assets	99,615,033	76,749,925
Property, Plant and Equipment	70,500,848	64,911,071
Accumulated depreciation	(41,629,685)	(38,745,557)
	28,871,163	26,165,514
Goodwill	32,395,740	14,819,835
Trademarks	3,680,037	166,312
Patents, technology, and other intangibles net of accumulated amortization	9,621,147	1,764,449
Deferred income taxes	1,180,355	4,532,361
	46,877,279	21,282,957
TOTAL ASSETS	$175,363,475	$124,198,396

LIABILITIES AND SHAREHOLDERS' EQUITY	September 30, 2017	December 31, 2016
Current Liabilities		
Accounts payable	$15,327,476	$7,048,174
Accrued compensation	3,273,317	3,112,404
Other accrued expenses	6,360,362	1,812,647
Current portion of long-term debt	6,550,000	892,857
Total Current Liabilities	31,511,155	12,866,082
Other long-term liabilities	288,805	288,805
Long-term debt, less current portion	29,062,500	892,857
Accrued postretirement benefits	1,018,815	1,051,700
Accrued pension cost	25,780,522	26,631,438
Shareholders' Equity		
Voting Preferred Stock, no par value:		
Authorized and unissued: 1,000,000 shares		
Nonvoting Preferred Stock, no par value:		
Authorized and unissued: 1,000,000 shares		
Common Stock, no par value:		
Authorized: 50,000,000 shares		
Issued: 8,956,144 shares in 2017 and 8,950,827 shares in 2016		
Outstanding: 6,261,415 shares in 2017 and 6,256,098 shares in 2016	29,277,169	29,146,622
Treasury Stock: 2,694,729 shares in 2017 and 2016	(19,105,723)	(19,105,723)
Retained earnings	98,779,632	95,631,216
Accumulated other comprehensive income (loss):		
Foreign currency translation	(902,749)	(2,165,081)
Unrealized loss on marketable securities and derivative, net of tax	(9,479)	--
Unrecognized net pension and postretirement benefit costs, net of tax	(20,419,472)	(21,039,520)
Accumulated other comprehensive loss	(21,331,700)	(23,204,601)
Total Shareholders' Equity	87,619,378	82,467,514
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$175,363,475	$124,198,396

See accompanying notes.

THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Nine Months Ended		Three Months Ended	
	September 30, 2017	October 1, 2016	September30, 2017	October 1, 2016
Net sales	$150,095,975	$103,463,316	$56,007,937	$33,478,347
Cost of products sold	(113,888,301)	(77,980,077)	(44,058,406)	(24,105,604)
Gross margin	36,207,674	25,483,239	11,949,531	9,372,743
Engineering expenses	(4,162,151)	(1,991,260)	(1,848,861)	(663,705)
Selling and administrative expenses	(23,749,219)	(16,161,133)	(6,527,029)	(5,444,924)
Operating profit	8,296,304	7,330,846	3,573,641	3,264,114
Interest expense	(659,884)	(97,486)	(327,206)	(28,817)
Other income	69,278	54,687	13,513	28,169
Income before income taxes	7,705,698	7,288,047	3,259,948	3,263,466
Income taxes	2,491,674	2,152,073	1,029,467	863,402
Net income	$5,214,024	$5,135,974	$2,230,481	$2,400,064
Earnings per Share:				
Basic	$.83	$.82	$.36	$.38
Diluted	$.83	$.82	$.35	$.38
Cash dividends per share:	$.33	$.33	$.11	$.11

See accompanying notes.

THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	Nine Months Ended		Three Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
Net income	$5,214,024	$5,135,974	$2,230,481	$2,400,064
Other comprehensive income/(loss):				
Change in foreign currency translation	1,262,332	(311,697)	378,509	(231,831)
Change in fair value marketable securities, net of tax benefit of: 2017 – $22,688 and $17,135, respectively 2016 - $-	41,548	—	31,379	—
Change in fair value of derivative financial instrument, net of tax benefit of: 2017 - $31,275 and $(10,406) 2016 - $-	(51,027)	—	16,978	—
Change in pension and postretirement benefit costs, net of taxes of: 2017 – $338,592 and $112,865 respectively 2016 – $559,542 and $(105,703), respectively	620,048	(696,200)	206,682	192,456
Total other comprehensive	1,872,901	(1,007,897)	633,548	(39,375)

income				
Comprehensive income	$7,086,925	$4,128,077	$2,864,029	$2,630,689

See accompanying notes
6

THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended	
	September 30, 2017	October 1, 2016
Operating Activities		
Net income	$5,214,024	$5,135,974
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,230,174	2,795,699
Unrecognized pension and postretirement benefits	74,839	952,205
Loss on sale of equipment and other assets	18,585	45,313
Provision for doubtful accounts	52,663	—
Issuance of Common Stock for directors' fees	130,547	112,086
Changes in operating assets and liabilities:		
Accounts receivable	(3,894,569)	(1,626,625)
Inventories	2,267,945	2,665,002
Prepaid expenses and other	(2,686,763)	78,914
Other assets	494,750	(67,324)
Accounts payable	1,466,401	(366,454)
Accrued compensation	(172,509)	(215,313)
Other accrued expenses	3,978,256	(526,930)
Net cash provided by operating activities	10,174,343	8,982,547
Investing Activities		
Marketable securities	(366,554)	—
Business Acquisition, net of cash acquired	(42,148,000)	—
Purchases of property, plant and equipment	(1,457,641)	(1,819,894)
Net cash used in investing activities	(43,972,195)	(1,819,894)
Financing Activities		
Proceeds from issuance of long-term debt	31,000,000	—
Proceeds from short term borrowings	6,614,611	—
Payments on revolving credit note	(1,614,611)	—
Principal payments on long-term debt	(2,173,214)	(1,071,428)
Dividends paid	(2,065,607)	(2,063,085)
Net cash provided by (used in) financing activities	31,761,179	(3,134,513)
Effect of exchange rate changes on cash	505,388	(203,066)
Net change in cash and cash equivalents	(1,531,285)	3,825,074
Cash and cash equivalents at beginning of period	22,725,376	17,814,986
Cash and cash equivalents at end of period	$21,194,091	$21,640,060

See accompanying notes.

7

THE EASTERN COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
September 30, 2017

Note A – 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 of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. Refer to the consolidated financial statements of The Eastern Company (the "Company") and the notes thereto included in the Company's Form 10-K for the fiscal year ended December 31, 2016 for additional information.

The accompanying condensed consolidated financial statements are unaudited. However, in the opinion of management, all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the results of operations for interim periods have been reflected therein. All intercompany accounts and transactions are eliminated. Operating results for interim periods are not necessarily indicative of the results that may be expected for the full year.

On April 3, 2017, the Company completed its acquisition of Velvac Holdings, Inc., a Delaware corporation including its subsidiaries ("Velvac"), pursuant to a Securities Purchase Agreement (the "Securities Purchase Agreement"), dated April 3, 2017, by and among Jeffery R. Porter, W. Greg Bland, John Backovitch, Dave Otto, Bob Otto, Timothy Rintelman, Robert Brester, Dan McGrew, Mark Moeller and Prospect Partners II, L.P. (collectively, the "Sellers"). Pursuant to the Securities Purchase Agreement, the Company acquired 100% of the issued and outstanding stock of Velvac from the Sellers (the "Acquisition") for $39.5 million and earnout consideration contingent upon Velvac achieving minimum earnings performance levels with the amount of any such earnout consideration based on a specific percentage (either 7.5% or 15%) of sales of Velvac's new proprietary Road-iQ product line measured over annual calculation periods through April 2022, as set forth in the Securities Purchase Agreement (the "Earnout Consideration"), subject to certain customary post-closing adjustments. The Acquisition was financed with a $31 million term loan from People's United Bank, National Association ("People's"), a $5 million draw down on the Company's $10 million revolving credit facility with People's and $3.5 million in cash. Please refer to the Form 8-K filed on April 7, 2017 and the amendment thereto files on June 19, 2017 for further details.

The condensed consolidated balance sheet as of December 31, 2016 has been derived from the audited consolidated balance sheet as of that date.

Commencing with this Quarterly Report on Form 10-Q, engineering expenses have been separately identified for all periods presented. These expenses have been reclassified from cost of products sold to selling and administrative expenses. Engineering expense is not necessarily a cost of product sold. Rather, these expenses are related to product development.

Note B – Earnings Per Share

The denominators used in the earnings per share computations are as follows:

	Nine Months Ended		Three Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
Basic:				

Weighted average shares outstanding	6,258,278	6,250,185	6,259,872	6,254,287
Diluted:				
Weighted average shares outstanding	6,258,278	6,250,185	6,259,872	6,254,287
Dilutive stock options	36,679	--	36,679	--
Denominator for diluted earnings per share	6,294,957	6,250,185	6,296,551	6,254,287

8

Note C – Inventories, Net

The components of inventories are as follows:

	September 30, 2017	December 31, 2016
Raw material and component parts	$11,729,271	$8,829,236
Work in process	9,456,164	7,118,149
Finished goods	24,022,378	18,082,901
	$45,207,813	$34,030,286

Note D – Segment Information

Segment financial information is as follows:

	Nine Months Ended		Three Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
Revenues:				
Sales to unaffiliated customers:				
Industrial Hardware	$83,500,656	$45,689,104	$32,959,599	$15,210,943
Security Products	46,232,410	43,722,828	16,115,356	13,648,701
Metal Products	20,362,909	14,051,384	6,932,982	4,618,703
	$150,095,975	$103,463,316	$56,007,937	$33,478,347
Income before income taxes:				
Industrial Hardware	$2,877,052	$3,769,045	$1,813,133	$1,574,573
Security Products	4,290,745	4,533,995	1,604,950	1,613,148
Metal Products	1,128,507	(972,194)	155,558	76,393
Operating Profit	8,296,304	7,330,846	3,573,641	3,264,114
Interest expense	(659,884)	(97,486)	(327,206)	(28,817)
Other income	69,278	54,687	13,513	28,169
	$7,705,698	$7,288,047	$3,259,948	$3,263,466

Note E – Recent Accounting Pronouncements

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations – Clarifying the Definition of a Business. ASU 2017-01 provides guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions or dispositions of assets or businesses. The amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The amendment should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is evaluating the impact of the new guidance.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles – Goodwill and Other: Simplifying the Test for Goodwill Impairment. ASU 2017-04 provides guidance to simplify the subsequent measure of goodwill by eliminating Step 2 from the goodwill impairment test. The amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The amendment should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period after January 1, 2017. The Company is evaluating the impact of the new guidance.

In February 2017, the FASB issued ASU No. 2017-06, Plan Accounting: Defined Benefit Pension Plans (Topic 960); Defined Contribution Pension Plans (Topic 962); Health and Welfare Benefit Plans (Topic 965): Employee Benefit Plan Master Trust Reporting. ASU 2017-06 provides guidance for reporting by an employee benefit plan for its interest in a master trust. The amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The amendment should be applied retrospectively with earlier application permitted as of the beginning of an interim or annual reporting period after December 15, 2018. The Company is evaluating the impact of the new guidance.

In March 2017, the FASB issued ASU No. 2017-07, Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. ASU 2017-07 provides guidance to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The amendment should be applied retrospectively with earlier application permitted as of the beginning of an interim or annual reporting period after December 15, 2017. The Company is evaluating the impact of the new guidance.

In September 2017, the FASB issued ASU No. 2017-13, Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840) and Leases (Topic 842). ASU 2017-13 provides guidance regarding amendments to the aforementioned topics following SEC Staff announcement. The amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is evaluating the impact of the new guidance.

The Company has implemented all new accounting pronouncements that are in effect and that could impact its consolidated financial statements and does not believe that there are any other new accounting pronouncements that have been issued, but are not yet effective, that might have a material impact on the consolidated financial statements of the Company.

Note F – Debt

On January 29, 2010, the Company signed a secured loan agreement (the "Loan Agreement") with People's United Bank, National Association ("People's"), which included a $5,000,000 term portion (the "Original Term Loan") and a $10,000,000 revolving credit portion. On January 25, 2012, the Company amended the Loan Agreement by taking an additional $5,000,000 term loan (the "2012 Term Loan"). Interest on the Original Term Loan portion of the Loan Agreement was fixed at 4.98%. Interest on the 2012 Term Loan was fixed at 3.90%. The interest rate on the revolving credit portion of the Loan Agreement varied based on the LIBOR rate or People's Prime rate plus a margin spread of 2.25%, with a floor rate of 3.25% and a maturity date of January 31, 2014. On January 23, 2014, the Company signed an amendment to the Loan Agreement which extended the maturity date of the $10,000,000 revolving credit portion of the Loan Agreement to July 1, 2016 and changed the interest rate to LIBOR plus 2.25%, eliminating the floor previously in place. On June 9, 2016, the Company signed a third amendment to its secured Loan Agreement which extended the maturity date of the $10,000,000 revolver portion of the Loan Agreement to July 1, 2018. On April 3, 2017, the Company signed an amended and restated loan agreement (the "Restated Loan Agreement") with People's that included a $31 million term portion and a $10 million revolving credit portion. Proceeds of the Restated Loan Agreement were used to repay the remaining outstanding term loans of the Company (approximately $1,429,000) and to acquire 100% of the common stock of Velvac Holdings, Inc. (see Note M). The term portion of the Restated Loan Agreement requires quarterly principal payments of $387,500 for a two-year period beginning July 3, 2017. The repayment amount then increases to $775,000 per quarter beginning July 1, 2019. The term portion of the Restated Loan Agreement is a five-year loan with any remaining outstanding balance due on March 1, 2022. The revolving credit portion of the Restated Loan Agreement has a quarterly commitment fee ranging from 0.2% to 0.375% based on operating results. Under the terms of the Restated Loan Agreement, this quarterly commitment fee will be 0.25% for the first six months. The revolving credit portion of the Restated Loan Agreement has a maturity date of April 1, 2022. On April 3, 2017, the Company borrowed approximately $6.6 million on the revolving credit portion of the Restated Loan Agreement. The Company subsequently paid off $1.6 million on the revolving credit portion leaving a balance on such revolving credit portion of $5 million.

The interest rates on the term portion and the revolving credit portion of the Restated Loan Agreement vary. The interest rates may vary based on the LIBOR rate plus a margin spread of 1.75% to 2.50%. The margin spread is based on operating results calculated on a rolling-four-quarter basis. The Company may also borrow funds at People's Prime rate. On September 30, 2017, the interest rate for one half ($15.3 million) of the term portion was 3.24%, using a 1 month LIBOR rate and 3.30% on the remaining balance ($15.3 million) of the term portion based on a 3 month LIBOR rate. The interest rate on the $5 million of the revolving credit portion was 3.24%.

The Company's loan covenants under the Restated Loan Agreement require the Company to maintain a consolidated minimum debt service coverage ratio of at least 1.1 to 1 for periods through December 31, 2018 and 1.2 to 1 thereafter, which is to be tested quarterly on a twelve-month trailing basis. In addition, the Company will be required to show a maximum total leverage ratio of 4.0x for periods through December 31, 2018, 3.5x for the periods from January 1, 2019 through December 31, 2019, 3.25x for the periods from January 1, 2020 through December 31, 2020 and 3.0x thereafter. The Company was in compliance with all covenants for the three and nine month periods ended September 30, 2017.

On April 4, 2017, the Company entered into an interest rate swap contract with People's with an original notional amount of $15,500,000, which is equal to 50% of the outstanding balance of the term portion of the Restated Loan Agreement on that date. The notional amount will decrease on a quarterly basis beginning July 3, 2017, following the principal repayment schedule of the term portion of the Restated Loan Agreement. The Company has a fixed interest rate of 1.92% on the swap contract and will pay the difference between the fixed rate and the LIBOR rate when the LIBOR rate is below 1.92% and will receive interest when the LIBOR rate exceeds 1.92%.

Note G – Goodwill

The following is a roll-forward of goodwill from year-end 2016 to the end of the third quarter of 2017:

	Industrial Hardware Segment	Security Products Segment	Metal Products Segment	Total
Beginning balance	$1,760,793	$13,059,042	$ —	$14,819,835
Investment – Velvac	17,502,024	—	—	17,502,024
Foreign exchange	73,881	—	—	73,881
Ending balance	$19,336,698	$13,059,042	$ —	$32,395,740

Note H – Intangibles

The gross carrying amount and accumulated amortization of amortizable intangible assets are as follows:

	Industrial Hardware Segment	Security Products Segment	Metal Products Segment	Total	Weighted-Average Amortization Period (Years)
2017 Gross Amount					
Patents and developed technology	$7,111,906	$1,069,594	$ --	$8,181,500	12.2
Customer relationships	3,650,000	449,706	--	4,099,706	9.5
Non-compete agreements	--	407,000	--	407,000	5.0
Intellectual property	--	307,370	--	307,370	5.0
Total Gross Intangibles	$10,761,906	$2,233,670	$ --	$12,995,576	10.8
2017 Accumulated Amortization					
Patents and developed technology	$1,888,433	$663,254	$ --	$2,551,687	
Customer relationships	182,500	247,338	--	429,838	
Non-compete agreements	--	223,850	--	223,850	
Intellectual property	--	169,054	--	169,054	
Accumulated Amortization	$				