INSTEEL INDUSTRIES INC
Form 10-Q
January 15, 2015
iiin20141228_10q.htm

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X]

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

For the Quarterly Period Ended December 27, 2014

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: 1-9929

Insteel Industries, Inc.

(Exact name of registrant as specified in its charter)

North Carolina

(State or other jurisdiction of

incorporation or organization)

56-0674867

(I.R.S. Employer

Identification No.)

1373 Boggs Drive, Mount Airy, North Carolina

(Address of principal executive offices)

27030

(Zip Code)

Registrant's telephone number, including area code: **(336) 786-2141**

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, 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 [X]

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 [X]

The number of shares outstanding of the registrant’s common stock as of January 14, 2015 was 18,377,251.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

INSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(In thousands except for per share data)

(Unaudited)

Three Months Ended

December 27,

December 28,

2014

2013

Net sales

$ 110,628 $ 87,218

Cost of sales

98,585 78,163

Gross profit	12,043	9,055
Selling, general and administrative expense	5,652	4,705
Other income, net	(40)	(32)
Interest expense	94	56
Interest income	-	(5)
Earnings before income taxes	6,337	4,331
Income taxes	2,187	1,584
Net earnings	$ 4,150	$ 2,747
Net earnings per share:		
Basic	$ 0.23	$ 0.15
Diluted	0.22	0.15
Weighted average shares outstanding:		
Basic	18,377	18,189

Diluted	18,820	18,587
Cash dividends declared per share	$ 0.03	$ 0.03
Comprehensive income	$ 4,150	$ 2,747

See accompanying notes to consolidated financial statements.

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INSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

December 27,

September 27,

2014

2014

Assets

Current assets:

Cash and cash equivalents

$ 11 $ 3,050

Accounts receivable, net

40,688 51,211

Inventories

87,464 81,899

Other current assets

4,784 6,433

Total current assets

132,947 142,593

Property, plant and equipment, net

91,443 90,386

Intangibles, net

9,600 9,816

Goodwill

6,965 6,965

Other assets

7,102 7,035

Total assets

$ 248,057 $ 256,795

Liabilities and shareholders' equity

Current liabilities:

Accounts payable

$ 30,874 $ 52,811

Accrued expenses

9,096 10,375

Total current liabilities

	39,970	63,186
Long-term debt	10,000	-
Other liabilities	15,163	14,726
Commitments and contingencies		
Shareholders' equity:		
Common stock	18,377	18,377
Additional paid-in capital	59,309	58,867
Retained earnings	107,028	103,429
Accumulated other comprehensive loss	(1,790)	(1,790)
Total shareholders' equity	182,924	178,883
Total liabilities and shareholders' equity	$ 248,057	$ 256,795

See accompanying notes to consolidated financial statements.

INSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

Three Months Ended

December 27,

December 28,

2014

2013

Cash Flows From Operating Activities:

Net earnings

$ 4,150 $ 2,747

Adjustments to reconcile net earnings to net cash provided by (used for) operating activities:

Depreciation and amortization

2,869 2,424

Amortization of capitalized financing costs

26 26

Stock-based compensation expense

442 408

Deferred income taxes

935 319

Excess tax benefits from stock-based compensation

- (86)

Gain on sale of property, plant and equipment

(77) -

Increase in cash surrender value of life insurance policies over premiums paid

(136) (289)

Net changes in assets and liabilities (net of assets and liabilities acquired):

Accounts receivable, net

10,360 7,356

Inventories

(5,565) (11,233)

Accounts payable and accrued expenses

(22,716) 4,387

Other changes

199 263

Total adjustments

(13,663) 3,575

Net cash provided by (used for) operating activities

(9,513) 6,322

Cash Flows From Investing Activities:

Capital expenditures

(3,515) (1,984)

Acquisition of business

411 -

Proceeds from sale of property, plant and equipment

89 -

Proceeds from surrender of life insurance policies

40 28

Increase in cash surrender value of life insurance policies

- (99)

Net cash used for investing activities

(2,975) (2,055)

Cash Flows From Financing Activities:

Proceeds from long-term debt

47,757 118

Principal payments on long-term debt

(37,757) (118)

Cash dividends paid

(551) (546)

Cash received from exercise of stock options

- 12

Excess tax benefits from stock-based compensation

- 86

Payment of employee tax withholdings related to net share transactions	-	(274)
Net cash provided by (used for) financing activities	9,449	(722)
Net increase (decrease) in cash and cash equivalents	(3,039)	3,545
Cash and cash equivalents at beginning of period	3,050	15,440
Cash and cash equivalents at end of period	$ 11	$ 18,985
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 16	$ 2
Income taxes, net	45	33
Non-cash investing and financing activities:		
Purchases of property, plant and equipment in accounts payable	206	740
Restricted stock units and stock options surrendered for withholding taxes payable	-	274
Post-closing purchase price adjustment for business acquired	65	-

See accompanying notes to consolidated financial statements.

INSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands)

(Unaudited)

Accumulated

Additional

Other

Total

Common Stock

Paid-In

Retained

Comprehensive

Shareholders'

	Shares	Amount	Capital	Earnings	Loss	Equity
Balance at September 27, 2014	18,377	$ 18,377	$ 58,867	$ 103,429	$ (1,790)	$ 178,883
Net earnings				4,150		4,150
Compensation expense associated with stock-based plans			442			442
Cash dividends declared				(551)		(551)
Balance at December 27, 2014	18,377	$ 18,377	$ 59,309	$ 107,028	$ (1,790)	$ 182,924

See accompanying notes to consolidated financial statements.

INSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(1) Basis of Presentation

The accompanying unaudited interim consolidated financial statements of Insteel Industries, Inc. ("we," "us," "our," "the Company" or "Insteel") have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC") for quarterly reports on Form 10-Q. Certain information and note disclosures normally included in the audited financial statements prepared in accordance with accounting principles generally accepted in the United States ("GAAP") have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. The September 27, 2014 consolidated balance sheet was derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should therefore be read in conjunction with the consolidated financial statements and notes for the fiscal year ended September 27, 2014 included in the Company's Annual Report on Form 10-K filed with the SEC.

The accompanying unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that the Company considers necessary for a fair presentation of results for these interim periods. The results of operations for the three-month period ended December 27, 2014 are not necessarily indicative of the results that may be expected for the fiscal year ending October 3, 2015 or future periods.

On August 15, 2014, the Company through its wholly-owned subsidiary, Insteel Wire Products ("IWP"), purchased substantially all of the assets associated with the prestressed concrete strand ("PC strand") business of American Spring Wire Corporation ("ASW") (see Note 3 to the consolidated financial statements).

The Company has evaluated subsequent events through the time of filing this Quarterly Report on Form 10-Q and has concluded that there are no significant events that occurred subsequent to the balance sheet date but prior to the filing of this report that would have a material impact on the consolidated financial statements.

(2) Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09 "Revenue from Contracts with Customers," which will supersede nearly all existing revenue recognition guidance under GAAP. ASU No. 2014-09 provides that an entity recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments, and assets recognized from costs incurred to obtain or fulfill a contract. ASU No. 2014-09 allows for either full retrospective or modified retrospective adoption and will become effective for the Company in the first quarter of fiscal 2018. The Company is evaluating the alternative transition methods and the potential effects of the adoption of this update on its financial statements.

(3) Business Combination

On August 15, 2014, the Company purchased substantially all of the assets associated with the PC strand business of ASW for an adjusted purchase price of $33.5 million, subject to certain additional post-closing adjustments (the "ASW Acquisition").

ASW manufactured PC strand at facilities located in Houston, Texas and Newnan, Georgia. The Company acquired, among other assets, the accounts receivable and inventories related to ASW's PC strand business, the production equipment at its facility in Houston, Texas and its production equipment and facility in Newnan, Georgia. Pursuant to an agreement with ASW, the Company is leasing the Houston facility from ASW with an option to purchase it in the future. In addition, the Company assumed certain of ASW's accounts payable and accrued liabilities related to its PC strand business.

Following is a summary of the Company’s preliminary allocation of the adjusted purchase price to the fair values of the assets acquired and liabilities assumed as of the date of the ASW Acquisition:

(In thousands)	
Assets acquired:	
Accounts receivable	$ 7,854
Inventories	6,292
Other current assets	786
Property, plant and equipment	8,638
Intangibles	8,530
Total assets acquired	$ 32,100
Liabilities assumed:	
Accounts payable	$ 3,240
Accrued expenses	2,358

Total liabilities assumed	5,598
Net assets acquired	26,502
Purchase price	33,467
Goodwill	$ 6,965

In connection with the ASW Acquisition, the Company acquired intangible assets consisting of customer relationships, developed technology and know-how, and a non-competition agreement. The ASW Acquisition was accounted for as a business purchase pursuant to Accounting Standards Codification ("ASC") Topic 805, *Business Combinations*. Acquisition and integration costs are not included as components of consideration transferred, but are recorded as expenses in the period in which such costs are incurred.

The following unaudited supplemental pro forma financial information reflects the combined results of operations of the Company had the ASW Acquisition occurred at the beginning of fiscal 2013. The pro forma information reflects certain adjustments related to the ASW Acquisition, including adjusted amortization and depreciation expense based on the fair value of the assets acquired and interest expense related to the borrowings on the Company's revolving credit facility. The pro forma information does not reflect any operating efficiencies or potential cost savings that may result from the ASW Acquisition. Accordingly, this pro forma information is for illustrative purposes and is not intended to represent or be indicative of the actual results of operations of the combined company that may have been achieved had the ASW Acquisition occurred at the beginning of fiscal 2013, nor is it intended to represent or be indicative of future results of operations. The pro forma combined results of operations for the prior year quarter are as follows:

December 28,

(In thousands)

2013

Net sales	$ 102,747
Earnings before income taxes	5,201
Net earnings	3,464

Restructuring charges. Subsequent to the ASW Acquisition, in fiscal 2014 the Company incurred employee separation costs for staffing reductions related to the acquisition. Following is a summary of the restructuring activity during the three-month period ended December 27, 2014:

(In thousands)	**Employee Separation Costs**
Liability as of September 27, 2014	$ 1,208
Cash payments	(53)
Liability as of December 27, 2014	$ 1,155

As of December 27, 2014 and September 27, 2014, the Company recorded a liability of $1.2 million on its consolidated balance sheet for restructuring liabilities, including $0.5 million in accrued expenses and $0.7 million in other liabilities.

(4) 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. The authoritative guidance for fair value measurements establishes a three-level fair value hierarchy that encourages an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs used to measure fair value are as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities, including certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

As of December 27, 2014 and September 27, 2014, the Company held financial assets that are required to be measured at fair value on a recurring basis. The financial assets held by the Company and the fair value hierarchy used to determine their fair values are as follows:

(In thousands)

Total at

December 27,

2014

Quoted Prices

in Active

Markets

(Level 1)

Observable

Inputs

(Level 2)

Current assets:

Cash equivalents

$ 1,490 $ 1,490 $ -

Other assets:

Cash surrender value of life insurance policies

6,963 - 6,963

Total

$ 8,453 $ 1,490 $ 6,963

(In thousands)

Total at

September 27,

2014

Quoted Prices

in Active

Markets

(Level 1)

Observable

Inputs

(Level 2)

Current assets:

Cash equivalents

$ 3,320 $ 3,320 $ -

Other assets:

Cash surrender value of life insurance policies

6,867 - 6,867

Total

$ 10,187 $ 3,320 $ 6,867

Cash equivalents, which include all highly liquid investments with original maturities of three months or less, are classified as Level 1 of the fair value hierarchy. The carrying amount of the Company's cash equivalents, which consist of investments in money market funds, approximates fair value due to their short maturities. Cash surrender value of life insurance policies are classified as Level 2. The fair value of the life insurance policies was determined by the underwriting insurance company's valuation models and represents the guaranteed value the Company would receive upon surrender of these policies as of the reporting date.

As of December 27, 2014 and September 27, 2014, the Company did not have any nonfinancial assets that were required to be measured at fair value on a nonrecurring basis other than the assets and liabilities that were acquired from ASW at fair value (see Note 3 to the consolidated financial statements). The carrying amounts of accounts receivable, accounts payable and accrued expenses approximates fair value due to the short-term maturities of these financial instruments. As of December 27, 2014, the carrying amount of long-term debt outstanding under the Company's revolving credit facility approximates its estimated fair value. The estimated fair value of long-term debt is primarily based upon quoted market prices as well as borrowing rates currently available to the Company for bank loans with similar terms and maturities.

(5) Intangible Assets

The primary components of the Company's intangible assets and the related accumulated amortization are as follows:

(In thousands)	**Gross**	**Accumulated Amortization**	**Net Book Value**
As of December 27, 2014:			
Customer relationships	$ 6,500	$ (119)	$ 6,381
Developed technology and know-how	1,800	(33)	1,767
Non-competition agreements	2,117	(665)	1,452
	$ 10,417	$ (817)	$ 9,600

(In thousands)

Gross

Accumulated Amortization

Net Book Value

As of September 27, 2014:

Customer relationships

$ 6,500 $ (38) $ 6,462

Developed technology and know-how

1,800 (11) 1,789

Non-competition agreements

2,117 (552) 1,565 $ 10,417 $ (601) $ 9,816

Amortization expense for intangibles was $216,000 and $94,000 for the three-month periods ended December 27, 2014 and December 28, 2013, respectively.

(6) Stock-Based Compensation

Under the Company's equity incentive plans, employees and directors may be granted stock options, restricted stock, restricted stock units and performance awards. As of December 27, 2014, there were 387,000 shares available for future grants under the plans.

Stock options. Under the Company's equity incentive plans, employees and directors may be granted options to purchase shares of the Company's common stock at the fair market value on the date of the grant. Options granted under these plans generally vest over three years and expire ten years from the date of the grant. Compensation expense and excess tax benefits associated with stock options for the three-month periods ended December 27, 2014 and December 28, 2013 are as follows:

Three Months Ended

	December 27,	**December 28,**
(In thousands)	**2014**	**2013**
Stock options:		
Compensation expense	$ 173	$ 165
Excess tax benefits	-	(86)

As of December 27, 2014, the remaining unamortized compensation cost related to unvested stock option awards was $279,000, which is expected to be recognized over a weighted average period of 1.53 years.

The following table summarizes stock option activity for the three-month period ended December 27, 2014:

Contractual **Term -** **Aggregate** **Options** **Exercise Price Per Share**
Weighted **Intrinsic**

Outstanding

Weighted

Average

Value

(in thousands)

Range

Average

(years)

(in thousands)

Outstanding at September 27, 2014

871 $ 6.89 - $ 20.50 $ 14.23

Exercised

\- - - - -

Outstanding at December 27, 2014

871 6.89 - 20.50 14.23

6.16

$ 7,947

Vested and anticipated to vest in the future at December 27, 2014

869 14.23

6.15

7,935

Exercisable at December 27, 2014

594 12.85

4.98

6,246

Stock option exercises include “net exercises,” pursuant to which the optionee received shares of common stock equal to the intrinsic value of the options (fair market value of common stock on the date of exercise less exercise price) reduced by any applicable withholding taxes.

Restricted stock units. Restricted stock units ("RSUs") granted under the Company's equity incentive plans are valued based upon the fair market value on the date of the grant and provide for a dividend equivalent payment which is included in compensation expense. The vesting period for RSUs is generally one year from the date of the grant for RSUs granted to directors and three years from the date of the grant for RSUs granted to employees. RSUs do not have voting rights. RSU compensation expense for the three-month periods ended December 27, 2014 and December 28, 2013 is as follows:

	Three Months Ended	
	December 27,	**December 28,**
(In thousands)	**2014**	**2013**
Compensation expense	$ 269	$ 243

As of December 27, 2014, the remaining unrecognized compensation cost related to unvested RSUs was $477,000, which is expected to be recognized over a weighted average vesting period of 1.74 years.

The following table summarizes RSU activity during the three-month period ended December 27, 2014:

(Unit amounts in thousands)	Restricted Stock Units Outstanding	Weighted Average Grant Date Fair Value
Balance, September 27, 2014	197	$ 15.68
Granted	-	-
Released	-	-
Balance, December 27, 2014	197	$ 15.68

(7) Income Taxes

***Effective income tax rate*.** The Company's effective income tax rate was 34.5% for the three-month period ended December 27, 2014 compared with 36.6% for the three-month period ended December 28, 2013. The year-over-year reduction in the effective rate was primarily due to changes in permanent book versus tax differences. The effective income tax rates for both periods were based upon the estimated rate applicable for the entire fiscal year adjusted to reflect any significant items related specifically to interim periods.

Deferred income taxes. As of December 27, 2014, the Company has recorded a current deferred tax asset (net of valuation allowance) of $1.5 million in other current assets and a non-current deferred tax liability of $6.9 million in other liabilities on its consolidated balance sheet. The Company has $13.5 million of state net operating loss carryforwards ("NOLs") that begin to expire in 2017, but principally expire between 2017 and 2032. The Company has also recorded $220,000 of gross deferred tax assets for various state tax credits that begin to expire in 2015, but principally expire between 2015 and 2020.

In accordance with ASC Topic 740 *Income Taxes*, the Company evaluates its deferred tax assets to determine if a valuation allowance is required based on t