FULLER H B CO
Form 10-Q
September 29, 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 2, 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: 001-09225**

**H.B. FULLER COMPANY**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Minnesota** | **41-0268370** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **1200 Willow Lake Boulevard, St. Paul, Minnesota** | **55110-5101** |
| (Address of principal executive offices) | (Zip Code) |

**(651) 236-5900**

(Registrant's telephone number, including area code)

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, 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 [X] | 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 Act).

Yes [ ] No [X]

The number of shares outstanding of the Registrant's Common Stock, par value $1.00 per share, was 50,332,826 as of September 22, 2017.

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**H.B. Fuller Company**

**Quarterly Report on Form 10-Q**

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## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements

**H.B. FULLER COMPANY AND SUBSIDIARIES**
**Condensed Consolidated Statements of Income**
(In thousands, except per share amounts)
(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | **September 2, 2017** | **August 27, 2016** | **September 2, 2017** | **August 27, 2016** |
| **Net revenue** | **$562,869** | $512,858 | **$1,627,843** | $1,519,698 |
| Cost of sales | **(412,469)** | (366,737) | **(1,192,409)** | (1,077,716) |
| Gross profit | **150,400** | 146,121 | **435,434** | 441,982 |
| Selling, general and administrative expenses | **(110,219)** | (97,692) | **(325,904)** | (301,143) |
| Special charges, net | **-** | 2,807 | **-** | 2,024 |
| Other income (expense), net | **150** | (956) | **661** | (7,603) |
| Interest expense | **(8,100)** | (6,809) | **(24,628)** | (19,714) |
| **Income before income taxes and income from equity method investments** | **32,231** | 43,471 | **85,563** | 115,546 |
| Income taxes | **(9,262)** | (12,513) | **(26,178)** | (35,563) |
| Income from equity method investments, net of tax | **2,170** | 1,840 | **6,449** | 5,172 |
| **Net income including non-controlling interests** | **25,139** | 32,798 | **65,834** | 85,155 |
| Net income attributable to non-controlling interests | **(1)** | (53) | **(34)** | (161) |
| **Net income attributable to H.B. Fuller** | **$25,138** | $32,745 | **$65,800** | $84,994 |
| | | | | |
| **Earnings per share attributable to H.B. Fuller common stockholders:** | | | | |
| Basic | 0.50 | 0.65 | 1.31 | 1.70 |
| Diluted | 0.49 | 0.64 | 1.28 | 1.66 |
| | | | | |
| **Weighted-average common shares outstanding:** | | | | |
| Basic | **50,384** | 50,261 | **50,374** | 50,122 |
| Diluted | **51,605** | 51,453 | **51,584** | 51,234 |
| | | | | |
| **Dividends declared per common share** | **$0.15** | $0.14 | **$0.44** | $0.41 |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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**H.B. FULLER COMPANY AND SUBSIDIARIES**
**Condensed Consolidated Statements of Comprehensive Income**
(In thousands)
(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | **September 2, 2017** | **August 27, 2016** | **September 2, 2017** | **August 27, 2016** |
| **Net income including non-controlling interests** | **$25,139** | $32,798 | **$65,834** | $85,155 |
| Other comprehensive income | | | | |
| Foreign currency translation | **29,090** | 3,368 | **37,084** | 3,860 |
| Defined benefit pension plans adjustment, net of tax | **1,627** | 1,677 | **4,810** | 5,032 |
| Interest rate swaps, net of tax | **10** | 10 | **30** | 30 |
| Cash-flow hedges, net of tax | **(99 )** | 35 | **7** | (156 ) |
| **Other comprehensive income** | **30,628** | 5,090 | **41,931** | 8,766 |
| Comprehensive income | **55,767** | 37,888 | **107,765** | 93,921 |
| Less: Comprehensive (loss) income attributable to non-controlling interests | **(11 )** | 53 | **23** | 161 |
| **Comprehensive income attributable to H.B. Fuller** | **$55,778** | $37,835 | **$107,742** | $93,760 |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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**H.B. FULLER COMPANY AND SUBSIDIARIES**
**Condensed Consolidated Balance Sheets**
(In thousands, except share and per share amounts)

| | **(Unaudited) September 2, 2017** | December 3, 2016 |
|---|---|---|
| **Assets** | | |
| **Current assets:** | | |
| Cash and cash equivalents | **$ 119,595** | $ 142,245 |
| Trade receivables (net of allowances of $12,214 and $12,310, as of September 2, 2017 and December 3, 2016, respectively) | **393,054** | 351,130 |
| Inventories | **317,968** | 247,399 |
| Other current assets | **86,294** | 70,479 |
| **Total current assets** | **916,911** | 811,253 |
| | | |
| Property, plant and equipment | **1,136,083** | 1,093,141 |
| Accumulated depreciation | **(609,262 )** | (577,866 ) |
| **Property, plant and equipment, net** | **526,821** | 515,275 |
| | | |
| Goodwill | **444,642** | 366,248 |
| Other intangibles, net | **238,484** | 205,359 |
| Other assets | **161,465** | 157,733 |
| **Total assets** | **$ 2,288,323** | $ 2,055,868 |
| | | |
| **Liabilities, redeemable non-controlling interest and total equity** | | |
| **Current liabilities:** | | |
| Notes payable | **$ 28,392** | $ 37,334 |
| Current maturities of long-term debt | **10,000** | 80,178 |
| Trade payables | **193,345** | 162,964 |
| Accrued compensation | **59,306** | 52,444 |
| Income taxes payable | **10,301** | 7,985 |
| Other accrued expenses | **47,621** | 50,939 |
| **Total current liabilities** | **348,965** | 391,844 |
| | | |
| Long-term debt, excluding current maturities | **760,581** | 585,759 |
| Accrued pension liabilities | **67,815** | 73,545 |
| Other liabilities | **78,426** | 62,174 |

| | | |
|---|---|---|
| **Total liabilities** | **1,255,787** | **1,113,322** |
| | | |
| Commitments and contingencies (Note 16) | | |
| **Redeemable non-controlling interest** | **-** | 4,277 |
| | | |
| **Equity:** | | |
| H.B. Fuller stockholders' equity: | | |
| Preferred stock (no shares outstanding) shares authorized – 10,045,900 | **-** | - |
| Common stock, par value $1.00 per share, shares authorized – 160,000,000, shares outstanding – 50,297,998 and 50,141,343, as of September 2, 2017 and December 3, 2016, respectively | **50,298** | 50,141 |
| Additional paid-in capital | **68,237** | 59,564 |
| Retained earnings | **1,134,411** | 1,090,900 |
| Accumulated other comprehensive loss | **(220,787)** | (262,729) |
| Total H.B. Fuller stockholders' equity | **1,032,159** | 937,876 |
| Non-controlling interests | **377** | 393 |
| **Total equity** | **1,032,536** | 938,269 |
| **Total liabilities, redeemable non-controlling interest and total equity** | **$ 2,288,323** | $ 2,055,868 |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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**H.B. FULLER COMPANY AND SUBSIDIARIES**
**Condensed Consolidated Statements of Total Equity**
(In thousands)
(Unaudited)

| | H.B. Fuller Company Shareholders | | | | | |
|---|---|---|---|---|---|---|
| | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Non-Controlling Interests | Total |
| **Balance at November 28, 2015** | $50,074 | $55,522 | $994,608 | $(227,284) | $406 | $873,326 |
| Comprehensive income (loss) | - | - | 124,128 | (35,445) | 226 | 88,909 |
| Dividends | - | - | (27,836) | - | - | (27,836) |
| Stock option exercises | 519 | 10,750 | - | - | - | 11,269 |
| Share-based compensation plans other, net | 116 | 14,485 | - | - | - | 14,601 |
| Tax benefit on share-based compensation plans | - | 1,467 | - | - | - | 1,467 |
| Repurchases of common stock | (568) | (22,660) | - | - | - | (23,228) |
| Redeemable non-controlling interest | - | - | - | - | (239) | (239) |
| **Balance at December 3, 2016** | 50,141 | 59,564 | 1,090,900 | (262,729) | 393 | 938,269 |
| Comprehensive income | - | - | 65,800 | 41,942 | 23 | 107,765 |
| Dividends | - | - | (22,289) | - | - | (22,289) |
| Stock option exercises | 438 | 14,595 | - | - | - | 15,033 |
| Share-based compensation plans other, net | 148 | 13,768 | - | - | - | 13,916 |
| Tax benefit on share-based compensation plans | - | 1,504 | - | - | - | 1,504 |
| Repurchases of common stock | (429) | (21,288) | - | - | - | (21,717) |
| Purchase of redeemable non-controlling interest | - | 94 | - | - | - | 94 |
| Redeemable non-controlling interest | - | - | - | - | (39) | (39) |
| **Balance at September 2, 2017** | **$50,298** | **$68,237** | **$1,134,411** | **$(220,787)** | **$377** | **$1,032,536** |

See accompanying

Notes to
Unaudited
Condensed
Consolidated
Financial
Statements.

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**H.B. FULLER COMPANY AND SUBSIDIARIES**
**Condensed Consolidated Statements of Cash Flows**
(In thousands)
(Unaudited)

| | Nine Months Ended | |
|---|---|---|
| | **September 2, 2017** | **August 27, 2016** |
| **Cash flows from operating activities:** | | |
| Net income including non-controlling interests | **$65,834** | $85,155 |
| Adjustments to reconcile net income including non-controlling interests to net cash provided by operating activities: | | |
| Depreciation | **36,375** | 36,730 |
| Amortization | **23,128** | 20,509 |
| Deferred income taxes | **1,660** | 3,785 |
| Income from equity method investments, net of dividends received | **(2,639)** | (5,172) |
| Gain on sale of assets | **(149)** | (2,794) |
| Share-based compensation | **12,034** | 9,469 |
| Excess tax benefit from share-based compensation | **(1,504)** | (1,462) |
| Gain on mark to market adjustment to contingent consideration liability | **(2,453)** | (801) |
| Non-cash charge for sale of inventories revalued at acquisition | **193** | 528 |
| Change in assets and liabilities, net of effects of acquisitions: | | |
| Trade receivables, net | **(14,016)** | 25,646 |
| Inventories | **(55,339)** | (6,165) |
| Other assets | **2,460** | 1,790 |
| Trade payables | **23,022** | (1,365) |
| Accrued compensation | **3,881** | (6,715) |
| Other accrued expenses | **(5,755)** | (4,858) |
| Income taxes payable | **(7,252)** | (1,415) |
| Accrued / prepaid pensions | **(3,969)** | (2,072) |
| Other liabilities | **12,639** | (9,088) |
| Other | **(17,345)** | 4,199 |
| **Net cash provided by operating activities** | **70,805** | 145,904 |
| | | |
| **Cash flows from investing activities:** | | |
| Purchased property, plant and equipment | **(35,511)** | (49,569) |
| Purchased businesses, net of cash acquired | **(123,305)** | (51,298) |
| Purchased investments | **(1,250)** | - |
| Proceeds from sale of property, plant and equipment | **745** | 4,403 |
| **Net cash used in investing activities** | **(159,321)** | (96,464) |

| | | |
|---|---|---|
| **Cash flows from financing activities:** | | |
| Proceeds from issuance of long-term debt | **643,000** | - |
| Repayment of long-term debt and payment of debt issuance costs | **(540,524)** | (16,875 ) |
| Net (payment of) proceeds from notes payable | **(10,921 )** | 6,639 |
| Dividends paid | **(22,058 )** | (20,570 ) |
| Purchase of redeemable non-controlling interest | **(3,127 )** | - |
| Proceeds from stock options exercised | **15,033** | 9,760 |
| Excess tax benefit from share-based compensation | **1,504** | 1,462 |
| Repurchases of common stock | **(21,717 )** | (11,901 ) |
| **Net cash provided by (used in) financing activities** | **61,190** | (31,485 ) |
| | | |
| Effect of exchange rate changes on cash and cash equivalents | **4,676** | (4,021 ) |
| **Net change in cash and cash equivalents** | **(22,650 )** | 13,934 |
| | | |
| Cash and cash equivalents at beginning of period | **142,245** | 119,168 |
| **Cash and cash equivalents at end of period** | **$119,595** | $133,102 |
| | | |
| Supplemental disclosure of cash flow information: | | |
| Dividends paid with company stock | **$231** | $185 |
| Cash paid for interest, net of amount capitalized of $201 and $556 for the periods ended September 2, 2017 and August 27, 2016, respectively | **$25,823** | $20,436 |
| Cash paid for income taxes, net of refunds | **$22,044** | $33,428 |

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**H.B. FULLER COMPANY AND SUBSIDIARIES**

**Notes to Condensed Consolidated Financial Statements**

(Amounts in thousands, except share and per share amounts)

(Unaudited)

**Note 1: Basis of Presentation**

The accompanying unaudited interim Condensed Consolidated Financial Statements of H.B. Fuller Company and Subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information necessary for a fair presentation of results of operations, comprehensive income, financial position, and cash flows in conformity with U.S. generally accepted accounting principles. In our opinion, the unaudited interim Condensed Consolidated Financial Statements reflect all adjustments of a normal recurring nature considered necessary for the fair presentation of the results for the periods presented. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Actual results could differ from these estimates. These unaudited interim Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the year ended December 3, 2016 as filed with the Securities and Exchange Commission.

On December 4, 2016, for our subsidiaries in Latin America, we changed the functional currency from the U.S. dollar to the entity's local currency based on management's analysis of the changes of the economic facts and circumstances in which these subsidiaries operate. The change in functional currency is accounted for prospectively from December 4, 2016 and financial statements prior to and including the nine months ended August 27, 2016 and the year ended December 3, 2016 have not been restated for the change in functional currency. Monetary assets and liabilities have been remeasured to the U.S. dollar at current exchange rates. Non-monetary assets (property, plant and equipment, net; goodwill; and intangible assets, net) have been remeasured to reflect the difference between the exchange rate when the asset arose and the exchange rate on the date of the change in functional currency. As a result of this change in functional currency, we recorded an $11,317 cumulative translation adjustment included in other comprehensive income for the nine months ended September 2, 2017.

*New Accounting Pronouncements*

In August 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. The ASU simplifies certain aspects of hedge accounting and improves disclosures of hedging arrangements through the elimination of the requirement to separately measure and report hedge ineffectiveness. The ASU generally requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item in order to align financial reporting of hedge relationships with economic results. Entities must apply the amendments to cash flow and net investment hedge relationships that exist on the date of adoption using a modified retrospective approach. The presentation and disclosure requirements must be applied prospectively. Our effective date for adoption of this guidance is our fiscal year beginning December 1, 2019. We are currently evaluating the effect that this guidance will have on our Consolidated Financial Statements.

In May 2017, the FASB issued ASU No. 2017-09, *Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting*. The ASU was issued to provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. Our effective date for adoption of this guidance is our fiscal year beginning December 2, 2018 with early adoption permitted. We will apply this guidance to applicable transactions after the adoption date.

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,* which requires employers to include only the service cost component of net periodic pension cost and net periodic postretirement benefit cost in operating expenses. The other components of net benefit cost, including amortization of prior service cost/credit, and settlement and curtailment effects, are to be included in nonoperating expenses. The ASU also stipulates that only the service cost component of net benefit cost is eligible for capitalization. Our effective date for adoption of this guidance is our fiscal year beginning December 2, 2018 with early adoption permitted. We are currently evaluating the effect that this guidance will have on our Consolidated Financial Statements.

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In February 2017, the FASB issued ASU No. 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets.* The ASU was issued to clarify the scope of the previous standard and to add guidance for partial sales of nonfinancial assets. Our effective date for adoption of this guidance is our fiscal year beginning December 2, 2018. We have evaluated the effect that this guidance will have on our Consolidated Financial Statements and related disclosures and determined it will not have a material impact.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment,* which removes Step 2 of the goodwill impairment test. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. Our effective date for prospective adoption of this guidance is our fiscal year beginning November 29, 2020 with early adoption permitted. We will apply this guidance to applicable impairment tests after the adoption date.

In January 2017, the FASB issued ASU No. 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business.* This ASU clarifies the definition of a business when evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. We adopted ASU 2017-01 during the quarter ended September 2, 2017 on a prospective basis. There was no material impact of adopting this ASU.

In November 2016, the FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force).* This ASU requires that the reconciliation of the beginning-of-period and end-of-period amounts shown in the statement of cash flows include cash and restricted cash equivalents. Our effective date for adoption of this guidance is our fiscal year beginning December 2, 2018. We have evaluated the effect that this guidance will have on our Consolidated Financial Statements and related disclosures and determined it will not have a material impact.

In October 2016, the FASB issued ASU No. 2016-17, *Consolidation (Topic 810): Interests Held through Related Parties That Are under Common Control.* This ASU changes how a decision maker treats indirect interests in a managed variable interest entity held through an entity under common control in its primary beneficiary (consolidation) analysis. Our effective date for adoption of this guidance is our fiscal year beginning December 3, 2017. We have evaluated the effect that this guidance will have on our Consolidated Financial Statements and related disclosures and determined it will not have a material impact.

In October 2016, the FASB issued ASU No. 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory.* This ASU changes the timing of income tax recognition for an intercompany sale of assets. The ASU requires the seller's tax effects and the buyer's deferred taxes to be recognized immediately upon the sale instead of deferring accounting for the income tax implications until the assets are sold to a third party or recovered through use. Our effective date for adoption of this guidance is our fiscal year beginning December 2, 2018. We are currently

evaluating the effect that this guidance will have on our Consolidated Financial Statements.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force).* This ASU requires changes in the presentation of certain items including but not limited to debt prepayment or debt extinguishment costs; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies and distributions received from equity method investees. Our effective date for adoption of this guidance is our fiscal year beginning December 2, 2018. We are currently evaluating the effect that this guidance will have on our Consolidated Financial Statements.

In June 2016, the FASB ASU No. 2016-13*, Financial Instruments - Credit Losses (Topic 326), Measurement of Credit Losses on Financial Statements.* This ASU requires a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. Our effective date for adoption of this guidance is our fiscal year beginning November 29, 2020. We are currently evaluating the effect that this guidance will have on our Consolidated Financial Statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting*. This ASU provides simplification in the accounting for share-based payment transactions including the accounting for income taxes, forfeitures, statutory tax withholding requirements and classification in the statement of cash flows. Our effective date for adoption of this guidance is our fiscal year beginning December 3, 2017. We are currently evaluating the effect that this guidance will have on our Consolidated Financial Statements.

In March 2016, the FASB issued ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606), Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*. This ASU provides guidance on recording revenue on a gross basis versus a net basis based on the determination of whether an entity is a principal or an agent when another party is involved in providing goods or services to a customer. The amendments in this ASU affect the guidance in ASU No. 2014-09 and are effective in the same timeframe as ASU No. 2014-09 as discussed below.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Subtopic 842).* This guidance changes accounting for leases and requires lessees to recognize the assets and liabilities arising from all leases, including those classified as operating leases under previous accounting guidance, on the balance sheet and requires disclosure of key information about leasing arrangements to increase transparency and comparability among organizations. Our effective date for adoption of this guidance is our fiscal year beginning December 1, 2019 with early adoption permitted. The new guidance must be adopted using a modified retrospective transition approach, and provides for certain practical expedients. We are currently evaluating the impact that the new guidance will have on our Consolidated Financial Statements.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which requires that equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Furthermore, equity investments without readily determinable fair values are to be assessed for impairment using a quantitative approach. Our effective date for adoption of this guidance is our fiscal year beginning December 2, 2018. We have evaluated the effect that this guidance will have on our Consolidated Financial Statements and related disclosures and determined it will not have a material impact.

In July 2015, the FASB issued ASU No. 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*, which requires a company to measure inventory within the scope of this guidance (inventory measured using first-in, first-out (FIFO) or average cost) at the lower of cost and net realizable value methods. Subsequent measurement is unchanged for inventory measured using the last-in, first-out (LIFO) or retail inventory method. Our effective date for adoption of this guidance is our fiscal year beginning December 3, 2017. We have evaluated the effect that this guidance will have on our Consolidated Financial Statements and related disclosures and determined it will not have a material impact.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606),* which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. This guidance will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for fiscal years and interim periods beginning after December 15, 2017 (as stated in ASU No. 2015-14 which defers the effective date and was issued in August 2015) and is now effective for our fiscal year beginning December 2, 2018. Early application as of the original effective date

is permitted under ASU 2015-14. The standard permits the use of either the retrospective or cumulative effect transition method. We are continuing to evaluate the effect this guidance will have on our Consolidated Financial Statements, including potential impacts on the timing of revenue recognition and additional information that may be necessary for expanded disclosures regarding revenue. We have identified an implementation project team and related oversight processes and are continuing with the assessment phase of the project. We have not concluded as to whether the new guidance will be adopted on a full or modified retrospective basis, but will not apply the early adoption provisions of the new guidance.

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**Note 2: Acquisitions**

*Royal Adhesives*

On September 2, 2017, we signed an agreement to purchase Royal Adhesives and Sealants (“Royal Adhesives”) for $1,575,000, subject to customary adjustments. The acquisition will be financed through new debt financing. Royal Adhesives, a manufacturer of high-value specialty adhesives and sealants, is a supplier of industrial adhesives in a diverse set of end markets, including aerospace, transportation, commercial roofing, insulating glass, solar, packaging and flooring applications and operates 19 manufacturing facilities in five countries. The acquisition is expected to expand our presence in North America, Europe and China and add new technology and packaging capabilities. The acquisition is expected to close during the fourth quarter of 2017.

The Stock Purchase Agreement contains certain limited termination rights for all parties, including, among others, the right to terminate if the transaction is not completed by March 2, 2018. In certain specified circumstances, upon termination of the Stock Purchase Agreement by the seller, including a termination by the seller for our breach, we will be required to pay the seller a termination fee equal to $78,800.

*Adecol*

On July 14, 2017, we entered into an agreement to purchase Adecol Ind. Quimica, Limitada (“Adecol”) for approximately 145,000 Brazilian real. Adecol is headquartered in Guarulhos, Brazil and works with customers to develop innovative, high-quality hot melt, reactive and polymer-based adhesive solutions in the packaging, converting and assembly markets. The acquisition is expected to enhance our business in Brazil by partnering with customers to produce new and better consumer and durable goods products in this region. The acquisition is expected to close during the fourth quarter of 2017.

*Wisdom Adhesives*

On January 27, 2017, we acquired substantially all of the assets of H.E. Wisdom & Sons, Inc. and its affiliate Wisdom Adhesives Southeast, L.L.C., (“Wisdom Adhesives”) headquartered in Elgin, Illinois. Wisdom Adhesives is a provider of adhesives for the packaging, paper converting and assembly markets. The acquisition will strengthen our position in the North America adhesives market. The purchase price of $123,305 was financed through borrowings on our revolving credit facility and was recorded in our Americas Adhesives operating segment. We incurred acquisition related costs of approximately $555, which were recorded as SG&A expenses in the Condensed Consolidated

Statement of Income for the nine months ended September 2, 2017.

The acquisition fair value measurement was preliminary as of September 2, 2017, subject to the completion of the valuation of Wisdom Adhesives and payment of any excess working capital amounts to the seller. We expect the fair value measurement process to be completed when the final appraisals are available, but no later than twelve months from the acquisition date.

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The following table summarizes the preliminary fair value measurement of the assets acquired and liabilities assumed as of the date of acquisition:

| | **Preliminary Valuation March 4, 2017** | **Fair Value Adjustments** | **Preliminary Valuation September 2, 2017** |
|---|---|---|---|
| Current assets | $ 13,729 | $ (31) | $ 13,698 |
| Property, plant and equipment | 10,516 | (1,885) | 8,631 |
| Goodwill | 60,313 | (792) | 59,521 |
| Other intangibles | | | |
| Customer relationships | 33,300 | 12,000 | 45,300 |
| Trademarks/trade names | 13,600 | (9,200) | 4,400 |
| Current liabilities | (8,153) | (92) | (8,245) |
| Total purchase price | $ 123,305 | $ - | $ 123,305 |

The preliminary expected lives of the acquired intangible assets are 15 years for customer relationships and 10 years for trademarks/trade names.

Based on the preliminary fair value measurement of the assets acquired and liabilities assumed, we allocated $59,521 to goodwill for the expected synergies from combining Wisdom Adhesives with our existing business. Such goodwill is deductible for tax purposes. The goodwill was assigned to our Americas Adhesives operating segment. The Wisdom Adhesives acquisition does not represent a material business combination, and therefore pro forma financial information is not provided.

*Cyberbond*

On June 8, 2016, we acquired Cyberbond, L.L.C., (“Cyberbond”) headquartered in Batavia, Illinois with operations in the United States and Europe. Cyberbond is a provider of industrial adhesives for the electronics, medical, audio equipment, automotive and structural markets. The acquisition will help us to broaden our global position and accelerate our growth in the high margin, high growth Engineering Adhesives segment. The purchase price of $42,182, net of cash acquired of $332, was funded through existing cash and was recorded in our Engineering Adhesives operating segment. We incurred acquisition related costs of approximately $527, which were recorded as SG&A expenses in the Condensed Consolidated Statement of Income for the year ended December 3, 2016.

The following table summarizes the final fair value measurement of the assets acquired and liabilities assumed as of the date of acquisition:

| | Amount |
|---|---|
| Current assets | $4,425 |
| Property, plant and equipment | 2,038 |
| Goodwill | 23,654 |
| Other intangibles | |
| Developed technology | 2,000 |
| Customer relationships | 14,400 |
| Trademarks/trade names | 700 |
| Other assets | 161 |
| Current liabilities | (1,889 ) |
| Long-term liabilities | (3,307 ) |
| Total purchase price | $42,182 |

The expected lives of the acquired intangible assets are seven years for developed technology, 15 years for customer relationships and 10 years for trademarks/trade names.

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Based on the fair value measurement of the assets acquired and liabilities assumed, we allocated $23,654 to goodwill for the expected synergies from combining Cyberbond with our existing business. The amount of goodwill deductible for tax purposes is $10,658. The goodwill was assigned to our Engineering Adhesives operating segment. The Cyberbond acquisition does not represent a material business combination, and therefore pro forma financial information is not provided.

*Advanced Adhesives*

On April 29, 2016, we acquired Advanced Adhesives Pty Limited and the business assets of Advanced Adhesives (New Zealand) Limited (together referred to as “Advanced Adhesives”), providers of industrial adhesives in Australia and New Zealand. The acquisition will help us to strengthen our industrial adhesives market position and leverage a broader technology portfolio in both Australia and New Zealand. The combined purchase price of $10,365 was funded through existing cash and was recorded in our Asia Pacific operating segment. We incurred acquisition related costs of approximately $646, which were recorded as SG&A expenses in the Condensed Consolidated Statements of Income for the year ended December 3, 2016.

The following table summarizes the final fair value measurement of the assets acquired and liabilities assumed as of the date of acquisition:

| | **Amount** |
|---|---|
| Current assets | $5,704 |
| Property, plant and equipment | 594 |
| Goodwill | 102 |
| Other intangibles | |
| Customer relationships | 7,575 |
| Trademarks/trade names | 146 |
| Current liabilities | (2,671 ) |
| Long-term liabilities | (1,085 ) |
| Total purchase price | $10,365 |

The expected lives of the acquired intangible assets are 15 years for customer relationships and one year for trademarks/trade names.

Based on the fair value measurement of the assets acquired and liabilities assumed, we allocated $102 to goodwill for the expected synergies from combining Advanced Adhesives with our existing business. Such goodwill is not deductible for tax purposes. The goodwill was assigned to our Asia Pacific operating segment. The Advanced Adhesives acquisition does not represent a material business combination, and therefore pro forma financial

information is not provided.

**Note 3: Restructuring Actions**

*Business Integration Project*

The integration of the industrial adhesives business we acquired in March 2012 involved a significant amount of restructuring and capital investment to optimize the new combined entity. In addition, we took a series of actions in our existing EIMEA operating segment to improve the profitability and future growth prospects of this operating segment. We combined these two initiatives into a single project which we refer to as the "Business Integration Project." During the third quarter and nine months ended August 27, 2016, we incurred costs of $2,807 and $2,024 related to transformation costs, workforce reduction costs, facility exit costs and other related costs for the Business Integration Project, which are included in special charges, net in the Condensed Consolidated Statements of Income. The Business Integration Project was substantially complete at the end of 2016.

*2017 Restructuring Plan*

During the first quarter of 2017, we approved a restructuring plan (the "2017 Restructuring Plan") related to organizational changes and other actions to optimize operations. The 2017 Restructuring Plan was implemented in the first quarter of 2017 and is currently expected to be completed by mid-year of fiscal 2018. During the three and nine months ended September 2, 2017, we recorded a pre-tax charge of $1,270 and $17,072 respectively, related to the implementation of the 2017 Restructuring Plan.

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The following table summarizes the pre-tax distribution of restructuring charges by income statement classification:

| | **Three Months Ended September 2, 2017** | **Nine Months Ended September 2, 2017** |
|---|---|---|
| Cost of sales | $ 471 | $ 9,370 |
| Selling, general and administrative | 799 | 7,702 |
| | $ 1,270 | $ 17,072 |

The following table summarizes the pre-tax impact of restructuring charges by segment:

| | **Three Months Ended September 2, 2017** | **Nine Months Ended September 2, 2017** |
|---|---|---|
| Americas Adhesives | $ 283 | $ 2,048 |
| EIMEA | 704 | 6,759 |
| Asia Pacific | 45 | 1,932 |
| Construction Products | 164 | 5,622 |
| Engineering Adhesives | 74 | 711 |
| | $ 1,270 | $ 17,072 |

A summary of the restructuring liability during the nine months ended September 2, 2017 is presented below:

| | **Employee-Related** | **Asset-Related** | **Other** | **Total** |
|---|---|---|---|---|
| Balance at December 3, 2016 | $ - | $ - | $ - | $ - |
| Expenses incurred | 10,130 | 5,185 | 1,757 | 17,072 |
| Non-cash charges | - | (4,291 ) | - | (4,291 ) |

| | | | | |
|---|---|---|---|---|
| Cash payments | (7,158 ) | (894 ) | (1,746) | (9,798 ) |
| Foreign currency translation | 448 | - | - | 448 |
| Balance at September 2, 2017 | $ 3,420 | $ - | $11 | $3,431 |

Non-cash charges include accelerated depreciation resulting from the cessation of use of certain long-lived assets and the recording of a provision related to the discontinuance of certain retail and wholesale products. Restructuring liabilities have been classified as a component of other accrued expenses on the Condensed Consolidated Balance Sheets.

**Note 4: Inventories**

The composition of inventories is as follows:

| | **September 2, 2017** | **December 3, 2016** |
|---|---|---|
| Raw materials | **$ 149,332** | $ 116,200 |
| Finished goods | **180,682** | 142,397 |
| LIFO reserve | **(12,046 )** | (11,198 ) |
| Total inventories | **$ 317,968** | $ 247,399 |

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**Note 5: Goodwill and Other Intangible Assets**

The goodwill activity for the nine months ended September 2, 2017 is presented below:

| | Americas Adhesives | EIMEA | Asia Pacific | Construction Products | Engineering Adhesives | Total |
|---|---|---|---|---|---|---|
| Balance at December 3, 2016 | $59,821 | $98,876 | $17,481 | $ 21,901 | $ 168,169 | $366,248 |
| Acquisitions | 59,521 [1] | - | - | - | - | 59,521 |
| Currency impact | 654 | 8,930 | 314 | 22 | 8,953 | 18,873 |
| Balance at September 2, 2017 | $119,996 | $107,806 | $17,795 | $ 21,923 | $ 177,122 | $444,642 |

[1] Preliminary goodwill balance as of September 2, 2017.

Balances of amortizable identifiable intangible assets, excluding goodwill and other non-amortizable intangible assets, are as follows:

| | September 2, 2017 | | | |
|---|---|---|---|---|
| **Amortizable Intangible Assets** | **Purchased Technology & Patents** | **Customer Relationships** | **All Other** | **Total** |
| Original cost | **$72,563** | **$ 305,863** | **$56,467** | **$434,893** |
| Accumulated amortization | **(31,751)** | **(129,732)** | **(35,482)** | **(196,965)** |
| Net identifiable intangibles | **$40,812** | **$ 176,131** | **$20,985** | **$237,928** |

| | December 3, 2016 | | | |
|---|---|---|---|---|
| **Amortizable Intangible Assets** | **Purchased Technology &** | **Customer Relationships** | **All Other** | **Total** |

| | Patents | | | |
|---|---|---|---|---|
| Original cost | $70,504 | $ 251,329 | $51,116 | $372,949 |
| Accumulated amortization | (21,448) | (116,411) | (30,198) | (168,057) |
| Net identifiable intangibles | $49,056 | $ 134,918 | $20,918 | $204,892 |

Amortization expense with respect to amortizable intangible assets was $7,899 and $7,023 for the third quarter ended September 2, 2017 and August 27, 2016, respectively, and $23,128 and $20,509 for the nine months ended September 2, 2017 and August 27, 2016, respectively.

Estimated aggregate amortization expense based on the current carrying value of amortizable intangible assets for the next five fiscal years are as follows:

| Fiscal Year | Remainder of 2017 | 2018 | 2019 | 2020 | 2021 | Thereafter |
|---|---|---|---|---|---|---|
| Amortization Expense | $ 9,070 | $32,619 | $30,407 | $27,998 | $26,519 | $ 111,315 |

Non-amortizable intangible assets as of September 2, 2017 are $556 and are related to trademarks and trade names.

**Note 6: Long-Term Debt**

On February 14, 2017, we issued $300,000 aggregate principal of 10-year unsecured public notes (“4.000% Notes”) due February 15, 2027 with a fixed coupon of 4.00 percent. Proceeds from this debt issuance were used to repay $138,000 outstanding under the revolving credit facility and prepay $158,750 of our term loan. We entered into interest rate swap agreements to convert $150,000 of the $300,000 4.000% Notes to a variable interest rate of 1-month LIBOR (in advance) plus 1.86 percent.

On April 12, 2017, we entered into a credit agreement with a consortium of financial institutions under which we established a $400,000 multi-currency revolving credit facility and a $100,000 term loan that we can use to repay existing indebtedness, finance working capital needs, finance acquisitions and for general corporate purposes. Interest on the revolving credit facility is payable at LIBOR plus 1.10 percent. A facility fee of 0.15 percent is payable quarterly. The interest rate on the term loan is payable at LIBOR plus 1.25 percent. The interest rates and the facility fee are based on a ratings grid. The credit agreement replaced the previous credit agreement entered into on October 31, 2014. The April 12, 2017 credit agreement expires April 12, 2022.

During the second quarter ended June 3, 2017, we entered into an interest rate swap agreement to convert $125,000 of our Series E private placement to a variable interest rate of 1-month LIBOR (in arrears) plus 2.22 percent. See Note 13 for further discussion of the interest rate swaps.

We adopted ASU No. 2015-03, *Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issue Costs*, during the quarter ended March 4, 2017 on a retrospective basis. The impact of adopting ASU No. 2015-03 on our financial statements was the reclassification of deferred debt issuance costs related to our long-term debt, with the exception of our revolving credit line, from an asset to a direct deduction to the corresponding debt. Reclassifications from an asset to a direct deduction to the corresponding debt of $2,386 was included in our Condensed Consolidated Balance Sheets as of December 3, 2016.

**Note 7: Redeemable Non-Controlling Interest**

We account for the non-controlling interest in H.B. Fuller Kimya Sanayi Ticaret A.S. (“HBF Kimya”) as a redeemable non-controlling interest because both the non-controlling shareholder and H.B. Fuller had an option, exercisable beginning August 1, 2018, to require the redemption of the shares owned by the non-controlling shareholder at a price determined by a formula based on 24 months trailing EBITDA. Since the option made the redemption of the non-controlling ownership shares of HBF Kimya outside of our control, these shares are classified as a redeemable

non-controlling interest in temporary equity in the Condensed Consolidated Balance Sheets. The non-controlling shareholder was entitled to increase his ownership by 1 percent per year for 5 years up to a maximum of 13 percent ownership based on the achievement of profitability targets in each year. The option was subject to a minimum price of €3,500.

The results of operations for the HBF Kimya non-controlling interest is consolidated in our financial statements. Both the non-controlling interest and the accretion adjustment to redemption value are included in net income attributable to non-controlling interests in the Condensed Consolidated Statements of Income and in the carrying value of the redeemable non-controlling interest on the Condensed Consolidated Balance Sheets. HBF Kimya's functional currency is the Turkish lira and changes in exchange rates affect the reported amount of the redeemable non-controlling interest.

During the first quarter of 2017, we purchased the remaining shares from the non-controlling shareholder for €4,206. The difference between the non-controlling interest balance and the purchase price was recorded in additional paid-in capital in the first quarter of 2017.

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| | Redeemable Non-Controlling Interest |
|---|---|
| Balance at December 3, 2016 | $ 4,277 |
| Net income attributed to redeemable non-controlling interest | 39 |
| Purchase of redeemable non-controlling interest | (4,468) |
| Foreign currency translation adjustment | 152 |
| Balance at September 2, 2017 | $ - |

**Note 8: Accounting for Share-Based Compensation**

*Overview*

We have various share-based compensation programs, which provide for equity awards including non-qualified stock options, restricted stock shares, restricted stock units, performance awards and deferred compensation. These equity awards fall under several plans and are described in detail in our Annual Report on Form 10-K for the year ended December 3, 2016.

*Grant-Date Fair Value*

We use the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of options granted during the quarter ended September 2, 2017 and August 27, 2016 was calculated using the following weighted average assumptions:

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | September 2, 2017 | August 27, 2016 | September 2, 2017 | August 27, 2016 |
| Expected life (in years) | 4.75 | 4.75 | 4.75 | 4.74 |
| Weighted-average expected volatility | 23.91% | 26.77% | 24.84% | 28.96% |
| Expected volatility | 23.91% | 25.71% - 27.10% | 23.91% - 24.88% | 25.71% - 29.23% |
| Risk-free interest rate | 1.85% | 0.98% | 1.89% | 1.43% |
| Expected dividend yield | 1.15% | 1.26% | 1.12% | 1.54% |
| Weighted-average fair value of grants | $10.58 | $9.38 | $10.81 | $7.72 |

Expected life – We use historical employee exercise and option expiration data to estimate the expected life assumption for the Black-Scholes grant-date valuation. We believe that this historical data is currently the best estimate of the expected term of a new option. We use a weighted-average expected life for all awards.

Expected volatility – Volatility is calculated using our stock's historical volatility for the same period of time as the expected life. We have no reason to believe that our future volatility will differ materially from historical volatility.

Risk-free interest rate – The rate is based on the U.S. Treasury yield curve in effect at the time of the grant for the same period of time as the expected life.

Expected dividend yield – The calculation is based on the total expected annual dividend payout divided by the average stock price.

*Expense*

We use the straight-line attribution method to recognize share-based compensation expense for option awards, restricted stock shares and restricted stock units with graded and cliff vesting. Incentive stock options and performance awards are based on certain performance-based metrics and the expense is adjusted quarterly, based on our projections of the achievement of those metrics. The amount of share-based compensation expense recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. The expense is recognized over the requisite service period, which for us is the period between the grant-date and the earlier of the award's stated vesting term or the date the employee is eligible for early vesting based on the terms of the plans.

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Total share-based compensation expense of $3,191 and $2,501 was included in our Condensed Consolidated Statements of Income for the third quarter ended September 2, 2017 and August 27, 2016, respectively. Total share-based compensation expense of $12,034 and $9,469 was included in our Condensed Consolidated Statements of Income for the nine months ended September 2, 2017 and August 27, 2016, respectively. All share-based compensation expense was recorded as SG&A expense. For the third quarter ended September 2, 2017 and August 27, 2016, there was $151 and $870 of excess tax benefit recognized. For the nine months ended September 2, 2017 and August 27, 2016, there was $1,504 and $1,462 of excess tax benefit recognized.

As of September 2, 2017, there was $8,818 of unrecognized compensation costs related to unvested stock option awards, which is expected to be recognized over a weighted-average period of 1.1 years. Unrecognized compensation costs related to unvested restricted stock units was $14,376, which is expected to be recognized over a weighted-average period of 1.2 years.

*Stock Option Activity*

The stock option activity for the nine months ended September 2, 2017 is presented below:

| | **Options** | **Average Exercise Price** |
|---|---|---|
| Outstanding at December 3, 2016 | 2,986,481 | $ 34.92 |
| Granted | 721,904 | 50.04 |
| Exercised | (437,694 ) | 37.39 |
| Forfeited or cancelled | (89,589 ) | 36.69 |
| Outstanding at September 2, 2017 | 3,181,102 | $ 38.39 |

The total fair value of options granted during the quarter ended September 2, 2017 and August 27, 2016 was $46 and $47, respectively. Total intrinsic value of options exercised during the third quarter ended September 2, 2017 and August 27, 2016 was $474 and $3,365, respectively. Intrinsic value is the difference between our closing stock price on the respective trading day and the exercise price, multiplied by the number of options exercised. The total fair value of options granted during the nine months ended September 2, 2017 and August 27, 2016 were $7,803 and $6,509, respectively. Total intrinsic value of options exercised during the nine months ended September 2, 2017 and August 27, 2016 were $7,099 and $5,114, respectively.

Proceeds received from option exercises during the third quarter ended September 2, 2017 and August 27, 2016 was $1,107 and $2,677, respectively, and $15,033 and $9,760 during the nine months ended September 2, 2017 and August 27, 2016.

*Restricted Stock Activity*

The nonvested restricted stock activity for the nine months ended September 2, 2017 is presented below:

| | Units | Shares | Total | Weighted-Average Grant Date Fair Value | Weighted-Average Remaining Contractual Life (in Years) |
|---|---|---|---|---|---|
| Nonvested at December 3, 2016 | 352,744 | 36,953 | 389,697 | $ 38.36 | 1.0 |
| Granted | 284,598 | - | 284,598 | 50.71 | 1.4 |
| Vested | (154,516) | (36,953) | (191,469) | 39.92 | - |
| Forfeited | (20,597) | - | (20,597) | 39.06 | 1.3 |
| Nonvested at September 2, 2017 | 462,229 | - | 462,229 | $ 44.72 | 1.2 |

Total fair value of restricted stock vested during the third quarter ended September 2, 2017 and August 27, 2016 was $250 and $25, respectively. Total fair value of restricted stock vested during the nine months ended September 2, 2017 and August 27, 2016 was $7,643 and $6,101, respectively. The total fair value of nonvested restricted stock at September 2, 2017 was $21,240.

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We repurchased 1,837 and 189 restricted stock shares during the third quarter ended September 2, 2017 and August 27, 2016, respectively. We repurchased 55,646 and 67,742 restricted stock shares during the nine months ended September 2, 2017 and August 27, 2016, respectively. The repurchases relate to statutory minimum tax withholding.

*Deferred Compensation Activity*

We have a Directors' Deferred Compensation plan that allows non-employee directors to defer all or a portion of their directors' compensation in a number of investment choices, including units representing shares of our common stock. We also have a Key Employee Deferred Compensation Plan that allows key employees to defer a portion of their eligible compensation in a number of investment choices, including units, representing shares of our common stock. We provide a 10 percent match on deferred compensation invested into units, representing shares of our common stock. The deferred compensation unit activity for the nine months ended September 2, 2017 is presented below:

| | **Non-employee Directors** | **Employees** | **Total** |
|---|---|---|---|
| Units outstanding December 3, 2016 | 424,319 | 41,116 | 465,435 |
| Participant contributions | 23,864 | 5,053 | 28,917 |
| Company match contributions | 2,386 | 505 | 2,891 |
| Payouts | (14,143) | (12,552) | (26,695) |
| Units outstanding September 2, 2017 | 436,426 | 34,122 | 470,548 |

Deferred compensation units are fully vested at the date of contribution.

**Note 9: Components of Net Periodic Cost (Benefit) related to Pension and Other Postretirement Benefit Plans**

| **Three Months Ended September 2, 2017 and August 27, 2016** | | |
|---|---|---|
| **Pension Benefits** | | **Other Postretirement Benefits** |
| **U.S. Plans** | **Non-U.S. Plans** | |

| Net periodic cost (benefit): | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
|---|---|---|---|---|---|---|
| Service cost | **$27** | $27 | **$546** | $519 | **$52** | $84 |
| Interest cost | **3,603** | 3,768 | **1,199** | 1,343 | **399** | 479 |
| Expected return on assets | **(6,365)** | (6,078) | **(2,510)** | (2,435) | **(1,447)** | (1,341) |
| Amortization: | | | | | | |
| Prior service cost | **8** | 7 | **(1 )** | (1 ) | **-** | (10 ) |
| Actuarial loss | **1,308** | 1,292 | **893** | 788 | **251** | 532 |
| Net periodic (benefit) cost | **$(1,419)** | $(984 ) | **$127** | $214 | **$(745 )** | $(256 ) |

| | **Nine Months Ended September 2, 2017 and August 27, 2016** | | | | | |
|---|---|---|---|---|---|---|
| | **Pension Benefits** | | | | **Other Postretirement Benefits** | |
| | **U.S. Plans** | | **Non-U.S. Plans** | | | |
| Net periodic cost (benefit): | **2017** | **2016** | **2017** | **2016** | **2017** | **2016** |
| Service cost | **$83** | $81 | **$1,566** | $1,480 | **$156** | $252 |
| Interest cost | **10,809** | 11,303 | **3,490** | 4,076 | **1,195** | 1,439 |
| Expected return on assets | **(19,093)** | (18,232) | **(7,301)** | (7,400) | **(4,341)** | (4,025) |
| Amortization: | | | | | | |
| Prior service cost | **22** | 21 | **(3 )** | (3 ) | **-** | (30 ) |
| Actuarial loss | **3,922** | 3,878 | **2,581** | 2,293 | **757** | 1,596 |
| Net periodic (benefit) cost | **$(4,257 )** | $(2,949 ) | **$333** | $446 | **$(2,233)** | $(768 ) |

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**Note 10: Accumulated Other Comprehensive Income (Loss)**

The following table provides details of total comprehensive income (loss):

| | Three Months Ended September 2, 2017 | | | | Three Months Ended August 27, 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | H.B. Fuller Stockholders | | | Non-controlling Interests | H.B. Fuller Stockholders | | | Non-controlling Interests |
| | Pre-tax | Tax | Net | Net | Pre-tax | Tax | Net | Net |
| **Net income including non-controlling interests** | **-** | **-** | **$25,138** | **$ 1** | - | - | $32,745 | $ 53 |
| Foreign currency translation adjustment[1] | **$29,102** | **-** | **29,102** | **(12 )** | $3,368 | - | 3,368 | - |
| Reclassification to earnings: | | | | | | | | |
| Defined benefit pension plans adjustment[2] | **2,459** | **$(832)** | **1,627** | **-** | 2,585 | $(908) | 1,677 | - |
| Interest rate swap[3] | **16** | **(6 )** | **10** | **-** | 16 | (6 ) | 10 | - |
| Cash-flow hedges[3] | **(160 )** | **61** | **(99 )** | **-** | 56 | (21 ) | 35 | - |
| **Other comprehensive income (loss)** | **$31,417** | **$(777)** | **30,640** | **(12 )** | $6,025 | $(935) | 5,090 | - |
| Comprehensive income (loss) | | | **$55,778** | **$ (11 )** | | | $37,835 | $ 53 |

| | Nine Months Ended September 2, 2017 | | | | Nine Months Ended August 27, 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | H.B. Fuller Stockholders | | | Non-controlling Interests | H.B. Fuller Stockholders | | | Non-controlling Interests |
| | Pretax | Tax | Net | Net | Pretax | Tax | Net | Net |
| **Net income including non-controlling interests** | **-** | **-** | **$65,800** | **$ 34** | - | - | $84,994 | $ 161 |
| Foreign currency translation adjustment[1] | **$37,095** | **-** | **37,095** | **(11 )** | $3,860 | - | 3,860 | - |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Reclassification to earnings: | | | | | | | | |
| Defined benefit pension plans adjustment[2] | **7,279** | **$(2,469)** | **4,810** | **-** | 7,755 | $(2,723) | 5,032 | - |
| Interest rate swap[3] | **48** | **(18)** | **30** | **-** | 45 | (15) | 30 | - |
| Cash-flow hedges[3] | **11** | **(4)** | **7** | **-** | (252) | 96 | (156) | - |
| **Other comprehensive income (loss)** | **$44,433** | **$(2,491)** | **41,942** | **(11)** | $11,408 | $(2,642) | 8,766 | - |
| Comprehensive income (loss) | | | **$107,742** | **$ 23** | | | $93,760 | $ 161 |

[1] Income taxes are not provided for foreign currency translation relating to permanent investments in international subsidiaries. As discussed in Note 1, the foreign currency translation adjustment for the quarter and nine months ended September 2, 2017 includes the impact of the change in functional currency for our subsidiaries in Latin America.

[2] Loss reclassified from accumulated other comprehensive income ("AOCI") into earnings as part of net periodic cost related to pension and other postretirement benefit plans is reported in cost of sales, SG&A expense and special charges, net.

[3] Loss reclassified from AOCI into earnings is reported

in other income
(expense), net.

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The components of accumulated other comprehensive loss is as follows:

| | September 2, 2017 | | |
|---|---|---|---|
| | Total | H.B. Fuller Stockholders | Non-controlling Interests |
| Foreign currency translation adjustment | **$(48,363)** | **$ (48,286)** | **$ (77)** |
| Defined benefit pension plans adjustment, net of taxes of $88,265 | **(171,291)** | **(171,291)** | **-** |
| Interest rate swap, net of taxes of ($36) | **58** | **58** | **-** |
| Cash-flow hedges, net of taxes of $780 | **(1,268)** | **(1,268)** | **-** |
| Accumulated other comprehensive loss | **$(220,864)** | **$ (220,787)** | **$ (77)** |

| | December 3, 2016 | | |
|---|---|---|---|
| | Total | H.B. Fuller Stockholders | Non-controlling Interests |
| Foreign currency translation adjustment | $(85,447) | $ (85,381) | $ (66) |
| Defined benefit pension plans adjustment, net of taxes of $90,734 | (176,101) | (176,101) | - |
| Interest rate swap, net of taxes of ($17) | 28 | 28 | - |
| Cash-flow hedges, net of taxes of $785 | (1,275) | (1,275) | - |
| Accumulated other comprehensive loss | $(262,795) | $ (262,729) | $ (66) |

**Note 11: Income Taxes**

As of September 2, 2017, we had a liability of $4,997 recorded under FASB ASC 740, *Income Taxes,* for gross unrecognized tax benefits (excluding interest), compared to $4,165 as of December 3, 2016. As of September 2, 2017, we had accrued $838 of gross interest relating to unrecognized tax benefits. For the quarter ended September 2, 2017, our recorded liability for gross unrecognized tax benefits increased by $489.

**Note 12: Earnings Per Share**

A reconciliation of the common share components for the basic and diluted earnings per share calculations is as follows:

| | **Three Months Ended** | | **Nine Months Ended** | | | |
|---|---|---|---|---|---|---|
| | **September 2,** | **August 27,** | **September 2,** | **August 27,** | | |
| (Shares in thousands) | **2017** | **2016** | July 1, 2017 | July 2, 2016 | July 1, 2017 | July 2, 2016 |
| Beginning Balance | $18.2 | $17.5 | $20.3 | $19.1 | | |
| Less: Payments | (4.5) | (4.6) | (12.8) | (9.7) | | |
| Provisions | 4.4 | 6.3 | 10.5 | 9.8 | | |
| Translation Adjustments | — | — | 0.1 | — | | |
| Ending Balance | $18.1 | $19.2 | $18.1 | $19.2 | | |

These liabilities are included in Other Accrued Expenses and Other Noncurrent Liabilities on the Consolidated Balance Sheet.

## 13. DERIVATIVE INSTRUMENTS

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed using derivative instruments are commodity price risk, currency exchange risk, and interest rate risk. Forward contracts on certain commodities are entered into to manage the price risk associated with forecasted purchases of materials used in the Company's manufacturing process. Forward contracts on certain currencies are entered into to manage forecasted cash flows in certain foreign currencies. Interest rate swaps are entered into to manage interest rate risk associated with the Company's floating rate borrowings.

The Company is exposed to credit losses in the event of non-performance by the counterparties to various financial agreements, including its commodity hedging transactions, foreign currency exchange contracts and interest rate swap agreements. Exposure to counterparty credit risk is managed by limiting counterparties to major international banks and financial institutions meeting established credit guidelines and continually monitoring their compliance with the credit guidelines. The Company does not obtain collateral or other security to support financial instruments subject to credit risk. The Company does not anticipate non-performance by its counterparties, but cannot provide assurances.

The Company recognizes all derivative instruments as either assets or liabilities at fair value in the statement of financial position. The Company designates commodity forward contracts as cash flow hedges of forecasted purchases of commodities, currency forward contracts as cash flow hedges of forecasted foreign currency cash flows and interest rate swaps as cash flow hedges of forecasted LIBOR-based interest payments. There were no significant collateral deposits on derivative financial instruments as of July 1, 2017.

Cash flow hedges

For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of AOCI and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or changes in market value of derivatives not designated as hedges are recognized in current earnings.

At July 1, 2017, the Company had $(2.1) million, net of tax, of derivative losses on closed hedge instruments in AOCI that will be realized in earnings when the hedged items impact earnings. At December 31, 2016, the Company had $(7.5) million, net of tax, of derivative losses on closed hedge instruments in AOCI that was subsequently realized in earnings when the hedged items impacted earnings.

As of July 1, 2017, the Company had the following currency forward contracts outstanding (with maturities extending through October 2019) to hedge forecasted foreign currency cash flows (in millions):

| | Notional Amount (in US Dollars) |
|---|---|
| Chinese Renminbi | $ 324.2 |
| Mexican Peso | 229.8 |
| Euro | 59.8 |
| Indian Rupee | 40.7 |
| Canadian Dollar | 37.1 |
| Australian Dollar | 13.7 |
| Thai Baht | 6.2 |
| British Pound | 7.8 |

As of July 1, 2017, the Company had the following commodity forward contracts outstanding (with maturities extending through December 2018) to hedge forecasted purchases of commodities (notional amounts expressed in terms of the dollar value of the hedged item (in millions):

| | Notional Amount |
|---|---|
| Copper | $ 62.9 |
| Aluminum | 5.3 |

As of July 1, 2017, the total notional amount of the Company's receive-variable/pay-fixed interest rate swap was $100.0 million (with maturity in August 2017).
Fair values of derivative instruments as of July 1, 2017 and December 31, 2016 were (in millions):

| | July 1, 2017 | | | |
|---|---|---|---|---|
| | Prepaid Expenses and Other Current Assets | Other Noncurrent Assets | Current Hedging Obligations | Noncurrent Hedging Obligations |
| Designated as hedging instruments: | | | | |
| Interest rate swap contracts | $— | $ — | $ 1.1 | $ — |
| Currency contracts | 6.9 | 5.1 | 12.8 | 1.1 |
| Commodity contracts | 5.1 | 0.2 | 0.2 | — |
| Not designated as hedging instruments: | | | | |
| Currency contracts | 3.2 | — | 0.4 | — |
| Commodity contracts | 0.1 | — | — | — |
| Total Derivatives | $15.3 | $ 5.3 | $ 14.5 | $ 1.1 |

| | December 31, 2016 | | | |
|---|---|---|---|---|
| | Prepaid Expenses and Other Current Assets | Other Noncurrent Assets | Current Hedging Obligations | Noncurrent Hedging Obligations |
| Designated as hedging instruments: | | | | |
| Interest rate swap contracts | $— | $ — | $ 3.3 | $ — |
| Currency contracts | 1.3 | 0.4 | 39.7 | 17.6 |
| Commodity contracts | 4.7 | — | — | — |
| Not designated as hedging instruments: | | | | |
| Currency contracts | 1.5 | — | 6.0 | — |
| Commodity contracts | 2.6 | — | — | — |
| Total Derivatives | $10.1 | $ 0.4 | $ 49.0 | $ 17.6 |

The effect of derivative instruments on the Condensed Consolidated Statements of Income and Comprehensive Income (pre-tax) was as follows (in millions):

Derivatives Designated as Cash Flow Hedging Instruments

| | Three Months Ended | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | July 1, 2017 | | | | July 2, 2016 | | | |
| | Commodity Forwards | Currency Forwards | Interest Rate Swaps | Total | Commodity Forwards | Currency Forwards | Interest Rate Swaps | Total |
| Gain (Loss) recognized in Other Comprehensive Income (Loss) | $2.2 | $ 13.9 | $ — | $16.1 | $0.7 | $ (18.2 ) | $ (0.3 ) | $ (17.8 ) |
| Amounts reclassified from Other Comprehensive Income (Loss): | | | | | | | | |
| Gain recognized in Net Sales | — | 0.3 | — | 0.3 | — | — | — | — |
| Gain (Loss) recognized in Cost of Sales | 3.8 | (7.5 ) | — | (3.7 ) | (4.3 ) | (6.7 ) | — | (11.0 ) |
| Loss recognized in Interest Expense | — | — | (1.1 ) | (1.1 ) | — | — | (1.3 ) | (1.3 ) |

| | Six Months Ended | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | July 1, 2017 | | | | July 2, 2016 | | | |
| | Commodity Forwards | Currency Forwards | Interest Rate Swaps | Total | Commodity Forwards | Currency Forwards | Interest Rate Swaps | Total |
| Gain (Loss) recognized in Other Comprehensive Income (Loss) | $4.5 | $ 42.9 | $ — | $47.4 | $2.1 | $ (15.6 ) | $ (0.7 ) | $ (14.2 ) |
| Amounts reclassified from Other Comprehensive Income (Loss): | | | | | | | | |
| Gain recognized in Net Sales | — | 0.4 | — | 0.4 | — | — | — | — |
| Gain (Loss) recognized in Cost of Sales | 4.7 | (19.1 ) | — | (14.4 ) | (9.7 ) | (13.2 ) | — | (22.9 ) |
| Loss recognized in Interest Expense | — | — | (2.2 ) | (2.2 ) | — | — | (2.5 ) | (2.5 ) |

The ineffective portion of hedging instruments recognized during the three and six months ended July 1, 2017 and July 2, 2016, respectively, was immaterial.

Derivatives Not Designated as Cash Flow Hedging Instruments (in millions):

| | Three Months Ended | | | |
|---|---|---|---|---|
| | July 1, 2017 | | July 2, 2016 | |
| | Commodity Forwards | Currency Forwards | Commodity Forwards | Currency Forwards |
| Gain (Loss) recognized in Cost of Sales | $(1.4) | $ — | $ 0.1 | $ — |
| Gain (Loss) recognized in Operating Expenses | — | 3.3 | — | (1.6) |

| | Six Months Ended | | | |
|---|---|---|---|---|
| | July 1, 2017 | | July 2, 2016 | |
| | Commodity Forwards | Currency Forwards | Commodity Forwards | Currency Forwards |
| Gain recognized in Cost of Sales | $0.2 | $ — | $ 0.2 | $ — |
| Gain (Loss) recognized in Operating Expenses | — | 7.7 | — | (0.7) |

The net AOCI hedging component balance of $(1.7) million loss at July 1, 2017 includes $0.4 million of net current deferred gains expected to be realized in the next twelve months.

The Company's commodity and currency derivative contracts are subject to master netting agreements with the respective counterparties which allow the Company to net settle transactions with a single net amount payable by one party to another party. The Company has elected to present the derivative assets and derivative liabilities on the Condensed Consolidated Balance Sheets on a gross basis for the periods ended July 1, 2017 and December 31, 2016.

The following table presents the derivative assets and derivative liabilities presented on a net basis under enforceable master netting agreements (in millions):

| | July 1, 2017 | | |
|---|---|---|---|
| | Gross Amounts as Presented in the Condensed Consolidated Balance Sheet | Derivative Contract Amounts Subject to Right of Offset | Derivative Contracts as Presented on a Net Basis |
| Prepaid Expenses and Other Current Assets: | | | |
| Derivative Currency Contracts | $10.1 | $ (5.6 ) | $ 4.5 |
| Derivative Commodity Contracts | 5.2 | (0.2 ) | 5.0 |
| Other Noncurrent Assets: | | | |
| Derivative Currency Contracts | 5.1 | (0.9 ) | 4.2 |
| Derivative Commodity Contracts | 0.2 | — | 0.2 |
| Current Hedging Obligations: | | | |
| Derivative Currency Contracts | 13.2 | (5.6 ) | 7.6 |
| Derivative Commodity Contracts | 0.2 | (0.2 ) | — |
| Noncurrent Hedging Obligations: | | | |
| Derivative Currency Contracts | 1.1 | (0.9 ) | 0.2 |

| | December 31, 2016 | | |
|---|---|---|---|
| | Gross Amounts as Presented in the Condensed Consolidated Balance Sheet | Derivative Contract Amounts Subject to Right of Offset | Derivative Contracts as Presented on a Net Basis |
| Prepaid Expenses and Other Current Assets: | | | |
| Derivative Currency Contracts | $2.8 | $ (1.7 ) | $ 1.1 |
| Derivative Commodity Contracts | 7.3 | — | 7.3 |
| Other Noncurrent Assets: | | | |
| Derivative Currency Contracts | 0.4 | (0.2 ) | 0.2 |
| Current Hedging Obligations: | | | |
| Derivative Currency Contracts | 45.7 | (1.7 ) | 44.0 |
| Noncurrent Hedging Obligations: | | | |
| Derivative Currency Contracts | 17.6 | (0.2 ) | 17.4 |

14. FAIR VALUE

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 (exit price). The inputs used to measure fair value are classified into the following hierarchy:

Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities
Level 2 Unadjusted quoted prices in active markets for similar assets or liabilities, or
Unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active, or
Inputs other than quoted prices that are observable for the asset or liability
Level 3 Unobservable inputs for the asset or liability

The Company uses the best available information in measuring fair value. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.
The fair values of cash equivalents and short-term deposits approximate their carrying values as of July 1, 2017 and December 31, 2016, due to the short period of time to maturity and are classified using Level 1 inputs. The fair values of trade receivables and accounts payable approximate the carrying values due to the short period of time to maturity. See Note 7 of Notes to Condensed Consolidated Financial Statements for disclosure of the approximate fair value of the Company's debt at July 1, 2017 and December 31, 2016.
The following table sets forth the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of July 1, 2017 and December 31, 2016 (in millions):

| | July 1, 2017 | December 31, 2016 | Classification |
|---|---|---|---|
| Assets: | | | |
| Prepaid Expenses and Other Current Assets: | | | |
| Derivative Currency Contracts | $ 10.1 | $ 2.8 | Level 2 |
| Derivative Commodity Contracts | 5.2 | 7.3 | Level 2 |
| Other Noncurrent Assets: | | | |
| Assets Held in Rabbi Trust | 5.5 | 5.4 | Level 1 |
| Derivative Currency Contracts | 5.1 | 0.4 | Level 2 |
| Derivative Commodity Contracts | 0.2 | — | Level 2 |
| Liabilities: | | | |
| Current Hedging Obligations: | | | |
| Interest Rate Swap | 1.1 | 3.3 | Level 2 |
| Derivative Currency Contracts | 13.2 | 45.7 | Level 2 |
| Derivative Commodity Contracts | 0.2 | — | Level 2 |
| Noncurrent Hedging Obligations: | | | |
| Derivative Currency Contracts | 1.1 | 17.6 | Level 2 |

Level 1 fair value measurements for assets held in a Rabbi Trust are unadjusted quoted prices.
Level 2 fair value measurements for derivative assets and liabilities are measured using quoted prices in active markets for similar assets and liabilities. Interest rate swaps are valued based on the discounted cash flows for the LIBOR forward yield curve for a swap with similar contractual terms. Foreign currency forwards are valued based on exchange rates quoted by domestic and foreign banks for similar instruments. Commodity forwards are valued based on observable market transactions of forward commodity prices.
During the six months ended July 1, 2017, there were no transfers between classification Levels 1, 2 or 3.

15. RESTRUCTURING AND RELATED COSTS

The Company incurred restructuring and restructuring related costs on projects beginning in 2014. Restructuring costs include employee termination and plant relocation costs. Restructuring-related costs include costs directly associated with actions resulting from our Simplification initiatives, such as asset write-downs or accelerated depreciation due to shortened useful lives in connection with site closures, discretionary employment benefit costs and other facility rationalization costs. Restructuring costs for employee termination expenses are generally required to be accrued over the employees remaining service period while restructuring costs for plant relocation costs and restructuring-related costs are generally required to be expensed as incurred.

The following is a reconciliation of provisions and payments for the restructuring projects for the three and six months ended July 1, 2017 and July 2, 2016 (in millions):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 1, 2017 | July 2, 2016 | July 1, 2017 | July 2, 2016 |
| Beginning Balance | $1.0 | $ 1.0 | $0.6 | $ 1.3 |
| Provision | 7.7 | 1.7 | 10.9 | 3.1 |
| Less: Payments | 7.4 | 1.3 | 10.2 | 3.0 |
| Ending Balance | $1.3 | $ 1.4 | $1.3 | $ 1.4 |

The following is a reconciliation of restructuring and restructuring-related costs for the restructuring projects for the three and six months ended July 1, 2017 and July 2, 2016, respectively (in millions):

| | Three Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | July 1, 2017 | | | July 2, 2016 | | |
| Restructuring Costs: | Cost of Sales | Operating Expenses | Total | Cost of Sales | Operating Expenses | Total |
| Employee Termination Expenses | $1.2 | $ 0.7 | $ 1.9 | $0.2 | $ 0.1 | $ 0.3 |
| Facility Related Costs | 1.6 | 0.1 | 1.7 | 0.4 | 0.4 | 0.8 |
| Other Expenses | 3.9 | — | 3.9 | 0.6 | — | 0.6 |
| Total Restructuring Costs | $6.7 | $ 0.8 | $ 7.5 | $1.2 | $ 0.5 | $ 1.7 |
| Restructuring Related Costs: | | | | | | |
| Other Employment Benefit Expenses | $0.2 | $ — | $ 0.2 | $— | $ — | $— |
| Total Restructuring Related Costs | $0.2 | $ — | $ 0.2 | $— | $ — | $— |
| Total Restructuring and Restructuring Related Costs | $6.9 | $ 0.8 | $ 7.7 | $1.2 | $ 0.5 | $ 1.7 |

| | Six Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | July 1, 2017 | | | July 2, 2016 | | |
| Restructuring Costs: | Cost of Sales | Operating Expenses | Total | Cost of Sales | Operating Expenses | Total |
| Employee Termination Expenses | $2.4 | $ 1.3 | $3.7 | $0.4 | $ 0.1 | $ 0.5 |
| Facility Related Costs | 2.3 | 0.3 | 2.6 | 0.5 | 0.4 | 0.9 |
| Other Expenses | 3.9 | — | 3.9 | 0.6 | — | 0.6 |
| Total Restructuring Costs | $8.6 | $ 1.6 | $10.2 | $1.5 | $ 0.5 | $ 2.0 |
| Restructuring Related Costs: | | | | | | |
| Other Employment Benefit Expenses | $0.7 | $ — | $0.7 | $0.5 | $ 0.6 | $ 1.1 |
| Total Restructuring Related Costs | $0.7 | $ — | $0.7 | $0.5 | $ 0.6 | $ 1.1 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total Restructuring and Restructuring Related Costs | $9.3 | $ 1.6 | $10.9 | $2.0 | $ 1.1 | $ 3.1 |

The following table shows the allocation of Restructuring Costs by segment for the three and six months ended July 1, 2017 and July 2, 2016. (in millions):

| | Total | Commercial and Industrial Systems | Climate Solutions | Power Transmission Solutions |
|---|---|---|---|---|
| Restructuring Costs - Three Months Ended July 1, 2017 | $ 7.7 | $ 6.9 | $ 0.6 | $ 0.2 |
| Restructuring Costs - Three Months Ended July 2, 2016 | $ 1.7 | $ 0.7 | $ 0.5 | $ 0.5 |

| | Total | Commercial and Industrial Systems | Climate Solutions | Power Transmission Solutions |
|---|---|---|---|---|
| Restructuring Costs - Six Months Ended July 1, 2017 | $ 10.9 | $ 8.6 | $ 1.7 | $ 0.6 |
| Restructuring Costs - Six Months Ended July 2, 2016 | $ 3.1 | $ 0.8 | $ 1.8 | $ 0.5 |

The Company's current restructuring activities are expected to continue into 2018. The Company expects to record aggregate future charges of approximately $8.7 million which includes $1.8 million of employee termination expenses and $6.9 million of facility related and other costs.

16. SUBSEQUENT EVENT

The Company has evaluated subsequent events from July 1, 2017 through the date of this report. The Company is not aware of any subsequent events that would require recognition or disclosure.

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

Unless the context requires otherwise, references in this Item 2 to “we,” “us,” “our” or the “Company” refer collectively to Regal Beloit Corporation and its subsidiaries.

Overview

Regal Beloit Corporation (NYSE: RBC), based in Beloit, Wisconsin (USA), is a leading manufacturer of electric motors, electrical motion controls, power generation and power transmission products serving markets throughout the world.

Operating Segments

Our company is comprised of three operating segments: Commercial and Industrial Systems, Climate Solutions and Power Transmission Solutions.

A description of the three operating segments is as follows:

- Commercial and Industrial Systems produces medium and large motors, commercial and industrial equipment, generator and custom drives and systems. These products serve markets including commercial Heating, Ventilation, and Air Conditioning ("HVAC"), pool and spa, standby and critical power and oil and gas systems.
- Climate Solutions produces small motors, controls and air moving solutions serving markets including residential and light commercial HVAC, water heaters and commercial refrigeration.
- 

Power Transmission Solutions manufactures, sells and services belt and chain drives, helical and worm gearing, mounted and unmounted bearings, couplings, modular plastic belts, conveying chains and components, hydraulic pump drives, large open gearing and specialty mechanical products serving markets including beverage, bulk handling, metals, special machinery, energy, aerospace and general industrial.

Components of Profit and Loss
Net Sales. We sell our products to a variety of manufacturers, distributors and end users. Our customers consist of a large cross-section of businesses, ranging from Fortune 100 companies to small businesses. A number of our products are sold to Original Equipment Manufacturers ("OEM's"), who incorporate our products, such as electric motors, into products they manufacture, and many of our products are built to the requirements of our customers. The majority of our sales derive from direct sales, but a significant portion derives from sales made by manufacturer's representatives, who are paid exclusively on commission. Our product sales are made via purchase order, long-term contract, and, in some instances, one-time purchases. Many of our products have broad customer bases, with the levels of concentration of revenues varying from division to division.

Our level of net sales for any given period is dependent upon a number of factors, including (i) the demand for our products; (ii) the strength of the economy generally and the end markets in which we compete; (iii) our customers' perceptions of our product quality at any given time; (iv) our ability to timely meet customer demands; (v) the selling price of our products; and (vi) the weather. As a result, our total revenue has tended to experience quarterly variations and our total revenue for any particular quarter may not be indicative of future results.

We use the term "organic sales" to refer to sales from existing operations excluding (i) sales from acquired businesses recorded prior to the first anniversary of the acquisition less the amount of sales attributable to any divested businesses ("acquisition sales"), and (ii) the impact of foreign currency translation. The impact of foreign currency translation is determined by translating the respective period's sales (excluding acquisition sales) using the same currency exchange rates that were in effect during the prior year periods. We use the term "organic sales growth" to refer to the increase in our sales between periods that is attributable to organic sales. We use the term "acquisition growth" to refer to the increase in our sales between periods that is attributable to acquisition sales.

Gross Profit. Our gross profit is impacted by our levels of net sales and cost of sales. Our cost of sales consists of costs for, among other things (i) raw materials, including copper, steel and aluminum; (ii) components such as castings, bars, tools, bearings and electronics; (iii) wages and related personnel expenses for fabrication, assembly and logistics personnel; (iv) manufacturing facilities, including depreciation on our manufacturing facilities and equipment, taxes, insurance and utilities; and (v) shipping. The majority of our cost of sales consists of raw materials and components. The price we pay for commodities and components can be subject to commodity price fluctuations. We attempt to mitigate this through fixed-price agreements with suppliers and our hedging strategies. We are currently reducing the number of our suppliers we use in order to leverage the better prices and terms that can be obtained with higher volume orders. A large amount of our suppliers are in North America. As we expand production and our geographic footprint, we expect it may be advantageous to increase our use of foreign suppliers. When we experience commodity price increases, we have tended to announce price increases to our customers who purchase via purchase order, with such increases generally taking effect a period of time after the public announcements. For those sales we make under long-term contracts, we tend to include material price formulas that specify quarterly or semi-annual price adjustments based on a variety of factors, including commodity prices.

Outside of general economic cyclicality, our different business units experience different levels of variation in gross margin from quarter to quarter based on factors specific to each division. For example, a portion of our Climate Solutions segment manufactures products that are used in air conditioning applications. As a result, our sales for that business tend to be lower in the first and fourth quarters and higher in the second and third quarters. In contrast, our Commercial and Industrial Systems segment and our Power Transmission Solutions segment have a broad customer base and a variety of applications, thereby helping to mitigate large quarter-to-quarter fluctuations outside of general economic conditions.

Operating Expenses. Our operating expenses consist primarily of (i) general and administrative expenses; (ii) sales and marketing expenses; (iii) general engineering and research and development expenses; and (iv) handling costs

incurred in conjunction with distribution activities. Personnel related costs are our largest operating expense.

Our general and administrative expenses consist primarily of costs for (i) salaries, benefits and other personnel expenses related to our executive, finance, human resource, information technology, legal and operations functions; (ii) occupancy expenses; (iii) technology related costs; (iv) depreciation and amortization; and (v) corporate-related travel. The majority of our general and administrative costs are for salaries and related personnel expenses. These costs can vary by division given the location of our different manufacturing operations.

Our sales and marketing expenses consist primarily of costs for (i) salaries, benefits and other personnel expenses related to our sales and marketing function; (ii) internal and external sales commissions and bonuses; (iii) travel, lodging and other out-of-pocket expenses associated with our selling efforts; and (iv) other related overhead.

Our general engineering and research and development expenses consist primarily of costs for (i) salaries, benefits and other personnel expenses; (ii) the design and development of new energy efficiency products and enhancements; (iii) quality assurance and testing; and (iv) other related overhead. Our research and development efforts tend to be targeted toward developing new products that would allow us to maintain or gain additional market share, whether in new or existing applications. While these costs make up an insignificant portion of our operating expenses in the Power Transmission Solutions segment, they are more substantial in our Commercial and Industrial Systems and Climate Solutions segments. In particular, a large driver of our research and development efforts in these two segments is energy efficiency, which generally means using less electrical power to produce more mechanical power.

Operating Profit. Our operating profit consists of the segment gross profit less the segment operating expenses. In addition, there are shared operating costs that cover corporate, engineering and IT expenses that are consistently allocated to the operating segments and are included in the segment operating expenses. Operating profit is a key metric used to measure year over year improvement of the segments.

Restructuring and Related Costs. Beginning in 2014, we announced the closure of several of our manufacturing and warehouse facilities and consolidation into existing facilities to simplify manufacturing operations in our Commercial and Industrial Systems, Climate Solutions and Power Transmission Solutions segments. As a result of these closures, we incurred restructuring and restructuring-related costs. Restructuring costs includes employee termination and plant relocation costs. Restructuring-related costs includes costs directly associated with actions resulting from our simplification initiatives, such as asset write-downs or accelerated depreciation due to shortened useful lives in connection with site closures, discretionary employment benefit costs and other facility rationalization costs. Restructuring costs for employee termination expenses are generally required to be accrued over the employees remaining service period while restructuring costs for plant relocation costs and restructuring-related costs are generally required to be expensed as incurred.

Outlook

Our order trends remain positive, and we continue to expect low single digit organic sales growth for the full year.

Results of Operations

Three Months Ended July 1, 2017 Compared to July 2, 2016

Net sales increased $30.6 million or 3.6% for the second quarter 2017 compared to the second quarter 2016. The increase consisted of an organic sales increase of 4.8%, a negative foreign currency translation impact of 0.7% and a negative impact from the sale of the Mastergear Worldwide (“Mastergear”) business of 0.5%. Gross profit of $223.0 million for the second quarter 2017 was relatively unchanged as compared to the second quarter 2016. Gross profit as a percentage of sales for the second quarter 2017 decreased 90 basis points as compared to the second quarter 2016 primarily driven by restructuring charges, commodity inflation and challenges of increasing our production after recent plant consolidations which were partially offset by the sales volume increase. Operating expenses for the second quarter 2017 increased $8.5 million or 6.5% as compared to the same period in the prior year. The prior year included a gain on the sale of Mastergear totaling $11.6 million.

Commercial and Industrial Systems Segment net sales for the second quarter 2017 were $407.4 million, an increase of $12.7 million or 3.2% as compared to the second quarter 2016. The increase consisted of an organic sales increase of 4.3%, driven by growth in Asia and improved oil and gas end markets and a negative foreign currency translation impact of 1.1%. Gross profit decreased $4.3 million as compared to the prior year. The decrease was mainly driven by an increase in restructuring costs due to the exit of a noncore business, commodity inflation and challenges of increasing our production after recent plant consolidations that was partially offset by the increase in sales volume. Operating expenses for the second quarter 2017 were flat at $71.3 million as compared to the same period in the prior year. Operating expenses as a percentage of net sales decreased 50 basis points as compared to second quarter 2016 due to leveraging of costs on the increased sales base and lower depreciation and amortization expenses which was partially offset by the increase in restructuring charges.

Climate Solutions Segment net sales were $270.5 million, an increase of 6.3% compared to second quarter 2016 net sales of $254.5 million. The increase consisted of an organic sales increase of 6.5%, driven by growth in North American residential HVAC and partially offset by weakness in commercial refrigeration. Foreign currency had a negative 0.2% impact on the net sales for the second quarter 2017. Gross profit increased $3.6 million or 5.6% compared to the prior year primarily due to the increase in sales volume. Operating expenses for the second quarter 2017 were $28.1 million which was an 80 basis points decrease as a percentage of net sales as compared to the prior year primarily due to leveraging of costs on the increased sales volume.
Power Transmission Solutions segment net sales for the first quarter 2017 were $191.3 million or a 1.0% increase compared to second quarter 2016 net sales of $189.4 million. The increase consisted of an organic sales growth increase of 3.5%, a negative impact from the Mastergear divestiture of 2.0% and a negative foreign currency translation impact of 0.5%. The increase in organic

sales was primarily driven by improved oil and gas and renewable energy end market demand. Gross profit for the first quarter 2017 increased $0.8 million or 1.3% primarily due to the increase in sales volume. Operating expenses for the second quarter 2017 increased $8.8 million as compared to the second quarter 2016. Operating expenses in the prior year were reduced by the gain on the sale of the Mastergear business of $11.6 million.

Six Months Ended July 1, 2017 Compared to July 2, 2016

Net sales increased $25.9 million or 1.6% for the six months ended July 1, 2017 compared to the six months ended July 2, 2016. The increase consisted of an organic sales growth increase of 2.8%, a negative impact from sales of the divested Mastergear business of 0.5% and a negative foreign currency translation impact of 0.6%. Gross profit for the six months ended July 1, 2017 decreased $1.7 million or 0.4% compared to the six months ended July 2, 2016 primarily due to increased restructuring charges and partially offset by the increase in sales volume. Operating expenses for the six months ended July 1, 2017 increased $1.2 million or 0.4% compared to the same period in the prior year due the $11.6 million gain on the sale of the Mastergear business recorded in the prior year which is partially offset by the leveraging of costs on the increased sales volume and lower depreciation and amortization expenses.

Commercial and Industrial Systems segment net sales increased $16.3 million or 2.1% for the six months ended July 1, 2017 compared to the six months ended July 2, 2016. The increase consisted of an organic sales increase of 3.0% and a negative foreign currency translation impact of 0.9%. Organic sales increase was primarily driven by growth in Asia and improved oil and gas end markets. Gross profit for six months ended 2017 decreased $2.3 million or 1.2% primarily due to the impact of increased restructuring charges resulting from the exit of a non-core business that was offset by increased sales volume. Operating expenses for the six months ended July 1, 2017 decreased $1.9 million or 1.3% compared to the six months ended July 2, 2016 due to leveraging of costs on the increased sales base and lower depreciation and amortization expenses.

Climate Solutions segment net sales increased $23.9 million or 4.8% for the six months ended July 1, 2017 compared to the six months ended July 2, 2016. The increase consisted of an organic sales increase of 5.1% and a negative foreign currency translation impact of 0.3%. The organic sales increase was primarily driven by growth in North American residential HVAC partially offset by weakness in commercial refrigeration. Gross profit increased $8.1 million or 6.7% primarily due to higher volumes. Operating expenses for the six months ended July 1, 2017 decreased $2.6 million or 4.3% as compared to the six months ended July 2, 2016.

Power Transmission Solutions segment net sales decreased $14.3 million or 3.7% for the six months ended July 1, 2017 compared to the six months ended July 2, 2016. The decrease consisted of a negative impact from sales of the divested Mastergear business of 2.3%, an organic sales decline of 0.8% and a negative foreign currency translation impact of 0.5%. Improved oil and gas and renewable energy end market demand sales partially offset the organic sales decline. Gross profit for the six months ended July 1, 2017 compared to the six months ended July 2, 2016 decreased $7.5 million or 5.8% primarily due to the lower sales volume. Operating expenses for the six months ended July 1, 2017 increased $5.7 million or 7.5% as compared to the six months ended July 2, 2016 as the prior year included the $11.6 million gain on the sale of the Mastergear business.

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 1, 2017 | July 2, 2016 | July 1, 2017 | July 2, 2016 |
| (Dollars in Millions) | | | | |
| Net Sales: | | | | |
| Commercial and Industrial Systems | $407.4 | $394.7 | $788.6 | $772.3 |
| Climate Solutions | 270.5 | 254.5 | 518.2 | 494.3 |
| Power Transmission Solutions | 191.3 | 189.4 | 375.9 | 390.2 |
| Consolidated | $869.2 | $838.6 | $1,682.7 | $1,656.8 |
| | | | | |
| Gross Profit as a Percent of Net Sales: | | | | |
| Commercial and Industrial Systems | 22.6 % | 24.4 % | 23.8 % | 24.6 % |
| Climate Solutions | 25.3 % | 25.4 % | 24.9 % | 24.5 % |
| Power Transmission Solutions | 32.8 % | 32.7 % | 32.5 % | 33.2 % |
| Consolidated | 25.7 % | 26.6 % | 26.1 % | 26.6 % |
| | | | | |
| Operating Expenses as a Percent of Net Sales: | | | | |
| Commercial and Industrial Systems | 17.5 % | 18.0 % | 17.9 % | 18.5 % |
| Climate Solutions | 10.4 % | 11.2 % | 11.1 % | 12.2 % |
| Power Transmission Solutions | 21.2 % | 16.8 % | 21.8 % | 19.6 % |
| Consolidated | 16.1 % | 15.7 % | 16.7 % | 16.9 % |
| | | | | |
| Income from Operations as a Percent of Net Sales: | | | | |
| Commercial and Industrial Systems | 5.1 % | 6.4 % | 5.9 % | 6.1 % |
| Climate Solutions | 14.9 % | 14.2 % | 13.8 % | 12.3 % |
| Power Transmission Solutions | 11.6 % | 16.0 % | 10.6 % | 13.6 % |
| Consolidated | 9.5 % | 10.9 % | 9.4 % | 9.7 % |
| | | | | |
| Income from Operations | $83.0 | $91.4 | $157.8 | $160.7 |
| Interest Expense | 14.7 | 14.8 | 29.1 | 29.8 |
| Interest Income | 1.0 | 1.2 | 2.0 | 2.3 |
| Income before Taxes | 69.3 | 77.8 | 130.7 | 133.2 |
| Provision for Income Taxes | 15.0 | 19.4 | 28.8 | 32.1 |
| Net Income | 54.3 | 58.4 | 101.9 | 101.1 |
| Less: Net Income Attributable to Noncontrolling Interests | 1.3 | 1.8 | 2.6 | 2.9 |
| Net Income Attributable to Regal Beloit Corporation | $53.0 | $56.6 | $99.3 | $98.2 |

The effective tax rate for the three months ended July 1, 2017 was 21.6% versus 24.9% for the three months ended July 2, 2016. The effective tax rate for the six months ended July 1, 2017 was 22.0% versus 24.1% for the six months ended July 2, 2016. The change in the effective tax rate for the three months and six months ended July 1, 2017 was primarily driven by the mix of earnings and the 2016 gain derived from the sale of the Mastergear business. The lower effective rate as compared to the 35.0% statutory Federal income tax rate is driven by lower foreign tax rates.

Liquidity and Capital Resources

General

Our principal source of liquidity is cash flow provided by operating activities. In addition to operating income, other significant factors affecting our cash flow include working capital levels, capital expenditures, dividends, share

repurchases, acquisitions, availability of debt financing, and the ability to attract long-term capital at acceptable terms.



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Cash flow provided by operating activities was $148.9 million for the six months ended July 1, 2017, a $27.2 million decrease from the six months ended July 2, 2016. The decrease was primarily the result of the higher investment in net working capital for the six months ended July 1, 2017 as compared to the six months ended July 2, 2016.

Cash flow used in investing activities was $31.9 million for the six months ended July 1, 2017 versus $2.1 million for the six months ended July 2, 2016. The change was driven by the $25.0 million received for the sale of our Mastergear business in the six months ended July 2, 2016.

Cash flow used in financing activities was $164.5 million for the six months ended July 1, 2017, compared to $151.7 million provided by financing activities for the six months ended July 2, 2016. Net repayments of $113.8 million were made during the six months ended July 1, 2017, compared to net repayments of $109.9 million made during the six months ended July 2, 2016. We paid $21.4 million in dividends to shareholders in the six months ended July 1, 2017, compared to $20.5 million for the six months ended July 2, 2016. Cash used for share repurchases was $21.0 million for the six months ended July 1, 2017. Cash used to purchase additional interest in joint ventures was $19.6 million for the six months ended July 2, 2016.

Our working capital was $910.3 million at July 1, 2017, compared to $830.4 million at December 31, 2016. At July 1, 2017 and December 31, 2016, our current ratio (which is the ratio of our current assets to current liabilities) was 2.2:1. Our working capital increased primarily due to an increase in Trade Receivables of $82.3 million at July 1, 2017 as compared to December 31, 2016. We will pay our $100.0 million 2007 Note due in August using existing cash as well as cash generated from operations.

The following table presents selected financial information and statistics as of July 1, 2017 and January 2, 2016 (in millions):

| | July 1, 2017 | December 31, 2016 |
|---|---|---|
| Cash and Cash Equivalents | $243.7 | $ 284.5 |
| Trade Receivables, Net | 544.5 | 462.2 |
| Inventories | 698.2 | 660.8 |
| Working Capital | 910.3 | 830.4 |
| Current Ratio | 2.2:1 | 2.2:1 |

At July 1, 2017, our cash and cash equivalents totaled $243.7 million. At July 1, 2017, $239.9 million of our cash was held by foreign subsidiaries and could be used in our domestic operations if necessary. The repatriation of cash from certain foreign subsidiaries could have adverse net tax consequences on us should we be required to pay and record US income taxes and foreign withholding taxes on such funds. We periodically evaluate our cash held outside the US and may pursue opportunities to repatriate certain foreign cash amounts to the extent that we do not incur unfavorable net tax consequences. During the six months ended July 1, 2017, we have repatriated $101.4 million of foreign cash.

Substantially all of our expenses are paid in cash, often with payment term provisions that include early payment discounts and time elements. We believe that our ability to generate positive cash flow coupled with our available revolving credit balance will be sufficient to fund our operations for the foreseeable future. We focus on optimizing our investment in working capital through improved and enforced payment terms, maintaining an optimal level of inventory and operational efficiencies. Additionally, we believe that our capital expenditures for maintenance of equipment and facilities will be consistent with prior levels and not present a funding challenge.

We will, from time to time, maintain excess cash balances which may be used to (i) fund operations, (ii) repay outstanding debt, (iii) fund acquisitions, (iv) pay dividends, (v) make investments in new product development programs, (vi) repurchase our common stock, or (vii) fund other corporate objectives.

Credit Agreement

In connection with the PTS Acquisition, on January 30, 2015, we entered into a new Credit Agreement (the “Credit Agreement”) with JPMorgan Chase Bank, N.A., as Administrative Agent and the lenders named therein, providing for a (i) 5-year unsecured term loan facility in the principal amount of $1.25 billion (the “Term Facility”) and (ii) a 5-year unsecured multicurrency revolving facility in the principal amount of $500.0 million (the “Multicurrency Revolving Facility”), including a $100 million letter of credit sub facility available for general corporate purposes. Borrowings under the Credit Agreement bear interest at floating rates

based upon indices determined by the currency of the borrowing, plus an applicable margin determined by reference to our consolidated funded debt to consolidated EBITDA ratio or at an alternative base rate.

The Term Facility was drawn in full on January 30, 2015 in connection with the closing of the PTS Acquisition. The loan under the Term Facility requires quarterly amortization at a rate starting at 5.0% per annum, increasing to 7.5% per annum after two years and further increasing to 10.0% per annum for the last two years of the Term Facility, unless previously prepaid. The weighted average interest rate on the Term Facility was 2.5% and 2.4% for the three and six months ended July 1, 2017, respectively and 1.9% for the three and six months ended July 2, 2016. The Credit Agreement requires we prepay the loans under the Term Facility with 100% of the net cash proceeds received from specified asset sales and borrowed money indebtedness, subject to certain exceptions.

At July 1, 2017, we had borrowings under the Multicurrency Revolving Facility in the amount of $15.9 million, $32.3 million of standby letters of credit issued under the facility, and $451.8 million of available borrowing capacity. The average daily balance in borrowings under the Multicurrency Revolving Facility was $114.8 and $109.2 million, and the weighted average interest rate on the Multicurrency Revolving Facility was 2.5% and 2.4% for the three and six months ended July 1, 2017, respectively. The average daily balance in borrowings under the Multicurrency Revolving Facility was $29.8 million and $52.7 million, and the weighted average interest rate on the Multicurrency Revolving Facility was 1.9% for the three and six months ended July 2, 2016. We pay a non-use fee on the aggregate unused amount of the Multicurrency Revolving Facility at a rate determined by reference to its consolidated funded debt to consolidated EBITDA ratio.

Senior Notes

At July 1, 2017, we had $600.0 million of senior notes (the “Notes”) outstanding. The Notes consist of (i) $500.0 million in senior notes (the “2011 Notes”) in a private placement which were issued in seven tranches with maturities from seven to twelve years and carry fixed interest rates and (ii) $100.0 million in senior notes (the “2007 Notes”) issued in 2007 with a floating interest rate based on a margin over the London Inter-Bank Offered Rate (“LIBOR”).

Details on the Notes at July 1, 2017 were (in millions):

| | Principal | Interest Rate | Maturity |
|---|---|---|---|
| Floating Rate Series 2007A | $ 100.0 | Floating [1] | August 23, 2017 |
| Fixed Rate Series 2011A | 100.0 | 4.1% | July 14, 2018 |
| Fixed Rate Series 2011A | 230.0 | 4.8 to 5.0% | July 14, 2021 |
| Fixed Rate Series 2011A | 170.0 | 4.9 to 5.1% | July 14, 2023 |
| | $ 600.0 | | |

[1] Interest rates vary as LIBOR varies. At July 1, 2017, the interest rate was 1.9%. At December 31, 2016, the interest rate was 1.6%

We have an interest rate swap agreement to manage fluctuations in cash flows resulting from interest rate risk (see also Note 13 of Notes to the Condensed Consolidated Financial Statements).

Compliance with Financial Covenants

The Credit Agreement and the Notes require us to meet specified financial ratios and to satisfy certain financial condition tests. We were in compliance with all financial covenants contained in the Notes and the Credit Agreement as of July 1, 2017.

Other Notes Payable

At July 1, 2017, other notes payable of approximately $5.3 million were outstanding with a weighted average interest rate of 5.1%. At December 31, 2016, other notes payable of approximately $5.1 million were outstanding with a weighted average rate of 5.6%.

Based on rates for instruments with comparable maturities and credit quality, which are classified as Level 2 inputs (see also Note 14 of Notes to the Condensed Consolidated Financial Statements), the approximate fair value of our total debt was $1,325.3 million and $1,433.4 million as of July 1, 2017 and December 31, 2016, respectively.

Critical Accounting Policies

Our disclosures of critical accounting policies, which are contained in our Annual Report on Form 10-K for the year ended December 31, 2016, have not materially changed since that report was filed.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk relating to our operations due to changes in interest rates, foreign currency exchange rates and commodity prices of purchased raw materials. We manage the exposure to these risks through a combination of normal operating and financing activities and derivative financial instruments such as interest rate swaps, commodity cash flow hedges and foreign currency forward exchange contracts. All hedging transactions are authorized and executed pursuant to clearly defined policies and procedures, which strictly prohibit the use of financial instruments for speculative purposes.

All qualified hedges are recorded on the balance sheet at fair value and are accounted for as cash flow hedges, with changes in fair value recorded in accumulated other comprehensive income (loss) (“AOCI”) in each accounting period. An ineffective portion of the hedges change in fair value, if any, is recorded in earnings in the period of change.

Interest Rate Risk

We are exposed to interest rate risk on certain of our short-term and long-term debt obligations used to finance our operations and acquisitions. At July 1, 2017, excluding the impact of interest rate swaps, we had $505.3 million of fixed rate debt and $794.9 million of variable rate debt. We utilize interest rate swaps to manage fluctuations in cash flows resulting from exposure to interest rate risk on forecasted variable rate interest payments.

We have LIBOR-based floating rate borrowings, which expose us to variability in interest payments due to changes in interest rates. A hypothetical 10% change in our weighted average borrowing rate on outstanding variable rate debt at July 1, 2017 would result in a $1.2 million change in after-tax annualized earnings. We have entered into a pay fixed/receive LIBOR-based floating interest rate swap to manage fluctuations in cash flows resulting from interest rate risk. This interest rate swap has been designated as a cash flow hedge against forecasted LIBOR-based interest payments.

Details regarding this instrument, as of July 1, 2017, are as follows (in millions):

| Instrument | Notional Amount | Maturity | Rate Paid | Rate Received | Fair Value (Loss) |
|---|---|---|---|---|---|
| Swap | $ 100.0 | August 23, 2017 | 5.4% | LIBOR (3 month) | $ (1.1 ) |

As of July 1, 2017, an interest rate swap liability of $(1.1) million was included in Current Hedging Obligations. As of December 31, 2016, an interest rate swap liability of $(3.3) million was included in Current Hedging Obligations. The unrealized loss on the effective portion of the contract, net of tax, of $(0.7) million and $(2.1) million as of July 1, 2017 and December 31, 2016, respectively, was recorded in AOCI.

Foreign Currency Risk

We are exposed to foreign currency risks that arise from normal business operations. These risks include the translation of local currency balances of foreign subsidiaries, intercompany loans with foreign subsidiaries and transactions denominated in foreign currencies. Our objective is to minimize our exposure to these risks through a combination of normal operating activities and the utilization of foreign currency exchange contracts to manage our exposure on the forecasted transactions denominated in currencies other than the applicable functional currency. Contracts are executed with credit worthy banks and are denominated in currencies of major industrial countries. We do not hedge our exposure to the translation of reported results of foreign subsidiaries from local currency to United States dollars.

Derivatives

As of July 1, 2017, derivative currency assets (liabilities) of $10.1 million, $5.1 million, $(13.2) million and $(1.1) million, are recorded in Prepaid Expenses and Other Current Assets, Other Noncurrent Assets, Current Hedging Obligations, and Noncurrent Hedging Obligations, respectively. As of December 31, 2016, derivative currency assets (liabilities) of $2.8 million, $0.4 million, $(45.7) million and $(17.6) million, are recorded in Prepaid Expenses and Other Current Assets, Other Noncurrent Assets, Current Hedging Obligations, and Noncurrent Hedging Obligations, respectively. The unrealized losses on the contracts of $(1.2) million net of tax, and $(34.4) million net of tax, as of July 1, 2017 and December 31, 2016 respectively, were recorded in AOCI. At July 1, 2017, we had $(3.1) million, net of tax, of derivative currency losses on closed hedge instruments in AOCI that will be realized

in earnings when the hedged items impact earnings. At December 31, 2016, we had $(8.0) million of derivative currency losses on closed hedge instruments in AOCI that will be realized in earnings when the hedged items impacted earnings.
The following table quantifies the outstanding foreign exchange contracts intended to hedge non-US dollar denominated receivables and payables and the corresponding impact on the value of these instruments assuming a hypothetical 10% appreciation/depreciation of their counter currency on July 1, 2017 (in millions):

| Currency | Notional Amount | Fair Value | Gain (Loss) From 10% Appreciation of Counter Currency | 10% Depreciation of Counter Currency |
|---|---|---|---|---|
| Chinese Renminbi | $ 324.2 | $ 3.1 | $ 32.4 | $ (32.4) |
| Mexican Peso | 229.8 | (5.6) | 23.0 | (23.0) |
| Euro | 59.8 | 0.5 | 6.0 | (6.0) |
| Indian Rupee | 40.7 | 3.0 | 4.1 | (4.1) |
| Canadian Dollar | 37.1 | 0.1 | 3.7 | (3.7) |
| Australian Dollar | 13.7 | (0.3) | 1.4 | (1.4) |
| Thai Baht | 6.2 | — | 0.6 | (0.6) |
| British Pound | 7.8 | 0.1 | 0.8 | (0.8) |

Gains and losses indicated in the sensitivity analysis would be offset by gains and losses on the underlying forecasted non-US dollar denominated cash flows.
Commodity Price Risk
We periodically enter into commodity hedging transactions to reduce the impact of changing prices for certain commodities such as copper and aluminum based upon forecasted purchases of such commodities. Qualified hedge transactions are designated as cash flow hedges and the contract terms of commodity hedge instruments generally mirror those of the hedged item, providing a high degree of risk reduction and correlation.
Derivatives
Derivative commodity assets (liabilities) of $5.2 million, $0.2 million, and $(0.2) million were recorded in Prepaid Expenses and Other Current Assets, Other Noncurrent Assets and Current Hedging Obligations, respectively, at July 1, 2017. Derivative commodity assets of $7.3 million are recorded in Prepaid Expenses at December 31, 2016. The unrealized gains on the effective portion of the contracts of $2.3 million net of tax and $2.9 million net of tax, as of July 1, 2017 and December 31 2016, respectively, were recorded in AOCI. At July 1, 2017, we had $1.0 million, net of tax, of derivative commodity gains on closed hedge instruments in AOCI that will be realized in earnings when the hedged items impact earnings. At December 31, 2016, there was $0.5 million, net of tax, of derivative commodity gains on closed hedge instruments in AOCI that were realized into earnings when the hedged items impacted earnings.
The following table quantifies the outstanding commodity contracts intended to hedge raw material commodity prices and the corresponding impact on the value of these instruments assuming a hypothetical 10% appreciation/depreciation of their prices on July 1, 2017 (in millions):

| Commodity | Notional Amount | Fair Value | Gain (Loss) From 10% Appreciation of Commodity Prices | 10% Depreciation of Commodity Prices |
|---|---|---|---|---|
| Copper | $ 62.9 | $ 4.9 | $ 6.3 | $ (6.3) |
| Aluminum | 5.3 | 0.3 | 0.5 | (0.5) |

Gains and losses indicated in the sensitivity analysis would be offset by the actual prices of the commodities.

The net AOCI balance of $(1.7) million loss at July 1, 2017 includes $0.4 million of net current deferred gains expected to be realized in the next twelve months.

Counterparty Risk

We are exposed to credit losses in the event of non-performance by the counterparties to various financial agreements, including our interest rate swap agreements, foreign currency exchange contracts and commodity hedging transactions. We manage exposure to counterparty credit risk by limiting our counterparties to major international banks and financial institutions meeting established credit guidelines and continually monitoring their compliance with the credit guidelines. We do not obtain collateral or other security to support financial instruments subject to credit risk. We do not anticipate non-performance by our counterparties, but cannot provide assurances.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company’s management, with the participation of the Company’s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company’s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report. Based on such evaluation, the Company’s Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company’s disclosure controls and procedures were effective to ensure that (a) information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and (b) information required to be disclosed by us in the reports the Company files or submits under the Exchange Act is accumulated and communicated to our management, including its Chief Executive Officer and its Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

There were no changes in the Company’s internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

There have been no material changes in the legal matters described in Part I, Item 3 of the Company’s Annual Report on Form 10-K for the year ended December 31, 2016, which is incorporated here by reference.

ITEM 1A. RISK FACTORS

Our business and financial results are subject to numerous risks and uncertainties. The risk and uncertainties have not changed materially from those reported in Item 1A in our 2016 Annual Report on Form 10-K for the year ended December 31, 2016, which is incorporated here by reference.

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

The following table contains detail related to the repurchase of our common stock based on the date of trade during the quarter ended July 1, 2017.

| 2017 Fiscal Month | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as a Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| April 2 to May 6 | 763 | $ 79.56 | — | 2,320,000 |
| May 7 to June 3 | 239,522 | 78.83 | 213,140 | 2,106,860 |
| June 4 to July 1 | 64,156 | 78.68 | 63,664 | 2,043,196 |
| | 304,441 | | 276,804 | |

Under our equity incentive plans, participants may pay the exercise price or satisfy all or a portion of the federal, state and local withholding tax obligations arising in connection with plan awards by electing to (a) have the Company withhold shares of common stock otherwise issuable under the award, (b) tender back shares received in connection with such award or (c) deliver other previously owned shares of common stock, in each case having a value equal to the exercise price or the amount to be withheld. During the quarter ended July 1 2017, we acquired 27,637 shares in connection with transactions pursuant to equity incentive plans.

In November, 2013, the Board of Directors approved the repurchase of up to 3.0 million shares of our common stock, which repurchase authority has no expiration date. Management is authorized to effect purchases from time to time in the open market or through privately negotiated transactions. During the quarter ended July 1 2017, we acquired 276,804 shares pursuant to this authorization. We have entered into a Rule10b5-1 trading plan for the purpose of repurchasing shares under this authorization, and certain of our purchases under the authorization during the quarter were made pursuant to the Rule10b5-1 trading plan.

ITEM 6. EXHIBITS

| Exhibit Number | Exhibit Description |
| --- | --- |
| 12 | Computation of Ratio of Earnings to Fixed Charges. |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certifications of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350. |
| 101 | The following materials from Regal Beloit Corporation's Quarterly Report on Form 10-Q for the quarter ended July 1, 2017, formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statements of Income, (ii) the Condensed Consolidated Statements of Comprehensive Income, (iii) the Condensed Consolidated Balance Sheets, (iv) the Condensed Consolidated Statements of Equity, (v) the Condensed Consolidated Statements of Cash Flows, and (vi) Notes to Condensed Consolidated Financial Statements. |

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

REGAL BELOIT CORPORATION
(Registrant)

/s/ Charles A. Hinrichs
Charles A. Hinrichs
Vice President
Chief Financial Officer
(Principal Financial Officer)

/s/ Robert A. Lazzerini
Robert A. Lazzerini
Vice President
Corporate Controller
(Principal Accounting Officer)

Date: August 8, 2017

INDEX TO EXHIBITS

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