CARPENTER TECHNOLOGY CORP
Form 10-Q
February 09, 2015

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 December 31, 2014

or

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

For the transition period from to

Commission File Number 1-5828

CARPENTER TECHNOLOGY CORPORATION
(Exact name of Registrant as specified in its Charter)

Delaware (State or other jurisdiction of incorporation or organization)	23-0458500 (I.R.S. Employer Identification No.)
P.O. Box 14662 Reading, Pennsylvania (Address of principal executive offices)	19610 (Zip Code)

610-208-2000
(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 o

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 o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.:

Large accelerated filer:	x		Accelerated filer:	o
Non-accelerated filer:	o	(Do not check if a smaller reporting company)	Smaller reporting company:	o

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

The number of shares outstanding of the issuer's common stock as of January 28, 2015 was 52,587,379.

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PART I
Item 1. Financial Statements

CARPENTER TECHNOLOGY CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited)
(in millions, except share data)

	December 31, 2014	June 30, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$28.8	$120.0
Accounts receivable, net	309.2	339.6
Inventories	757.1	699.2
Deferred income taxes	9.4	—
Other current assets	87.5	35.7
Total current assets	1,192.0	1,194.5
Property, plant and equipment, net	1,416.6	1,407.0
Goodwill	257.5	257.7
Other intangibles, net	75.7	80.6
Other assets	113.2	117.7
Total assets	$3,055.0	$3,057.5
LIABILITIES		
Current liabilities:		
Short-term debt	$37.0	$—
Accounts payable	191.3	278.1
Accrued liabilities	137.2	148.0
Deferred income taxes	—	4.5
Total current liabilities	365.5	430.6
Long-term debt, net of current portion	607.1	604.3
Accrued pension liabilities	209.4	203.4
Accrued postretirement benefits	161.3	163.2
Deferred income taxes	182.5	110.7
Other liabilities	53.2	41.0
Total liabilities	1,579.0	1,553.2
Contingencies and commitments (see Note 8)		
STOCKHOLDERS' EQUITY		
Common stock — authorized 100,000,000 shares; issued 55,190,220 shares at December 31, 2014 and 55,161,875 shares at June 30, 2014; outstanding 53,050,765 shares at December 31, 2014 and 53,137,144 shares at June 30, 2014	276.0	275.8
Capital in excess of par value	260.3	263.5
Reinvested earnings	1,329.9	1,311.6
Common stock in treasury (2,139,455 shares and 2,024,731 shares at December 31, 2014 and June 30, 2014, respectively), at cost	(107.4)	(101.4)
Accumulated other comprehensive loss	(282.8)	(245.2)
Total equity	1,476.0	1,504.3
Total liabilities and equity	$3,055.0	$3,057.5

See accompanying notes to consolidated financial statements.

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CARPENTER TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(in millions, except per share data)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2014	2013	2014	2013
NET SALES	$548.4	$503.5	$1,098.2	$1,002.1
Cost of sales	463.4	408.1	944.1	803.3
Gross profit	85.0	95.4	154.1	198.8
Selling, general and administrative expenses	40.0	47.9	86.9	95.5
Operating income	45.0	47.5	67.2	103.3
Interest expense, net	(6.8)	(3.7)	(13.8)	(8.2)
Other income, net	—	0.6	4.8	0.8
Income before income taxes	38.2	44.4	58.2	95.9
Income tax expense	14.1	14.9	20.6	31.8
Net income	$24.1	$29.5	$37.6	$64.1
EARNINGS PER COMMON SHARE:				
Basic	$0.45	$0.55	$0.70	$1.20
Diluted	$0.45	$0.55	$0.70	$1.19
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:				
Basic	53.4	53.2	53.5	53.2
Diluted	53.6	53.6	53.7	53.5
Cash dividends per common share	$0.18	$0.18	$0.36	$0.36

See accompanying notes to consolidated financial statements.

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CARPENTER TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
($ in millions)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2014	2013	2014	2013
Net income	$24.1	$29.5	$37.6	$64.1
Other comprehensive (loss) income, net of tax				
Pension and postretirement benefits, net of tax of $(1.9), $(2.0), $(3.7) and $(4.3), respectively	2.9	3.9	5.9	7.5
Net (loss) gain on derivative instruments, net of tax of $4.3, $(1.4), $15.3 and $(3.6), respectively	(7.3)	2.4	(25.5)	6.0
Unrealized gain on marketable securities, net of tax of $0.0, $0.0, $0.0 and $0.0, respectively	—	0.2	—	0.1
Foreign currency translation	(10.1)	1.4	(18.0)	4.9
Other comprehensive (loss) income	(14.5)	7.9	(37.6)	18.5
Comprehensive income	$9.6	$37.4	$—	$82.6

See accompanying notes to consolidated financial statements.

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CARPENTER TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
($ in millions)

	Six Months Ended December 31,	
	2014	2013
OPERATING ACTIVITIES		
Net income	$37.6	$64.1
Adjustments to reconcile net income to net cash provided from operating activities:		
Depreciation and amortization	60.6	53.5
Deferred income taxes	69.5	(0.7)
Net pension expense	23.0	28.0
Stock-based compensation expense	2.2	5.9
Net loss on disposal of property and equipment	0.4	0.1
Changes in working capital and other:		
Accounts receivable	22.7	78.8
Inventories	(62.2)	(59.3)
Other current assets	(61.4)	(9.6)
Accounts payable	(28.0)	(49.1)
Accrued liabilities	(25.0)	(35.2)
Pension plan contributions	(3.9)	(3.1)
Other postretirement plan contributions	(6.7)	(7.0)
Other, net	(1.3)	(3.3)
Net cash provided from operating activities	27.5	63.1
INVESTING ACTIVITIES		
Purchases of property, equipment and software	(127.4)	(204.5)
Proceeds from disposals of property and equipment	0.1	0.3
Net cash used for investing activities	(127.3)	(204.2)
FINANCING ACTIVITIES		
Net change in short-term debt	37.0	—
Dividends paid	(19.3)	(19.2)
Purchase of treasury stock	(10.0)	—
Tax benefits on share-based compensation	0.6	1.9
Proceeds from stock options exercised	0.7	5.6
Net cash provided from (used for) financing activities	9.0	(11.7)
Effect of exchange rate changes on cash and cash equivalents	(0.4)	1.5
DECREASE IN CASH AND CASH EQUIVALENTS	(91.2)	(151.3)
Cash and cash equivalents at beginning of period	120.0	257.5
Cash and cash equivalents at end of period	$28.8	$106.2
SUPPLEMENTAL CASH FLOW INFORMATION:		
Non-cash operating activities:		
Technology licensing agreement, Note 14	$—	$9.7
Non-cash investing activities:		
Acquisition of property, equipment and software	$7.6	$64.9
Non-cash financing activities:		
Seller-financed debt related to the purchase of software	$4.9	$—

See accompanying notes to consolidated financial statements.

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CARPENTER TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
FOR THE SIX MONTHS ENDED DECEMBER 31, 2014 AND 2013
(Unaudited)
($ in millions, except per share data)

	Common Stock Par Value Of $5	Capital in Excess of Par Value	Reinvested Earnings	Common Stock in Treasury	Accumulated Other Comprehensive (Loss) Gain	Total Equity
Balances at June 30, 2014	$275.8	$263.5	$1,311.6	$(101.4)	$ (245.2)	$1,504.3
Net income			37.6			37.6
Pension and postretirement benefits gain, net of tax					5.9	5.9
Net loss on derivative instruments, net of tax					(25.5)	(25.5)
Foreign currency translation					(18.0)	(18.0)
Cash Dividends:						
Common @ $0.36 per share			(19.3)			(19.3)
Purchase of treasury stock				(10.0)		(10.0)
Share-based compensation plans		(4.3)		4.0		(0.3)
Stock options exercised	0.2	0.5				0.7
Tax windfall on share-based compensation		0.6				0.6
Balances at December 31, 2014	$276.0	$260.3	$1,329.9	$(107.4)	$ (282.8)	$1,476.0

	Common Stock Par Value Of $5	Capital in Excess of Par Value	Reinvested Earnings	Common Stock in Treasury	Accumulated Other Comprehensive (Loss) Gain	Total Equity
Balances at June 30, 2013	$274.6	$254.4	$1,217.3	$(107.5)	$ (335.7)	$1,303.1
Net income			64.1			64.1
Pension and postretirement benefits gain, net of tax					7.5	7.5
Net gain on derivative instruments, net of tax					6.0	6.0
Unrealized gain on marketable securities, net of tax					0.1	0.1
Foreign currency translation					4.9	4.9
Cash Dividends:						
Common @ $0.36 per share			(19.2)			(19.2)
		(1.5)		4.2		2.7

Share-based compensation plans						
Stock options exercised	1.0	4.6				5.6
Tax windfall on share-based compensation		1.9				1.9
Balances at December 31, 2013	$275.6	$259.4	$1,262.2	$(103.3)	$ (317.2)	$1,376.7

See accompanying notes to consolidated financial statements.

CARPENTER TECHNOLOGY CORPORATION
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements 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 and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, considered necessary for a fair statement of the results are reflected in the interim periods presented. The June 30, 2014 consolidated balance sheet data was derived from audited financial statements, but does not include all the disclosures required by U.S. generally accepted accounting principles. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in Carpenter's annual report on Form 10-K for the year ended June 30, 2014 (the "2014 Form 10-K"). Operating results for the three and six months ended December 31, 2014 are not necessarily indicative of the operating results for any future period.

Certain amounts in the consolidated financial statements and notes to the consolidated financial statements for prior year periods have been reclassified to conform to the fiscal year 2015 presentation.

As used throughout this report, unless the context requires otherwise, the terms "Carpenter", the "Company", "Registrant", "Issuer", "we" and "our" refer to Carpenter Technology Corporation.

2. Revision to Statement of Cash Flows

During the third quarter of fiscal year 2014, the Company identified an error in the classification of amounts reported in previously reported statements of cash flows. The classification error is related to the reporting of purchases of property, equipment and software that should be adjusted for amounts not yet paid in cash as of the balance sheet date, which were incorrectly reflected as cash used in investing activities and cash provided from operating activities. The Company assessed the materiality of this classification error and determined that the classification error is not material to any previously reported financial statements. The revision of prior reported amounts has no impact on the reported change in cash and cash equivalents or amounts reported in the consolidated balance sheets, statements of income, statements of comprehensive income or statements of changes in equity. The effects of the revisions to the statement of cash flows for the six months ended December 31, 2013 are presented in the following table:

($ in millions)	As Reported	Revision Impact	As Revised
Net cash provided from operating activities	$71.0	$(7.9)	$63.1
Net cash used for investing activities	(212.1)	7.9	(204.2)
Net cash used for financing activities	(11.7)	—	(11.7)
Effect of exchange rate changes on cash and cash equivalents	1.5	—	1.5
Decrease in cash and cash equivalents	$(151.3)	$—	$(151.3)

3. Earnings Per Common Share

The Company calculates basic and diluted earnings per share using the two class method. Under the two class method, earnings are allocated to common stock and participating securities (nonvested restricted shares and units that receive non-forfeitable dividends) according to their participation rights in dividends and undistributed earnings. The earnings available to each class of stock are divided by the weighted average number of outstanding shares for the period in each class. Diluted earnings per share assumes the issuance of common stock for all potentially dilutive share equivalents outstanding.

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(Unaudited)

The calculations of basic and diluted earnings per common share for the three and six months ended December 31, 2014 and 2013 were as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
(in millions, except per share data)	2014	2013	2014	2013
Net income	$24.1	$29.5	$37.6	$64.1
Less: earnings and dividends allocated to participating securities	—	(0.1)	(0.1)	(0.2)
Earnings available for Carpenter common stockholders used in calculation of basic earnings per share	$24.1	$29.4	$37.5	$63.9
Weighted average number of common shares outstanding, basic	53.4	53.2	53.5	53.2
Basic earnings per common share	$0.45	$0.55	$0.70	$1.20
Net income	$24.1	$29.5	$37.6	$64.1
Less: earnings and dividends allocated to participating securities	—	(0.1)	(0.1)	(0.2)
Earnings available for Carpenter common stockholders used in calculation of diluted earnings per share	$24.1	$29.4	$37.5	$63.9
Weighted average number of common shares outstanding, basic	53.4	53.2	53.5	53.2
Effect of shares issuable under share-based compensation plans	0.2	0.4	0.2	0.3
Weighted average number of common shares outstanding, diluted	53.6	53.6	53.7	53.5
Diluted earnings per common share	$0.45	$0.55	$0.70	$1.19

The following awards issued under share-based compensation plans were excluded from the above calculations of diluted earnings per share because their effects were anti-dilutive:

	Three Months Ended December 31,		Six Months Ended December 31,	
(in millions)	2014	2013	2014	2013
Stock options	0.7	—	0.6	0.1

4. Inventories

Inventories consisted of the following components as of December 31, 2014 and June 30, 2014:

($ in millions)

	December 31, 2014	June 30, 2014
Raw materials and supplies	$140.8	$122.3
Work in process	414.6	393.9
Finished and purchased products	201.7	183.0
Total inventory	$757.1	$699.2

Inventories are valued at the lower of cost or market. Cost for inventories is principally determined using the last-in, first-out ("LIFO") method.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

5. Accrued Liabilities

Accrued liabilities consisted of the following as of December 31, 2014 and June 30, 2014:

($ in millions)	December 31, 2014	June 30, 2014
Accrued compensation and benefits	$43.2	$49.8
Derivative financial instruments	21.5	4.7
Accrued pension liabilities	16.4	19.3
Accrued postretirement benefits	15.5	15.5
Accrued interest expense	11.2	11.2
Accrued income taxes	—	8.4
Other	29.4	39.1
Total accrued liabilities	$137.2	$148.0

6. Pension and Other Postretirement Benefits

The components of the net periodic benefit cost related to the Company’s pension and other postretirement benefits for the three and six months ended December 31, 2014 and 2013 were as follows:

Three months ended December 31,	Pension Plans		Other Postretirement Plans	
($ in millions)	2014	2013	2014	2013
Service cost	$8.0	$8.2	$1.1	$1.0
Interest cost	13.5	14.3	3.0	3.1
Expected return on plan assets	(17.2)	(15.7)	(1.7)	(1.6)
Amortization of net loss	4.2	5.5	0.5	0.3
Amortization of prior service cost	0.1	0.1	—	—
	$8.6	$12.4	$2.9	$2.8
Six months ended December 31,	Pension Plans		Other Postretirement Plans	
($ in millions)	2014	2013	2014	2013
Service cost	$16.0	$16.2	$2.2	$2.0
Interest cost	27.0	28.6	5.9	6.2
Expected return on plan assets	(34.4)	(31.4)	(3.3)	(3.2)
Amortization of net loss	8.4	11.0	1.0	0.6
Amortization of prior service cost	0.2	0.2	—	—
	$17.2	$24.6	$5.8	$5.6

Historically, the Company capitalized in inventory only the service cost portion of periodic benefit costs associated with manufacturing employees. During the three months ended December 31, 2013, the Company began to capitalize the portion of periodic benefit costs related to the interest cost, expected return on assets and amortization of net actuarial loss and prior service cost (benefit), which the Company refers to as pension earnings, interest and deferrals (“pension EID”), related to current manufacturing employees in inventory. The impact of this change resulted in an increase in the amount of capitalized periodic benefit costs of $2.2 million during the three and six months ended December 31, 2013. This change did not have a material impact on any previously reported amounts.

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During the six months ended December 31, 2014 and 2013, the Company made $3.9 million and $3.1 million, respectively, of contributions to its qualified defined benefit pension plans. The Company currently expects to make approximately $3.2 million of contributions to its qualified defined benefit pension plans during the remainder of fiscal year 2015.

7. Debt

The Company has a $500.0 million syndicated credit agreement ("Credit Agreement") that extends to June 2018. Interest on the borrowings under the Credit Agreement accrue at variable rates, based upon LIBOR or a defined "Base Rate," both determined based upon the rating of the Company's senior unsecured long-term debt (the "Debt Rating"). The applicable margin to be added to LIBOR ranges from 0.75% to 1.90% (1.25% as of December 31, 2014), and for Base Rate-determined loans, from 0.00% to 0.90% (0.25% as of December 31, 2014). The Company also pays a quarterly commitment fee ranging from 0.075% to 0.375% (0.150% as of December 31, 2014), determined based upon the Debt Rating, of the unused portion of the $500.0 million commitment under the Credit Agreement. In addition, the Company must pay certain letter of credit fees, ranging from 0.75% to 1.90% (1.25% as of December 31, 2014), with respect to letters of credit issued under the Credit Agreement. The Company has the right to voluntarily prepay and reborrow loans and to terminate or reduce the commitments under the facility. As of December 31, 2014, the Company had $8.2 million of issued letters of credit and $37.0 million of short-term borrowings under the Credit Agreement. The balance of the Credit Agreement ($454.8 million) was available to the Company.

The Company is subject to certain financial and restrictive covenants under the Credit Agreement, which, among other things, require the maintenance of a minimum interest coverage ratio of 3.50 to 1.00. The interest coverage ratio is defined in the Credit Agreement as, for any period, the ratio of consolidated earnings before interest, taxes, depreciation and amortization and non-cash net pension expense ("EBITDA") to consolidated interest expense for such period. The Credit Agreement also requires the Company to maintain a debt to capital ratio of less than 55%. The debt to capital ratio is defined in the Credit Agreement as the ratio of consolidated indebtedness, as defined therein, to consolidated capitalization, as defined therein. As of December 31, 2014 and June 30, 2014, the Company was in compliance with all of the covenants of the Credit Agreement.

Long-term debt outstanding as of December 31, 2014 and June 30, 2014 consisted of the following:

($ in millions)	December 31, 2014	June 30, 2014
Medium-term notes, Series B at 6.97% to 7.10% due from April 2018 to May 2018 (face value of $55.0 million at December 31, 2014 and June 30, 2014)	$55.0	$55.0
Senior unsecured notes, 5.20% due July 2021 (face value of $250.0 million at December 31, 2014 and June 30, 2014)	252.5	249.7
Senior unsecured notes, 4.45% due March 2023 (face value of $300.0 million at December 31, 2014 and June 30, 2014)	299.6	299.6
Total	607.1	604.3
Less: amounts due within one year	—	—
Long-term debt, net of current portion	$607.1	$604.3

For the three months ended December 31, 2014 and 2013, interest costs totaled $7.5 million and $8.2 million, respectively, of which $0.7 million and $4.5 million, respectively, were capitalized as part of the cost of property, plant, equipment and software. For the six months ended December 31, 2014 and 2013, interest costs totaled $15.1 million and $16.1 million, respectively, of which $1.3 million and $7.9 million, respectively, were capitalized as part of the cost of property, plant, equipment and software.

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CARPENTER TECHNOLOGY CORPORATION
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. Contingencies and Commitments

Environmental

The Company is subject to various federal, state, local and international environmental laws and regulations relating to pollution, protection of public health and the environment, natural resource damages and occupational safety and health. Although compliance with these laws and regulations may affect the costs of the Company's operations, compliance costs to date have not been material. The Company has environmental remediation liabilities at some of its owned operating facilities and has been designated as a potentially responsible party ("PRP") with respect to certain third party Superfund waste-disposal sites and other third party-owned sites. Additionally, the Company has been notified that it may be a PRP with respect to other Superfund sites as to which no proceedings have been instituted against the Company. Neither the exact amount of remediation costs nor the final method of their allocation among all designated PRP's at these Superfund sites have been determined. The liability for future environmental remediation costs is evaluated by management on a quarterly basis. The Company accrues amounts for environmental remediation costs that represent management's best estimate of the probable and reasonably estimable undiscounted future costs related to environmental remediation. During the six months ended December 31, 2014, the Company increased the liability for a company-owned former operating site by $0.1 million. The liabilities recorded for environmental remediation costs at Superfund sites, other third party-owned sites and Carpenter-owned current or former operating facilities remaining at December 31, 2014 and June 30, 2014 were $15.6 million and $15.5 million, respectively.

Estimates of the amount and timing of future costs of environmental remediation requirements are inherently imprecise because of the continuing evolution of environmental laws and regulatory requirements, the availability and application of technology, the identification of currently unknown remediation sites and the allocation of costs among the PRP's. Based upon information currently available, such future costs are not expected to have a material effect on Carpenter's financial position, results of operations or cash flows over the long-term. However, such costs could be material to Carpenter's financial position, results of operations or cash flows in a particular future quarter or year.

Other

The Company is defending various routine claims and legal actions that are incidental to its business and common to its operations, including those pertaining to product claims, commercial disputes, patent infringement, employment actions, employee benefits, compliance with domestic and foreign laws, personal injury claims and tax issues. Like many other manufacturing companies in recent years, the Company, from time to time, has been named as a defendant in lawsuits alleging personal injury as a result of exposure to chemicals and substances in the workplace. The Company provides for costs relating to these matters when a loss is probable and the amount of the loss is reasonably estimable. The effect of the outcome of these matters on the Company's future results of operations and liquidity cannot be predicted because any such effect depends on future results of operations and the amount and timing (both as to recording future charges to operations and cash expenditures) of the resolution of such matters. While it is not feasible to determine the outcome of these matters, management believes that the total liability from these matters will not have a material effect on the Company's financial position, results of operations or cash flows over the long-term. However, there can be no assurance that an increase in the scope of pending matters or that any future lawsuits, claims, proceedings or investigations will not be material to the Company's financial position, results of operations or cash flows in a particular future quarter or year.

9. Share Repurchase Program

In October 2014, the Company's Board of Directors authorized a share repurchase program. The program authorizes the purchase of up to $500.0 million of the Company's outstanding common stock. The shares may be repurchased from time to time at the Company's discretion based on capital needs of the business, general market conditions and market price of the stock. The share repurchase program may be discontinued at any time. During the three months ended December 31, 2014, the Company purchased 200,400 of its common stock on the open market for an aggregate of $10.0 million.

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CARPENTER TECHNOLOGY CORPORATION
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

10. Fair Value Measurements

The fair value hierarchy has three levels based on the inputs used to determine fair value. Level 1 refers to quoted prices in active markets for identical assets or liabilities. Level 2 refers to observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data. Level 3 refers to unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs. Currently, the Company does not use Level 1 and 3 inputs.

The following tables present the Company's assets and liabilities that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy:

December 31, 2014	Fair Value Measurements Using Input Type
($ in millions)	Level 2
Assets:	
Marketable securities	
Municipal auction rate securities	$5.2
Derivative financial instruments	5.4
Total assets	$10.6
Liabilities:	
Derivative financial instruments	$35.1

June 30, 2014	Fair Value Measurements Using Input Type
($ in millions)	Level 2
Assets:	
Marketable securities	
Municipal auction rate securities	$5.2
Derivative financial instruments	20.4
Total assets	$25.6
Liabilities:	
Derivative financial instruments	$10.9

The Company's derivative financial instruments consist of commodity forward contracts, foreign currency forward contracts, interest rate swaps and forward interest rate swaps. These instruments are measured at fair value using the market method valuation technique. The inputs to this technique utilize information related to foreign exchange rates, commodity prices and interest rates published by third party leading financial news and data providers. This is observable data; however, the valuation of these instruments is not based on actual transactions for the same instruments and, as such, they are classified as Level 2. The Company's use of derivatives and hedging policies are more fully discussed in Note 12.

The Company has currently chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with accounting principles generally accepted in the United States.

The carrying amounts of other financial instruments not listed in the table below approximate fair value due to the short-term nature of these items. The carrying amounts and estimated fair values of the Company's financial instruments not recorded at fair value in the financial statements were as follows:

($ in millions)	December 31, 2014 Carrying Value	December 31, 2014 Fair Value	June 30, 2014 Carrying Value	June 30, 2014 Fair Value
Long-term debt, including current portion	$607.1	$629.0	$604.3	$638.7
Company-owned life insurance	$17.0	$17.0	$16.2	$16.2

The carrying amount for company-owned life insurance reflects cash surrender values based upon the market values of underlying securities, using level 2 inputs, net of any outstanding policy loans. The carrying value associated with the cash surrender value of these policies is recorded in other assets in the accompanying consolidated balance sheets.

The fair values of long-term debt as of December 31, 2014 and June 30, 2014 were determined by using current interest rates for debt with terms and maturities similar to the Company's existing debt arrangements and accordingly would be classified as Level 2 inputs in the fair value hierarchy.

11. Other Income, Net

Other income, net consisted of the following:

($ in millions)	Three Months Ended December 31, 2014	Three Months Ended December 31, 2013	Six Months Ended December 31, 2014	Six Months Ended December 31, 2013
Legal settlement	$—	$—	$4.4	$—
Foreign exchange	(0.3)	(0.8)	0.3	(1.2)
Equity in (losses) earnings of unconsolidated subsidiaries	(0.5)	0.1	(0.4)	0.3
Unrealized gains on company-owned life insurance contracts and investments held in rabbi trusts	0.8	1.1	0.5	1.5
Other	—	0.2	—	0.2
Total other income, net	$—	$0.6	$4.8	$0.8

12. Derivatives and Hedging Activities

The Company uses commodity forwards, interest rate swaps, forward interest rate swaps and foreign currency forwards to manage risks generally associated with commodity price, interest rate and foreign currency rate fluctuations. The following explains the various types of derivatives and includes a recap about the impact the derivative instruments had on the Company's financial position, results of operations and cash flows.

Cash Flow Hedging — Commodity forward contracts: The Company enters into commodity forward contracts to fix the price of a portion of anticipated future purchases of certain critical raw materials and energy to manage the risk of cash flow variability associated with volatile commodity prices. The commodity forward contracts have been designated as cash flow hedges. The qualifying hedge contracts are marked-to-market at each reporting date and any unrealized gains or losses are included in accumulated other comprehensive income (“AOCI”) to the extent effective, and reclassified to cost of sales in the period during which the hedged transaction affects earnings or it becomes probable that the forecasted transaction will not occur. As of December 31, 2014, the Company had forward contracts to purchase 27.7 million pounds of certain raw materials with settlement dates through June 2019.

Cash Flow Hedging — Forward interest rate swaps: Historically, the Company has entered into forward interest rate swap contracts to manage the risk of cash flow variability associated with fixed interest debt expected to be issued. The forward interest rate swaps were designated as cash flow hedges. The qualifying hedge contracts were marked-to-market at each reporting date and any unrealized gains or losses were included in accumulated other comprehensive income to the extent effective, and reclassified to interest expense in the period during which the hedged transaction affects earnings or it becomes probable that the forecasted transaction will not occur. For the three months ended December 31, 2014 and 2013, net gains of $0.1 million and $0.1 million, respectively, were recorded as a reduction to interest expense. For the six months ended December 31, 2014 and 2013, net gains of $0.2 million and $0.2 million, respectively, were recorded as a reduction to interest expense. These amounts represent the impact of previously terminated swaps which are being amortized over the remaining term of the underlying debt.

Cash Flow Hedging — Foreign currency forward contracts: The Company uses foreign currency forward contracts to hedge a portion of anticipated future sales denominated in foreign currencies, principally the Euro and Pound Sterling, in order to offset the effect of changes in exchange rates. The qualifying hedge contracts are marked-to-market at each reporting date and any unrealized gains or losses are included in accumulated other comprehensive income to the extent effective, and reclassified to net sales in the period during which the transaction affects earnings or it becomes probable that the forecasted transaction will not occur.

The Company also uses foreign currency forward contracts to protect certain short-term asset positions denominated in foreign currency against the effect of changes in exchange rates. These positions do not qualify for hedge accounting and accordingly are marked-to-market at each reporting date through charges to other income and expense. As of December 31, 2014 and June 30, 2014, the fair value of the outstanding foreign currency forwards not designated as hedging instruments and the charges to income for changes in fair value for these contracts were not material.

Fair Value Hedging - Interest rate swaps: The Company uses interest rate swaps to achieve a level of floating rate debt relative to fixed rate debt where appropriate. The Company has designated fixed to floating interest rate swaps as fair value hedges. Accordingly, the changes in the fair value of these instruments are immediately recorded in earnings. The mark-to-market values of both the fair value hedging instruments and the underlying debt obligations are recorded as equal and offsetting gains and losses in interest expense in the consolidated statements of income. As of December 31, 2014 and June 30, 2014, the total notional amount of floating interest rate contracts was $150.0 million and $0.0 million, respectively. For the three months ended December 31, 2014 and 2013, net gains of $0.9 million and $0.0 million, respectively, were recorded as a reduction to interest expense. For the six months ended December 31, 2014 and 2013, net gains of $1.2 million and $0.0 million, respectively, were recorded as a reduction to interest expense.

The fair value and location of outstanding derivative contracts recorded in the accompanying consolidated balance sheets were as follows as of December 31, 2014 and June 30, 2014:

December 31, 2014 ($ in millions)	Interest Rate Swaps	Foreign Currency Contracts	Commodity Contracts	Total Derivatives
Asset Derivatives:				
Derivatives designated as hedging instruments:				
Other current assets	$1.2	$1.1	$—	$2.3
Other assets	2.8	0.1	0.2	3.1
Total asset derivatives	$4.0	$1.2	$0.2	$5.4
Liability Derivatives:				
Derivatives designated as hedging instruments:				
Accrued liabilities	$—	$—	$21.5	$21.5
Other liabilities	—	—	13.6	13.6
Total liability derivatives	$—	$—	$35.1	$35.1

June 30, 2014 ($ in millions)	Interest Rate Swaps	Foreign Currency Contracts	Commodity Contracts	Total Derivatives
Asset Derivatives:				
Derivatives designated as hedging instruments:				
Other current assets	$—	$—	$11.3	$11.3
Other assets	—	—	9.1	9.1
Total asset derivatives	$—	$—	$20.4	$20.4
Liability Derivatives:				
Derivatives designated as hedging instruments:				
Accrued liabilities	$—	$0.4	$4.3	$4.7
Other liabilities	—	0.2	6.0	6.2
Total liability derivatives	$—	$0.6	$10.3	$10.9

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Cash Flow Hedges

For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative is reported as a component of accumulated other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transactions affect earnings or it becomes probable the forecasted transaction will not occur. The following is a summary of the (losses) gains related to cash flow hedges recognized during the three and six months ended December 31, 2014 and 2013:

($ in millions)	Amount of (Loss) Gain Recognized in AOCI on Derivatives (Effective Portion) Three Months Ended December 31, 2014	2013	Six Months Ended December 31, 2014	2013
Derivatives in Cash Flow Hedging Relationship:				
Commodity contracts	$(14.8)	$(3.0)	$(43.2)	$(4.4)
Foreign exchange contracts	0.5	(0.3)	2.1	(0.8)
Total	$(14.3)	$(3.3)	$(41.1)	$(5.2)

($ in millions) Derivatives in Cash Flow Hedging Relationship:	Location of (Loss) Gain Reclassified from AOCI into Income	Amount of (Loss) Gain Reclassified from AOCI into Income (Effective Portion) Three Months Ended December 31, 2014	2013	Amount of (Loss) Gain Reclassified from AOCI into Income (Ineffective Portion) Three Months Ended December 31, 2014	2013
Commodity contracts	Cost of sales	$(3.5)	$(6.8)	$(0.6)	$0.3
Foreign exchange contracts	Net sales	0.7	(0.3)	—	—
Forward interest rate swaps	Interest expense	0.1	0.1	—	—
Total		$(2.7)	$(7.0)	$(0.6)	$0.3

($ in millions) Derivatives in Cash Flow Hedging Relationship:	Location of (Loss) Gain Reclassified from AOCI into Income	Amount of (Loss) Gain Reclassified from AOCI into Income (Effective Portion) Six Months Ended December 31, 2014	2013	Amount of (Loss) Gain Reclassified from AOCI into Income (Ineffective Portion) Six Months Ended December 31, 2014	2013
Commodity contracts	Cost of sales	$(1.5)	$(14.4)	$(0.2)	$0.3
Foreign exchange contracts	Net sales	1.0	(0.5)	—	—
Forward interest rate swaps	Interest expense	0.2	0.2	—	—

Total	$(0.3)	$(14.7)	$(0.2)	$0.3

The Company estimates that $11.4 million of net derivative losses included in AOCI as of December 31, 2014 will be reclassified into earnings within the next 12 months.

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The changes in AOCI associated with derivative hedging activities during the three and six months ended December 31, 2014 and 2013 were as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
($ in millions)	2014	2013	2014	2013
Balance, beginning	$(10.6)	$(37.9)	$7.6	$(41.5)
Current period changes in fair value, net of tax	(9.0)	(2.0)	(25.7)	(3.2)
Reclassification to earnings, net of tax	1.7	4.4	0.2	9.2
Balance, ending	$(17.9)	$(35.5)	$(17.9)	$(35.5)

According to the provisions of the Company's derivative arrangements, in the event that the fair value of outstanding derivative positions with certain counterparties exceeds certain thresholds, the Company may be required to issue cash collateral to the counterparties. The Company's contracts with these counterparties allow for netting of derivative instrument positions executed under each contract. As of December 31, 2014 and June 30, 2014, the Company had no cash collateral held by counterparties.

The Company is exposed to credit loss in the event of nonperformance by counterparties on its derivative instruments as well as credit or performance risk with respect to its customer commitments to perform. Although nonperformance is possible, the Company does not anticipate nonperformance by any of the parties. In addition, various master netting arrangements are in place with counterparties to facilitate settlements of gains and losses on these contracts.

13. Income Taxes

The effective tax rate used for interim periods is the estimated annual effective consolidated tax rate, based on the current estimate of full year results, except that taxes related to specific events, if any, are recorded in the interim period in which they occur.

Income tax expense for the three months ended December 31, 2014 was $14.1 million, or 36.9 percent of pre-tax income as compared with $14.9 million, or 33.6 percent of pre-tax income for the three months ended December 31, 2013. Income tax expense for the six months ended December 31, 2014 was $20.6 million, or 35.4 percent of pre-tax income as compared with $31.8 million, or 33.2 percent of pre-tax income for the six months ended December 31, 2013. The current period tax expense includes net tax charges of $1.6 million for the unfavorable impact of bonus depreciation on domestic manufacturing benefits recorded in the prior year net of additional research and development credits as a result of the December 2014 enactment of the Tax Increase Prevention Act.

14. Superalloy Powders Technical Assistance and Powder Supply Agreements

On September 30, 2013, the Company entered into a multi-level agreement with United Technologies Corporation ("UTC") through its Pratt & Whitney Division, which includes a technical assistance agreement and a long-term powder supply agreement. The technical assistance agreement provides for the licensing of technology associated with the production of superalloy powders. As a result of the agreements, the Company began construction of a superalloy powder facility which is expected to take approximately 18 months to construct at an estimated cost of $30 million. Once the facility is qualified by UTC, the Company will supply UTC with superalloy powder for up to 20 years. The powder supply agreement provides for minimum guaranteed purchase quantities of specified materials for a period of 12 years.

According to the terms of the technology licensing agreement, the Company paid a $13.0 million up-front license fee in equal quarterly installments beginning on December 15, 2013. This amount has been capitalized and will be amortized as a reduction to revenue over the term of the minimum guarantee period of 12 years. As of December 31, 2014, $13.0 million of the upfront license fee is included in other assets.

15. Business Segments

The Company has two reportable segments, Specialty Alloys Operations ("SAO") and Performance Engineered Products ("PEP").

The SAO segment is comprised of the Company's major premium alloy and stainless steel manufacturing operations. This includes operations performed at mills primarily in Reading and Latrobe and surrounding areas in Pennsylvania, South Carolina and Alabama. The combined assets of the SAO operations are being managed in an integrated manner to optimize efficiency and profitability across the total system.

The PEP segment is comprised of the Company's differentiated operations. This segment includes the Dynamet titanium business, the Carpenter Powder Products business, the Amega West business, the Specialty Steel Supply business, the Latrobe Special Metals Distribution business and Aceros Fortuna based in Mexico. The businesses in the PEP segment are managed with an entrepreneurial structure to promote flexibility and agility to quickly respond to market dynamics. It is our belief this model will ultimately drive overall revenue and profit growth.

The Company's executive management evaluates the performance of these operating segments based on sales, operating income and cash flow generation. Segment operating profit excludes general corporate costs, which include executive and director compensation, and other corporate facilities and administrative expenses not allocated to the segments. Also excluded are items that management considers not representative of ongoing operations, such as restructuring related charges, transaction costs associated with acquisitions and other specifically-identified income or expense items.

The service cost component of the Company's net pension expense, which represents the estimated cost of future pension liabilities earned associated with active employees, is included in the operating income of the business segments. The residual net pension expense, which is comprised of the expected return on plan assets, interest costs on the projected benefit obligations of the plans and amortization of actuarial gains and losses and prior service costs, is included under the heading "Pension earnings, interest and deferrals".

On a consolidated basis, there were no significant individual customers that accounted for 10 percent or more of the Company's net sales for the three and six months ended December 31, 2014 and 2013, respectively.

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Segment Data	Three Months Ended December 31,		Six Months Ended December 31,	
($ in millions)	2014	2013	2014	2013
Net Sales:				
Specialty Alloys Operations	$438.3	$407.5	$874.2	$802.5
Performance Engineered Products	133.7	113.7	263.7	232.2
Intersegment	(23.6)	(17.7)	(39.7)	(32.6)
Consolidated net sales	$548.4	$503.5	$1,098.2	$1,002.1
Operating Income:				
Specialty Alloys Operations	$43.4	$54.4	$68.0	$118.1
Performance Engineered Products	12.6	8.6	22.2	20.2
Corporate costs	(7.0)	(11.3)	(17.3)	(24.2)
Pension earnings, interest and deferrals	(2.4)	(3.8)	(4.7)	(9.8)
Intersegment	(1.6)	(0.4)	(1.0)	(1.0)
Consolidated operating income	$45.0	$47.5	$67.2	$103.3
Depreciation and Amortization:				
Specialty Alloys Operations	$23.2	$19.6	$46.8	$39.1
Performance Engineered Products	5.9	5.9	12.0	11.7
Corporate	1.2	1.5	2.3	3.0
Intersegment	(0.2)	(0.2)	(0.5)	(0.3)
Consolidated depreciation and amortization	$30.1	$26.8	$60.6	$53.5
Capital Expenditures:				
Specialty Alloys Operations	$52.7	$106.7	$104.3	$189.7
Performance Engineered Products	16.1	5.1	22.9	12.1
Corporate	0.3	2.6	1.3	3.1
Intersegment	(0.7)	(0.2)	(1.1)	(0.4)
Consolidated capital expenditures	$68.4	$114.2	$127.4	$204.5

	December 31, 2014	June 30, 2014
Total Assets:		
Specialty Alloys Operations	$2,437.5	$2,454.8
Performance Engineered Products	510.8	491.7
Corporate	140.7	144.9
Intersegment	(34.0)	(33.9)
Consolidated total assets	$3,055.0	$3,057.5

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16. Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606). The guidance in ASU 2014-09 requires that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance in ASU 2014-09 is required for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. The Company is evaluating the impact of the adoption of ASU 2014-09 and does not expect the adoption to have a significant impact on the Company's Consolidated Financial Statements.

17. Reclassifications from Accumulated Other Comprehensive Income (AOCI)

The changes in AOCI by component, net of tax, for the three months ended December 31, 2014 and 2013 were as follows:

Three Months Ended December 31, 2014 ($ in millions) (a)	Cash flow hedging items	Pension and other postretirement benefit plan items	Unrealized losses on available-for-sale securities	Foreign currency items	Total
Balance at September 30, 2014	$(10.6)	$(233.7)	$(0.4)	$(23.6)	$(268.3)
Other comprehensive loss before reclassifications	(9.0)	—	—	(10.1)	(19.1)
Amounts reclassified from AOCI (b)	1.7	2.9	—	—	4.6
Net current-period other comprehensive (loss) income	(7.3)	2.9	—	(10.1)	(14.5)
Balance at December 31, 2014	$(17.9)	$(230.8)	$(0.4)	$(33.7)	$(282.8)

Three Months Ended December 31, 2013 ($ in millions) (a)	Cash flow hedging items	Pension and other postretirement benefit plan items	Unrealized losses on available-for-sale securities	Foreign currency items	Total
Balance at September 30, 2013	$(37.9)	$(270.0)	$(0.5)	$(16.7)	$(325.1)
Other comprehensive (loss) income before reclassifications	(2.0)	—	0.2	1.4	(0.4)
Amounts reclassified from AOCI (b)	4.4	3.9	—	—	8.3
Net current-period other comprehensive income	2.4	3.9	0.2	1.4	7.9
Balance at December 31, 2013	$(35.5)	$(266.1)	$(0.3)	$(15.3)	$(317.2)

(a) All amounts are net of tax. Amounts in parentheses indicate debits.
(b) See separate table below for further details.

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The changes in AOCI by component, net of tax, for the six months ended December 31, 2014 and 2013 were as follows:

Six Months Ended December 31, 2014 ($ in millions) (a)	Cash flow hedging items	Pension and other postretirement benefit plan items	Unrealized losses on available-for-sale securities	Foreign currency items	Total
Balance at June 30, 2014	$7.6	$(236.7)	$(0.4)	$(15.7)	$(245.2)
Other comprehensive loss before reclassifications	(25.7)	—	—	(18.0)	(43.7)
Amounts reclassified from AOCI (b)	0.2	5.9	—	—	6.1
Net current-period other comprehensive (loss) income	(25.5)	5.9	—	(18.0)	(37.6)
Balance at December 31, 2014	$(17.9)	$(230.8)	$(0.4)	$(33.7)	$(282.8)

Six Months Ended December 31, 2013 ($ in millions) (a)	Cash flow hedging items	Pension and other postretirement benefit plan items	Unrealized losses on available-for-sale securities	Foreign currency items	Total
Balance at June 30, 2013	$(41.5)	$(273.6)	$(0.4)	$(20.2)	$(335.7)
Other comprehensive (loss) income before reclassifications	(3.2)	—	0.1	4.9	1.8
Amounts reclassified from AOCI (b)	9.2	7.5	—	—	16.7
Net current-period other comprehensive income	6.0	7.5	0.1	4.9	18.5
Balance at December 31, 2013	$(35.5)	$(266.1)	$(0.3)	$(15.3)	$(317.2)

(a) All amounts are net of tax. Amounts in parentheses indicate debits.
(b) See separate table below for further details.

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The following is a summary of amounts reclassified from AOCI for the three and six months ended December 31, 2014 and 2013:

($ in millions) (a)	Location of (loss) gain	Amount Reclassified from AOCI Three Months Ended December 31,		Amount Reclassified from AOCI Six Months Ended December 31,	
Details about AOCI Components		2014	2013	2014	2013
Cash flow hedging items:					
Commodity contracts	Cost of sales	$(3.5)	$(6.8)	$(1.5)	$(14.4)
Foreign exchange contracts	Net sales	0.7	(0.3)	1.0	(0.5)
Forward interest rate swaps	Interest expense	0.1	0.1	0.2	0.2
	Total before tax	(2.7)	(7.0)	(0.3)	(14.7)
	Tax benefit	1.0	2.6	0.1	5.5
	Net of tax	$(1.7)	$(4.4)	$(0.2)	$(9.2)
Amortization of pension and other postretirement benefit plan items					
Net actuarial loss	(b)	$(4.7)	$(5.8)	$(9.4)	$(11.6)
Prior service cost	(b)	(0.1)	(0.1)	(0.2)	(0.2)
	Total before tax	(4.8)	(5.9)	(9.6)	(11.8)
	Tax benefit	1.9	2.0	3.7	4.3
	Net of tax	$(2.9)	$(3.9)	$(5.9)	$(7.5)

(a) Amounts in parentheses indicate debits to income/loss.
(b) These AOCI components are included in the computation of net periodic benefit cost (see Note 6 for additional details).

During the three months ended December 31, 2014, the Company identified an error related to the accounting for an equity method investment. Since the investee's financial statements are prepared using a functional currency other than the US dollar, the Company should be translating the Company's investment balance into a US dollar equivalent at the end of each period. The impact of correcting this error was a $4.9 million reduction in other assets with an offsetting adjustment to accumulated other comprehensive loss in the Company's consolidated balance sheet as of December 31, 2014. This adjustment is included in foreign currency translation in the consolidated statements of comprehensive income for the three months and six months ended December 31, 2014. The Company determined that neither the prior period errors nor the current period adjustment were material to the periods presented.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Background and General

We are engaged in the manufacturing, fabrication and distribution of specialty metals. We primarily process basic raw materials such as nickel, cobalt, titanium, manganese, chromium, molybdenum, iron scrap and other metal alloying elements through various melting, hot forming and cold working facilities to produce finished products in the form of billet, bar, rod, wire and narrow strip in many sizes and finishes. We also produce certain metal powders. Our sales are distributed directly from our production plants and distribution network as well as through independent distributors. Unlike many other specialty steel producers, we operate our own worldwide network of service and distribution centers. These service centers, located in the United States, Canada, Mexico, Europe and Asia allow us to work more closely with customers and to offer various just-in-time stocking programs. We also manufacture and rent down-hole drilling tools and components used in the oil and gas industry.

As part of our overall business strategy, we have sought out and considered opportunities related to strategic acquisitions, divestitures and joint collaborations as well as possible business unit dispositions aimed at broadening our offering to the marketplace. We have participated with other companies to explore potential terms and structures of such opportunities and expect that we will continue to evaluate these opportunities.

Our discussions below in this Item 2 are based upon the more detailed discussions about our business, operations and financial condition included in Item 7 of our 2014 Form 10-K. Our discussions here focus on our results during or as of the three and six month periods ended December 31, 2014 and the comparable periods of fiscal year 2014, and to the extent applicable, on material changes from information discussed in the 2014 Form 10-K and other important intervening developments or information that we have reported on Form 8-K. These discussions should be read in conjunction with the 2014 Form 10-K for detailed background information and with any such intervening Form 8-K.

Impact of Raw Material Prices and Product Mix

We value most of our inventory utilizing the last-in, first-out ("LIFO") inventory costing methodology. Under the LIFO inventory costing method, changes in the cost of raw materials and production activities are recognized in cost of sales in the current period even though these materials may have been acquired at potentially significantly different values due to the length of time from the acquisition of the raw materials to the sale of the processed finished goods to the customers. In a period of rising raw material costs, the LIFO inventory valuation normally results in higher costs of sales. Conversely, in a period of decreasing raw material costs, the LIFO inventory valuation normally results in lower costs of sales.

The volatility of the costs of raw materials has impacted our operations over the past several years. We, and others in our industry, generally have been able to pass cost increases on major raw materials through to our customers using surcharges that are structured to recover increases in raw material costs. Generally, the formula used to calculate a surcharge is based on published prices of the respective raw materials for the previous month which correlates to the prices we pay for our raw material purchases. However, a portion of our surcharges to customers may be calculated using a different surcharge formula or may be based on the raw material prices at the time of order, which creates a lag between surcharge revenue and corresponding raw material costs recognized in cost of sales. The surcharge mechanism protects our net income on such sales except for the lag effect discussed above. However, surcharges have had a dilutive effect on our gross margin and operating margin percentages as described later in this report.

Approximately 25 percent of our net sales are sales to customers under firm price sales arrangements. Firm price sales arrangements involve a risk of profit margin fluctuations, particularly when raw material prices are volatile. In order to reduce the risk of fluctuating profit margins on these sales, we enter into commodity forward contracts to purchase certain critical raw materials necessary to produce the related products sold. Firm price sales arrangements generally include certain annual purchasing commitments and consumption schedules agreed to by the customers at selling prices based on raw material prices at the time the arrangements are established. If a customer fails to meet the volume commitments (or the consumption schedule deviates from the agreed-upon terms of the firm price sales arrangements), the Company may need to absorb the gains or losses associated with the commodity forward contracts on a temporary basis. Gains or losses associated with commodity forward contracts are reclassified to earnings/loss when earnings are impacted by the hedged transaction. Because we value most of our inventory under the LIFO costing methodology, changes in the cost of raw materials and production activities are recognized in cost of sales in the current period attempting to match the most recently incurred costs with revenues. Gains or losses on the commodity forward contracts are reclassified from other comprehensive income together with the actual purchase price of the underlying commodities when the underlying commodities are purchased and recorded in inventory. To the extent that the total purchase price of the commodities, inclusive of the gains or losses on the commodity forward contracts, are higher or lower

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relative to the beginning of year costs, our cost of goods sold reflects such amounts. Accordingly, the gains and/or losses associated with commodity forward contracts may not impact the same period that the firm price sales arrangements revenue is recognized, and comparisons of gross profit from period to period may be impacted. These firm price sales arrangements are expected to continue as we look to strengthen our long-term customer relationships by expanding, renewing and in certain cases extending to a longer term, our customer long-term arrangements.

We produce hundreds of grades of materials with a wide range of pricing and profit levels depending on the grade. In addition, our product mix within a period is subject to the fluctuating order patterns of our customers as well as decisions we may make on participation in certain products based on available capacity, including the impacts of capacity commitments we may have under existing customer agreements. While we expect to see positive contribution from a more favorable product mix in our margin performance over time, the impact by period may fluctuate and period-to-period comparisons may vary.

Net Pension Expense

Net pension expense, as we define it below, includes the net periodic benefit costs related to both our pension and other postretirement plans. The net periodic benefit costs are determined annually based on beginning of year balances and are recorded ratably throughout the fiscal year, unless a significant re-measurement event occurs. We currently expect that the total net periodic benefit costs for fiscal year 2015 will be $45.9 million as compared with $60.1 million in fiscal year 2014. The following is the pension expense for the three and six months ended December 31, 2014 and 2013:

	Three Months Ended December 31,		Six Months Ended December 31,	
($ in millions)	2014	2013	2014	2013
Pension plans	$8.6	$12.4	$17.2	$24.6
Other postretirement plans	2.9	2.8	5.8	5.6
Net periodic benefit costs	$11.5			