

STARRETT L S CO
Form 10-Q
January 31, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2018

OR

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

For the transition period from to

Commission file number 1-367

THE L. S. STARRETT COMPANY

(Exact name of registrant as specified in its charter)

MASSACHUSETTS

(State or other jurisdiction of incorporation or organization)

04-1866480

(I.R.S. Employer Identification No.)

121 CRESCENT STREET, ATHOL, MASSACHUSETTS 01331-1915

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code 978-249-3551

Indicate by check mark whether the registrant (1) has filed all
reports required to be filed by Section 13 or 15(d) of the Securities

Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).

YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definition of "large accelerated filer," "accelerated

filer”, “smaller reporting company”, and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check One):

Large Accelerated Filer Accelerated Filer
Non-Accelerated Filer Smaller Reporting Company

Emerging Growth Company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES
NO

Common Shares outstanding as of January 30, 2019

| | |
|-----------------------|-----------|
| Class A Common Shares | 6,181,987 |
| Class B Common Shares | 710,238 |

THE L. S. STARRETT COMPANY

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PART I. FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS**

THE L. S. STARRETT COMPANY

Consolidated Balance Sheets

(in thousands except share data)

| | 12/31/2018 | 06/30/2018 |
|---|-------------|------------|
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash | \$ 13,427 | \$ 14,827 |
| Accounts receivable (less allowance for doubtful accounts of \$1,085 and \$1,277, respectively) | 31,585 | 33,089 |
| Inventories | 60,702 | 58,039 |
| Prepaid expenses and other current assets | 8,590 | 7,273 |
| Total current assets | 114,304 | 113,228 |
| Property, plant and equipment, net | 35,390 | 36,514 |
| Taxes receivable | 1,756 | 1,820 |
| Deferred tax assets, net | 16,151 | 16,739 |
| Intangible assets, net | 8,800 | 9,317 |
| Goodwill | 4,668 | 4,668 |
| Total assets | \$ 181,069 | \$ 182,286 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current maturities of debt | \$ 2,994 | \$ 3,655 |
| Accounts payable | 11,996 | 9,836 |
| Accrued expenses | 6,559 | 7,533 |
| Accrued compensation | 4,661 | 5,163 |
| Total current liabilities | 26,210 | 26,187 |
| Other tax obligations | 2,809 | 2,751 |
| Long-term debt, net of current portion | 17,434 | 17,307 |
| Postretirement benefit and pension obligations | 44,119 | 46,499 |

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| | | |
|--|------------|------------|
| Other non-current liabilities | 1,711 | 1,671 |
| Total liabilities | 92,283 | 94,415 |
| Stockholders' equity: | | |
| Class A Common stock \$1 par (20,000,000 shares authorized; 6,181,987 outstanding at December 31, 2018 and 6,302,356 outstanding at June 30, 2018) | 6,182 | 6,302 |
| Class B Common stock \$1 par (10,000,000 shares authorized; 710,238 outstanding at December 31, 2018 and 720,447 outstanding at June 30, 2018) | 710 | 720 |
| Additional paid-in capital | 55,051 | 55,641 |
| Retained earnings | 76,918 | 74,368 |
| Accumulated other comprehensive loss | (50,075) | (49,160) |
| Total stockholders' equity | 88,786 | 87,871 |
| Total liabilities and stockholders' equity | \$ 181,069 | \$ 182,286 |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Operations

(in thousands except per share data) (unaudited)

| | 3 Months Ended | | 6 Months Ended | |
|---|----------------|-------------|----------------|-------------|
| | 12/31/2018 | 12/31/2017 | 12/31/2018 | 12/31/2017 |
| Net sales | \$56,532 | \$ 52,124 | \$108,433 | \$ 103,942 |
| Cost of goods sold | 38,111 | 36,194 | 73,480 | 71,473 |
| Gross margin | 18,421 | 15,930 | 34,953 | 32,469 |
| % of Net sales | 32.6 % | 30.6 % | 32.2 % | 31.2 % |
| | | | | |
| Selling, general and administrative expenses | 15,141 | 15,486 | 30,905 | 31,576 |
| Operating income (loss) | 3,280 | 444 | 4,048 | 893 |
| Other income (expense) | (289) | 653 | (115) | 844 |
| Income (loss) before income taxes | 2,991 | 1,097 | 3,933 | 1,737 |
| Income tax expense (benefit) | 1,065 | 7,618 | 1,423 | 7,832 |
| Net income (loss) | \$1,926 | \$ (6,521) | \$2,510 | \$ (6,095) |
| | | | | |
| Basic income (loss) per share | \$0.27 | \$ (0.93) | \$0.36 | \$ (0.87) |
| Diluted income (loss) per share | \$0.27 | \$ (0.93) | \$0.35 | \$ (0.87) |
| | | | | |
| Weighted average outstanding shares used in per share calculations: | | | | |
| Basic | 7,018 | 7,008 | 7,022 | 7,009 |
| Diluted | 7,067 | 7,008 | 7,077 | 7,009 |
| | | | | |
| Dividends per share | \$- | \$ 0.10 | \$- | \$ 0.20 |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Comprehensive Income (Loss)

(in thousands) (unaudited)

| | 3 Months Ended | | 6 Months Ended | |
|--|----------------|-------------|----------------|-------------|
| | 12/31/2018 | 9/30/2018 | 12/31/2017 | 9/30/2017 |
| Net income (loss) | \$1,926 | \$ (6,521) | \$2,510 | \$ (6,095) |
| Other comprehensive income (loss): | | | | |
| Currency translation gain (loss) | 696 | (1,576) | (875) | 685 |
| Pension and postretirement plans, net of tax of \$0, \$0, \$0, and \$0, respectively | - | (27) | - | (54) |
| Other comprehensive income (loss) | 696 | (1,603) | (875) | 631 |
| Total comprehensive income (loss) | \$2,622 | \$ (8,124) | \$1,635 | \$ (5,464) |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Stockholders' Equity

For the Six Months Ended December 31, 2018

(in thousands except per share data) (unaudited)

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Total |
|---|-----------------|------------|----------------------------------|----------------------|---|------------|
| | Class A | Class B | | | | |
| Balance June 30, 2018 | \$6,302 | \$720 | \$ 55,641 | \$ 74,368 | \$ (49,160) |) \$87,871 |
| Total comprehensive income (loss) | - | - | - | 2,510 | (875) |) 1,635 |
| Transfer of historical translation adjustment | - | - | - | 40 | (40) |) - |
| Repurchase of shares | (154) | (3) | (777) | - | - | (934) |
| Issuance of stock | - | 8 | 32 | - | - | 40 |
| Stock-based compensation | 19 | - | 155 | - | - | 174 |
| Conversion | 15 | (15) | - | - | - | - |
| Balance December 31, 2018 | \$6,182 | \$710 | \$ 55,051 | \$ 76,918 | \$ (50,075) |) \$88,786 |

Accumulated balance consists of:

| | | |
|--|-------------|---|
| Translation loss | \$ (49,841) |) |
| Pension and postretirement plans, net of taxes | (234) |) |
| | \$ (50,075) |) |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Cash Flows

(in thousands) (unaudited)

6 Months Ended
12/31/2018 2/31/2017

Cash flows from operating activities:

| | | |
|--|---------|-------------|
| Net income | \$2,510 | \$ (6,095) |
| Non-cash operating activities: | | |
| Depreciation | 2,561 | 2,802 |
| Amortization | 1,155 | 978 |
| Stock-based compensation | 174 | 185 |
| Net long-term tax obligations | 111 | 343 |
| Deferred taxes | 532 | 7,250 |
| Postretirement benefit and pension obligations | 323 | 294 |

Working capital changes:

| | | |
|---|----------|----------|
| Accounts receivable | 1,118 | 1,618 |
| Inventories | (3,294) | (3,245) |
| Other current assets | (1,393) | (1,874) |
| Other current liabilities | 1,160 | 179 |
| Prepaid pension expense | (2,498) | (1,857) |
| Other | 347 | 57 |
| Net cash provided by operating activities | 2,806 | 635 |

Cash flows from investing activities:

| | | |
|---|----------|----------|
| Purchases of property, plant and equipment | (1,877) | (2,625) |
| Software development | (695) | (633) |
| Net cash provided by (used in) investing activities | (2,572) | (3,258) |

Cash flows from financing activities:

| | | |
|---|----------|----------|
| Proceeds from borrowing | 1,000 | 5,500 |
| Debt repayments | (1,534) | (797) |
| Proceeds from common stock issued | 40 | 220 |
| Shares repurchased | (934) | (534) |
| Dividends paid | - | (1,401) |
| Net cash provided by (used in) financing activities | (1,428) | 2,988 |

Effect of exchange rate changes on cash (206) 159

Net increase (decrease) in cash (1,400) 524

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| | | |
|-------------------------------------|-----------------|------------------|
| Cash, beginning of period | <i>14,827</i> | <i>14,607</i> |
| Cash, end of period | <i>\$13,427</i> | <i>\$ 15,131</i> |
| Supplemental cash flow information: | | |
| Interest paid | <i>\$428</i> | <i>\$ 307</i> |
| Income taxes paid, net | <i>1,221</i> | <i>(323)</i> |

See Notes to Unaudited Consolidated Financial Statements

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THE L. S. STARRETT COMPANY

Notes to Unaudited Consolidated Financial Statements

December 31, 2018

Note 1: Basis of Presentation and Summary of Significant Account Policies

The unaudited interim financial statements as of and for the *six* months ended *December 31, 2018* have been prepared by The L.S. Starrett Company (the “Company”) in accordance with accounting principles generally accepted in the United States of America for interim financial reporting. Accordingly, they do *not* include all of the information and notes required by generally accepted accounting principles for complete financial statements. These unaudited financial statements, which, in the opinion of management, reflect all adjustments (including normal recurring adjustments) necessary for a fair presentation, should be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form *10-K* for the year ended *June 30, 2018*. Operating results are *not* necessarily indicative of the results that *may* be expected for any future interim period or for the entire fiscal year.

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect amounts reported in the consolidated financial statements and accompanying notes. Note 2 to the Company’s Consolidated Financial Statements included in the Annual Report on Form *10-K* for the year ended *June 30, 2018* describes the significant accounting policies and methods used in the preparation of the consolidated financial statements.

Note 2: Segment Information

The segment information and the accounting policies of each segment are the same as those described in the notes to the consolidated financial statements entitled “Financial Information by Segment & Geographic Area” included in our Annual Report on Form *10-K* for the year ended *June 30, 2018*. Our business is aggregated into *two* reportable segments based on geography of operations: North American Operations and International Operations. Segment income is measured for internal reporting purposes by excluding corporate expenses, which are included in unallocated in the table below. Other income and expense, including interest income and expense, and income taxes are excluded entirely from the table below. There were *no* significant changes in the segment operations or in the

segment assets from the Annual Report. Financial results for each reportable segment are as follows (in thousands):

| | North American Operations | International Operations | Unallocated | Total |
|--|--|-------------------------------------|--------------------|--------------|
| <u>Three Months ended December 31, 2018</u> | | | | |
| Sales ¹ | \$ 34,628 | \$ 21,904 | \$ - | \$56,532 |
| Operating Income (Loss) | \$ 2,938 | \$ 1,716 | \$ (1,374) |) \$3,280 |
| <u>Three Months ended December 31, 2017</u> | | | | |
| Sales ² | \$ 31,100 | \$ 21,024 | \$ - | \$52,124 |
| Operating Income (Loss) | \$ 1,294 | \$ 315 | \$ (1,165) |) \$444 |

¹. Excludes \$1,047 of North American segment intercompany sales to the International segment, and \$3,744 of International segment intercompany sales to the North American segment.

². Excludes \$1,581 of North American segment intercompany sales to the International segment, and \$3,298 of International segment intercompany sales to the North American segment.

| | North American Operations | International Operations | Unallocated | Total |
|--|--|-------------------------------------|--------------------|--------------|
| <u>Six Months ended December 31, 2018</u> | | | | |
| Sales ¹ | \$ 64,828 | \$ 43,605 | \$ - | \$108,433 |
| Operating Income (Loss) | \$ 3,167 | \$ 3,810 | \$ (2,929) |) \$4,048 |
| <u>Six Months ended December 31, 2017</u> | | | | |
| Sales ² | \$ 60,818 | \$ 43,124 | \$ - | \$103,942 |
| Operating Income (Loss) | \$ 2,989 | \$ 727 | \$ (2,823) |) \$893 |

¹. Excludes \$2,180 of North American segment intercompany sales to the International segment, and \$7,063 of International segment intercompany sales to the North American segment.

². Excludes \$3,277 of North American segment intercompany sales to the International segment, and \$6,688 of International segment intercompany sales to the North American segment.

Note 3: Revenue from Contracts with Customers

On *July 1, 2018*, the Company adopted ASC Topic 606, Revenue from Contracts with Customers, and all the related amendments (“ASC Topic 606”), using the modified retrospective method. In addition, the Company elected to apply certain of the permitted practical expedients within the revenue recognition guidance and make certain accounting policy elections, including those related to significant financing components, sales taxes and shipping and handling activities. Most of the changes resulting from the adoption of ASC Topic 606 on *July 1, 2018* were changes in presentation within the Unaudited Consolidated Balance Sheet. Therefore, while the Company made adjustments to certain opening balances on its *July 1, 2018* Unaudited Consolidated Balance Sheet, the Company made *no* adjustment to opening Retained Earnings. The Company expects the impact of the adoption of ASC Topic 606 to be immaterial to its net income on an ongoing basis; however, adoption did increase the level of disclosures concerning net sales. Results for reporting periods beginning *July 1, 2018* are presented under the new guidance, while prior period amounts continue to be reported in accordance with previous guidance without revision.

The core principle of ASC Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The application of the FASB’s guidance on revenue recognition requires the Company to recognize the amount of revenue and consideration that the Company expects to receive in exchange for goods and services transferred to our customers. To do this, the Company applies the *five*-step model prescribed by the FASB, which requires us to: (1) identify the contract with the customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when, or as, the Company satisfies a performance obligation.

The Company accounts for a contract or purchase order when it has approval and commitment from both parties, the rights of the parties are identified, payment terms are identified, the contract has commercial substance and collectability of consideration is probable. Revenue is recognized when control of the product passes to the customer, which is upon shipment, unless otherwise specified within the customer contract or on the purchase order as delivery, and is recognized at the amount that reflects the consideration the Company expects to receive for the products sold, including various forms of discounts. When revenue is recorded, estimates of returns are made and recorded as a reduction of revenue. Contracts with customers are evaluated to determine if there are separate performance obligations related to timing of product shipment that will be satisfied in different accounting periods. When that is the case, revenue is deferred until each performance obligation is met. *No* performance obligation related amounts were deferred as of *December 31, 2018*. Purchase orders are of durations less than *one* year. As such, the Company applies the practical expedient in ASC paragraph 606-10-50-14 and does *not* disclose information about remaining performance obligations that have original expected durations of *one* year or less, for which work has *not* yet been performed.

Certain taxes assessed by governmental authorities on revenue producing transactions, such as value added taxes, are excluded from revenue and recorded on a net basis.

Performance Obligations

The Company's primary source of revenue is derived from the manufacture and distribution of metrology tools and equipment and saw blades and related products sold to distributors. The Company recognizes revenue for sales to our customers when transfer of control of the related good or service has occurred. All of the Company's revenue was recognized under the point in time approach for the *six* months ended *December 31, 2018*. Contract terms with certain metrology equipment customers could result in products and services being transferred over time as a result of the customized nature of some of the Company's products, together with contractual provisions in the customer contracts that provide the Company with an enforceable right to payment for performance completed to date; however, under typical terms, the Company does *not* have the right to consideration until the time of shipment from its manufacturing facilities or distribution centers, or until the time of delivery to its customers. If certain contracts in the future provide the Company with this enforceable right of payment, the timing of revenue recognition from products transferred to customers over time *may* be slightly accelerated compared to the Company's right to consideration at the time of shipment or delivery.

The Company's typical payment terms vary based on the customer, geographic region, and the type of goods and services in the contract or purchase order. The period of time between invoicing and when payment is due is typically *not* significant. Amounts billed and due from the Company's customers are classified as receivables on the Unaudited Consolidated Balance Sheet. As the Company's standard payment terms are usually less than *one* year, the Company has elected the practical expedient under ASC paragraph *606-10-32-18* to *not* assess whether a contract has a significant financing component.

The Company's customers take delivery of goods, and they are recognized as revenue at the time of transfer of control to the customer, which is usually at the time of shipment, unless otherwise specified in the customer contract or purchase order. This determination is based on applicable shipping terms, as well as the consideration of other indicators, including timing of when the Company has a present right to payment, when physical possession of products is transferred to customers, when the customer has the significant risks and rewards of ownership of the asset, and any provisions in contracts regarding customer acceptance.

While unit prices are generally fixed, the Company provides variable consideration for certain of our customers, typically in the form of promotional incentives at the time of sale. The Company utilizes the most likely amount consistently to estimate the effect of uncertainty on the amount of variable consideration to which the Company would be entitled. The most likely amount method considers the single most likely amount from a range of possible consideration amounts. The most likely amounts are based upon the contractual terms of the incentives and historical experience with each customer. The Company records estimates for cash discounts, promotional rebates, and other promotional allowances in the period the related revenue is recognized ("Customer Credits"). The provision for Customer Credits is recorded as a reduction from gross sales and reserves for Customer Credits are presented within accrued sales incentives on the Unaudited Consolidated Balance Sheet. Actual Customer Credits have *not* differed materially from estimated amounts for each period presented. Amounts billed to customers for shipping and handling are included in net sales and costs associated with shipping and handling are included in cost of sales. The Company has concluded that its estimates of variable consideration are *not* constrained according to the definition within the new standard. Additionally, the Company applies the practical expedient in ASC paragraph 606-10-25-18B and accounts for shipping and handling activities that occur after the customer has obtained control of a good as a fulfillment activity, rather than a separate performance obligation.

With the adoption of ASC Topic 606, the Company reclassified certain amounts related to variable consideration. Under ASC Topic 606, the Company is required to present a refund liability and a return asset within the Unaudited Consolidated Balance Sheet, whereas in periods prior to adoption, the Company presented the estimated margin impact of expected returns as a contra-asset within accounts receivable. The changes in the refund liability are reported in net sales, and the changes in the return asset are reported in cost of sales in the Unaudited Consolidated Statements of Operations. As a result, the balance sheet presentation was adjusted beginning in Fiscal 2019. As of *December 31, 2018*, the balance of the return asset is *\$0.1* million and the balance of the refund liability is *\$0.3* million, and they are presented within prepaid expenses and other current assets and accrued expenses, respectively, on the Unaudited Consolidated Balance Sheet.

The Company, in general, warrants its products against certain defects in material and workmanship when used as designed, for a period of up to *1* year. The Company does *not* sell extended warranties.

Contract Balances

Contract assets primarily relate to the Company's rights to consideration for work completed but *not* billed at the reporting date on contracts with customers. Contract assets are transferred to receivables when the rights become unconditional. Contract liabilities primarily relate to contracts where advance payments or deposits have been received, but performance obligations have *not* yet been met, and therefore, revenue has *not* been recognized. The Company had *no* contract asset balances, but had contract liability balances of \$0.3 million at *December 31, 2018*.

Disaggregation of Revenue

The Company operates in *two* reportable segments: North America and International. ASC Topic 606 requires further disaggregation of an entity's revenue. In the following table, the Company's net sales by shipping origin are disaggregated accordingly for the *three* and *six* months ended *December 31, 2018* and *2017*:

| | Three Months Ended | | Six Months Ended | |
|-----------------------------|-------------------------------|-----------------|-------------------------|------------------|
| | 12/31/18 | 12/31/17 | 12/31/18 | 12/31/17 |
| <u>North America</u> | | | | |
| United States | \$32,413 | \$28,899 | \$60,360 | \$56,358 |
| Canada & Mexico | 2,215 | 2,201 | 4,468 | 4,460 |
| | 34,628 | 31,100 | 64,828 | 60,818 |
| <u>International</u> | | | | |
| Brazil | 12,519 | 11,648 | 24,886 | 24,445 |
| United Kingdom | 5,657 | 6,146 | 11,673 | 12,327 |
| China | 2,052 | 1,644 | 3,761 | 3,389 |
| Australia & New Zealand | 1,676 | 1,586 | 3,285 | 2,963 |
| | 21,904 | 21,024 | 43,605 | 43,124 |
| Total Sales | \$56,532 | \$52,124 | \$108,433 | \$103,942 |

Note 4: Recent Accounting Pronouncements

In *February 2016*, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-02, "Leases (Topic 842)." ASU 2016-02 requires that a lessee recognize the assets and liabilities that arise from operating leases. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of *12* months or less, a lessee is permitted to make an accounting policy election by class of underlying asset *not* to recognize lease assets and lease liabilities. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. This amendment will be effective for fiscal years beginning after *December 15, 2018*, including interim periods within those fiscal years. The FASB issued ASU No. 2018-10 "Codification Improvements to Topic 842, Leases" and ASU No. 2018-11 "Leases (Topic 842) Targeted Improvements" in *July 2018*, and ASU No. 2018-20 "Leases (Topic 842) - Narrow Scope Improvements for Lessors" in *December 2018*. ASU 2018-10 and ASU 2018-20 provide certain amendments that affect narrow aspects of the guidance issued in ASU 2016-02. ASU 2018-11 allows all entities adopting ASU 2016-02 to choose an additional (and optional) transition method of adoption, under which

an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company will adopt this guidance beginning with its *first* quarter ended *September 30, 2019*.

The Company has established a transition team, and continues to evaluate critical components of ASC Topic 842 and the potential impact of the guidance on the Company's financial position, results of operations and cash flows. The Company is also in the process of determining which practical expedients will be applied by the Company for implementation of the ASC. At this time, the Company has *not* completed its full evaluation; however, it believes the adoption of ASC Topic 842, at a minimum, will increase the total assets and total liabilities reported on the Company's Consolidated Balance Sheet.

In *June 2016*, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments," and subsequent amendment to the guidance, ASU 2018-19 in *November 2018*. The standard significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are *not* measured at fair value through net income. The standard will replace today's "incurred loss" approach with an "expected loss" model for instruments measured at amortized cost. The amendment will affect loans, debt securities, trade receivables, net investments in leases, off balance sheet credit exposures, reinsurance receivables, and any other financial assets *not* excluded from the scope that have the contractual right to receive cash. ASU 2018-19 clarifies that receivables arising from operating leases are accounted for using lease guidance and *not* as financial instruments. The amendments should be applied on either a prospective transition or modified-retrospective approach depending on the subtopic. This ASU is effective for annual periods beginning after *December 15, 2019*, and interim periods therein. Early adoption is permitted for annual periods beginning after *December 15, 2018*, and interim periods therein. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

In *January 2017*, the FASB issued ASU No. 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." Under the new guidance, if a reporting unit's carrying value amount exceeds its fair value, an entity will record an impairment charge based on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. The standard eliminates the requirement to calculate goodwill impairment using Step 2, which calculates an impairment charge by comparing the implied fair value of goodwill with its carrying amount. The standard does *not* change the guidance on completing Step 1 of the goodwill impairment test. The amendments in this ASU are effective for annual and interim periods beginning after *December 15, 2019* and should be applied prospectively for annual and any interim goodwill impairment tests. Early adoption is permitted for entities for interim or annual goodwill impairment tests performed on testing dates after *January 1, 2017*. The Company is currently evaluating the impact of the update on our consolidated financial statements.

In *February 2018*, the FASB issued ASU No. 2018-02, "Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income". For deferred tax items recognized in Accumulated Other Comprehensive Income (AOCI), changes in tax rates can leave amounts "stranded" in AOCI. Under ASU 2018-02, FASB has given companies an option to reclassify the stranded tax effects resulting from the tax law and tax rate changes under the Tax Cuts and Jobs Act of 2017 from AOCI to retained earnings. This guidance is effective for fiscal years beginning after *December 15, 2018* and requires companies to disclose whether they are or are *not* opting to reclassify the income tax effects from the new 2017 tax act. Early adoption is permitted. The Company is currently evaluating the impact of this update on its consolidated financial statements.

In *August 2018*, the FASB issued ASU No. 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement." The ASU modifies the disclosure requirements in Topic 820, Fair Value Measurement, by removing certain disclosure requirements related to the fair value hierarchy, modifying existing disclosure requirements related to measurement uncertainty and adding new disclosure requirements, such as disclosing the changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and disclosing the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. This ASU is effective for public companies for annual reporting periods and interim periods within those annual periods beginning after *December 15, 2019*. The Company is currently evaluating the effect, if any, that ASU 2018-13 will have on its consolidated financial statements.

In *August 2018*, the FASB issued ASU No. 2018-14, "Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20): Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans." ASU 2018-14 removes certain disclosures that are *not* considered cost beneficial, clarifies certain required disclosures and added additional disclosures. This ASU is effective for public companies for annual reporting periods and interim periods within those annual periods beginning after *December 15, 2020*. The amendments in ASU 2018-14 must be applied on a retrospective basis. The Company is currently assessing the effect, if any, that ASU 2018-14 will have on its consolidated financial statements.

Note 5: Stock-based Compensation

On *September 5, 2012*, the Board of Directors adopted The L.S. Starrett Company *2012* Long Term Incentive Plan (the “*2012* Stock Plan”). The *2012* stock plan was approved by shareholders on *October 17, 2012*, and the material terms of its performance goals were re-approved by shareholders at the Company’s Annual Meeting held on *October 18, 2017*. The *2012* Stock Plan permits the granting of the following types of awards to officers, other employees and non-employee directors: stock options; restricted stock awards; unrestricted stock awards; stock appreciation rights; stock units including restricted stock units; performance awards; cash-based awards; and awards other than previously described that are convertible or otherwise based on stock. The *2012* Stock Plan provides for the issuance of up to *500,000* shares of common stock.

Options granted vest in periods ranging from *one* year to *three* years and expire *ten* years after the grant date. Restricted stock units (“RSU”) granted generally vest from *one* year to *three* years. Vested restricted stock units will be settled in shares of common stock. As of *December 31, 2018*, there were *20,000* stock options and *197,002* restricted stock units outstanding. In addition, there were *230,033* shares available for grant under the *2012* Stock Plan as of *December 31, 2018*.

For stock option grants, the fair value of each grant is estimated at the date of grant using the Binomial Options pricing model. The Binomial Options pricing model utilizes assumptions related to stock volatility, the risk-free interest rate, the dividend yield, and employee exercise behavior. Expected volatilities utilized in the model are based on the historic volatility of the Company’s stock price. The risk free interest rate is derived from the U.S. Treasury Yield curve in effect at the time of the grant. The expected life is determined using the average of the vesting period and contractual term of the options (Simplified Method).

No stock options were granted during the *six* months ended *December 31, 2018* and *2017*.

The weighted average contractual term for stock options outstanding as of *December 31, 2018* was *4* years. The aggregate intrinsic value of stock options outstanding as of *December 31, 2018* was less than *\$0.1* million. Stock options exercisable as of *December 31, 2018* were *20,000*. In recognizing stock compensation expense for the *2012* Stock Incentive Plan, management has estimated that there will be *no* forfeitures of options.

The Company accounts for stock options and RSU awards by recognizing the expense of the grant date fair value ratably over vesting periods generally ranging from *one* year to *three* years. The related expense is included in selling, general and administrative expenses.

There were *67,000* RSU awards with a fair value of *\$6.34* per RSU granted during the *six* months ended *December 31, 2018*. There were *10,799* RSUs settled, and *no* RSUs forfeited during the *six* months ended *December 31, 2018*. The aggregate intrinsic value of RSU awards outstanding as of *December 31, 2018* was *\$1.0* million. As of *December 31, 2018*, all vested awards had been issued and settled.

On *February 5, 2013*, the Board of Directors adopted The L.S. Starrett Company *2013* Employee Stock Ownership Plan (the "*2013* ESOP"). The purpose of the plan is to supplement existing Company programs through an employer funded individual account plan dedicated to investment in common stock of the Company, thereby encouraging increased ownership of the Company while providing an additional source of retirement income. The plan is intended as an employee stock ownership plan within the meaning of Section *4975 (e) (7)* of the Internal Revenue Code of *1986*, as amended. U.S. employees who have completed a year of service are eligible to participate.

Compensation expense related to all stock based plans for the *six* month periods ended *December 31, 2018* and *2017* was *\$0.1* million, and *\$0.2* million respectively. As of *December 31, 2018*, there was *\$1.9* million of total unrecognized compensation costs related to outstanding stock-based compensation arrangements. Of this cost, *\$1.4* million relates to performance based RSU grants that are *not* expected to be awarded. The remaining *\$0.5* million is expected to be recognized over a weighted average period of *2.0* years.

Note 6: Inventories

Inventories consist of the following (in thousands):

| | 12/31/2018 | 6/30/2018 |
|-------------------------------------|------------|-----------|
| Raw material and supplies | \$ 26,103 | \$ 23,764 |
| Goods in process and finished parts | 17,635 | 18,423 |
| Finished goods | 41,300 | 40,739 |
| | 85,038 | 82,926 |
| LIFO Reserve | (24,336) | (24,887) |
| | \$ 60,702 | \$ 58,039 |

LIFO inventories were \$7.3 million and \$8.4 million at *December 31, 2018* and *June 30, 2018*, respectively, such amounts being approximately \$24.3 million and \$24.9 million, respectively, less than if determined on a FIFO basis. The use of LIFO, as compared to FIFO, resulted in a \$0.6 million decrease in cost of sales for the *six months ended December 31, 2018* compared to a \$0.2 million increase for the *six months ended December 31, 2017*.

Note 7: Goodwill and Intangible Assets

The Company's acquisition of Bytewise in *2011* and a private software company in *2017* resulted in the recognition of goodwill totaling \$4.7 million. The Company is required, on a set date, to annually assess its goodwill in order to determine whether or *not* it is more likely than *not* that the fair value of the reporting unit's goodwill exceeded its carrying amount. Determining the fair value of a reporting unit is subjective and requires the use of significant estimates and assumptions.

The Company performed a qualitative analysis of its Bytewise reporting unit for its *October 1, 2018* annual assessment of goodwill (commonly referred to as "Step Zero"). From a qualitative perspective, in evaluating whether it is more likely than *not* that the fair value of a reporting unit exceeds its carrying amount, relevant events and circumstances are taken into account, with greater weight assigned to events and circumstances that most affect the fair value or the carrying amounts of its assets. Items that were considered included, but were *not* limited to, the following: macroeconomic conditions, industry and market conditions, cost factors, overall financial performance and changes in management or key personnel. After assessing these and other factors the Company determined that it was more likely than *not* that the fair value of the Bytewise reporting unit exceeded its carrying amount as of *October 1, 2018*. If future results significantly vary from current estimates and related projections due to changes in industry or market conditions, the Company *may* be required to record impairment charges.

The Company performed a qualitative analysis for its *February 1, 2018* annual assessment of goodwill associated with its purchase of a private software company. From a qualitative perspective, in evaluating whether it is more likely than *not* that the fair value of a reporting unit exceeds its carrying amount, relevant events and circumstances are taken into account, with greater weight assigned to events and circumstances that most affect the fair value or the carrying amounts of its assets. Items that were considered included, but were *not* limited to, the following: macroeconomic conditions, industry and market conditions, cost factors, overall financial performance and changes in management or key personnel. After assessing these and other factors the Company determined that it was more likely than *not* that the fair value of this reporting unit exceeded its carrying amount as of *February 1, 2018*. If future results significantly vary from current estimates and related projections due to changes in industry or market conditions, the Company *may* be required to record impairment charges.

Amortizable intangible assets consist of the following (in thousands):

| | 12/31/2018 | 6/30/2018 |
|----------------------------|------------|-----------|
| Non-compete agreement | \$ 600 | \$ 600 |
| Trademarks and trade names | 2,070 | 2,070 |
| Completed technology | 2,358 | 2,358 |
| Customer relationships | 5,580 | 5,580 |
| Software development | 8,185 | 7,600 |
| Other intangible assets | 325 | 325 |
| Total | 19,118 | 18,533 |
| Accumulated amortization | (10,318) | (9,216) |
| Total net balance | \$ 8,800 | \$ 9,317 |

Amortizable intangible assets are being amortized on a straight-line basis over the period of expected economic benefit.

The estimated useful lives of the intangible assets subject to amortization range between 5 years for software development and 20 years for some trademark and trade name assets.

The estimated aggregate amortization expense for the remainder of fiscal 2019 and for each of the next *five* years and thereafter, is as follows (in thousands):

| | |
|--------------------------|----------|
| 2019 (Remainder of year) | \$ 1,192 |
| 2020 | 1,884 |
| 2021 | 1,481 |
| 2022 | 1,249 |

| | |
|------------|-------|
| 2023 | 947 |
| 2024 | 540 |
| Thereafter | 1,507 |

Note 8: Pension and Post-retirement Benefits

The Company has *two* defined benefit pension plans, *one* for U.S. employees and another for U.K. employees. The Company has a postretirement medical and life insurance benefit plan for U.S. employees. The Company also has defined contribution plans.

The U.K. defined benefit plan was closed to new entrants in fiscal *2009*.

On *December 21, 2016*, the Company amended the U.S. defined benefit pension plan to freeze benefit accruals effective *December 31, 2016*. Consequently, the Plan is closed to new participants and current participants will *no* longer earn additional benefits after *December 31, 2016*.

Net periodic benefit costs for all of the Company's defined benefit pension plans consist of the following (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--------------------------------|--------------------|------------|------------------|------------|
| | 12/31/2018 | 12/31/2017 | 12/31/2018 | 12/31/2017 |
| Service cost | \$- | \$ - | \$- | \$ - |
| Interest cost | 1,500 | 1,518 | 3,006 | 3,029 |
| Expected return on plan assets | (1,279) | (1,291) | (2,563) | (2,576) |
| Amortization of net loss | 7 | 6 | 14 | 12 |
| | \$228 | \$ 233 | \$457 | \$ 465 |

Net periodic benefit costs for the Company's Postretirement Medical Plan consists of the following (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--------------------------------------|--------------------|------------|------------------|------------|
| | 12/31/2018 | 12/31/2017 | 12/31/2018 | 12/31/2017 |
| Service cost | \$18 | \$ 22 | \$36 | \$ 43 |
| Interest cost | 67 | 67 | 133 | 134 |
| Amortization of prior service credit | (135) | (135) | (269) | (269) |
| Amortization of net loss | 8 | 25 | 15 | 50 |
| | \$(42) | \$ (21) | \$(85) | \$ (42) |

For the *six* month period ended *December 31, 2018*, the Company contributed \$1.8 million to the U.S. and \$0.5 million to the UK pension plans. The Company estimates that it will contribute an additional \$3.1 million for the remainder of fiscal 2019.

The Company's pension plans use fair value as the market-related value of plan assets and recognize net actuarial gains or losses in excess of *ten* percent (*10%*) of the greater of the market-related value of plan assets or of the plans' projected benefit obligation in net periodic (benefit) cost as of the plan measurement date. Net actuarial gains or losses that are less than *10%* of the thresholds noted above are accounted for as part of accumulated other comprehensive loss.

Note 9: Debt

Debt is comprised of the following (in thousands):

| | 12/31/2018 | 6/30/2018 |
|---|------------|-----------|
| <u>Short-term and current maturities</u> | | |
| Loan and Security Agreement | \$ 1,727 | \$ 1,688 |
| Other loans | 1,267 | 1,967 |
| | 2,994 | 3,655 |
| <u>Long-term debt</u> | | |
| Loan and Security Agreement, net of current portion | 17,434 | 17,307 |
| | \$ 20,428 | \$ 20,962 |

The Company amended its Loan and Security Agreement, which includes a Line of Credit and a Term Loan (“Credit Facility”), in *January 2018*. Borrowings under the Line of Credit *may not* exceed \$23.0 million. The Line of Credit has an interest rate of LIBOR plus 1.5%, and expires on *April 30, 2021*. The effective interest rate on the Line of Credit under the Loan and Security Agreement for the *six* months ended *December 31, 2018* and *2017* was 3.9% and 3.1%, respectively. As of *December 31, 2018*, \$13.9 million was outstanding on the Line of Credit.

Availability under the Line of Credit is subject to a borrowing base comprised of accounts receivable and inventory. The Company believes that the borrowing base will consistently produce availability under the Line of Credit in excess of \$23.0 million. A 0.25% commitment fee is charged on the unused portion of the Line of Credit.

The obligations under the Credit Facility are unsecured. In the event of certain triggering events, such obligations would become secured by the assets of the Company’s domestic subsidiaries. A triggering event occurs when the Company fails to achieve any of the financial covenants noted below in consecutive quarters.

The financial covenants of the amended Loan and Security Agreement are: 1) funded debt to EBITDA, excluding non-cash and retirement benefit expenses (“maximum leverage”), *not* to exceed 2.25 to 1.00, 2) annual capital expenditures *not* to exceed \$15.0 million, 3) maintain a Debt Service Coverage Rate of a minimum of 1.25 to 1.00, and 4) maintain consolidated cash plus liquid investments of *not* less than \$10.0 million at any time. As of *December 31, 2018*, the Company was in compliance with all the financial debt covenants related to its Loan and Security Agreement.

On *November 22, 2011*, in conjunction with the Bytewise acquisition, the Company entered into a *\$15.5 million* term loan (the “Term Loan”) under the then existing Loan and Security Agreement. The Term Loan is a *ten* year loan bearing a fixed interest rate of *4.5%* and is payable in fixed monthly payments of principal and interest of *\$160,640*. The Term Loan had a balance of *\$5.3 million* at *December 31, 2018*.

In *December 2017*, the Company’s Brazilian subsidiary entered into *two* short-term loans with local banks in order to support the Company’s strategic initiatives. The loans backed by the entity’s US dollar denominated export receivables were made with Santander Bank and Bradesco Bank and totaled *\$3.5 million*. The Santander loan of *\$1.5 million* has a term of *180* days and a rate of *4.19%* and the Bradesco loan of *\$2.0 million* has a term of *360* days and a rate of *4.75%*. The Santander loan was paid off in fiscal year *2018*, and in this fiscal year, the Bradesco loan was refinanced, extending the due date of the loan to *March 29, 2019* at the same *APR* of *4.75%*. As of *December 31, 2018*, the outstanding balance on the Bradesco loan was *\$1.3 million*.

Note 10: Income Taxes

The Company is subject to U.S. federal income tax and various state, local, and foreign income taxes in numerous jurisdictions. The Company’s domestic and foreign tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to the Company’s interpretation of applicable tax laws in the jurisdictions in which it files.

The Company provides for income taxes on an interim basis based on an estimate of the effective tax rate for the year. This estimate is reassessed on a quarterly basis. Discrete tax items are accounted for in the quarterly period in which they occur.

On *December 22, 2017*, the Tax Cuts and Jobs Act was enacted in the United States. The Act reduces the U.S. federal corporate tax rate from a graduated rate of *35%* to a flat rate of *21%*, requires companies to pay a *one-time* transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates new taxes on certain foreign sourced earnings. Accounting Standard Codification (“ASC”) *740* requires filers to record the effect of tax law changes in the period enacted. However, the SEC issued Staff Accounting Bulletin *No. 118* (“SAB *118*”), that permits filers to record provisional amounts during a measurement period ending *no* later than *one* year from the date of the Act’s enactment.

As of *December 31, 2018*, the Company has completed the accounting for the tax effects of the enactment of the Act. During the *six* months ended *December 31, 2018*, the Company did *not* recognize any significant adjustments to the provisional tax expense previously recorded.

The Company has incorporated the other impacts of tax reform that became effective for the Company in fiscal 2019 including the provisions related to Global Intangible Low Taxed Income (“GILTI”), Foreign Derived Intangible Income (“FDII”), Base Erosion Anti Abuse Tax (“BEAT”), as well as other provisions, which limit tax deductibility of expenses. For fiscal 2019, the GILTI provisions are expected to have the most significant impact to the Company. Under the new law, U.S. taxes are imposed on foreign income in excess of a deemed return on tangible assets of its foreign subsidiaries. In general, this foreign income will effectively be taxed at an additional 10.5% tax rate reduced by any available current year foreign tax credits. The ability to benefit foreign tax credits *may* be limited under the GILTI rules as a result of the utilization of net operating losses, foreign sourced income and other potential limitations within the foreign tax credit calculation. The estimated impact of GILTI for fiscal 2019 is an increase to the Company’s effective tax rate of approximately 8%.

The tax expense for the *second* quarter of fiscal 2019 was \$1.1 million on a profit before tax of \$3.0 million (an effective tax rate of 35%). The tax rate for the *second* quarter of fiscal 2019 was higher than the U.S. statutory rate primarily due to the GILTI provisions, which became effective in fiscal 2019, as well as changes in the jurisdictional mix of earnings. The tax expense for the *second* quarter of fiscal 2018 was \$7.6 million on a profit before tax for the quarter of \$1.1 million (an effective tax rate of 694%). Before the tax charge related to the new tax legislation, tax expense for the *second* quarter of fiscal 2018 was \$0.4 million or 33.5% of pre-tax income.

For the *first* half of fiscal 2019, tax expense was \$1.4 million on profit before tax of \$3.9 million (an effective tax rate of 36%). The tax rate for the *first* half of fiscal 2019 was higher than the U.S. statutory rate primarily due to the GILTI provisions, which became effective in fiscal 2019, as well as changes in the jurisdictional mix of earnings. For the *first* half of fiscal 2018, tax expense was \$7.8 million on profit before tax of \$1.7 million (an effective tax rate of 451%). Before the tax charge related to new tax legislation, tax expense was \$0.6 million or 33.5% of pre-tax income.

U.S. Federal tax returns for years prior to fiscal 2015 are generally *no* longer subject to review by tax authorities; however, tax loss carryforwards from earlier years are still subject to adjustment. As of *December 31, 2018*, the Company has substantially resolved all open income tax audits and there were *no* other local or federal income tax audits in progress. In international jurisdictions including Australia, Brazil, Canada, China, Germany, Mexico, New Zealand, Singapore and the UK, which comprise a significant portion of the Company's operations, the years that *may* be examined vary by country. The Company's most significant foreign subsidiary in Brazil is subject to audit for the calendar years 2013 – present. During the next *twelve* months, it is possible there will be a reduction of \$0.2 million in long-term tax obligations due to the expiration of the statute of limitations on prior year tax returns.

Accounting for income taxes requires estimates of future benefits and tax liabilities. Due to the temporary differences in the timing of recognition of items included in income for accounting and tax purposes, deferred tax assets or liabilities are recorded to reflect the impact arising from these differences on future tax payments. With respect to recorded tax assets, the Company assesses the likelihood that the asset will be realized by addressing the positive and negative evidence to determine whether realization is more likely than *not* to occur. If realization is in doubt because of uncertainty regarding future profitability, the Company provides a valuation allowance related to the asset to the extent that it is more likely than *not* that the deferred tax asset will *not* be realized. Should any significant changes in the tax law or the estimate of the necessary valuation allowance occur, the Company would record the impact of the change, which could have a material effect on the Company's financial position.

No valuation allowance has been recorded for the Company's U.S. federal and foreign deferred tax assets related to temporary differences in items included in taxable income. The Company continues to believe that due to forecasted future taxable income and certain tax planning strategies available, it is more likely than *not* that, it will be able to utilize the tax benefit provided by those differences. In the U.S., a partial valuation allowance has been provided for foreign tax credit carryforwards due to the uncertainty of generating sufficient foreign source income to utilize those credits in the future and certain state net operating loss carryforwards that will expire in the near future unutilized.

Note 11: Contingencies

The Company is involved in certain legal matters, which arise, in the normal course of business. These matters are *not* expected to have a material impact on the Company's financial condition, results of operations or cash flows.

Note 12: Facility Closure

The Company decided in *January 2018* to vacate its facility in Mt. Airy, North Carolina, and move current operations to a smaller building. The Company is also considering selling the facility with a lease back provision to accommodate remaining operations. While there are *no* definitive plans set yet, the Company still anticipates that the sale could happen within the current fiscal year. The Company incurred a *\$4.1* million impairment charge in fiscal *2016*, when the majority of the plant's operations were relocated to the Company's Brazilian production facility. As of *December 31, 2018*, the carrying value of the building is *\$2.2* million, and based on comparable sales data sourced from the Company's real estate agent, the Company believes that the current fair value of the building exceeds its carrying value.

ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

Three months ended December 31, 2018 and December 31, 2017

Overview

The Company continued its first quarter growth in its core precision measuring tools, and saw products in North and Latin America and coupled with a recovery in high-end metrology. Sales increased 13% or \$6.7 million in constant dollars, more than offsetting a \$2.3 million unfavorable currency impact due to the strong US dollar.

The North American precision hand tool business continued to experience strong demand. The implementation of a new production planning system increased throughput and improved fulfillment rates. The Company's saw products gained momentum lead by an improving Brazilian economy and saw plant consolidation, which delivered increased sales volume and higher gross margin.

Net sales increased \$4.4 million or 8% from \$52.1 million in fiscal 2018 to \$56.5 million in fiscal 2019 with North America and International posting gains of \$3.5 million and \$0.9 million, respectively. Operating income increased \$2.8 million due to a \$2.5 million increase in gross margin and a \$0.3 million decrease in selling, general and administrative expenses.

Net Sales

North American sales increased \$3.5 million or 11% from \$31.1 million in fiscal 2018 to \$34.6 million in fiscal 2019 due to improved fill rates and higher shipments of precision measuring tools plus a recovery in the second quarter of high-end metrology system sales.

International sales increased \$0.9 million or 4% from \$21.0 million in fiscal 2018 to \$21.9 million in fiscal 2019 primarily due to increased volumes in Brazil and China offsetting the impact of unfavorable currency fluctuations.

Gross Margin

Gross margin increased \$2.5 million or 16% from 31% of sales in fiscal 2018 to 33% of sales in fiscal 2019.

North American gross margins increased \$1.5 million from \$8.8 million or 28% of sales in fiscal 2018 to \$10.3 million or 30% of sales in fiscal 2019 due to increased sales volume of precision measuring tools in Athol and relatively stable fixed overhead.

International gross margins increased \$1.0 million from 34% of sales in fiscal 2018 to 37% of sales in fiscal 2019 as margins based upon constant dollars increased \$1.6 million which more than offset currency losses of \$0.6 million.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased \$0.3 million or 2% from \$15.5 million in fiscal 2018 to \$15.2 million in fiscal 2019.

North American expenses, including Corporate, increased \$0.1 million from \$8.6 million in fiscal 2018 to \$8.7 million in fiscal 2019 due higher sales commissions based increased sales.

International expenses decreased \$0.4 million or 6% due principally to weakening Brazilian Real compared to the US dollar.

Other Income (Expense)

Other income decreased \$0.9 million based upon \$0.6 million of income in fiscal 2018 related to a favorable legal settlement in Brazil coupled with \$0.3 million expense due to higher interest expense in fiscal 2019.

Income Taxes

The tax expense for the second quarter of fiscal 2019 was \$1.1 million on pre-tax income of \$3.0 million or an effective tax rate of 36%. The tax rate for the second quarter of fiscal 2019 was higher than the US statutory rate primarily due to GILTI provisions, which became effective in fiscal 2019, as well as changes in the jurisdictional mix of earnings, particularly Brazil with a statutory of 34%. The tax expense for the second quarter of fiscal 2018 was \$7.6 million on a profit before tax of \$1.1 million or an effective tax rate of 694% due to the impact of the new tax legislation, which reduced the benefit of deferred tax assets.

Net Income

The Company recorded net income of \$1.9 million or \$0.27 per diluted share in the second quarter of fiscal 2019 compared to net loss of \$6.5 million or \$(0.93) per diluted share in fiscal 2018 principally due to a \$2.8 million increase in operating income and a significantly lower effective tax rate.

Six months ended December 31, 2018 and December 31, 2017

Overview

Net sales increased \$4.5 million or 4% from \$103.9 million in fiscal 2018 to \$108.4 million in fiscal 2019. Operating income increased \$3.2 million in fiscal 2019 compared to fiscal 2018 due to a \$2.5 million increase in gross margin and a \$0.7 million reduction in selling, general and administrative expenses.

Net Sales

North American sales increased \$4.0 million or 7% from \$60.8 million in fiscal 2018 to \$64.8 million in fiscal 2019 due to a \$4.2 million increase on precision measuring tools.

International sales increased \$0.5 million or 1% from \$43.1 million in fiscal 2018 to \$43.6 million in fiscal 2018 based upon strong organic growth in Brazil and China.

Gross Margin

Gross margin increased \$2.5 million or 8% and improved to 32% of sales in fiscal 2019 from 31% of sales in fiscal 2018.

North American gross margins increased \$0.4 million or 2% in fiscal 2019 compared to fiscal 2018 as increased sales volume of precision measuring hand tools offset lower sales of high margin metrology equipment.

International gross margins increased \$2.1 million based upon increased sales volume and improved margins in Brazil.

Selling, General and Administrative Expenses

Selling, general and administrative expense decreased \$0.7 million or 2% from \$31.6 million in fiscal 2018 to \$30.9 million in fiscal 2019.

North American expenses, including Corporate, increased \$0.4 million or 2% due to increased selling commissions related to sales growth in precision measuring hand tools.

International expenses decreased \$1.1 million or 8% as increased spending of \$0.5 million was more than offset by a \$1.6 million favorable currency adjustments related primarily to the weaker Brazilian Real.

Other Income (Expense)

Other income decreased \$0.9 million based upon \$0.8 million of income in fiscal 2018 related to a favorable legal settlement in Brazil coupled with \$0.1 million expense due to higher interest expense in fiscal 2019.

Income Taxes

The tax expense for the first half of fiscal 2019 was \$1.4 million on pre-tax income of \$3.9 million or an effective tax rate of 36%. The tax rate for the first half of fiscal 2019 was higher than the US statutory rate primarily due to GILTI provisions, which became effective in fiscal 2019, as well as changes in the jurisdictional mix of earnings, particularly Brazil with a statutory of 34%. The tax expense for the first half of fiscal 2018 was \$7.8 million on a profit before tax of \$1.7 million or an effective tax rate of 451% due to the impact of the new tax legislation, which reduced the benefit of deferred tax assets.

Net Income

The Company recorded net income of \$2.5 million or \$0.35 per diluted share in the first half of fiscal 2019 compared to net loss of \$6.1 million or \$(0.87) per diluted share in fiscal 2018 principally due to a \$3.2 million increase in operating income and a significantly lower effective tax rate.

LIQUIDITY AND CAPITAL RESOURCES

| Cash flows (in thousands) | Six Months Ended | |
|---|------------------|------------|
| | 12/31/2018 | 12/31/2017 |
| Cash provided by operating activities | \$2,806 | \$ 635 |
| Cash provided by (used in) investing activities | (2,572) | (3,258) |
| Cash provided by (used in) financing activities | (1,428) | 2,988 |
| Effect of exchange rate changes on cash | (206) | 159 |
| Net increase (decrease) in cash | \$(1,400) | \$ 524 |

Fiscal 2019 net cash flow for the six months ended December 31, 2018 decreased \$1.9 million compared to the six months ending December 31, 2017 principally due to reduced borrowings of debt in fiscal 2019.

Liquidity and Credit Arrangements

The Company believes it maintains sufficient liquidity and has the resources to fund its operations. In addition to its cash, the Company maintains a \$23 million line of credit in connection with its Loan and Security Agreement, of which, \$13.9 million was outstanding as of December 31, 2018. Availability under the agreement is further reduced by open letters of credit totaling \$0.9 million. The Loan and Security Agreement contains financial covenants with respect to leverage, tangible net worth, and interest coverage, and also contains customary affirmative and negative covenants, including limitations on indebtedness, liens, acquisitions, asset dispositions and fundamental corporate changes, and certain customary events of default. As of December 31, 2018, the Company was in compliance with all its financial covenants. The Loan and Security Agreement was amended on January 30, 2018 to extend the Line of Credit for an additional three years until April 30, 2021.

The effective interest rate on the borrowings under the Loan and Security Agreement during the six months ended December 31, 2018 and 2017 was 3.9% and 3.1% respectively.

OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any material off-balance sheet arrangements as defined under the Securities and Exchange Commission rules.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

There have been no material changes in quantitative and qualitative disclosures about market risk from what was reported in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2018.

ITEM 4. CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Company's President and Chief Executive Officer and Chief Financial Officer, has evaluated the Company's disclosure controls and procedures as of December 31, 2018, and they have concluded that our disclosure controls and procedures were effective as of such date. All information required to be filed in this report was recorded, processed, summarized and reported within the time period required by the rules and regulations of the Securities and Exchange Commission, and such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2018, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective.

There have been no changes in internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting during the quarter ended December 31, 2018.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

SAFE HARBOR STATEMENT

UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Quarterly Report on Form 10-Q contains forward-looking statements about the Company's business, competition, sales, expenditures, foreign operations, plans for reorganization, interest rate sensitivity, debt service, liquidity and capital resources, and other operating and capital requirements. In addition, forward-looking statements may be included in future Company documents and in oral statements by Company representatives to securities analysts and investors. The Company is subject to risks that could cause actual events to vary materially from such forward-looking statements. You should carefully review and consider the information regarding certain factors which could materially affect our business, financial condition or future results set forth under Item 1A. "Risk Factors" in our Form 10-K for the year ended June 30, 2018. There have been no material changes from the factors disclosed in our Form 10-K for the year ended June 30, 2018.

ITEM 6. EXHIBITS

31a Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

31b Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

32 Certifications of the Principal Executive Officer and the Principal Financial Officer pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

The following materials from The L. S. Starrett Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2018 are furnished herewith, formatted in XBRL (Extensible Business Reporting Language): (i) the 101 Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Income (Loss), (iv) the Consolidated Statement of Stockholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) Notes to Consolidated Financial Statements, tagged as blocks of text.

SIGNATURES

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.

THE L. S. STARRETT COMPANY

(Registrant)

Date January 31, 2019 /S/R. Douglas A. Starrett
Douglas A. Starrett - President and CEO (Principal Executive Officer)

Date January 31, 2019 /S/R. Francis J. O'Brien
Francis J. O'Brien - Treasurer and CFO (Principal Accounting Officer)