BLACKROCK CALIFORNIA MUNICIPAL INCOME TRUST
Form N-2/A
June 19, 2001

As filed with the Securities and Exchange Commission on June 19, 2001

Securities Act Registration No. 333-58228

Investment Company Registration No. 811-10331

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM N-2

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933 [X]

Pre-Effective Amendment No. 2 [X]

Post-Effective Amendment No. [_]
and/or
REGISTRATION STATEMENT UNDER
THE INVESTMENT COMPANY ACT OF 1940 [X]

AMENDMENT NO. 2 [X]

BlackRock California Municipal Income Trust
(Exact Name of Registrant as Specified In Declaration of Trust)

100 Bellevue Parkway
Wilmington, Delaware 19809
(Address of Principal Executive Offices)

(888) 825-2257
(Registrant's Telephone Number, including Area Code)

Ralph L. Schlosstein, President BlackRock California Municipal Income Trust 345 Park Avenue New York, New York 10154
(Name and Address of Agent for Service)

Copies to:

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New York, New York 10036

Approximate Date of Proposed Public Offering: As soon as practicable after the effective date of this Registration Statement.

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

Title of Securities Being Registered	Amount Being Registered	Proposed Maximum Offering Price per Unit	Proposed Maximum Aggregate Offering Price (/1/)	Amou Registr
Common Shares, $.001 par value..................	4,000,000 shares	$15.00	$60,000,000	$15,00

(/1/)Estimated solely for the purpose of calculating the registration fee.

(/2/)$375 previously paid.

The registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that the Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such dates as the Commission, acting pursuant to said Section 8(a), may determine.

BLACKROCK CALIFORNIA MUNICIPAL INCOME TRUST

CROSS REFERENCE SHEET

Part A--Prospectus

Items in Part A of Form N-2	Location in Prospectus
Item 1. Outside Front Cover	Cover Page
Item 2. Inside Front and Outside Back Cover	

	Page................................	Cover Page
Item 3.	Fee Table and Synopsis...............	Prospectus Summary; Summary of Trust Expenses
Item 4.	Financial Highlights.................	Not Applicable
Item 5.	Plan of Distribution.................	Cover Page; Prospectus Summary; Underwriting
Item 6.	Selling Shareholders.................	Not Applicable
Item 7.	Use of Proceeds......................	Use of Proceeds; The Trust's Investments
Item 8.	General Description of the Registrant...........................	The Trust; The Trust's Investments; Risks; Description of Shares; Certain Provisions in the Declaration of Trust
Item 9.	Management...........................	Management of the Trust; Custodian and Transfer Agent
Item 10.	Capital Stock, Long-Term Debt, and Other Securities.....................	Description of Shares; Distributions; Dividend Reinvestment Plan; Certain Provisions in the Declaration of Trust; Tax Matters
Item 11.	Defaults and Arrears on Senior Securities...........................	Not Applicable
Item 12.	Legal Proceedings....................	Legal Opinions
Item 13.	Table of Contents of the Statement of Additional Information...............	Table of Contents for the Statement of Additional Information

Part B--Statement of Additional Information

	Items in Part A of Form N-2	Location in Prospectus
Item 14.	Cover Page...........................	Cover Page
Item 15.	Table of Contents....................	Cover Page
Item 16.	General Information and History.......	Not Applicable
Item 17.	Investment Objective and Policies.....	Investment Objective and Policies; Investment Policies and Techniques; Portfolio Transactions
Item 18.	Management...........................	Management of the Trust; Portfolio Transactions
Item 19.	Control Persons and Principal Holders of Securities........................	Management of the Trust
Item 20.	Investment Advisory and Other Services.............................	Management of the Trust; Experts
	Brokerage Allocation and Other	

Item 21. Practices........................... Portfolio Transactions

Item 22. Tax Status........................... Tax Matters; Distributions

Item 23. Financial Statements................. Report of Independent Auditors

Part C--Other Information

Items 24-33 have been answered in Part C of this Registration Statement.

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+The information in this Prospectus is not complete and may be changed. We may +
+not sell these securities until the Registration Statement filed with the +
+Securities and Exchange Commission is effective. This Prospectus is not an +
+offer to sell these securities and is not soliciting an offer to buy these +
+securities in any state where the offer or sale is not permitted. +
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SUBJECT TO COMPLETION, DATED JUNE 19, 2001

PROSPECTUS

[LOGO OF BLACKROCK]

4,000,000 Shares

BlackRock California Municipal Income Trust

Common Shares

$15.00 per share

Investment Objective. BlackRock California Municipal Income Trust (the "Trust") is a newly organized, non-diversified, closed-end management investment company. The Trust's investment objective is to provide current income exempt from regular Federal and California income taxes.

Portfolio Contents. The Trust will invest primarily in municipal bonds that pay interest that is exempt from regular Federal and California income taxes. The Trust will invest in municipal bonds that, in the opinion of the Trust's investment advisor and sub-advisor, are underrated or undervalued. Under normal market conditions, the Trust expects to be fully invested in these tax-exempt municipal bonds. The Trust will invest at least 80% of its total assets in municipal bonds that at the time of investment are investment grade quality. Investment grade quality bonds are bonds rated within the four highest grades (Baa or BBB or better by Moody's Investor Service, Inc. ("Moody's"), Standard & Poors Ratings Group ("S&P") or Fitch IBCA, Inc. ("Fitch")) or bonds that are unrated but judged to be of comparable quality by the Trust's investment advisor and sub-advisor. The Trust may invest up to 20% of its total assets in municipal bonds that at the time of investment are rated Ba/BB or B by Moody's, S&P or Fitch or bonds that are unrated but judged to be of comparable quality by the Trust's investment advisor and sub-advisor. Bonds of below investment grade quality are regarded as having predominately speculative characteristics with respect to the issuer's capacity to pay interest and repay principal, and

are commonly referred to as "junk bonds." The Trust intends to invest primarily in long-term bonds and expects bonds in its portfolio to have a dollar weighted average maturity of 15 years or more under current market conditions. The Trust cannot ensure that it will achieve its investment objective.

No Prior History. Because the Trust is newly organized, its shares have no history of public trading. Shares of closed-end investment companies frequently trade at a discount from their net asset value. This risk may be greater for investors expecting to sell their shares in a relatively short period after completion of the public offering. The Trust's common shares have been approved for listing on the New York Stock Exchange under the symbol "BFZ".

Preferred Shares. Within approximately one to three months after completion of this offering of common shares, the Trust intends to offer preferred shares representing approximately 38% of the Trust's capital immediately after the issuance of such preferred shares. There can be no assurance, however, that preferred shares representing such percentage of the Trust's capital will actually be issued. The use of preferred shares to leverage the common shares can create risks.

Investing in the common shares involves certain risks.
See "Risks" on page 18 of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public Offering Price..................................	$15.00	$
Sales Load..	$ 0.675	$
Proceeds, before expenses, to the Trust.................	$14.325	$

The underwriters expect to deliver the common shares to purchasers on or about July , 2001.

Salomon Smith Barney — Merrill Lynch & Co.

A.G. Edwards & Sons, Inc. — Prudential Securities

UBS Warburg

Gruntal & Co., L.L.C. — Raymond James

Wedbush Morgan Securities, Inc.

July , 2001.

You should read the prospectus, which contains important information about the Trust, before deciding whether to invest and retain it for future reference. A Statement of Additional Information, dated July , 2001, containing additional information about the Trust, has been filed with the Securities and Exchange Commission and is incorporated by reference in its entirety into this prospectus. You may request a free copy of the Statement of Additional Information, the table of contents of which is on page 38 of this prospectus, by calling (888) 825-2257 or by writing to the Trust, or obtain a copy (and other information regarding the Trust) from the Securities and Exchange Commission web site (http://www.sec.gov).

The Trust's common shares do not represent a deposit or obligation of, and are not guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board or any other government agency.

The underwriters named in this prospectus may purchase up to additional common shares at the public offering price within 45 days from the date of this prospectus to cover over-allotments.

2

You should rely only on the information contained or incorporated by reference in this prospectus. The Trust has not authorized anyone to provide you with different information. The Trust is not making an offer of these securities in any state where the offer is not permitted. You should not assume that the information contained in this prospectus is accurate as of any date other than the date on the front of this prospectus.

TABLE OF CONTENTS

	Page
Prospectus Summary	4
Summary of Trust Expenses	10
The Trust	12
Use of Proceeds	12
The Trust's Investments	12
Preferred Shares and Leverage	16
Risks	18
How the Trust Manages Risk	21
Management of the Trust	22
Net Asset Value	26
Distributions	26
Dividend Reinvestment Plan	26

Description of Shares 28
Certain Provisions in the Agreement and Declaration of Trust 30
Closed-End Trust Structure 31
Repurchase of Shares 32
Tax Matters 32
Underwriting 35
Custodian and Transfer Agent 37
Legal Opinions 37
Table of Contents for the Statement of Additional Information 38

Until August , 2001 (25 days after the date of this prospectus), all dealers that buy, sell or trade the common shares, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers' obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

PRIVACY PRINCIPLES OF THE TRUST

The Trust is committed to maintaining the privacy of shareholders and to safeguarding their non-public personal information. The following information is provided to help you understand what personal information the Trust collects, how the Trust protects that information and why, in certain cases, the Trust may share information with select other parties.

Generally, the Trust does not receive any non-public personal information relating to its shareholders, although certain non-public personal information of shareholders may become available to the Trust. The Trust does not disclose any non-public personal information about its shareholders or former shareholders to anyone, except as permitted by law or as is necessary in order to service shareholder accounts (for example, to a transfer agent or third party administrator).

The Trust restricts access to non-public personal information about the shareholders to employees of the Trust's investment advisor and its affiliates with a legitimate business need for the information. The Trust maintains physical, electronic and procedural safeguards designed to protect the non-public personal information of its shareholders.

PROSPECTUS SUMMARY

This is only a summary. This summary may not contain all of the information that you should consider before investing in our common shares. You should review the more detailed information contained in this prospectus and in the Statement of Additional Information.

The Trust.................. BlackRock California Municipal Income Trust is a newly organized, non-diversified, closed-end management investment company. Throughout the prospectus, we refer to BlackRock California

Municipal Income Trust simply as the "Trust" or as "we," "us" or "our." The Trust is designed to provide tax benefits to investors who are residents of California. See "The Trust."

The Offering................

The Trust is offering common shares of beneficial interest at $15.00 per share through a group of underwriters led by Salomon Smith Barney Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, A.G. Edwards & Sons, Inc., Prudential Securities Incorporated, UBS Warburg LLC, Gruntal & Co., L.L.C., Raymond James & Associates, Inc. and Wedbush Morgan Securities, Inc. The common shares of beneficial interest are called "common shares" in the rest of this prospectus. You must purchase at least 100 common shares ($1,500). The Trust has given the underwriters an option to purchase up to additional common shares to cover orders in excess of common shares. BlackRock Advisors, Inc. has agreed to pay organizational expenses and offering costs (other than sales load) that exceed $0.03 per share. See "Underwriting."

Investment Objective...

The Trust's investment objective is to provide current income exempt from regular Federal and California income taxes.

Investment Policies.........

The Trust will invest primarily in municipal bonds that pay interest that is exempt from regular Federal and California income taxes. The Trust will invest in municipal bonds that, in the opinion of BlackRock Advisors, Inc. ("BlackRock Advisors" or the "Advisor") and BlackRock Financial Management, Inc. ("BlackRock Financial Management" or the "Sub-Advisor"), are underrated or undervalued. Underrated municipal bonds are those whose ratings do not, in the Advisor's or Sub-Advisor's opinion, reflect their true creditworthiness. Undervalued municipal bonds are bonds that, in the Advisor's or Sub-Advisor's opinion, are worth more than the value assigned to them in the marketplace. Under normal market conditions, the Trust expects to be fully invested in these tax-exempt municipal bonds. The Trust will invest at least 80% of its total assets in municipal bonds that at the time of investment are investment grade quality. Investment grade quality bonds are bonds rated within the four highest grades (Baa or BBB or better by Moody's, S&P or Fitch) or bonds that are unrated but judged to be of comparable quality by the Advisor or the Sub-Advisor. The Trust may invest up to 20% of its total assets in

municipal bonds that at the time of investment are rated Ba/BB

or B by Moody's, S&P or Fitch or bonds that are unrated but judged to be of comparable quality by the Advisor and the Sub-Advisor. Bonds of below investment grade quality are regarded as having predominately speculative characteristics with respect to the issuer's capacity to pay interest and repay principal, and are commonly referred to as "junk bonds." The Trust intends to invest primarily in long-term bonds and expects bonds in its portfolio to have a dollar weighted average maturity of 15 years or more under current market conditions. The Trust cannot ensure that it will achieve its investment objective. See "The Trust's Investments."

Special Tax Considerations.............. While exempt-interest dividends are excluded from gross income for Federal income tax purposes, they may be subject to the Federal alternative minimum tax in certain circumstances. Distributions of any capital gain or other taxable income will be taxable to shareholders. The Trust may not be a suitable investment for investors subject to the Federal alternative minimum tax or who would become subject to such tax by investing in the Trust. See "Tax Matters."

Proposed Offering of Preferred Shares............

Approximately one to three months after completion of this offering of the common shares (subject to market conditions), the Trust intends to offer preferred shares of beneficial interest ("Preferred Shares") that will represent approximately 38% of the Trust's capital after their issuance. The issuance of Preferred Shares will leverage the common shares. Leverage involves greater risks. The Trust's leveraging strategy may not be successful. See "Risks--Leverage Risk." The money the Trust obtains by selling the Preferred Shares will be invested in long-term municipal bonds that will generally pay fixed rates of interest over the life of the bonds. The Preferred Shares will pay adjustable rate dividends based on shorter-term interest rates. The adjustment period could be as short as a day or as long as a year or more. If the rate of return, after the payment of applicable expenses of the Trust, on the long-term bonds purchased by the Trust is greater than the dividends paid by the Trust on the Preferred

Shares, the Trust will generate more income by investing the proceeds of the Preferred Shares than it will need to pay dividends on the Preferred Shares. If so, the excess income will be used to pay higher dividends to holders of common shares. However, the Trust cannot assure you that the issuance of Preferred Shares will result in a higher yield on the common shares. Once Preferred Shares are issued, the net asset value and market price of the common shares and the yield to holders of common shares will be more volatile. See "Preferred Shares and Leverage" and "Description of Shares--Preferred Shares."

Investment Advisor..........

BlackRock Advisors will be the Trust's investment advisor and BlackRock Advisors' affiliate, BlackRock Financial Management, will provide certain day-to-day investment management services to

the Trust. Throughout the prospectus, we sometimes refer to BlackRock Advisors and BlackRock Financial Management collectively as "BlackRock." BlackRock Advisors will receive an annual fee, payable monthly, in a maximum amount equal to 0.60% of the average weekly value of the Trust's Managed Assets. "Managed Assets" means the total assets of the Trust (including any assets attributable to any Preferred Shares that may be outstanding) minus the sum of accrued liabilities (other than debt representing financial leverage). The liquidation preference of the Preferred Shares is not a liability. BlackRock Advisors has voluntarily agreed to waive receipt of a portion of the investment management fee or other expenses of the Trust in the amount of 0.25% of the average weekly values of the Trust's Managed Assets for the first five years of the Trust's operations (through July 31, 2006), and for a declining amount for an additional four years (through July 31, 2010). See "Management of the Trust."

Distributions.............. The Trust intends to distribute monthly all or a portion of its net investment income to holders of common shares. We expect to declare the initial monthly dividend on the Trust's common shares approximately 45 days after completion of this offering and to pay that initial monthly dividend approximately 60 to 90 days after completion of this offering. Unless an election is made to receive dividends in cash,

shareholders will automatically have all dividends and distributions reinvested in common shares through the receipt of additional unissued but authorized common shares from the Trust or by purchasing common shares in the open market through the Trust's Dividend Reinvestment Plan. See "Dividend Reinvestment Plan."

The Trust will distribute to holders of its common shares monthly dividends of all or a portion of its tax-exempt interest income after payment of dividends on any Preferred Shares of the Trust which may be outstanding. If the Trust realizes a capital gain or other taxable income, it will be required to allocate such income between the common shares and the Preferred Shares in proportion to the total distributions paid to each class for the year in which the income is realized. See "Distributions" and "Preferred Shares and Leverage."

Listing.................... The common shares have been approved for listing on the New York Stock Exchange, subject to notice of issuance, under the trading or "ticker" symbol "BFZ". See "Description of Shares--Common Shares."

Custodian and Transfer Agent...................... State Street Bank and Trust Company will serve as the Trust's Custodian and EquiServe Trust Company, N.A., will serve as the Trust's Transfer Agent. See "Custodian and Transfer Agent."

Market Price of Shares...... Shares of closed-end investment companies frequently trade at prices lower than their net asset value. Shares of closed-end investment companies like the Trust that invest predominately in

6

investment grade municipal bonds have during some periods traded at prices higher than their net asset value and during other periods traded at prices lower than their net asset value. The Trust cannot assure you that its common shares will trade at a price higher than or equal to net asset value. The Trust's net asset value will be reduced immediately following this offering by the sales load and the amount of the organization and offering expenses paid by the Trust. See "Use of Proceeds." In addition to net asset value, the market price of the Trust's common shares may be affected by such factors as dividend levels, which are in turn affected by expenses, call

protection for portfolio securities, dividend stability, portfolio credit quality, liquidity and market supply and demand. See "Preferred Shares and Leverage," "Risks," "Description of Shares" and the section of the Statement of Additional Information with the heading "Repurchase of Common Shares." The common shares are designed primarily for long-term investors and you should not purchase common shares of the Trust if you intend to sell them shortly after purchase.

Special Risk Considerations.............. No Operating History. The Trust is a newly organized closed-end investment company with no history of operations.

Market Discount Risk. Shares of closed-end management investment companies frequently trade at a discount from their net asset value.

Interest Rate Risk. Generally, when market interest rates fall, bond prices rise, and vice versa. Interest rate risk is the risk that the municipal bonds in the Trust's portfolio will decline in value because of increases in market interest rates. The prices of longer-term bonds fluctuate more than prices of shorter-term bonds as interest rates change. Because the Trust will invest primarily in long-term bonds, net asset value and market price per share of the common shares will fluctuate more in response to changes in market interest rates than if the Trust invested primarily in shorter-term bonds. The Trust's use of leverage, as described below, will tend to increase common share interest rate risk.

Credit Risk. Credit risk is the risk that one or more municipal bonds in the Trust's portfolio will decline in price, or fail to pay interest or principal when due, because the issuer of the bond experiences a decline in its financial status. Under normal market conditions, the Trust will invest at least 80% of its total assets in municipal bonds rated Baa/BBB or higher. The Trust may invest up to 20% (measured at the time of investment) of its total assets in municipal bonds that are rated Ba/BB or B or that are unrated but judged to be of comparable quality by BlackRock. The prices of these lower grade bonds are more sensitive to negative developments, such as a decline in the issuer's revenues or a general economic downturn, than are the prices of higher grade securities. Municipal bonds of below investment grade quality are predominantly speculative with respect to the issuer's capacity to

pay interest and repay principal when due and therefore involve a greater risk of default.

Concentration in California Issuers. The Trust's policy of investing primarily in municipal obligations of issuers located in California makes the Trust more susceptible to adverse economic, political or regulatory occurrences affecting those issuers. For a discussion of economic and other conditions in California, see "The Trusts Investments--Municipal Bonds--Risks Relating to California Municipal Bonds."

Economic Sector Risk. The Trust may invest 25% or more of its total assets in municipal obligations of issuers in the same economic sector, such as hospitals or life care facilities and transportation related issuers. This may make the Trust more susceptible to adverse economic, political or regulatory occurrences affecting a particular economic sector.

Leverage Risk. The use of leverage through the issuance of Preferred Shares creates an opportunity for increased common share net income, but also creates risks for the holders of common shares. The Trust's leveraging strategy may not be successful. We anticipate that Preferred Shares will pay adjustable rate dividends based on shorter-term interest rates that would be periodically reset. The Trust will invest the proceeds of the Preferred Shares offering in long-term, typically fixed rate, municipal bonds. So long as the Trust's municipal bond portfolio provides a higher rate of return, net of Trust expenses, than the Preferred Share dividend rate, as reset periodically, the leverage will cause the holders of common shares to receive a higher current rate of return than if the Trust were not leveraged. If, however, long- and/or short-term rates rise, the Preferred Share dividend rate could exceed the rate of return on long-term bonds held by the Trust that were acquired during periods of generally lower interest rates, reducing return to the holders of common shares. Leverage creates two major types of risks for the holders of common shares:

- the likelihood of greater volatility of net asset value and market price of the common shares because changes in the value of the Trust's bond portfolio, including bonds bought with the proceeds of the Preferred Shares offering, are borne entirely by the holders of common shares; and

- the possibility either that common share income will fall if the Preferred Share

dividend rate rises or that common share income will fluctuate because the Preferred Share dividend rate varies.

Municipal Bond Market Risk. The amount of public information available about the municipal bonds in the Trust's portfolio is generally less than that for corporate equities or bonds and the investment performance of the Trust may therefore be more dependent on the analytical abilities of BlackRock than would be a

8

stock fund or taxable bond fund. The secondary market for municipal bonds, particularly the below investment grade bonds in which the Trust may invest, also tends to be less well-developed or liquid than many other securities markets, which may adversely affect the Trust's ability to sell its bonds at attractive prices.

The ability of municipal issuers to make timely payments of interest and principal may be diminished in general economic downturns and as governmental cost burdens are reallocated among Federal, state and local governments. In addition, laws enacted in the future by Congress or state legislatures or referenda could extend the time for payment of principal and/or interest, or impose other constraints on enforcement of such obligations, or on the ability of municipalities to levy taxes. Issuers of municipal bonds might seek protection under the bankruptcy laws. In the event of bankruptcy of such an issuer, the Trust could experience delays in collecting principal and interest and the Trust may not, in all circumstances, be able to collect all principal and interest to which it is entitled. To enforce its rights in the event of a default in the payment of interest or repayment of principal, or both, the Trust may take possession of and manage the assets securing the issuer's obligations on such securities, which may increase the Trust's operating expenses. Any income derived from the Trust's ownership or operation of such assets may not be tax-exempt.

Non-Diversification. The Trust has registered as a "non-diversified" investment company under the Investment Company Act of 1940, as amended (the "Investment Company Act"). For Federal income tax purposes, the Trust, with respect to up to 50% of its total assets, will be able to invest more than 5% (but not more than 25%) of the value of its total assets in the obligations of any single issuer. To the extent the Trust invests a relatively high percentage of its assets in the

obligations of a limited number of issuers, the Trust may be more susceptible than a more widely diversified investment company to any single economic, political or regulatory occurrence.

Anti-takeover Provisions. The Trust's Agreement and Declaration of Trust, as amended and restated, includes provisions that could limit the ability of other entities or persons to acquire control of the Trust or convert the Trust to open-end status. These provisions could deprive the holders of common shares of opportunities to sell their common shares at a premium over the then current market price of the common shares or at net asset value.

9

SUMMARY OF TRUST EXPENSES

The following table shows Trust expenses as a percentage of net assets attributable to common shares.

Shareholder Transaction Expenses	
Sales Load Paid by You (as a percentage of offering price)	4.50%
Dividend Reinvestment Plan Fees	None*

	Percentage of Net Assets Attributable to Common Shares**
Annual Expenses	
Management Fees	0.97%
Fee and Expense Waiver Years 1-5	(0.40%)***
Net Management Fees Years 1-5	0.57%***
Other Expenses	0.32%
Total Net Annual Expenses Years 1-5	0.89%

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* You will be charged a $2.50 service charge and pay brokerage charges if you direct the Plan Agent (defined below) to sell your common shares held in a dividend reinvestment account.

** Stated as a percentage of the Trust's total Managed Assets assuming the issuance of Preferred Shares in an amount equal to 38% of the Trust's capital (after their issuance), the Trust's expenses would be estimated as set out in the table below. "Managed Assets" means the total assets of the Trust (including any assets attributable to any Preferred Shares that may

be outstanding) minus the sum of accrued liabilities (other than debt representing financial leverage). The liquidation preference of the Preferred Shares is not a liability.

	Percentage of Total Managed Assets
Annual Expenses	
Management Fees..	0.60%
Fee and Expense Waiver Years 1-5........................	(0.25%)***
Net Management Fees Years 1-5...........................	0.35%***
Other Expenses..	0.20%
Total Net Annual Expenses Years 1-5.....................	0.55%***

*** BlackRock Advisors has voluntarily agreed to waive receipt of a portion of the investment management fee or other expenses of the Trust in the amount of 0.40% of average weekly net assets attributable to common shares (0.25% of average weekly Managed Assets) for the first 5 years of the Trust's operations, 0.32 (0.20%) in year 6, 0.24 (0.15%) in year 7, 0.16 (0.10%) in year 8 and 0.08 (0.05%) in year 9. Without the waiver, "Total Net Annual Expenses Years 1-5" would be estimated to be 1.29% of average weekly net assets attributable to the common shares total net assets and 0.80% of average weekly Managed Assets attributable to common shares. BlackRock Advisors has agreed to pay all organizational expenses and offering costs (other than sales load) that exceed $0.03 per common share (0.20% of the offering price).

The purpose of the table above and the example below is to help you understand all fees and expenses that you, as a holder of common shares, would bear directly or indirectly. The expenses shown in the table under "Other Expenses" and "Total Net Annual Expenses Years 1-5" are based on estimated amounts for the Trust's first year of operations and assume that the Trust issues 11,666,666 common shares. If the Trust issues fewer common shares, all other things being equal, these expenses would increase. See "Management of the Trust" and "Dividend Reinvestment Plan."

10

The following example illustrates the expenses (including the sales load of $45) that you would pay on a $1,000 investment in common shares, assuming (1) total net annual expenses of 0.89% of net assets attributable to common shares in years 1 through 5, increasing to 1.29% in year 10 and (2) a 5% annual return:(/1/)

1 Year	3 Years	5 Years	10 Years(/2/)

Total Expenses Incurred...................	$54	$73	$94	$175

(/1/) The example should not be considered a representation of future expenses. The example assumes that the estimated "Other Expenses" set forth in the Annual Expenses table are accurate, that fees and expenses increase as described in note 2 below and that all dividends and distributions are reinvested at net asset value. Actual expenses may be greater or less than those assumed. Moreover, the Trust's actual rate of return may be greater or less than the hypothetical 5% return shown in the example.

(/2/) Assumes waiver of fees and expenses of 0.32% of average weekly net assets attributable to common shares in year 6 (0.20% of average weekly Managed Assets), 0.24% (0.15%) in year 7, 0.16% (0.10%) in year 8 and 0.08% (0.05%) in year 9 and assumes that Preferred Shares remain 38% of the Trust's capital throughout the periods reflected. BlackRock Advisors has not agreed to waive any portion of its fees and expenses beyond July 31, 2010. See "Management of the Fund--Investment Management Agreement."

THE TRUST

The Trust is a newly organized, non-diversified, closed-end management investment company registered under the Investment Company Act. The Trust was organized as a Delaware business trust on March 30, 2001, pursuant to an Agreement and Declaration of Trust, as later amended and restated, governed by the laws of the State of Delaware. As a newly organized entity, the Trust has no operating history. The Trust's principal office is located at 100 Bellevue Parkway, Wilmington, Delaware 19809, and its telephone number is (888) 825-2257. The Trust is designed to provide tax benefits to investors who are residents of California for tax purposes.

USE OF PROCEEDS

The net proceeds of the offering of common shares will be approximately $ ($ if the underwriters exercise the over-allotment option in full) after payment of the estimated organization and offering costs. The Trust will invest the net proceeds of the offering in accordance with the Trust's investment objective and policies as stated below. We currently anticipate that the Trust will be able to invest substantially all of the net proceeds in municipal bonds that meet the Trust's investment objective and policies within three months after the completion of the offering. Pending such investment, it is anticipated that the proceeds will be invested in short-term, tax-exempt or taxable investment grade securities.

THE TRUST'S INVESTMENTS

Investment Objective and Policies

The Trust's investment objective is to provide current income exempt from regular Federal and California income taxes.

The Trust will invest primarily in municipal bonds that pay interest that is exempt from regular Federal and California income taxes. Under normal market conditions, the Trust expects to be fully invested (at least 95% of its net

assets) in such tax-exempt municipal bonds. Under normal market conditions, the Trust will invest at least 80% of its total assets in investment grade quality municipal bonds. Investment grade quality means that such bonds are rated, at the time of investment, within the four highest grades (Baa or BBB or better by Moody's, S&P or Fitch) or are unrated but judged to be of comparable quality by BlackRock. Municipal bonds rated Baa by Moody's are investment grade, but Moody's considers municipal bonds rated Baa to have speculative characteristics. Changes in economic conditions or other circumstances are more likely to lead to a weakened capacity for municipal bonds that are rated BBB or Baa (or that have equivalent ratings) to make principal and interest payments than is the case for higher grade municipal bonds. The Trust may invest up to 20% of its total assets in municipal bonds that are rated, at the time of investment, Ba/BB or B by Moody's, S&P or Fitch or that are unrated but judged to be of comparable quality by BlackRock. Bonds of below investment grade quality (Ba/BB or below) are commonly referred to as "junk bonds." Bonds of below investment grade quality are regarded as having predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. These credit quality policies apply only at the time a security is purchased, and the Trust is not required to dispose of a security if a rating agency downgrades its assessment of the credit characteristics of a particular issue. In determining whether to retain or sell a security that a rating agency has downgraded, BlackRock may consider such factors as BlackRock's assessment of the credit quality of the issuer of the security, the price at which the security could be sold and the rating, if any, assigned to the security by other rating agencies. Appendix A to the Statement of Additional Information contains a general description of Moody's, S&P's and Fitch's ratings of municipal bonds. See "Risks" below for a general description of the economic and credit characteristics of municipal issuers in California. The Trust may also invest in securities of other open- or closed-end investment companies that invest primarily in municipal bonds of the types in which the Trust may invest directly and in tax-exempt preferred shares that pay dividends exempt from regular Federal income tax. Subject to the Trust's policy of investing at least 80% of its total assets in municipal bonds exempt from California income tax, the Trust may invest in securities that pay

interest that is not exempt from California income tax when, in the judgement of BlackRock, the return to the shareholders after payment of applicable California income tax would be higher than the return available from comparable securities that pay interest that is, or make other distributions that are, exempt from California income tax. See "--Other Investment Companies," "--Tax-Exempt Preferred Shares" and "--Initial Portfolio Composition."

The Trust will invest in municipal bonds that, in BlackRock's opinion, are underrated or undervalued. Underrated municipal bonds are those whose ratings do not, in BlackRock's opinion, reflect their true creditworthiness. Undervalued municipal bonds are bonds that, in the opinion of BlackRock, are worth more than the value assigned to them in the marketplace. BlackRock may at times believe that bonds associated with a particular municipal market sector (for example, electrical utilities), or issued by a particular municipal issuer, are undervalued. BlackRock may purchase those bonds for the Trust's portfolio because they represent a market sector or issuer that BlackRock considers undervalued, even if the value of those particular bonds appears to be consistent with the value of similar bonds. Municipal bonds of particular types (for example, hospital bonds, industrial revenue bonds or bonds issued by a particular municipal issuer) may be undervalued because there is a temporary excess of supply in that market sector, or because of a general decline in the market price of municipal bonds of the market sector for reasons that do not apply to the particular municipal bonds that are considered undervalued. The Trust's investment in underrated or undervalued municipal bonds will be based

on BlackRock's belief that their yield is higher than that available on bonds bearing equivalent levels of interest rate risk, credit risk and other forms of risk, and that their prices will ultimately rise, relative to the market, to reflect their true value. Any capital appreciation realized by the Trust will generally result in capital gains distributions subject to Federal capital gains taxes.

The Trust may purchase municipal bonds that are additionally secured by insurance, bank credit agreements or escrow accounts. The credit quality of companies which provide these credit enhancements will affect the value of those securities. Although the insurance feature reduces certain financial risks, the premiums for insurance and the higher market price paid for insured obligations may reduce the Trust's income. Insurance generally will be obtained from insurers with a claims-paying ability rated Aaa by Moody's or AAA by S&P or Fitch. The insurance feature does not guarantee the market value of the insured obligations or the net asset value of the common shares. The Trust may purchase insured bonds and may purchase insurance for bonds in its portfolio.

During temporary defensive periods, including the period during which the net proceeds of this offering are being invested, and in order to keep the Trust's cash fully invested, the Trust may invest up to 100% of its net assets in liquid, short-term investments, including high quality, short-term securities that may be either tax-exempt or taxable. The Trust may not achieve its investment objective under these circumstances. The Trust intends to invest in taxable short-term investments only if suitable tax-exempt short-term investments are not available at reasonable prices and yields. If the Trust invests in taxable short-term investments, a portion of your dividends would be subject to regular Federal and California income taxes.

The Trust cannot change its investment objective without the approval of the holders of a majority of the outstanding common shares and, once the Preferred Shares are issued, the Preferred Shares voting together as a single class, and of the holders of a majority of the outstanding Preferred Shares voting as a separate class. A "majority of the outstanding" means (1) 67% or more of the shares present at a meeting, if the holders of more than 50% of the shares are present or represented by proxy, or (2) more than 50% of the shares, whichever is less. See "Description of Shares--Preferred Shares--Voting Rights" and the Statement of Additional Information under "Description of Shares--Preferred Shares" for additional information with respect to the voting rights of holders of Preferred Shares.

Municipal Bonds

General. Municipal bonds are either general obligation or revenue bonds and typically are issued to finance public projects, such as roads or public buildings, to pay general operating expenses or to refinance

outstanding debt. Municipal bonds may also be issued for private activities, such as housing, medical and educational facility construction or for privately owned industrial development and pollution control projects. General obligation bonds are backed by the full faith and credit, or taxing authority, of the issuer and may be repaid from any revenue source. Revenue bonds may be repaid only from the revenues of a specific facility or source. The Trust also may purchase municipal bonds that represent lease obligations. These carry special risks because the issuer of the bonds may not be obligated to appropriate money annually to make payments under the lease. In order to reduce this risk, the Trust will only purchase municipal bonds representing lease obligations where BlackRock believes the issuer has a strong incentive to continue making

appropriations until maturity.

The municipal bonds in which the Trust will invest are generally issued by the State of California, political subdivisions of the State, and authorities or other intermediaries of the State and such political subdivisions and pay interest that, in the opinion of bond counsel to the issuer, or on the basis of another authority believed by BlackRock to be reliable, is exempt from regular Federal and California income taxes. BlackRock will not conduct its own analysis of the tax status of the interest paid by municipal bonds held by the Trust. The Trust may also invest in municipal bonds issued by United States Territories (such as Puerto Rico or Guam) that are exempt from regular Federal and California income taxes. In addition to the types of municipal bonds described in the prospectus, the Trust may invest in other securities that pay interest that is, or make other distributions that are, exempt from regular Federal income tax and/or state and local personal tax, regardless of the technical structure of the issuer of the instrument. The Trust treats all of such tax-exempt securities as municipal bonds.

The yields on municipal bonds are dependent on a variety of factors, including prevailing interest rates and the condition of the general money market and the municipal bond market, the size of a particular offering, the maturity of the obligation and the rating of the issue. The market value of municipal bonds will vary with changes in interest rate levels and as a result of changing evaluations of the ability of bond issuers to meet interest and principal payments.

The Trust will invest primarily in municipal bonds with long-term maturities in order to maintain a weighted average maturity of 15 or more years, but the weighted average maturity of obligations held by the Trust may be shortened, depending on market conditions.

Risks Relating to California Municipal Bonds. Because the Trust invests primarily in a portfolio of California municipal bonds, the Trust is more susceptible to political, economic, regulatory or other factors affecting issuers of California municipal bonds than a fund which does not limit its investments to such issuers. These risks include possible legislative, State constitutional or regulatory amendments that may affect the ability of State and local governments or regional governmental authorities to raise money to pay principal and interest on their municipal bonds. Economic, fiscal and budgetary conditions throughout the State may also influence the Trust's performance.

The following information is a summary of a more detailed description of certain factors affecting California municipal securities which is contained in the Trust's Statement of Additional Information. Investors should obtain a copy of the Statement of Additional Information for a more detailed discussion of such factors. Such information is derived from certain official statements of the State of California published in connection with the issuance of specific California municipal securities, as well as from other publicly available documents. Such information has not been independently verified by the Trust and may not apply to all California municipal securities acquired by the Trust. The Trust assumes no responsibility for the completeness or accuracy of such information.

California State and local government obligations may be adversely affected by political and economic conditions and developments within the State of California and the nation as a whole. With respect to an investment in the Trust, through popular initiative and legislative activity, the ability of the State of California and its local governments to raise money through property taxes and to increase spending has been the subject

of considerable debate and change in recent years. Various State Constitutional amendments, for example, have been adopted which have the effect of limiting property tax and spending increases, while legislation has sometimes added to these limitations and has at other times sought to reduce their impact. To date, these Constitutional, legislative and budget developments do not appear to have severely decreased the ability of the State and local governments to pay principal and interest on their obligations. It can be expected that similar types of State legislation or Constitutional proposals will continue to be introduced. The impact of future developments in these areas is unclear.

During the past year, California has experienced difficulties with the prices of natural gas and electricity in much of the State. These difficulties are likely to continue for several years. Because of capacity constraints in electric generation and transmission, California utilities have been forced to purchase wholesale power at high prices. While the government of California and the Federal Energy Regulatory Commission are considering further actions to deal with the shortcomings of California's energy market, it is not possible to predict what the long-term impact of these developments will be on California's economy. Such fuel and energy issues could have severe adverse effects on the State's economy. In turn, these recent developments regarding energy in California may adversely influence the Trust's performance. For more information regarding these developments, see "Investment Policies and Techniques--Factors Pertaining to California--Recent Developments Regarding Energy" in the Trust's Statement of Additional Information.

Although revenue obligations of the State of California or its political subdivisions may be payable from a specific project or source, including lease rentals, there can be no assurance that future economic difficulties and the resulting impact on State and local government finances will not adversely affect the market value of the portfolio of the Trust or the ability of the respective obligors to make timely payments of principal and interest on such obligations.

The value of California municipal instruments may also be affected by general conditions in the money markets or the municipal bond markets, the levels of Federal income tax rates, the supply of tax-exempt bonds, the credit quality and rating of the issues and perceptions with respect to the level of interest rates.

There can be no assurance that there will not be a decline in economic condition or that particular California municipal securities in the portfolio of the Trust will not be adversely affected by any changes.

For more information, see "Investment Policies and Techniques--Factors Pertaining to California" in the Statement of Additional Information.

When-Issued and Forward Commitment Securities

The Trust may buy and sell municipal bonds on a when-issued basis and may purchase or sell municipal bonds on a "forward commitment" basis. When such transactions are negotiated, the price, which is generally expressed in yield terms, is fixed at the time the commitment is made, but delivery and payment for the securities takes place at a later date. This type of transaction may involve an element of risk because no interest accrues on the bonds prior to settlement and, because bonds are subject to market fluctuations, the value of the bonds at the time of delivery may be less or more than cost. A separate account of the Trust will be established with its custodian consisting of cash,

or other liquid high grade debt securities having a market value at all times, at least equal to the amount of the commitment.

Other Investment Companies

The Trust may invest up to 10% of its total assets in securities of other open- or closed-end investment companies that invest primarily in municipal bonds of the types in which the Trust may invest directly. The Trust generally expects to invest in other investment companies either during periods when it has large amounts of uninvested cash, such as the period shortly after the Trust receives the proceeds of the offering of its common shares or Preferred Shares, or during periods when there is a shortage of attractive, high-yielding municipal bonds available in the market. As a shareholder in an investment company, the Trust will bear its ratable share of that investment company's expenses, and would remain subject to payment of the Trust's advisory and other fees and expenses with respect to assets so invested. Holders of common shares would therefore be subject to duplicative expenses to the extent the Trust invests in other investment companies.

15

BlackRock will take expenses into account when evaluating the investment merits of an investment in an investment company relative to available municipal bond investments. In addition, the securities of other investment companies may also be leveraged and will therefore be subject to the same leverage risks to which the Trust is subject. As described in this prospectus in the sections entitled "Risks" and "Preferred Shares and Leverage," the net asset value and market value of leveraged shares will be more volatile and the yield to shareholders will tend to fluctuate more than the yield generated by unleveraged shares. Investment companies may have investment policies that differ from those of the Trust. In addition, to the extent the Trust invests in other investment companies, the Trust will be dependent upon the investment and research abilities of persons other than BlackRock. The Trust treats its investments in such open- or closed-end investment companies as investments in municipal bonds.

Tax-Exempt Preferred Shares

The Trust may also invest up to 10% of its total assets in preferred interests of other investment funds that pay dividends that are exempt from regular Federal income tax. A portion of such dividends may be capital gain distributions subject to federal capital gains tax. Such funds in turn invest in municipal bonds and other assets that generally pay interest or make distributions that are exempt from regular Federal income tax, such as revenue bonds issued by state or local agencies to fund the development of low-income, multi-family housing. Investment in such tax-exempt preferred shares involves many of the same issues as investing in other open- or closed-end investment companies as discussed above. These investments also have additional risks, including liquidity risk, the absence of regulation governing investment practices, capital structure and leverage, affiliated transactions and other matters, and concentration of investments in particular issuers or industries. Revenue bonds issued by state or local agencies to finance the development of low-income, multi-family housing involve special risks in addition to those associated with municipal bonds generally, including that the underlying properties may not generate sufficient income to pay expenses and interest costs. Such bonds are generally non-recourse against the property owner, may be junior to the rights of others with an interest in the properties, may pay interest that changes based in part on the financial performance of the property, may be prepayable without penalty and may be used to finance the

construction of housing developments which, until completed and rented, do not generate income to pay interest. Increases in interest rates payable on senior obligations may make it more difficult for issuers to meet payment obligations on subordinated bonds. The Trust will treat investments in tax-exempt preferred shares as investments in municipal bonds.

Initial Portfolio Composition

If current market conditions persist, the Trust expects that approximately 100% of its initial portfolio will consist of investment grade quality municipal bonds, rated as such at the time of investment, meaning that such bonds are rated by national rating agencies within the four highest grades or are unrated but judged to be of comparable quality by BlackRock (approximately 80% in Aaa/AAA; 10% in A; and 10% in Baa/BBB). BlackRock generally expects to select obligations that may not be redeemed at the option of the issuer for approximately ten years from the date of purchase by the Trust. See "--Investment Objective and Policies."

PREFERRED SHARES AND LEVERAGE

Approximately one to three months after the completion of the offering of the common shares, subject to market conditions, the Trust intends to offer Preferred Shares representing approximately 38% of the Trust's capital immediately after the issuance of the Preferred Shares. The Preferred Shares will have complete priority upon distribution of assets over the common shares. The issuance of Preferred Shares will leverage the common shares. Leverage involves greater risks. The Trust's leveraging strategy may not be successful. Although the timing and other terms of the offering of Preferred Shares and the terms of the Preferred Shares will be determined by the Trust's board of trustees, the Trust expects to invest the proceeds of the Preferred Shares offering in long-term municipal bonds. The Preferred Shares will pay adjustable rate dividends based on

shorter-term interest rates, which would be redetermined periodically by an auction process. The adjustment period for Preferred Share dividends could be as short as one day or as long as a year or more. So long as the Trust's portfolio is invested in securities that provide a higher rate of return than the dividend rate of the Preferred Shares, after taking expenses into consideration, the leverage will cause you to receive a higher current rate of income than if the Trust were not leveraged.

Changes in the value of the Trust's bond portfolio, including bonds bought with the proceeds of the Preferred Shares offering, will be borne entirely by the holders of common shares. If there is a net decrease, or increase, in the value of the Trust's investment portfolio, the leverage will decrease, or increase (as the case may be), the net asset value per common share to a greater extent than if the Trust were not leveraged. During periods in which the Trust is using leverage, the fees paid to BlackRock for advisory and sub-advisory services will be higher than if the Trust did not use leverage because the fees paid will be calculated on the basis of the Trust's total assets, including the gross proceeds from the issuance of Preferred Shares.

For tax purposes, the Trust is currently required to allocate tax-exempt interest income, net capital gain and other taxable income, if any, between the common shares and Preferred Shares in proportion to total distributions paid to each class for the year in which the net capital gain or other taxable income

is realized. If net capital gain or other taxable income is allocated to Preferred Shares, instead of solely tax-exempt income, the Trust will likely have to pay higher total dividends to Preferred Shareholders or make special payments to Preferred Shareholders to compensate them for the increased tax liability. This would reduce the total amount of dividends paid to the holders of common shares, but would increase the portion of the dividend that is tax-exempt. If the increase in dividend payments or the special payments to Preferred Shareholders are not entirely offset by a reduction in the tax liability of, and an increase in the tax-exempt dividends received by, the holders of common shares, the advantage of the Trust's leveraged structure to holders of common shares will be reduced.

Under the Investment Company Act, the Trust is not permitted to issue Preferred Shares unless immediately after such issuance the value of the Trust's total assets is at least 200% of the liquidation value of the outstanding Preferred Shares (i.e., the liquidation value may not exceed 50% of the Trust's total assets). In addition, the Trust is not permitted to declare any cash dividend or other distribution on its common shares unless, at the time of such declaration, the value of the Trust's total assets is at least 200% of such liquidation value. If Preferred Shares are issued, the Trust intends, to the extent possible, to purchase or redeem Preferred Shares from time to time to the extent necessary in order to maintain coverage of any Preferred Shares of at least 200%. In addition, as a condition to obtaining ratings on the Preferred Shares, the terms of any Preferred Shares issued are expected to include asset coverage maintenance provisions which will require the redemption of the Preferred Shares in the event of non-compliance by the Trust and may also prohibit dividends and other distributions on the common shares in such circumstances. In order to meet redemption requirements, the Trust may have to liquidate portfolio securities. Such liquidations and redemptions would cause the Trust to incur related transaction costs and could result in capital losses to the Trust. Prohibitions on dividends and other distributions on the common shares could impair the Trust's ability to qualify as a regulated investment company under the Internal Revenue Code of 1986 as amended, (the "Code"). If the Trust has Preferred Shares outstanding, two of the Trust's trustees will be elected by the holders of Preferred Shares voting separately as a class. The remaining trustees of the Trust will be elected by holders of common shares and Preferred Shares voting together as a single class. In the event the Trust failed to pay dividends on Preferred Shares for two years, holders of Preferred Shares would be entitled to elect a majority of the trustees of the Trust.

The Trust will be subject to certain restrictions imposed by guidelines of one or more rating agencies that may issue ratings for Preferred Shares issued by the Trust. These guidelines are expected to impose asset coverage or portfolio composition requirements that are more stringent than those imposed on the Trust by the Investment Company Act. It is not anticipated that these covenants or guidelines will impede BlackRock from managing the Trust's portfolio in accordance with the Trust's investment objective and policies.

17

The Trust may also borrow money as a temporary measure for extraordinary or emergency purposes, including the payment of dividends and the settlement of securities transactions which otherwise might require untimely dispositions of Trust securities.

Assuming that the Preferred Shares will represent approximately 38% of the Trust's capital and pay dividends at an annual average rate of 3.00%, the income generated by the Trust's portfolio (net of estimated expenses) must exceed 1.14% in order to cover the dividend payments and other expenses specifically related to the Preferred Shares. Of course, these numbers are

merely estimates used for illustration. Actual Preferred Share dividend rates will vary frequently and may be significantly higher or lower than the rate estimated above.

The following table is furnished in response to requirements of the Securities and Exchange Commission. It is designed to illustrate the effect of leverage on common share total return, assuming investment portfolio total returns (comprised of income and changes in the value of bonds held in the Trust's portfolio) of -10%, -5%, 0%, 5% and 10%. These assumed investment portfolio returns are hypothetical figures and are not necessarily indicative of the investment portfolio returns experienced or expected to be experienced by the Trust. See "Risks." The table further reflects the issuance of Preferred Shares representing 38% of the Trust's total capital, a 5.03% yield on the Trust's investment portfolio, net of expenses, and the Trust's currently projected annual Preferred Share dividend rate of (3.00%).

Assumed Portfolio Total Return (Net of Expenses)............................	(10)%	(5)%	0 %	5%	10%
Common Share Total Return...............	(17.97)%	(9.90)%	(1.84)%	6.23%	14.29%

Common share total return is composed of two elements--the common share dividends paid by the Trust (the amount of which is largely determined by the net investment income of the Trust after paying dividends on Preferred Shares) and gains or losses on the value of the securities the Trust owns. As required by Securities and Exchange Commission rules, the table assumes that the Trust is more likely to suffer capital losses than to enjoy capital appreciation. For example, to assume a total return of 0% the Trust must assume that the tax-exempt interest it receives on its municipal bond investments is entirely offset by losses in the value of those bonds.

Unless and until Preferred Shares are issued, the common shares will not be leveraged and this section will not apply.

RISKS

The net asset value of the common shares will fluctuate with and be affected by, among other things, interest rate risk, credit risk, reinvestment risk and leverage risk, and an investment in common shares will be subject to market discount risk, inflation risk and municipal bond market risk, each of which is more fully described below.

Newly Organized. The Trust is a newly organized, non-diversified, closed-end management investment company and has no operating history.

Market Discount Risk. As with any stock, the price of the Trust's shares will fluctuate with market conditions and other factors. If shares are sold, the price received may be more or less than the original investment. Net asset value will be reduced immediately following the initial offering by the amount of the sales load and organizational and selling expenses paid by the Trust. Common shares are designed for long-term investors and should not be treated as trading vehicles. Shares of closed-end management investment companies frequently trade at a discount from their net asset value. The Trust's shares may trade at a price that is less than the initial offering price. This risk may be greater for investors who sell their shares in a relatively short period of time after completion of the initial offer. The Trust's initial net asset

value will be reduced by a 4.5% sales load charge.

Interest Rate Risk. Interest rate risk is the risk that bonds, and the Trust's net assets, will decline in value because of changes in interest rates. Generally, municipal bonds will decrease in value when interest rates rise and increase in value when interest rates decline. This means that the net asset value of the common shares will fluctuate with interest rate changes and the corresponding changes in the value of the Trust's municipal bond holdings. The value of the longer-term bonds in which the Trust generally invests fluctuates more in response to changes in interest rates than does the value of shorter-term bonds. Because the Trust will invest primarily in long-term bonds, the net asset value and market price per share of the common shares will fluctuate more in response to changes in market interest rates than if the Trust invested primarily in shorter-term bonds. The Trust's use of leverage, as described below, will tend to increase common share interest rate risk.

Credit Risk. Credit risk is the risk that an issuer of a municipal bond will become unable to meet its obligation to make interest and principal payments. In general, lower rated municipal bonds carry a greater degree of risk that the issuer will lose its ability to make interest and principal payments, which could have a negative impact on the Trust's net asset value or dividends. The Trust may invest up to 20% of its total assets in municipal bonds that are rated Ba/BB or B by Moody's, S&P or Fitch or that are unrated but judged to be of comparable quality by BlackRock. Bonds rated Ba/BB or B are regarded as having predominately speculative characteristics with respect to the issuer's capacity to pay interest and repay principal, and these bonds are commonly referred to as junk bonds. These securities are subject to a greater risk of default. The prices of these lower grade bonds are more sensitive to negative developments, such as a decline in the issuer's revenues or a general economic downturn, than are the prices of higher grade securities. Lower grade securities tend to be less liquid than investment grade securities. The market values of lower grade securities tend to be more volatile than is the case for investment grade securities.

State Concentration Risk. Because the Trust primarily purchases municipal bonds issued by the State of California or county or local government municipalities or their agencies, districts, political subdivisions or other entities, shareholders may be exposed to additional risks. In particular, the Trust is susceptible to political, economic or regulatory factors affecting issuers of California municipal bonds. There can be no assurance that California will not experience a decline in economic conditions or that the California municipal bonds purchased by the Trust will not be affected by such a decline.

For a discussion of economic and other conditions in California, see "The Trust's Investments--Municipal Bonds--Risks Relating to California Municipal Bonds."

Municipal Bond Market Risk. Investing in the municipal bond market involves certain risks. The amount of public information available about the municipal bonds in the Trust's portfolio is generally less than that for corporate equities or bonds, and the investment performance of the Trust may therefore be more dependent on the analytical abilities of BlackRock than would be a stock fund or taxable bond fund. The secondary market for municipal bonds, particularly the below investment grade bonds in which the Trust may invest, also tends to be less well-developed or liquid than many other securities markets, and may adversely affect the Trust's ability to sell its bonds at attractive prices.

The ability of municipal issuers to make timely payments of interest and principal may be diminished in general economic downturns and as governmental cost burdens are reallocated among Federal, state and local governments. In addition, laws enacted in the future by Congress or state legislatures or referenda could extend the time for payment of principal and/or interest, or impose other constraints on enforcement of such obligations or on the ability of municipalities to levy taxes. Issuers of municipal bonds might seek protection under the bankruptcy laws. In the event of bankruptcy of such an issuer, the Trust could experience delays in collecting principal and interest and the Trust may not, in all circumstances, be able to collect all principal and interest to which it is entitled. To enforce its rights in the event of a default in the payment of interest or repayment of principal, or both, the Trust may take possession of and manage the assets securing the issuer's obligations on such securities, which may increase the Trust's operating expenses. Any income derived from the Trust's ownership or operation of such assets may not be tax-exempt.

Reinvestment Risk. Reinvestment risk is the risk that income from the Trust's bond portfolio will decline if and when the Trust invests the proceeds from matured, traded, prepaid or called bonds at market interest rates that are below the portfolio's current earnings rate. A decline in income could affect the common shares' market price or their overall returns.

Leverage Risk. Leverage risk is the risk associated with the issuance of the Preferred Shares to leverage the common shares. There is no assurance that the Trust's leveraging strategy will be successful. Once the Preferred Shares are issued, the net asset value and market value of the common shares will be more volatile, and the yield to the holders of common shares will tend to fluctuate with changes in the shorter-term dividend rates on the Preferred Shares. If the dividend rate on the Preferred Shares approaches the net rate of return on the Trust's investment portfolio, the benefit of leverage to the holders of the common shares would be reduced. If the dividend rate on the Preferred Shares exceeds the net rate of return on the Trust's portfolio, the leverage will result in a lower rate of return to the holders of common shares than if the Trust were not leveraged. Because the long-term bonds included in the Trust's portfolio will typically pay fixed rates of interest while the dividend rate on the Preferred Shares will be adjusted periodically, this could occur even when both long-term and short-term municipal rates rise. In addition, the Trust will pay (and the holders of common shares will bear) any costs and expenses relating to the issuance and ongoing maintenance of the Preferred Shares. Accordingly, the Trust cannot assure you that the issuance of Preferred Shares will result in a higher yield or return to the holders of the common shares.

Similarly, any decline in the net asset value of the Trust's investments will be borne entirely by the holders of common shares. Therefore, if the market value of the Trust's portfolio declines, the leverage will result in a greater decrease in net asset value to the holders of common shares than if the Trust were not leveraged. This greater net asset value decrease will also tend to cause a greater decline in the market price for the common shares. The Trust might be in danger of failing to maintain the required 200% asset coverage or of losing its ratings on the Preferred Shares or, in an extreme case, the Trust's current investment income might not be sufficient to meet the dividend requirements on the Preferred Shares. In order to counteract such an event, the Trust might need to liquidate investments in order to fund a redemption of some or all of the Preferred Shares. Liquidation at times of low municipal bond prices may result in capital loss and may reduce returns to the holders of

common shares.

While the Trust may from time to time consider reducing leverage in response to actual or anticipated changes in interest rates in an effort to mitigate the increased volatility of current income and net asset value associated with leverage, there can be no assurance that the Trust will actually reduce leverage in the future or that any reduction, if undertaken, will benefit the holders of common shares. Changes in the future direction of interest rates are very difficult to predict accurately. If the Trust were to reduce leverage based on a prediction about future changes to interest rates, and that prediction turns out to be incorrect, the reduction in leverage would likely operate to reduce the income and/or total returns to holders of common shares relative to the circumstance where the Trust had not reduced leverage. The Trust may decide that this risk outweighs the likelihood of achieving the desired reduction to volatility in income and share price if the prediction were to turn out to be correct, and determine not to reduce leverage as described above.

The Trust may invest in the securities of other investment companies. Such securities may also be leveraged and will therefore be subject to the leverage risks described above. This additional leverage may in certain market conditions reduce the net asset value of the Trust's common shares and the returns to the holders of common shares.

Inflation Risk. Inflation risk is the risk that the value of assets or income from investment will be worth less in the future as inflation decreases the value of money. As inflation increases, the real value of the common shares and distributions on those shares can decline. In addition, during any periods of rising inflation, Preferred Share dividend rates would likely increase, which would tend to further reduce returns to the holders of common shares.

20

Economic Sector Risk. The Trust may invest 25% or more of its total assets in municipal obligations of issuers in the same economic sector, including without limitation the following: lease rental obligations of state and local authorities; obligations dependent on annual appropriations by a state's legislature for payment; obligations of state and local housing finance authorities, municipal utilities systems or public housing authorities; obligations of hospitals or life care facilities; and industrial development or pollution control bonds issued for electric utility systems, steel companies, paper companies or other purposes. This may make the Trust more susceptible to adverse economic, political, or regulatory occurrences affecting a particular economic sector. For example, health care related issuers are susceptible to Medicare, Medicaid and other third party payor reimbursement policies, and national and state health care legislation. As concentration increases, so does the potential for fluctuation in the net asset value of the Trust's common shares.

Non-Diversification. The Trust has registered as a "non-diversified" investment company under the Investment Company Act. For Federal income tax purposes, the Trust, with respect to up to 50% of its total assets, will be able to invest more than 5% (but not more than 25%) of the value of its total assets in the obligations of any single issuer. To the extent the Trust invests a relatively high percentage of its assets in the obligations of a limited number of issuers, the Trust may be more susceptible than a more widely diversified investment company to any single economic, political or regulatory occurrence.

HOW THE TRUST MANAGES RISK

Investment Limitations

The Trust has adopted certain investment limitations designed to limit investment risk. These limitations are fundamental and may not be changed without the approval of the holders of a majority of the outstanding common shares and, if issued, Preferred Shares voting together as a single class, and the approval of the holders of a majority of the Preferred Shares voting as a separate class. Among other restrictions, the Trust may not invest more than 25% of total Trust assets in securities of issuers in any one industry, except that this limitation does not apply to municipal bonds backed by the assets and revenues of governments or political subdivisions of governments.

The Trust may become subject to guidelines which are more limiting than its investment restrictions in order to obtain and maintain ratings from Moody's or S&P on the Preferred Shares that it intends to issue. The Trust does not anticipate that such guidelines would have a material adverse effect on the Trust's common shareholders or the Trust's ability to achieve its investment objective. See "Investment Objective and Policies" in the Statement of Additional Information for a complete list of the fundamental and non-fundamental investment policies of the Trust.

Quality Investments

The Trust will invest at least 80% of its total assets in bonds of investment grade quality at the time of investment. Investment grade quality means that such bonds are rated by national rating agencies within the four highest grades (Baa or BBB or better by Moody's, S&P or Fitch) or are unrated but judged to be of comparable quality by BlackRock.

Limited Issuance of Preferred Shares

Under the Investment Company Act, the Trust could issue Preferred Shares having a total liquidation value (original purchase price of the shares being liquidated plus any accrued and unpaid dividends) of up to one-half of the value of the total net assets of the Trust. If the total liquidation value of the Preferred Shares was ever more than one-half of the value of the Trust's total net assets, the Trust would not be able to declare dividends on the common shares until the liquidation value, as a percentage of the Trust's assets, was reduced. The Trust intends to issue Preferred Shares representing about 38% of the Trust's total net assets immediately after the

time of issuance if the Trust sells all common shares discussed in this prospectus. This higher than required margin of net asset value provides a cushion against later fluctuations in the value of the Trust's portfolio and will subject common shareholders to less income and net asset value volatility than if the Trust were more leveraged. The Trust intends to purchase or redeem Preferred Shares, if necessary, to keep the liquidation value of the Preferred Shares below one-half of the value of the Trust's total net assets.

Management of Investment Portfolio and Capital Structure to Limit Leverage Risk

The Trust may take certain actions if short-term interest rates increase or market conditions otherwise change (or the Trust anticipates such an increase

or change) and the Trust's leverage begins (or is expected) to adversely affect common shareholders. In order to attempt to offset such a negative impact of leverage on common shareholders, the Trust may shorten the average maturity of its investment portfolio (by investing in short-term, high quality securities) or may extend the maturity of outstanding Preferred Shares. The Trust may also attempt to reduce the leverage by redeeming or otherwise purchasing Preferred Shares. As explained above under "Risks--Leverage Risk," the success of any such attempt to limit leverage risk depends on BlackRock's ability to accurately predict interest rate or other market changes. Because of the difficulty of making such predictions, the Trust may never attempt to manage its capital structure in the manner described above.

If market conditions suggest that additional leverage would be beneficial, the Trust may sell previously unissued Preferred Shares or Preferred Shares that the Trust previously issued but later repurchased.

Currently, the Trust may not invest in inverse floating securities, which are securities that pay interest at rates that vary inversely with changes in prevailing short-term tax-exempt interest rates and which represent a leveraged investment in an underlying municipal bond. This restriction is a non-fundamental policy of the Trust that may be changed by vote of the Trust's board of trustees.

Hedging Strategies

The Trust may use various investment strategies designed to limit the risk of bond price fluctuations and to preserve capital. These hedging strategies include using financial futures contracts, options on financial futures or options based on either an index of long-term municipal securities or on taxable debt securities whose prices, in the opinion of BlackRock, correlate with the prices of the Trust's investments. Successful implementation of most hedging strategies would generate taxable income and the Trust has no present intention to use these strategies.

MANAGEMENT OF THE TRUST

Trustees and Officers

The board of trustees is responsible for the overall management of the Trust, including supervision of the duties performed by BlackRock. There are eight trustees of the Trust. Two of the trustees are "interested persons" (as defined in the Investment Company Act). The name and business address of the trustees and officers of the Trust and their principal occupations and other affiliations during the past five years are set forth under "Management of the Trust" in the Statement of Additional Information.

Investment Advisor and Sub-Advisor

BlackRock Advisors, Inc. acts as the Trust's investment advisor. BlackRock Financial Management, Inc. acts as the Trust's sub-advisor. BlackRock Advisors and BlackRock Financial Management both are wholly owned subsidiaries of BlackRock, Inc., which is one of the largest publicly traded investment management firms in the United States with $201.6 billion of assets under management as of March 31, 2001. BlackRock, Inc. and its affiliates manage assets on behalf of more than 3,300 institutions and 200,000 individuals worldwide, including nine of the 10 largest companies in the U.S. as determined by Fortune Magazine, through

a variety of equity, fixed income, liquidity and alternative investment separate accounts and mutual funds, including the company's flagship fund families, BlackRock Funds and BlackRock Provident Institutional Funds. BlackRock, Inc. is the nation's 26th largest asset management firm according to Pensions & Investments, May 14, 2001.

The BlackRock organization has over 12 years of experience managing closed-end products and currently advises a closed-end family of 20 funds. BlackRock has 13 leveraged municipal closed-end funds and six open-end municipal funds under management and over $16.2 billion in municipal assets firm-wide. Clients are served from the company's headquarters in New York City, as well as offices in Wilmington, Delaware, San Francisco, California, Hong Kong, Edinburgh, Scotland and Tokyo, Japan. BlackRock, Inc. is a member of The PNC Financial Services Group, Inc. ("PNC"), one of the largest diversified financial services organizations in the United States, and is majority-owned by PNC and by BlackRock employees.

Investment Philosophy. BlackRock's investment decision-making process for the municipal bond sector is subject to the same discipline, oversight and investment philosophy that the firm applies to other sectors of the fixed income market.

BlackRock uses a relative value strategy that evaluates the trade-off between risk and return to seek to achieve the Trust's investment objective of generating current income exempt from regular Federal and California income taxes. This strategy is combined with disciplined risk control techniques and applied in sector, sub-sector and individual security selection decisions. BlackRock's extensive personnel and technology resources are the key drivers of the investment philosophy.

BlackRock's Municipal Bond Team. BlackRock uses a team approach to managing municipal portfolios. BlackRock believes that this approach offers substantial benefits over one that is dependent on the market wisdom or investment expertise of only a few individuals.

BlackRock's municipal bond team includes five portfolio managers with an average experience of 14 years and five credit research analysts with an average experience of 11 years. Kevin M. Klingert, a managing director, senior portfolio manager and head of municipal bonds at BlackRock leads the team, a position he has held since joining BlackRock in 1991. Mr. Klingert has over 17 years of experience in the municipal market. Prior to joining BlackRock in 1991, Mr. Klingert was an Assistant Vice President at Merrill Lynch, Pierce, Fenner & Smith Incorporated, which he joined in 1985. The portfolio management team also includes Craig Kasap, James McGinley, F. Howard Downs, and Anthony Pino. Mr. Kasap, CFA has been a portfolio manager at BlackRock for over four years and is a member of BlackRock's Investment Strategy Group. Prior to joining BlackRock in 1997, Mr. Kasap spent the previous three years as a municipal bond trader with Keystone Investments in Boston where he was involved in formulating the firm's municipal bond investment strategies. Mr. McGinley has been a portfolio manager and a member of the Investment Strategy Group at BlackRock Financial Management since 1999. Prior to joining BlackRock in 1999, Mr. McGinley was Vice President of Municipal Trading from 1996 to 1999 and Manager of the Municipal Strategy Group from 1995 to 1999 with Prudential Securities. Mr. McGinley joined Prudential Securities in 1993 as an Associate in Municipal Research. F. Howard Downs has been a portfolio manager since joining BlackRock in 1999. Prior to joining BlackRock in 1999, Mr. Downs was a Vice President, Institutional Salesman and Sales Manager from 1990 to 1999 at William E. Simon and Sons Municipal Securities, Inc. Mr. Downs was one of the

original employees of William E. Simon and Sons Municipal Securities, Inc., founded in 1990, and was responsible for sales of municipal bonds. Anthony Pino has been a portfolio manager since joining BlackRock in 1999. Prior to joining BlackRock in 1999, he was a Brokerage Coordinator at CPI Capital. From 1996 to 1999, Mr. Pino was an Assistant Vice President and trader in the Municipal Strategy Group at Prudential Securities.

BlackRock's municipal bond portfolio managers are responsible for over 70 municipal bond portfolios, valued at approximately $12 billion. Municipal mandates include the management of open- and closed-end mutual funds, municipal-only separate accounts, or municipal allocations within larger institutional mandates.

In addition, BlackRock manages 14 municipal liquidity accounts valued at approximately $4.2 billion. Currently, the team manages 13 closed-end municipal funds with approximately $3.5 billion in managed assets as of March 31, 2001.

BlackRock's Investment Process. BlackRock has in-depth expertise in the fixed income market. BlackRock applies the same risk-controlled, active sector rotation style to the management process for all of its fixed income portfolios. BlackRock believes that it is unique in its integration of taxable and municipal bond specialists. Both taxable and municipal bond portfolio managers share the same trading floor and interact frequently for determining the firm's overall investment strategy. This interaction allows each portfolio manager to access the combined experience and expertise of the entire portfolio management group at BlackRock.

BlackRock's portfolio management process emphasizes research and analysis of specific sectors and securities, not interest rate speculation. BlackRock believes that market-timing strategies can be highly volatile and potentially produce inconsistent results. Instead, BlackRock thinks that value over the long-term is best achieved through a risk-controlled approach, focusing on sector allocation, security selection and yield curve management.

In the municipal market, BlackRock believes one of the most important determinants of value is supply and demand. BlackRock's ability to monitor investor flows and frequency and seasonality of issuance is helpful in anticipating the supply and demand for sectors. BlackRock believes that breadth and expertise of its municipal bond team allow it to anticipate issuance flows, forecast which sectors are likely to have the most supply and plan its investment strategy accordingly.

BlackRock also believes that over the long-term, intense credit analysis will add incremental value and avoid significant relative performance impairments. The municipal credit team is led by Susan C. Heide, Ph.D., who has been, since 1999, Managing Director, Head of Municipal Credit Research and co-chair of BlackRock's Credit Committee. From 1995 to 1999, Dr. Heide was a Director and Head of Municipal Credit Research. Dr. Heide specializes in the credit analysis of municipal securities and as such chairs the monthly municipal bond presentation to the Credit Committee. In addition, Dr. Heide supervises the team of municipal bond analysts that assists with the ongoing surveillance of the $12 billion in municipal bonds managed by BlackRock.

Prior to joining BlackRock as a Vice President and Head of Municipal Credit Research in 1993, Dr. Heide was Director of Research and a portfolio manager at OFFITBANK. For eight years prior to this assignment (1984 to 1992), Dr. Heide

was with American Express Company's Investment Division where she was the Vice President of Credit Research, responsible for assessing the creditworthiness of $6 billion in municipal securities. Dr. Heide began her investment career in 1983 at Moody's Investors Service, Inc. where she was a municipal bond analyst.

Dr. Heide initiated the Disclosure Task Force of the National Federation of Municipal Analysts in 1988 and was co-chairperson of this committee from its inception through the completion of the Disclosure Handbook for Municipal Securities--1992 Update, published in January 1993. As a result of these efforts, the SEC implemented primary and secondary disclosure regulations for municipal bonds in July 1995. Dr. Heide has authored a number of articles on municipal finance and edited The Handbook of Municipal Bonds published in the fall of 1994. Dr. Heide was selected by the Bond Buyer as a first team All-American Municipal Analyst in 1990 and was recognized in subsequent years.

BlackRock's approach to credit risk incorporates a combination of sector-based top-down macro-analysis of industry sectors to determine relative weightings with a name-specific (issuer-specific), bottom-up detailed credit analysis of issuers and structures. The sector-based approach focuses on rotating into sectors that are undervalued and exiting sectors when fundamentals or technicals become unattractive. The name-specific approach focuses on identifying special opportunities where the market undervalues a credit, and devoting concentrated resources to research the credit and monitor the position. BlackRock's analytical process focuses on anticipating change in credit trends before market recognition. Credit research is a critical, independent element of BlackRock's municipal process.

Investment Management Agreement

Pursuant to an investment management agreement between BlackRock Advisors and the Trust and certain waivers relating thereto, the Trust has agreed to pay for the investment advisory services and facilities provided by BlackRock Advisors a fee payable monthly in arrears at an annual rate equal to 0.60% of the average weekly value of the Trust's Managed Assets (the "management fee"). BlackRock Advisors has voluntarily agreed to waive receipt of a portion of the management fee or other expenses of the Trust in the amount of 0.25% of the average weekly value of the Trust's Managed Assets for the first five years of the Trust's operations (through July 31, 2006), and for a declining amount for an additional four years (through July 31, 2010). The Trust will also reimburse BlackRock Advisors for all out-of-pocket expenses BlackRock Advisors incurs in connection with performing administrative services for the Trust. In addition, with the approval of the board of trustees, a pro rata portion of the salaries, bonuses, health insurance, retirement benefits and similar employment costs for the time spent on Trust operations (other than the provision of services required under the investment management agreement) of all personnel employed by BlackRock Advisors who devote substantial time to Trust operations or the operations of other investment companies advised by the Advisor may be reimbursed to BlackRock Advisors. Managed Assets are the total assets of the Trust, which includes any proceeds from the Preferred Shares, minus the sum of accrued liabilities (other than indebtedness attributable to leverage). This means that during periods in which the Trust is using leverage, the fee paid to BlackRock Advisors will be higher than if the Trust did not use leverage because the fee is calculated as a percentage of the Trust's Managed Assets, which include those assets purchased with leverage.

In addition to the management fee of BlackRock Advisors, the Trust pays all

other costs and expenses of its operations, including compensation of its trustees (other than those affiliated with BlackRock Advisors), custodian, transfer and dividend disbursing agent expenses, legal fees, rating agency fees, expenses of independent auditors, expenses of repurchasing shares, expenses of preparing, printing and distributing shareholder reports, notices, proxy statements and reports to governmental agencies, and taxes, if any.

For the first nine years of the Trust's operation, BlackRock Advisors has undertaken to waive its management fee and expenses payable by the Trust in the amounts, and for the time periods, set forth below:

Twelve Month Period Ending July 31	Percentage Waived (as a percentage of average weekly Managed Assets*)
2002**	0.25%
2003	0.25%
2004	0.25%
2005	0.25%
2006	0.25%
2007	0.20%
2008	0.15%
2009	0.10%
2010	0.05%

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* Including net assets attributable to Preferred Shares.
** From the commencement of operations.

BlackRock Advisors has not undertaken to waive any portion of the Trust's fees and expenses beyond July 31, 2010 or after termination of the investment management agreement.

25

NET ASSET VALUE

The net asset value of the common shares of the Trust will be computed based upon the value of the Trust's portfolio securities and other assets. Net asset value per common share will be determined as of the close of the regular trading session on the New York Stock Exchange no less frequently than on the Friday of each week and on the last business day of each month. In the event that any Friday is not a business day, the net asset value will be calculated on a date determined by BlackRock Advisors. The Trust calculates net asset value per common share by subtracting the Trust's liabilities (including accrued expenses, dividends payable and any borrowings of the Trust) and the liquidation value of any outstanding Preferred Shares of the Trust from the Trust's total assets (the value of the securities the Trust holds plus cash or other assets, including interest accrued but not yet received) and dividing the result by the total number of common shares of the Trust outstanding.

The Trust values its fixed income securities by using market quotations, prices provided by market makers or estimates of market values obtained from yield data relating to instruments or securities with similar characteristics in accordance with procedures established by the board of trustees of the Trust. A substantial portion of the Trust's fixed income investments will be valued utilizing one or more pricing services approved by the Trust's board of trustees. Debt securities having a remaining maturity of 60 days or less when purchased and debt securities originally purchased with maturities in excess of 60 days but which currently have maturities of 60 days or less are valued at cost adjusted for amortization of premiums and accretion of discounts. Any securities or other assets for which current market quotations are not readily available are valued at their fair value as determined in good faith under procedures established by and under the general supervision and responsibility of the Trust's board of trustees.

DISTRIBUTIONS

The Trust will distribute to holders of its common shares monthly dividends of all or a portion of its tax-exempt interest income after payment of dividends on any Preferred Shares of the Trust which may be outstanding. It is expected that the initial monthly dividend on shares of the Trust's common shares will be declared approximately 45 days and paid approximately 60 to 90 days after completion of this offering. The Trust expects that all or a portion of any capital gain and other taxable income will be distributed at least annually.

Various factors will affect the level of the Trust's income, including the asset mix, the amount of leverage utilized by the Trust and the effects thereof and the Trust's use of hedging. To permit the Trust to maintain a more stable monthly distribution, the Trust may from time to time distribute less than the entire amount of tax-exempt interest income earned in a particular period. The undistributed tax-exempt interest income would be available to supplement future distributions. As a result, the distributions paid by the Trust for any particular monthly period may be more or less than the amount of tax-exempt interest income actually earned by the Trust during the period. Undistributed tax-exempt interest income will add to the Trust's net asset value and, correspondingly, distributions from undistributed tax-exempt interest income will deduct from the Trust's net asset value. Shareholders will automatically have all dividends and distributions reinvested in common shares of the Trust issued by the Trust or purchased in the open market in accordance with the Trust's Dividend Reinvestment Plan unless an election is made to receive cash. See "Dividend Reinvestment Plan."

DIVIDEND REINVESTMENT PLAN

Unless you elect to receive cash by contacting the Plan Agent, all dividends declared for your common shares of the Trust will be automatically reinvested by EquiServe Trust Company, N.A. (the "Plan Agent"), agent for shareholders in administering the Trust's Dividend Reinvestment Plan (the "Plan"), in additional common shares of the Trust. If you elect not to participate in the Dividend Reinvestment Plan, you will receive all dividends in cash paid by check mailed directly to you (or, if the shares are held in street or other nominee

name, then to such nominee) by EquiServe Trust Company, N.A., as dividend disbursing agent. You may elect not to participate in the Dividend Reinvestment

Plan and to receive all dividends in cash by sending written instructions or by contacting EquiServe Trust Company, N.A., as dividend disbursing agent, at the address set forth below. Participation in the Dividend Reinvestment Plan is completely voluntary and may be terminated or resumed at any time without penalty by contacting the Plan Agent before the dividend record date; otherwise such termination or resumption will be effective with respect to any subsequently declared dividend or other distribution.

The Plan Agent will open an account for each common shareholder under the Plan in the same name in which such common shareholder's common shares are registered. Whenever the Trust declares a dividend or capital gain distribution (together, a "dividend") payable in cash, non-participants in the Plan will receive cash and participants in the Plan will receive the equivalent in common shares. The common shares will be acquired by the Plan Agent for the participants' accounts, depending upon the circumstances described below, either (i) through receipt of additional unissued but authorized common shares from the Trust ("newly issued common shares") or (ii) by purchase of outstanding common shares on the open market ("open-market purchases") on the New York Stock Exchange or elsewhere. If, on the payment date for any dividend, the net asset value per common share is equal to or less than the market price per common share, the Plan Agent will invest the dividend amount in newly issued common shares on behalf of the participants. The number of newly issued common shares to be credited to each participant's account will be determined by dividing the dollar amount of the dividend by the net asset value per common share on the date the common shares are issued. If, on the payment date for any dividend, the net asset value per common share is greater than the market value, the Plan Agent will invest the dividend amount in common shares acquired on behalf of the participants in open-market purchases. In the event of a market discount on the payment date for any dividend, the Plan Agent will have until the last business day before the next date on which the common shares trade on an "ex-dividend" basis or 30 days after the payment date for such dividend, whichever is sooner (the "last purchase date"), to invest the dividend amount in common shares acquired in open-market purchases. It is contemplated that the Trust will pay monthly income dividends. Therefore, the period during which open-market purchases can be made will exist only from the payment date of each dividend through the date before the next "ex-dividend" date which typically will be approximately ten days. If, before the Plan Agent has completed its open-market purchases, the market price per common share exceeds the net asset value per common share, the average per common share purchase price paid by the Plan Agent may exceed the net asset value of the common shares, resulting in the acquisition of fewer common shares than if the dividend had been paid in newly issued common shares on the dividend payment date. Because of the foregoing difficulty with respect to open-market purchases, the Plan provides that if the Plan Agent is unable to invest the full dividend amount in open-market purchases during the purchase period or if the market discount shifts to a market premium during the purchase period, the Plan Agent may cease making open-market purchases and may invest the uninvested portion of the dividend amount in newly issued common shares at the net asset value per common share at the close of business on the last purchase date.

The Plan Agent maintains all shareholders' accounts in the Dividend Reinvestment Plan and furnishes written confirmation of all transactions in the accounts, including information needed by shareholders for tax records. Common shares in the account of each Dividend Reinvestment Plan participant will be held by the Plan Agent on behalf of the Dividend Reinvestment Plan participant, and each shareholder proxy will include those shares purchased or received pursuant to the Dividend Reinvestment Plan. The Plan Agent will forward all proxy solicitation materials to participants and vote proxies for shares held under the Dividend Reinvestment Plan in accordance with the instructions of the participants.

In the case of shareholders such as banks, brokers or nominees which hold shares for others who are the beneficial owners, the Plan Agent will administer the Dividend Reinvestment Plan on the basis of the number of common shares certified from time to time by the record shareholder's name and held for the account of beneficial owners who participate in the Dividend Reinvestment Plan.

There will be no brokerage charges with respect to common shares issued directly by the Trust. However, each participant will pay a pro rata share of brokerage commissions incurred in connection with open-market

purchases. The automatic reinvestment of dividends will not relieve participants of any Federal, state or local income tax that may be payable (or required to be withheld) on such dividends. See "Tax Matters."

The Trust reserves the right to amend or terminate the Dividend Reinvestment Plan. There is no direct service charge to participants in the Dividend Reinvestment Plan; however, the Trust reserves the right to amend the Dividend Reinvestment Plan to include a service charge payable by the participants.

All correspondence concerning the Dividend Reinvestment Plan should be directed to the Plan Agent at 150 Royall Street, Canton, Massachusetts 02021.

DESCRIPTION OF SHARES

Common Shares

The Trust is an unincorporated business trust organized under the laws of Delaware pursuant to an Agreement and Declaration of Trust dated as of March 30, 2001, as later amended and restated. The Trust is authorized to issue an unlimited number of common shares of beneficial interest, par value $.001 per share. Each common share has one vote and, when issued and paid for in accordance with the terms of this offering, will be fully paid and non-assessable except that the Trustees shall have the power to cause shareholders to pay expenses of the Trust by setting off charges due from shareholders from declared but unpaid dividends owed the shareholders or by reducing the number of common shares owned by each respective shareholder. Whenever Preferred Shares are outstanding, the holders of common shares will not be entitled to receive any distributions from the Trust unless all accrued dividends on Preferred Shares have been paid, and unless asset coverage (as defined in the Investment Company Act) with respect to Preferred Shares would be at least 200% after giving effect to the distributions and unless certain other requirements imposed by any rating agencies rating the Preferred Shares have been met. See "--Preferred Shares" below. All common shares are equal as to dividends, assets and voting privilegn, Times, serif; VERTICAL-ALIGN: bottom; BACKGROUND-COLOR: #ffffff">

Less: Net earnings attributable to noncontrolling interest, net of tax

(25) (48)

Net loss attributable to Twin Disc

$(2,696) $(4,323)

Dividends per share

$- $0.09

Loss per share data:

Basic loss per share attributable to Twin Disc common shareholders

$(0.24) $(0.39)

Diluted loss per share attributable to Twin Disc common shareholders

$(0.24) $(0.39)

Weighted average shares outstanding data:

Basic shares outstanding

11,217 11,313

Dilutive stock awards

- -

Diluted shares outstanding

11,217 11,313

Comprehensive loss:

Net loss

$(2,671) $(4,275)

Benefit plan adjustments, net of income taxes of $399 and $423, respectively

672 739

Foreign currency translation adjustment

683 (1,805)

Comprehensive loss

(1,316) (5,341)

Less: Comprehensive income attributable to noncontrolling interest

(81) (29)

Comprehensive loss attributable to Twin Disc

$(1,397) $(5,370)

The notes to condensed consolidated financial statements are an integral part of these statements.

3

TWIN DISC, INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

(UNAUDITED)

	For the Quarter Ended	
	September 30, 2016	September 25, 2015
Cash flows from operating activities:		
Net loss	**$ (2,671)**	**$ (4,275)**
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	**1,916**	**2,221**
Restructuring expenses	**219**	**-**
Provision for deferred income taxes	**(1,335)**	**(7,006)**
Stock compensation expense and other non-cash changes, net	**325**	**378**
Net change in operating assets and liabilities	**(1,115)**	**6,310**
Net cash used by operating activities	**(2,661)**	**(2,372)**
Cash flows from investing activities:		
Proceeds from sale of business (see Note L)	**-**	**3,500**
Proceeds from life insurance policy	**-**	**1,907**
Acquisitions of fixed assets	**(525)**	**(1,403)**
Proceeds from sale of fixed assets	**8**	**79**
Other, net	**(129)**	**(185)**
Net cash (used) provided by investing activities	**(646)**	**3,898**
Cash flows from financing activities:		
Borrowings under revolving loan agreement	**13,943**	**22,780**
Repayments under revolving loan agreement	**(12,751)**	**(22,315)**
Dividends paid to shareholders	**-**	**(1,019)**
Dividends paid to noncontrolling interest	**(109)**	**(192)**
Excess tax (shortfall) benefits from stock compensation	**(133)**	**52**
Payments of withholding taxes on stock compensation	**(140)**	**(190)**
Net cash provided (used) by financing activities	**810**	**(884)**
Effect of exchange rate changes on cash	**301**	**(542)**
Net change in cash	**(2,196)**	**100**

Cash:		
Beginning of period	**18,273**	**22,936**
End of period	**$ 16,077**	**$ 23,036**

The notes to condensed consolidated financial statements are an integral part of these statements.

4

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

(AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

A. Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared by Twin Disc, Incorporated (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and, in the opinion of the Company, include all adjustments, consisting only of normal recurring items, necessary for a fair statement of results for each period. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. The Company believes that the disclosures made are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report filed on Form 10-K for June 30, 2016. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States.

New Accounting Releases

In August 2016, the Financial Accounting Standards Board ("FASB") issued updated guidance to the Accounting Standards Codification ("ASC") that addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017 (the Company's fiscal 2019), with early adoption permitted. The Company is currently evaluating the potential impact of this guidance on the Company's financial statements and disclosures.

In March 2016, the FASB issued updated guidance to the ASC, intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016 (the Company's fiscal 2018), with early adoption permitted. The Company is currently evaluating the potential impact of this guidance on the Company's financial statements and disclosures.

In February 2016, the FASB issued guidance which replaces the existing guidance for leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance

sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The guidance is effective for fiscal years beginning after December 15, 2018 (the Company's fiscal 2020), including interim periods within those fiscal years and requires retrospective application. The Company is currently evaluating the potential impact of this guidance on the Company's financial statements and disclosures.

In July 2015, the FASB issued guidance intended to simplify the measurement of inventory and to closely align with International Financial Reporting Standards. Current guidance requires inventories to be measured at the lower of cost or market. Under this new guidance, inventories other than those measured under LIFO are to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance is to be applied prospectively, and is effective for fiscal years beginning after December 15, 2016 (the Company's fiscal 2018). The adoption of this guidance is not expected to have a material impact on the Company's financial statements and disclosures.

In July 2015, the FASB issued guidance to reduce complexity in employee benefit plan accounting, which is consistent with its Simplification Initiative of improving areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. This guidance update consists of several parts that affect the reporting of defined benefit pension plans, defined contribution pension plans, and their fair value measurements, among others. This guidance is effective for fiscal years beginning after December 15, 2015 (the Company's fiscal 2017). The adoption of this guidance did not have a material impact on the Company's financial statements and disclosures.

In April 2015, the FASB issued guidance intended to amend current presentation guidance by requiring that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. With regard to debt issuance costs in connection with line-of-credit arrangements, they are to be presented as an asset and amortized ratably over the term of the arrangement. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 (the Company's fiscal 2017). The adoption of this guidance did not have a material impact on the Company's financial statements and disclosures.

In August 2014, the FASB issued updated guidance intended to define management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern. The amendments in this guidance are effective for fiscal years ending after December 15, 2016 (the Company's fiscal 2017), and interim periods within fiscal years beginning after December 15, 2016. The adoption of this guidance is not expected to have a material impact on the Company's financial statements and disclosures.

In May 2014, the FASB issued updated guidance on revenue from contracts with customers. This revenue recognition guidance supersedes existing U.S. GAAP guidance, including most industry-specific guidance. The core principle is 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 identifies steps to apply in achieving this principle. This updated guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017 (the Company's fiscal 2019). The Company is currently evaluating the potential impact of this guidance on the Company's financial statements and disclosures.

B. Inventories

The major classes of inventories were as follows:

	September 30, 2016	June 30, 2016
Inventories:		
Finished parts	$ 45,786	$ 45,622
Work in process	8,392	8,020
Raw materials	12,950	12,927
	$ 67,128	$ 66,569

C. Warranty

The Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its suppliers. However, its warranty obligation is affected by product failure rates, the number of units affected by the failure and the expense involved in satisfactorily addressing the situation. The warranty reserve is established based on our best estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. When evaluating the adequacy of the reserve for warranty costs, management takes into consideration the term of the warranty coverage, historical claim rates and costs of repair, knowledge of the type and volume of new products and economic trends. While we believe the warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due and payable in the future could differ materially from what actually transpires. The following is a listing of the activity in the warranty reserve during the quarter ended September 30, 2016 and September 25, 2015:

	For the Quarter Ended	
	September 30, 2016	September 25, 2015
Reserve balance, beginning of period	$3,607	$ 5,245
Current period expense (adjustment)	182	(303)
Payments or credits to customers	(762)	(721)
Translation	9	(1)
Reserve balance, end of period	$3,036	$ 4,220

The current portion of the warranty accrual ($2,343 and $2,986 as of September 30, 2016 and September 25, 2015, respectively) is reflected in accrued liabilities, while the long-term portion ($693 and $1,234 as of September 30, 2016 and September 25, 2015, respectively) is included in other long-term liabilities on the consolidated balance sheets.

D. Contingencies

The Company is involved in litigation of which the ultimate outcome and liability to the Company, if any, is not presently determinable. Management believes that final disposition of such litigation will not have a material impact on the Company's results of operations, financial position or cash flows.

E. Business Segments

The Company and its subsidiaries are engaged in the manufacture and sale of marine and heavy-duty off-highway power transmission equipment. Principal products include marine transmissions, surface drives, propellers and boat management systems, as well as power-shift transmissions, hydraulic torque converters, power take-offs, industrial clutches and controls systems. The Company sells to both domestic and foreign customers in a variety of market areas, principally pleasure craft, commercial and military marine markets, as well as in the energy and natural resources, government and industrial markets.

The Company has two reportable segments: manufacturing and distribution. Its segment structure reflects the way management makes operating decisions and manages the growth and profitability of the business. It also corresponds with management's approach of allocating resources and assessing the performance of its segments. The accounting practices of the segments are the same as those described in the summary of significant accounting policies. Transfers among segments are at established inter-company selling prices. Management evaluates the performance of its segments based on net earnings.

Information about the Company's segments is summarized as follows:

	For the Quarter Ended	
	September 30, 2016	September 25, 2015
Net sales		
Manufacturing segment sales	$30,499	$ 29,057
Distribution segment sales	15,395	20,724
Inter/Intra segment elimination - manufacturing	(8,126)	(8,477)
Inter/Intra segment elimination – distribution	(1,933)	(3,931)
	$35,835	$ 37,373
Net loss attributable to Twin Disc		
Manufacturing segment net loss	$(1,420)	$ (2,847)

Distribution segment net earnings	271	553
Corporate and eliminations	(1,547)	(2,029)
	$(2,696)	$ (4,323)

Assets	September 30, 2016	June 30, 2016
Manufacturing segment assets	$222,629	$221,590
Distribution segment assets	51,381	52,719
Corporate assets and elimination of intercompany assets	(61,254)	(60,387)
	$212,756	$213,922

F. Stock-Based Compensation

Performance Stock Awards ("PSA")

During the first quarter of fiscal 2017 and 2016, the Company granted a target number of 99.6 and 60.5 PSAs, respectively, to various employees of the Company, including executive officers. The fiscal 2017 PSAs will vest if the Company achieves performance-based target objectives relating to average return on invested capital, average annual sales and average annual Earnings Per Share ("EPS") (as defined in the PSA Grant Agreement), in the cumulative three fiscal year period ending June 30, 2019. These PSAs are subject to adjustment if the Company's return on invested capital, net sales, and EPS for the period falls below or exceeds the specified target objective, and the maximum number of performance shares that can be awarded if the target objective is exceeded is 149.4. Based upon actual results to date and the low probability of achieving the threshold performance levels, the Company is currently not accruing compensation expense for these PSAs.

The fiscal 2016 PSAs will vest if the Company achieves (a) performance-based target objectives relating to average annual sales and consolidated economic profit, and (b) relative Total Shareholder Return (“TSR”) (as defined in the PSA Grant Agreement), in the cumulative three fiscal year period ending June 30, 2018. These PSAs are subject to adjustment if the Company’s net sales, economic profit and relative TSR for the period falls below or exceeds the specified target objective, and the maximum number of performance shares that can be awarded if the target objective is exceeded is 90.7. Based upon actual results to date and the low probability of achieving the threshold performance levels, the Company is currently not accruing as compensation expense for the portion of the PSAs relating to the average annual sales and economic profit measures. The Company is currently accruing compensation expense for the TSR measure. Compensation expense relating to the relative TSR portion is recognized based on the grant date fair value over the vesting period.

There were 171.8 and 86.4 unvested PSAs outstanding at September 30, 2016 and September 25, 2015, respectively. The fair value of the PSAs (on the date of grant) is expensed over the performance period for the shares that are expected to ultimately vest. Compensation expense of $15 was recognized for the quarter ended September 30, 2016, related to PSAs. There was no compensation expense for the quarter ended September 25, 2015, related to PSAs. The weighted average grant date fair value of the unvested awards at September 30, 2016 was $13.38. At September 30, 2016, the Company had $2,229 of unrecognized compensation expense related to the unvested shares that would vest if the specified target objective was achieved for the fiscal 2017, 2016 and 2015 awards. The total fair value of PSAs vested as of September 30, 2016 and September 25, 2015 was $0.

Performance Stock Unit Awards (“PSU”)

There were no grants of PSUs during the first quarter of fiscal 2017 and 2016.

There were 11.4 and 29.9 unvested PSUs outstanding at September 30, 2016 and September 25, 2015, respectively. The weighted average grant date fair value of the unvested awards at September 30, 2016 was $30.16. PSUs are remeasured at fair-value based upon the Company’s stock price at the end of each reporting period. The fair-value of the PSUs is expensed over the performance period for the shares that are expected to ultimately vest. There was no compensation expense for the quarters ended September 30, 2016 and September 25, 2015, related to PSUs. At September 30, 2016, the Company had $135 of unrecognized compensation expense related to the unvested shares that would vest if the specified target objective was achieved for the fiscal 2015 awards. The total fair value of PSU awards vested as of September 30, 2016 and September 25, 2015 were $0. The PSU awards are cash based, and would therefore be recorded as a liability on the Company’s consolidated balance sheets. As of September 30, 2016 and June 30, 2016, there were no awards included in liabilities in our consolidated balance sheets due to actual results to date and the low probability of achieving any of the threshold performance levels.

Restricted Stock Awards (“RS”)

The Company has unvested RS awards outstanding that will vest if certain service conditions are fulfilled. The fair value of the RS grants is recorded as compensation expense over the vesting period, which is generally 1 to 3 years. During the first quarter of fiscal 2017 and 2016, the Company granted 101.3 and 68.4 service based restricted shares, respectively, to employees and non-employee directors in each year. There were 218.0 and 133.4 unvested shares outstanding at September 30, 2016 and September 25, 2015, respectively. Compensation expense of $326 and $355 was recognized for the quarters ended September 30, 2016 and September 25, 2015, respectively. The total fair value of restricted stock grants vested as of September 30, 2016 and September 25, 2015 was $265 and $461, respectively. As of September 30, 2016, the Company had $1,808 of unrecognized compensation expense related to restricted stock which will be recognized over the next three years.

G. Pension and Other Postretirement Benefit Plans

The Company has non-contributory, qualified defined benefit plans covering substantially all domestic employees hired prior to October 1, 2003 and certain foreign employees. Additionally, the Company provides health care and life insurance benefits for certain domestic retirees. Components of net periodic benefit cost for the defined benefit pension plans and the other postretirement benefit plan are as follows:

	For the Quarter Ended	
	September 30, 2016	September 25, 2015
Pension Benefits:		
Service cost	$221	$ 130
Interest cost	1,125	1,225
Expected return on plan assets	(1,442)	(1,692)
Amortization of transition obligation	9	9
Amortization of prior service cost	1	-
Amortization of actuarial net loss	899	908
Net periodic benefit cost	$813	$ 580
Postretirement Benefits:		
Service cost	$6	$ 7
Interest cost	122	151
Amortization of actuarial net loss	182	182
Net periodic benefit cost	$310	$ 340

The Company expects to contribute approximately $1,467 to its pension plans in fiscal 2017. As of September 30, 2016, $155 in contributions has been made.

The Company has reclassified $672 (net of $399 in taxes) of benefit plan adjustments from accumulated other comprehensive loss during the quarter ended September 30, 2016. The Company has reclassified $739 (net of $423 in taxes) of benefit plan adjustments from accumulated other comprehensive loss during the quarter ended September 25, 2015. These reclassifications are included in the computation of net periodic benefit cost.

H. Income Taxes

For the quarters ended September 30, 2016 and September 25, 2015, the Company's effective income tax rate was 28.3% and 34.1%, respectively. Expected domestic losses are lower compared to prior year by $10,180. The ratio of foreign income inclusions to a smaller domestic loss resulted in a 4.6% benefit reflected in the rate. The federal research and development credit was extended and this additional benefit was offset by reduced foreign tax credits resulting in a net decrease in the effective tax rate of 1%.

The Company maintains valuation allowances when it is more likely than not that all or a portion of a deferred tax asset will not be realized. Changes in valuation allowances from period to period are included in the tax provision in the period of change. In determining whether a valuation allowance is required, the Company takes into account such factors as prior earnings history, expected future earnings, carry-back and carry-forward periods, and tax strategies that could potentially enhance the likelihood of realization of a deferred tax asset. Due to recent operating income in certain foreign jurisdictions with a history of generating operating losses, the company has evaluated the realizability of the net deferred tax assets related to these jurisdictions. This evaluation concluded that, based primarily upon a history of losses in this jurisdiction and failure to achieve targeted levels of improvement, a full valuation allowance continues to be necessary.

The Company has not provided for additional U.S. income taxes on cumulative earnings of consolidated foreign subsidiaries that are considered to be reinvested indefinitely. The Company reaffirms its position that these earnings remain permanently invested, and has no plans to repatriate funds to the U.S. for the foreseeable future. Such earnings could become taxable upon the sale or liquidation of these foreign subsidiaries or upon dividend repatriation.

Accounting policies for interim reporting require the Company to adjust its effective tax rate each quarter to be consistent with the estimated annual effective tax rate. Under this effective tax rate methodology, the Company applies an estimated annual income tax rate to its year-to-date ordinary earnings to derive its income tax provision each quarter.

The Company has approximately $904 of unrecognized tax benefits, including related interest and penalties, as of September 30, 2016, which, if recognized, would favorably impact the effective tax rate. There was no significant change in the total unrecognized tax benefits due to the settlement of audits, the expiration of statutes of limitations or for other items during the quarter ended September 30, 2016. It appears possible that the amount of unrecognized tax benefits could change in the next twelve months due to on-going audit activity.

Annually, the Company files income tax returns in various taxing jurisdictions inside and outside the United States. In general, the tax years that remain subject to examination are 2011 through 2016 for the major operations in Italy, Canada, Belgium, and Japan. The tax years open to examination in the U.S. are for years subsequent to fiscal 2012. The state of Wisconsin income tax audit remains ongoing for the fiscal years 2010 through 2015. It is reasonably possible that other audit cycles will be completed during fiscal 2017.

I. Goodwill and Other Intangibles

The Company reviews goodwill for impairment on a reporting unit basis annually as of the end of the fiscal year, and whenever events or circumstances ("triggering events") indicate that the carrying value of goodwill may not be recoverable. The Company monitors for interim triggering events on an ongoing basis. Such triggering events include unfavorable operating results and macroeconomic trends, and market capitalization of the company below its book value.

The fair value of reporting units is primarily driven by projected growth rates and operating results under the income approach using a discounted cash flow model, which applies an appropriate market-participant discount rate, and consideration of other market approach data from guideline public companies. If declining actual operating results or future operating results become indicative that the fair value of the Company's reporting units has declined below their carrying values, an interim goodwill impairment test may need to be performed and may result in a non-cash goodwill impairment charge. If the Company's market capitalization falls below the Company's carrying value for a sustained period of time or if such a decline becomes indicative that the fair value of the Company's reporting units has declined to below their carrying values, an interim goodwill impairment test may need to be performed and may result in a non-cash goodwill impairment charge.

For the quarter ended September 30, 2016, the Company performed a review of potential triggering events, such as the continued market softness and operating losses experienced during the quarter, as well as its market capitalization levels, and concluded that these events were not indicative that the fair values of its reporting units had more likely than not declined to below their carrying values at September 30, 2016.

As of September 30, 2016, goodwill is carried in the following reporting units:

Reporting Unit	
US Industrial	$2,589
European Industrial	2,550
Total	**$5,139**

The changes in the carrying amount of goodwill, all of which is allocated to the manufacturing segment, for the quarter ended September 30, 2016 were as follows:

	Gross Carrying Amount	Accumulated Impairment	Net Book Value
Balance at June 30, 2016	$ 16,392	$ (11,272)	$ 5,120
Translation adjustment	19	-	19
Balance at September 30, 2016	$ 16,411	$ (11,272)	$ 5,139

The gross carrying amount and accumulated amortization of the Company's intangible assets that have definite useful lives and are subject to amortization as of September 30, 2016 and June 30, 2016 were as follows:

	September 30, 2016			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment	Net Book Value
Licensing agreements	$ 3,015	$ (2,580)	$ -	$ 435
Non-compete agreements	2,128	(2,045)	(83)	-
Trade name	1,678	(296)	-	1,382
Other	6,617	(5,308)	(1,194)	115
	$ 13,438	$ (10,229)	$ (1,277)	$ 1,932

	June 30, 2016			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment	Net Book Value
Licensing agreements	$3,015	$ (2,565)	$ -	$450
Non-compete agreements	2,128	(2,045)	(83)	-
Trade name	1,668	(275)	-	1,393
Other	6,615	(5,301)	(1,194)	120
	$13,426	$ (10,186)	$ (1,277)	$1,963

The weighted average remaining useful life of the intangible assets included in the table above is approximately 14 years.

Intangible amortization expense was $43 and $37 for the quarters ended September 30, 2016, and September 25, 2015, respectively. Estimated intangible amortization expense for the remainder of fiscal 2017 and each of the next five fiscal years is as follows:

Fiscal Year	
2017	$138
2018	180
2019	168
2020	154
2021	150
2022	143

The gross carrying amount of the Company's intangible assets that have indefinite lives and are not subject to amortization as of September 30, 2016 and June 30, 2016 was $204 and $201, respectively. These assets are comprised of acquired trade names.

J. Long-term Debt

Long-term debt at September 30, 2016 and June 30, 2016 consisted of the following:

	September 30, 2016	June 30, 2016
Revolving loan	$ 9,670	$8,478

Other	24	23
Subtotal	9,694	8,501
Less: current maturities and short-term borrowings	-	-
Total long-term debt	$ 9,694	$8,501

The revolving loan agreement as of September 30, 2016 pertains to the revolving loan facility which the Company entered into on April 22, 2016 with Bank of Montreal (the "BMO Agreement"). The BMO Agreement is secured by substantially all of the Company's personal property, including accounts receivable, inventory, and certain machinery and equipment of its primary manufacturing facility in Racine, Wisconsin, and the personal property of Mill-Log Equipment Co., Inc., a wholly-owned domestic subsidiary of the Company. The BMO Agreement provides for a borrowing base calculation to determine borrowing capacity. This capacity will be based upon eligible domestic inventory, eligible accounts receivable and machinery and equipment, subject to certain adjustments. As of September 30, 2016, the Company's borrowing capacity under the terms of the BMO Agreement was approximately $22,273, and the Company had approximately $11,570 of available borrowings. As of September 30, 2016, the interest rate under this agreement was 2.27%.

The Company's revolving loan agreement approximates fair value at September 30, 2016 and June 30, 2016. If measured at fair value in the financial statements, long-term debt (including the current portion) would be classified as Level 2 in the fair value hierarchy.

K. Shareholders' Equity

The Company from time to time makes open market purchases of its common stock under authorizations given to it by the Board of Directors, of which 315 shares as of September 30, 2016 remain authorized for purchase. The Company did not make any open market purchases of its shares during the quarter ended September 30, 2016.

The following is a reconciliation of the Company's equity balances for the first fiscal quarters of 2017 and 2016:

	Twin Disc, Inc. Shareholders' Equity					
	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Non-Controlling Interest	Total Equity
Balance, June 30, 2016	$11,761	$175,662	$ (44,143)	$(26,790)	$ 563	$117,053
Net (loss) income		(2,696)			25	(2,671)
Translation adjustments			627		56	683
Benefit plan adjustments, net of tax			672			672
Cash dividends					(109)	(109)
Compensation expense and windfall tax benefits	208					208
Shares (acquired) issued, net	(1,493)			1,353		(140)
Balance, September 30, 2016	$10,476	$172,966	$ (42,844)	$(25,437)	$ 535	$115,696

	Twin Disc, Inc. Shareholders' Equity					
	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Non-Controlling Interest	Total Equity
Balance, June 30, 2015	$12,259	$190,807	$ (35,481)	$(28,057)	$ 639	$140,167
Net (loss) income		(4,323)			48	(4,275)
Translation adjustments			(1,787)		(18)	(1,805)
Benefit plan adjustments, net of tax			739			739
Cash dividends		(1,019)			(192)	(1,211)
Compensation expense and windfall tax benefits	303					303
Shares (acquired) issued, net	(1,045)			857		(188)
Balance, September 25, 2015	$11,517	$185,465	$ (36,529)	$(27,200)	$ 477	$133,730

Reconciliations for the changes in accumulated other comprehensive income (loss), net of tax, by component for the quarters ended September 30, 2016, and September 25, 2015, are as follows:

	Translation Adjustment	Benefit Plan Adjustment
Balance at June 30, 2016	$ 5,158	$ (49,301)
Translation adjustment during the quarter	627	-
Amounts reclassified from accumulated other comprehensive income	-	672
Net current period other comprehensive (loss) income	627	672
Balance at September 30, 2016	$ 5,785	$ (48,629)

	Translation Adjustment	Benefit Plan Adjustment
Balance at June 30, 2015	$ 6,740	$ (42,221)
Translation adjustment during the quarter	(1,787)	-
Amounts reclassified from accumulated other comprehensive income	-	739
Net current period other comprehensive (loss) income	(1,787)	739
Balance at September 25, 2015	$ 4,953	$ (41,482)

Reconciliation for the reclassifications out of accumulated other comprehensive income (loss), net of tax for the quarter ended September 30, 2016 is as follows:

	Amount Reclassified Quarter Ended September 30, 2016	
Amortization of benefit plan items		
Actuarial losses	$ 1,061	(a)
Transition asset and prior service benefit	10	(a)
Total before tax benefit	1,071	
Tax benefit	399	
Total reclassification net of tax	$ 672	

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see Note G "Pension and Other Postretirement Benefit Plans" for further details).

Reconciliation for the reclassifications out of accumulated other comprehensive income (loss), net of tax for the quarter ended September 25, 2015 is as follows:

	Amount Reclassified Quarter Ended September 25, 2015	
Amortization of benefit plan items		
Actuarial losses	$ 1,153	(a)
Transition asset and prior service benefit	9	(a)
Total before tax benefit	1,162	
Tax benefit	423	
Total reclassification net of tax	$ 739	

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see Note G "Pension and Other Postretirement Benefit Plans" for further details).

L. Restructuring of Operations

In response to challenging global market conditions within the Company's oil and gas, global pleasure craft and commercial marine markets, the Company undertook a series of restructuring actions starting in late fiscal 2015, and continuing into the current fiscal quarter.

The following is a roll-forward of restructuring activity:

Accrued restructuring liability, June 30, 2016	$801
Additions during the quarter	258
Payments and adjustments	(385)
Accrued restructuring liability, September 30, 2016	$674

The additions for the quarter ended September 30, 2016 consist of one-time special benefit payments relating to the elimination of several full-time positions in the Company's Belgian and Italian locations, under voluntary termination programs that are expected to be in place through December 2017.

Those additions do not include additional employee termination costs of $442, which were incurred by the Company's Italian operation on September 30, 2016. The Italian operation's reporting date for the quarter was as of August 26, 2016, which conforms to its statutory fiscal quarter reporting date and facilitates prompt reporting of consolidated amounts. This amount will be included in the Company's second fiscal quarter financial statements.

On October 19, 2016, in response to the softness in its markets, the Company's U.S. manufacturing operation implemented a further reduction in its plant workforce. As a result, the Company expects to record restructuring expenses of $170 in the second fiscal quarter.

On September 25, 2015, as part of its initiative to focus resources on core manufacturing and product development activities aimed at improving profitability, the Company sold one of its distribution entities in the U.S. The proceeds of $4,100 represent the sale of distribution rights to its southeastern U.S. territories, amounting to $600, and certain assets, consisting primarily of inventories, for $3,500. The gain on sale of $500 (before adjustment) is recorded as other operating income in the statement of operations in fiscal 2016.

Item 2. Management Discussion and Analysis

In the financial review that follows, we discuss our results of operations, financial condition and certain other information. This discussion should be read in conjunction with our consolidated financial statements as of September 30, 2016, and related notes, as reported in Item 1 of this Quarterly Report.

Some of the statements in this Quarterly Report on Form 10-Q are "forward looking statements" as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements include the Company's description of plans and objectives for future operations and assumptions behind those plans. The words "anticipates," "believes," "intends," "estimates," and "expects," or similar anticipatory expressions, usually identify forward-looking statements. In addition, goals established by Twin Disc, Incorporated should not be viewed as guarantees or promises of future performance. There can be no assurance the Company will be successful in achieving its goals.

In addition to the assumptions and information referred to specifically in the forward-looking statements, other factors, including but not limited to those factors discussed under Item 1A, Risk Factors, of the Company's Annual Report filed on Form 10-K for June 30, 2016 could cause actual results to be materially different from what is expressed or implied in any forward looking statement.

Results of Operations

(In thousands)

	Quarter Ended September 30, 2016	%	**September 25, 2015**	%
Net sales	$35,835		$ 37,373	
Cost of goods sold	26,662		29,183	
Gross profit	9,173	25.6%	8,190	21.9 %
Marketing, engineering and administrative expenses	12,475	34.8%	15,240	40.8 %
Restructuring of operations	258	0.7 %	-	0.0 %
Other operating expense (income)	-	0.0 %	(500)	-1.3 %
Loss from operations	$(3,560)	-9.9 %	$ (6,550)	-17.5%

Comparison of the First Quarter of FY 2017 with the First Quarter of FY 2016

Net sales for the first quarter decreased 4.1%, or $1.5 million, to $35.8 million from $37.4 million in the same period a year ago. The decline is primarily the result of softening demand in Asia for the Company's commercial marine products, along with a reduction in global demand for industrial products. While consistent with the prior year, the demand for products sold into the North American and Asian oil and gas markets remains severely depressed. Demand from customers in Europe also remains weak, while overall demand in North America remains stable for the Company's commercial marine products. The sales decline was seen most heavily in Asia, as the percentage of sales to this region fell to 19% of total consolidated net sales in the first quarter of fiscal 2017 compared to 22% for the first quarter of fiscal 2016. Currency translation had a favorable impact on fiscal 2017 sales compared to the prior year totaling $0.4 million primarily due to the strengthening of the Asian currencies against the U.S. dollar.

Sales at our manufacturing segment increased 5.0%, or $1.4 million, versus the same period last year. In the current fiscal quarter, our U.S. manufacturing operation, the largest, experienced a 27.6%, or $4.2 million, increase in sales versus the first fiscal quarter of 2016. The primary driver for this increase was the extended plant shutdown in fiscal 2016, which resulted in 21 additional shipping days during the first quarter of fiscal 2017, compared to the first quarter of fiscal 2016. This increase was largely offset by a decrease of $3.1 million at the Company's Belgian manufacturing operation, driven by reduced North American demand for its marine transmissions. The Company's Italian manufacturing operations, which continue to be hampered by the softness in the European mega yacht and industrial markets, experienced relatively flat sales compared to the prior fiscal year's first quarter, reporting a 1.8% increase compared to the first quarter of fiscal 2016. The Company's Swiss manufacturing operation, which supplies customized propellers for the global mega yacht and patrol boat markets, experienced a 10.8% increase in sales, primarily due to increased shipments for the global pleasure craft and patrol boat markets.

Our distribution segment experienced a 25.7%, or $5.3 million, decrease in sales compared to the first quarter of fiscal 2016. Nearly half of this decrease, or $2.6 million, relates to the prior year sale of the Company's distribution entity covering the southeast territory of the U.S. The Company's Asian distribution operations in Singapore and Japan saw a combined 33.4% decrease in sales compared to the prior fiscal year's first quarter. This decline reflects the ongoing challenges in the Asian economy hampering demand for the Company's commercial marine transmissions in the Asian market. The Company's distribution operation in the Northwest of the United States and Southwest of Canada experienced a decrease in sales of 13.9%. The year over year decrease was driven by reduced shipments of aftermarket service and components for the Canadian oil and gas markets. The Company's distribution operation in Australia, which provides boat accessories, propulsion and marine transmission systems for the pleasure craft market, saw a slight increase in sales primarily due to a favorable currency impact.

The elimination for net inter/intra segment sales decreased $2.3 million, primarily due to the sale of the Company's distribution entity covering the southeast territory of the U.S noted above, accounting for the remainder of the net change in sales versus the same period last year.

Gross profit as a percentage of sales increased 370 basis points to 25.6% of sales, compared to 21.9% of sales for the same period last year. The Company was able to offset an unfavorable volume impact ($0.9 million) with the positive impact of the cost reduction actions taken over the past several quarters. These actions resulted in a reduction in fixed manufacturing costs of $1.1 million compared to the prior fiscal year first quarter, as well as improved manufacturing efficiencies of nearly $0.8 million. The Company continues to focus on eliminating cost and improving efficiencies through the significant downturn in many of its markets.

For the fiscal 2017 first quarter, marketing, engineering and administrative (ME&A) expenses, as a percentage of sales, were 34.8%, compared to 40.8% for the fiscal 2016 first quarter. ME&A expenses decreased $2.8 million versus the same period last fiscal year. The decrease in ME&A expenses for the quarter relates to the Company's ongoing focus on cost containment, including the positive impact of the restructuring actions taken over the past several quarters, totaling approximately $2.3 million. These savings, combined with a reduction in pension expense ($0.2 million) and corporate development costs ($0.5 million), were partially offset by an unfavorable exchange impact ($0.1 million) and increased bonus expense ($0.2 million).

The Company incurred nearly $0.3 million in restructuring charges during the first quarter of fiscal 2017, generating expected annualized savings of approximately $0.4 million, primarily associated with cost reduction actions at its European operations. The Company continues to focus on actively managing its cost structure and reducing fixed costs in light of the current challenging business cycle. Further actions have already been taken in the second fiscal quarter to reduce employment at the Company's U.S. and Italian manufacturing operations, resulting in an anticipated charge of $0.6 million in the second fiscal quarter and estimated annualized savings of $1.0 million.

For the quarter ended September 30, 2016, the Company performed a review of potential triggering events, such as the continued market softness and operating losses experienced during the quarter, as well as its market capitalization levels, and concluded that these events were not indicative that the fair values of its reporting units had more likely than not declined to below their carrying values at September 30, 2016.

During the first quarter of fiscal 2016, the Company sold the distribution rights and assets of its distribution entity covering the southeast U.S. territory for approximately $4.1 million, resulting in a net operating gain of $0.5 million.

Interest expense remains relatively immaterial at less than $0.1 million for the first quarter of both the current and prior fiscal year. The Company has focused on controlling debt and managing cash flow through this down cycle in many of its markets.

The unfavorable movement in other expense (income) compared to the prior year is primarily due to the impact of currency movements related to the euro and Japanese yen.

The fiscal 2017 first quarter tax rate was 28.3%, compared to the fiscal 2016 first quarter rate of 34.1%. Both periods were impacted by non-deductible operating losses in a foreign jurisdiction that is subject to a full valuation allowance. Adjusting both periods for the non-deductible losses, the fiscal 2017 first quarter rate would have been 39.6%, compared to 35.2% for the fiscal 2016 first quarter. This increase was primarily a function of jurisdictional mix and reduced foreign tax credits.

Financial Condition, Liquidity and Capital Resources

Comparison between September 30, 2016 and June 30, 2016

As of September 30, 2016, the Company had net working capital of $87.9 million, which represents a decrease of $1.0 million, or 1.1%, from the net working capital of $88.9 million as of June 30, 2016.

Cash decreased $2.2 million to $16.1 million as of September 30, 2016, versus $18.3 million as of June 30, 2016. The majority of the cash as of September 30, 2016 is at the Company's overseas operations in Europe ($6.6 million) and Asia-Pacific ($7.6 million).

Trade receivables of $25.8 million were up just $0.4 million, or approximately 1.6%, when compared to last fiscal year-end. The impact of foreign currency translation was to increase accounts receivable by $0.1 million versus June 30, 2016. The net remaining increase is driven by the timing of sales within the quarter.

Inventories increased by $0.6 million, or 0.8%, versus June 30, 2016 to $67.1 million. The impact of foreign currency translation was to increase inventories by $0.2 million versus June 30, 2016. The Company will continue to search for opportunities to reduce inventory in fiscal 2017 following a very successful effort in fiscal 2016 ($13.7 million or 17%). On a consolidated basis, as of September 30, 2016, the Company's backlog of orders to be shipped over the next six months approximates $33.1 million, compared to $35.7 million at June 30, 2016 and $37.5 million at September 25, 2015. The decrease versus the end of the prior fiscal year is being experienced at the Company's domestic manufacturing location. As a percentage of six month backlog, inventory has increased from 186% at June 30, 2016 to 203% at September 30, 2016.

Net property, plant and equipment (PP&E) decreased $1.2 million versus June 30, 2016. This includes the addition of $0.5 million in capital expenditures, primarily at the Company's U.S. and Belgian-based manufacturing operations, which was more than offset by depreciation of $1.9 million. The net remaining increase is due to foreign currency translation effects. In total, the Company expects to invest between $4 and $6 million in capital assets in fiscal 2017. These anticipated expenditures reflect the Company's plans to continue investing in modern equipment and facilities, its global sourcing program and new products. The Company continues to review its capital plans based on overall market conditions and availability of capital, and may make changes to its capital plans accordingly. The Company's capital program is focused on modernizing key core manufacturing, assembly and testing processes and improving efficiencies at its facilities around the world.

Accounts payable as of September 30, 2016 of $15.2 million were up $0.5 million, or 3.4%, from June 30, 2016. The impact of foreign currency translation was to increase accounts payable by $0.2 million versus June 30, 2016. The remaining slight increase is consistent with the small increase in inventory and the Company's persistent focus on effective working capital management.

Total borrowings and long-term debt as of September 30, 2016 increased by $1.2 million, or roughly 14%, to $9.7 million versus June 30, 2016. Cash needs were driven primarily by working capital requirements. During the first quarter, the Company incurred negative free cash flow (defined as operating cash flow less acquisitions of fixed assets) of ($3.2) million and ended the quarter with total debt, net of cash, of ($6.4) million, compared to ($9.8) million at June 30, 2016, for a net change of $3.4 million.

Total equity decreased $1.4 million, or 1.2%, to $115.7 million as of September 30, 2016. Retained earnings decreased by $2.7 million, reflecting the net loss for the first fiscal quarter. Net favorable foreign currency translation of $0.7 million was reported. The net remaining increase in equity of $0.6 million primarily represents the amortization of net actuarial loss and prior service cost on the Company's defined benefit pension plans.

On April 22, 2016, the Company entered into a revolving Credit Agreement (the "BMO Agreement") with Bank of Montreal ("BMO"). This agreement permits the Company to enter into loans up to $40 million. This maximum may be increased under the BMO Agreement by an additional $10 million so long as there exists no default and certain other conditions specified in the BMO Agreement are satisfied.

In general, each revolving loan under the BMO Agreement will bear interest at a Eurodollar Rate, as defined. This rate as of September 30, 2016 was 2.27%. In addition to monthly interest payments, the Company will be responsible for paying a quarterly unused fee equal to 0.15% of the average daily unused portion of the revolving credit commitment. The Company may prepay loans subject to certain limitations. Borrowings under the BMO Agreement are secured by substantially all of the Company's personal property, including accounts receivable, inventory, certain machinery and equipment, and intellectual property, and the personal property of Mill-Log Equipment Co., Inc. ("Mill-Log"), a wholly-owned domestic subsidiary of the Company. The Company has also pledged 100% of its equity interests in certain domestic subsidiaries and 65% of its equity interests in certain foreign subsidiaries. The Company has entered into a security agreement, IP security agreement and pledge agreement with BMO, and Mill-Log has entered into a guaranty agreement, guarantor security agreement and pledge agreement with BMO, which collectively grant BMO a security interest in these assets and holdings as administrative agent for itself and other lenders that may enter into the BMO Agreement. The Company has also entered into a negative pledge agreement with BMO, pursuant to which it has agreed not to sell, lease or otherwise encumber real estate that it owns except as permitted by the BMO Agreement and the negative pledge agreement. Within thirty days upon the occurrence of an event of default (as defined) that is not cured within the prescribed cure period, or if availability under the BMO Agreement is less than the greater of 15% of the aggregate revolving credit commitments and $6.0 million, the Company and Mill-Log will execute and deliver mortgages to BMO on all real estate owned by them at such time to further secure borrowings under the BMO Agreement.

The Company’s balance sheet remains very strong, there are no material off-balance-sheet arrangements, and it continues to have sufficient liquidity for near-term needs. The Company had approximately $11.6 million of available borrowings under the BMO Agreement as of September 30, 2016. The Company expects to continue to generate enough cash from operations, as well as its credit facilities, to meet its operating and investing needs. As of September 30, 2016, the Company also had cash of $16.1 million, primarily at its overseas operations. These funds, with some restrictions and tax implications, are available for repatriation as deemed necessary by the Company. In fiscal 2017, the Company expects to contribute $1.5 million to its defined benefit pension plans, the minimum contribution required.

Net working capital decreased $1.0 million, or 1.1%, during the first quarter of fiscal 2017, and the current ratio remained consistent at 3.5 for September 30, 2016 and June 30, 2016. The slight decrease in net working capital was primarily driven by a decrease in global cash balances.

The Company expects capital expenditures to be approximately $4 million - $6 million in fiscal 2017. These anticipated expenditures reflect the Company’s plans to continue to conserve capital while investing in modern equipment and facilities, its global sourcing program and new products.

Management believes that available cash, the BMO credit facility, and potential access to debt markets will be adequate to fund the Company’s capital requirements for the foreseeable future.

As of September 30, 2016, the Company has obligations under non-cancelable operating lease contracts and loan agreements for certain future payments.

The Company has approximately $0.9 million of unrecognized tax benefits, including related interest and penalties, as of September 30, 2016, which, if recognized, would favorably impact the effective tax rate. See Note H of the Condensed Consolidated Financial Statements for disclosures surrounding uncertain income tax positions.

The Company maintains defined benefit pension plans for some of its operations in the United States and Europe. The Company has established the Benefits Committee (a non-Board management committee) to oversee the operations and administration of the defined benefit plans. The Company estimates that fiscal 2017 contributions to all defined benefit plans will total $1.5 million. As of September 30, 2016, $0.2 million in contributions have been made.

New Accounting Releases

In August 2016, the Financial Accounting Standards Board (“FASB”) issued updated guidance to the Accounting Standards Codification (“ASC”) that addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017 (the Company’s fiscal 2019), with early adoption permitted. The Company is currently evaluating the potential impact of this guidance on the Company’s financial statements and disclosures.

In March 2016, the FASB issued updated guidance to the ASC, intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016 (the Company’s fiscal 2018), with early adoption permitted. The Company is currently evaluating the potential impact of this guidance on the Company’s financial statements and disclosures.

In February 2016, the FASB issued guidance which replaces the existing guidance for leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The guidance is effective for fiscal years beginning after December 15, 2018 (the Company’s fiscal 2020), including interim periods within those fiscal years and requires retrospective application. The Company is currently evaluating the potential impact of this guidance on the Company’s financial statements and disclosures.

In July 2015, the FASB issued guidance intended to simplify the measurement of inventory and to closely align with International Financial Reporting Standards. Current guidance requires inventories to be measured at the lower of cost or market. Under this new guidance, inventories other than those measured under LIFO are to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance is to be applied prospectively, and is effective for fiscal years beginning after December 15, 2016 (the Company’s fiscal 2018). The adoption of this guidance is not expected to have a material impact on the Company’s financial statements and disclosures.

In July 2015, the FASB issued guidance to reduce complexity in employee benefit plan accounting, which is consistent with its Simplification Initiative of improving areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. This guidance update consists of several parts that affect the reporting of defined benefit pension plans, defined contribution pension plans, and their fair value measurements, among others. This guidance is effective for fiscal years beginning after December 15, 2015 (the Company’s fiscal 2017). The adoption of this guidance did not have a material impact on the Company’s financial statements and disclosures.

In April 2015, the FASB issued guidance intended to amend current presentation guidance by requiring that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. With regard to debt issuance costs in connection with line-of-credit arrangements, they are to be presented as an asset and amortized ratably over the term of the arrangement. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 (the Company’s fiscal 2017). The adoption of this guidance did not have a material impact on the Company’s financial statements and disclosures.

In August 2014, the FASB issued updated guidance intended to define management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern. The amendments in this guidance are effective for fiscal years ending after December 15, 2016 (the Company’s fiscal 2017), and interim periods within fiscal years beginning after December 15, 2016. The adoption of this guidance is not expected to have a material impact on the Company’s financial statements and disclosures.

In May 2014, the FASB issued updated guidance on revenue from contracts with customers. This revenue recognition guidance supersedes existing U.S. GAAP guidance, including most industry-specific guidance. The core principle is 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 identifies steps to apply in achieving this principle. This updated guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017 (the Company's fiscal 2019). The Company is currently evaluating the potential impact of this guidance on the Company's financial statements and disclosures.

Critical Accounting Policies

The preparation of this Quarterly Report requires management's judgment to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenues and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates.

Twin Disc's critical accounting policies are described in Item 7 of the Company's Annual Report filed on Form 10-K for June 30, 2016. There have been no significant changes to those accounting policies subsequent to June 30, 2016.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

The Company is exposed to market risks from changes in interest rates, commodities and foreign exchange. To reduce such risks, the Company selectively uses financial instruments and other pro-active management techniques. All hedging transactions are authorized and executed pursuant to clearly defined policies and procedures, which prohibit the use of financial instruments for trading or speculative purposes.

Interest rate risk - The Company's earnings exposure related to adverse movements of interest rates is primarily derived from outstanding floating rate debt instruments that are indexed to a Eurodollar Rate. In accordance with BMO Agreement expiring April 22, 2021, the Company has the option of borrowing at a Eurodollar Rate plus an additional "Add-On" of 1.75%. Due to the relative stability of interest rates, the Company did not utilize any financial instruments at September 30, 2016 to manage interest rate risk exposure. A 10 percent increase or decrease in the applicable interest rate would result in a change in pretax interest expense of approximately $22,000.

Commodity price risk - The Company is exposed to fluctuation in market prices for such commodities as steel and aluminum. The Company does not utilize commodity price hedges to manage commodity price risk exposure.

Currency risk - The Company has exposure to foreign currency exchange fluctuations. Approximately 28% of the Company's revenues in the quarter ended September 30, 2016 were denominated in currencies other than the U.S. dollar. Of that total, approximately 56% was denominated in euros with the balance composed of Japanese yen, the Swiss franc, Indian rupee and the Australian and Singapore dollars. The Company does not hedge the translation exposure represented by the net assets of its foreign subsidiaries. Foreign currency translation adjustments are recorded as a component of shareholders' equity. Forward foreign exchange contracts are occasionally used to hedge the currency fluctuations on significant transactions denominated in foreign currencies.

Derivative financial instruments - The Company has written policies and procedures that place all financial instruments under the direction of the Company's corporate treasury group and restrict derivative transactions to those intended for hedging purposes. The use of financial instruments for trading purposes is prohibited. The Company occasionally uses financial instruments to manage the market risk from changes in foreign exchange rates.

The Company primarily enters into forward exchange contracts to reduce the earnings and cash flow impact of non-functional currency denominated receivables and payables. These contracts are highly effective in hedging the cash flows attributable to changes in currency exchange rates. Gains and losses resulting from these contracts offset the foreign exchange gains or losses on the underlying assets and liabilities being hedged. The maturities of the forward exchange contracts generally coincide with the settlement dates of the related transactions. Gains and losses on these contracts are recorded in Other expense, net in the Condensed Consolidated Statement of Operations as the

changes in the fair value of the contracts are recognized and generally offset the gains and losses on the hedged items in the same period. The primary currency to which the Company was exposed in fiscal 2017 and 2016 was the euro. At September 30, 2016, the Company had two outstanding forward exchange contracts to purchase U.S. dollars in the notional value of $700,000 with a weighted average maturity of 29 days. The fair value of the Company's contracts was a loss of $2,000 at September 30, 2016. The Company had no outstanding forward exchange contracts at June 30, 2016.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures*

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("the Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing, and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act, and that such information is accumulated and communicated to the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely discussions regarding required disclosure.

(b) *Changes in Internal Control Over Financial Reporting*

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f) and 15d-15(f). During the period covered by this report, no changes were made which have materially affected, or which are reasonably likely to materially affect, our internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

Twin Disc is a defendant in several product liability or related claims which are considered either adequately covered by appropriate liability insurance or involving amounts not deemed material to the business or financial condition of the Company.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in response to Item 1A to Part I of our 2016 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) *Unregistered Sales of Equity Securities*

There were no securities of the Company sold by the Company during the quarter ended September 30, 2016, which were not registered under the Securities Act of 1933, in reliance upon an exemption from registration provided by Section 4 (2) of the Act.

(b) *Use of Proceeds*

Not applicable.

(c) *Issuer Purchases of Equity Securities*

Issuer Purchases of Equity Securities

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1, 2016 – July 29, 2016	12,869	NA	0	315,000
July 30, 2016 – Aug. 26, 2016	0	NA	0	315,000
Aug. 27, 2016 – Sept. 30, 2016	0	NA	0	315,000
Total	12,869	NA	0	315,000

The Company did not purchase any shares of common stock during the quarter ended September 30, 2016, pursuant to our publicly announced program (described below). The amounts shown in Column (a) above represent shares of common stock delivered to the Company as payment of withholding taxes due on the vesting of restricted stock issued under the Twin Disc, Incorporated 2010 Long-Term Incentive Compensation Plan.

On February 1, 2008, the Board of Directors authorized the purchase of up to 500,000 shares of common stock at market values, of which 250,000 shares were purchased during fiscal 2009 and 125,000 shares were purchased during fiscal 2012. On July 27, 2012, the Board of Directors authorized the purchase of an additional 375,000 shares of common stock at market values. This authorization has no expiration. During the second quarter of fiscal 2013, the Company purchased 185,000 shares under this authorization.

Item 3. Defaults Upon Senior Securities

None.

Item 5. Other Information

None.

Item 6. Exhibits

31a Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31b Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32a Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32b Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101.INS XBRL Instance Document

101.SCH XBRL Schema

101.CAL XBRL Calculation Linkbase

101.DEF XBRL Definition Linkbase

101.LAB XBRL Label Linkbase

101.PRE XBRL Presentation Linkbase

SIGNATURE

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

	TWIN DISC, INCORPORATED (Registrant)
Date: November 9, 2016	/s/ DEBBIE A. LANGE Debbie A. Lange Corporate Controller Chief Accounting Officer

22