

STARRETT L S CO
Form 10-Q
November 04, 2015
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015

OR

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

For the transition period from to

Commission file number 1-367

THE L. S. STARRETT COMPANY

(Exact name of registrant as specified in its charter)

MASSACHUSETTS 04-1866480
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

121 CRESCENT STREET, ATHOL, MASSACHUSETTS 01331-1915
(Address of principal executive offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for

the past 90 days.

YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller

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

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

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

YES
NO

Common Shares outstanding as of October 31, 2015

Class A Common Shares 6,240,805

Class B Common Shares 777,520

THE L. S. STARRETT COMPANY

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

THE L. S. STARRETT COMPANY

Consolidated Balance Sheets

(in thousands except share data)

| | September 30, 2015 (unaudited) | June 30, 2015 |
|---|---|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash | \$ 12,939 | \$11,108 |
| Short-term investments | 7,565 | 7,855 |
| Accounts receivable (less allowance for doubtful accounts of \$609 and \$612, respectively) | 29,172 | 40,311 |
| Inventories | 60,090 | 63,003 |
| Current deferred income tax assets | 4,253 | 4,554 |
| Prepaid expenses and other current assets | 6,777 | 6,582 |
| Total current assets | 120,796 | 133,413 |
| Property, plant and equipment, net | 42,867 | 44,413 |
| Income taxes receivable | 3,209 | 3,383 |
| Deferred income tax assets, net of current portion | 18,715 | 18,803 |
| Intangible assets, net | 6,954 | 7,125 |
| Goodwill | 3,034 | 3,034 |
| Other assets | 2,149 | 2,101 |
| Total assets | \$ 197,724 | \$212,272 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Notes payable and current maturities of long-term debt | \$ 1,534 | \$1,552 |
| Accounts payable | 8,853 | 9,471 |
| Accrued expenses | 5,227 | 7,011 |
| Accrued compensation | 4,325 | 5,565 |
| Total current liabilities | 19,939 | 23,599 |

| | | |
|---|------------|------------|
| Long-term debt, net of current portion | 18,773 | 18,552 |
| Other income tax obligations | 4,785 | 4,607 |
| Deferred income tax liabilities | 1,520 | 1,548 |
| Postretirement benefit and pension obligations | 48,838 | 49,536 |
| Total liabilities | 93,855 | 97,842 |
| Stockholders' equity: | | |
| Class A Common stock \$1 par (20,000,000 shares authorized; 6,238,575 outstanding at September 30, 2015 and 6,223,558 outstanding at June 30, 2015) | 6,238 | 6,224 |
| Class B Common stock \$1 par (10,000,000 shares authorized; 780,776 outstanding at September 30, 2015 and 789,069 outstanding at June 30, 2015) | 781 | 789 |
| Additional paid-in capital | 54,964 | 54,869 |
| Retained earnings | 97,282 | 98,164 |
| Accumulated other comprehensive loss | (55,396) | (45,616) |
| Total stockholders' equity | 103,869 | 114,430 |
| Total liabilities and stockholders' equity | \$ 197,724 | \$ 212,272 |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Operations

(in thousands except per share data) (unaudited)

| | 3 Months Ended | |
|---|----------------|-----------|
| | 9/30/2015 | 9/30/2014 |
| Net sales | \$51,038 | \$ 60,172 |
| Cost of goods sold | 35,186 | 41,029 |
| Gross margin | 15,852 | 19,143 |
| % of Net sales | 31.1 % | 31.8 % |
| Selling, general and administrative expenses | 15,673 | 18,077 |
| Operating income | 179 | 1,066 |
| Other income | 303 | 675 |
| Income before income taxes | 482 | 1,741 |
| Income tax expense | 660 | 818 |
| Net income (loss) | \$(178) | \$ 923 |
| Basic and diluted income (loss) per share | \$(0.03) | \$ 0.13 |
| Weighted average outstanding shares used in per share calculations: | | |
| Basic | 7,014 | 6,965 |
| Diluted | 7,014 | 6,999 |
| Dividends per share | \$0.10 | \$ 0.10 |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Comprehensive Loss

(in thousands) (unaudited)

| | 3 Months Ended | |
|---|----------------|-------------|
| | 9/30/2015 | 9/30/2014 |
| Net income (loss) | \$(178) | \$ 923 |
| Other comprehensive loss: | | |
| Translation loss | (9,780) | (6,948) |
| Pension and postretirement plans, net of tax of \$0 and \$22 respectively | - | (22) |
| Other comprehensive loss | (9,780) | (6,970) |
| Total comprehensive loss | \$(9,958) | \$ (6,047) |

THE L. S. STARRETT COMPANY

Consolidated Statements of Stockholders' Equity

For the Three Months Ended September 30, 2015

(in thousands except per share data) (unaudited)

| | Common Stock Outstanding | | Addi- tional Paid-in Capital | Retained Earnings | Accumulated Other Com-prehensive Loss | Total |
|--|---|--------------------|---|------------------------------|--|--------------|
| | Class A | Class B | | | | |
| Balance June 30, 2015 | \$6,224 | \$789 | \$54,869 | \$98,164 | \$ (45,616) | \$114,430 |
| Total comprehensive loss | | | | (178) | (9,780) | (9,958) |
| Dividends (\$0.10 per share) | | | | (704) | | (704) |
| Repurchase of shares | (6) | (2) | (99) | | | (107) |
| Issuance of stock | 14 | | 192 | | | 206 |
| Stock-based compensation | | | 2 | | | 2 |
| Conversion | 6 | (6) | | | | - |
| Balance September 30, 2015 | \$6,238 | \$781 | \$54,964 | \$97,282 | \$ (55,396) | \$103,869 |
| Accumulated balance consists of: | | | | | | |
| Translation loss | | | | | \$ (47,080) |) |
| Pension and postretirement plans, net of taxes | | | | | (8,316) |) |
| | | | | | \$ (55,396) |) |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Cash Flows

(in thousands) (unaudited)

3 Months Ended
9/30/2015 9/30/2014

| | | |
|--|----------|----------|
| Cash flows from operating activities: | | |
| Net income (loss) | \$(178) | \$ 923 |
| Non-cash operating activities: | | |
| Depreciation | 1,558 | 1,996 |
| Amortization | 333 | 317 |
| Stock-based compensation | 144 | 125 |
| Net long-term tax obligations | 433 | - |
| Deferred taxes | 42 | 1,343 |
| Unrealized transaction (gain) loss | 42 | (1) |
| Income from equity method investment | (47) | (47) |
| Working capital changes: | | |
| Accounts receivable | 6,799 | 5,825 |
| Inventories | (2,298) | (3,457) |
| Other current assets | (827) | (1,219) |
| Other current liabilities | (868) | (1,012) |
| Postretirement benefit and pension obligations | (271) | (6) |
| Other | (5) | 170 |
| Net cash provided by operating activities | 4,857 | 4,957 |
| Cash flows from investing activities: | | |
| Additions to property, plant and equipment | (2,003) | (1,584) |
| Software development | (162) | (122) |
| Purchase of investments | - | (28) |
| Net cash used in investing activities | (2,165) | (1,734) |
| Cash flows from financing activities: | | |
| Proceeds from short-term borrowings | - | 921 |
| Proceeds from long-term borrowings | 750 | - |
| Long-term debt repayments | (547) | (379) |
| Proceeds from common stock issued | 64 | 66 |
| Shares purchased | (107) | (11) |
| Dividends paid | (704) | (697) |
| Net cash used in financing activities | (544) | (100) |
| Effect of exchange rate changes on cash | (317) | (1,033) |
| Net increase in cash | 1,831 | 2,090 |

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| | | |
|---------------------------|----------|-----------|
| Cash, beginning of period | 11,108 | 16,233 |
| Cash, end of period | \$12,939 | \$ 18,323 |

Supplemental cash flow information:

| | | |
|------------------------|-------|--------|
| Interest paid | \$163 | \$ 187 |
| Income taxes paid, net | 295 | 897 |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY

Notes to Unaudited Consolidated Financial Statements

September 30, 2015

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

The balance sheet as of June 30, 2015, which has been derived from audited financial statements, and the unaudited interim financial statements as of and for the three months ended September 30, 2015, have been prepared by The L.S. Starrett Company (the “Company”) in accordance with accounting principles generally accepted in the United States of America for interim financial reporting. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. These unaudited financial statements, which, in the opinion of management, reflect all adjustments (including normal recurring adjustments) necessary for a fair presentation, should be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended June 30, 2015. Operating results are not necessarily indicative of the results that may be expected for any future interim period or for the entire fiscal year.

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect amounts reported in the consolidated financial statements and accompanying notes. Note 2 to the Company’s Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended June 30, 2015 describes the significant accounting policies and methods used in the preparation of the consolidated financial statements.

Note 2: Recent Accounting Pronouncements

In May 2014, the FASB issued a new standard related to the “Revenue from Contracts with Customers” which amends the existing accounting standards for revenue recognition. The standard requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services. This standard is applicable for fiscal years beginning after December 15, 2017 and for interim periods within those years and early adoption is not permitted. The Company expects to adopt this standard on July 1, 2018. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

Accounting Standards Update (ASU) 2015-11, "Inventory - Simplifying the Measurement of Inventory" requires companies to measure most inventory at the lower of cost or net realizable value, thereby simplifying the current guidance under which a company must measure inventory at the lower of cost or market. This Update eliminates the need to determine replacement cost and evaluate whether said cost is within a quantitative range. This Update also further aligns U.S. GAAP and international accounting standards. For public companies, the guidance in ASU 2015-11 is effective for annual periods beginning after December 15, 2016, and interim periods thereafter. Early adoption is permitted. Management does not expect ASU 2015-11 to have a material impact on the Company's financial statements and disclosures.

Note 3: Stock-based Compensation

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

Options granted vest in periods ranging from one year to three years and expire ten years after the grant date. Restricted stock units ("RSU") granted generally vest from one year to three years. Vested restricted stock units will be settled in shares of common stock. As of September 30, 2015, there were 20,000 stock options and 76,101 restricted stock units outstanding. In addition, there were 391,600 shares available for grant under the 2012 Stock Plan as of September 30, 2015.

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

No stock options were granted during the three months ended September 30, 2015 and 2014.

The weighted average contractual term for stock options outstanding as of September 30, 2015 was 7.25 years. The aggregate intrinsic value of stock options outstanding as of September 30, 2015 was \$0.1 million. Stock options exercisable as of September 30, 2015 were 13,167.

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

There were 40,200 RSU awards with a fair value of \$15.11 per RSU granted during the three months ended September 30, 2015. There were 6,333 RSUs settled during the three months ended September 30, 2015. The aggregate intrinsic value of RSU awards outstanding as of September 30, 2015 was \$1.2 million. As of September 30, 2015 all vested awards had been issued and settled.

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

Compensation expense related to all stock based plans for the three month periods ended September 30, 2015 and 2014 was \$0.1 million and \$0.1 million, respectively. As of September 30, 2015, there was \$1.2 million of total unrecognized compensation costs related to outstanding stock-based compensation arrangements. Of this cost \$0.4 relates to performance based RSU grants that are not expected to be awarded. The remaining \$0.8 million is expected to be recognized over a weighted average period of 2.3 years.

Note 4: Inventories

Inventories consist of the following (in thousands):

| | 9/30/2015 | 6/30/2015 |
|-------------------------------------|-----------|-----------|
| Raw material and supplies | \$ 32,316 | \$ 32,784 |
| Goods in process and finished parts | 16,851 | 18,569 |
| Finished goods | 39,094 | 39,689 |
| | 88,261 | 91,042 |
| LIFO Reserve | (28,171) | (28,039) |
| Inventories | \$ 60,090 | \$ 63,003 |

LIFO inventories were \$13.5 million and \$14.6 million at September 30, 2015 and June 30, 2015, respectively, such amounts being approximately \$28.2 million and \$28.0 million, respectively, less than if determined on a FIFO basis. The use of LIFO, as compared to FIFO, resulted in a \$0.1 million increase in cost of sales for the three months ended September 30, 2015 compared to a \$0.1 million decrease for the three months ended September 30, 2014.

Note 5: Goodwill and Intangible Assets

Goodwill is measured as the excess of the cost of acquisition over the sum of the amounts assigned to identifiable tangible and intangible assets acquired less liabilities assumed. The Company's acquisition of Bytewise in 2011 gave rise to goodwill. The Company performs an impairment assessment on an annual basis as of the end of October or more frequently if circumstances warrant. The impairment assessment is a two-step process. The first step requires a comparison of the fair value of the reporting unit to its carrying value. If the carrying value of the reporting unit exceeds the fair value, the second step of the evaluation must be performed. The second step compares the fair value of the reporting unit's goodwill with the carrying value of the goodwill. If the carrying value of the reporting unit's goodwill is greater than the implied fair value of its goodwill, an impairment loss will be recognized for the excess.

Determining the fair value of a reporting unit is subjective and requires the use of significant estimates and assumptions. With the assistance of an independent third-party appraisal firm, on October 31, 2014, the Company estimated the fair value using an income approach based on the present value of future cash flows. The Company believes this approach yields the most appropriate evidence of fair value. The Company also utilized the comparable company multiples method and market transaction fair value method to validate the fair value amount it obtained using the income approach. The key assumptions utilized in the discounted cash flow model included estimates of future cash flows from operating activities offset by estimated capital expenditures of the reporting unit, the estimated terminal value for the reporting unit, a discount rate based on a weighted average cost of capital, overall economic conditions, and an assessment of current market capitalization. Any unfavorable material changes to these key assumptions could potentially impact the Company's fair value determinations. As of October 31, 2014, the fair value of the goodwill assessment exceeded the carrying amount by approximately 37%. Therefore no goodwill impairment was recorded. If future results significantly vary from current estimates, related projections, or business assumptions in the future due to changes in industry or market conditions, the Company may be required to record impairment charges.

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

| | 9/30/2015 | 6/30/2015 |
|----------------------------|-----------|-----------|
| Non-compete agreement | \$ 600 | \$ 600 |
| Trademarks and trade names | 1,480 | 1,480 |
| Completed technology | 2,358 | 2,358 |
| Customer relationships | 4,950 | 4,950 |
| Software development | 1,817 | 1,655 |
| Other intangible assets | 325 | 325 |
| Total | 11,530 | 11,368 |
| Accumulated amortization | (4,576) | (4,243) |
| Total net balance | \$ 6,954 | \$ 7,125 |

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

The estimated useful lives of the intangible assets subject to amortization are 14 years for trademarks and trade names, 8 years for non-compete agreements, 10 years for completed technology, 8 years for customer relationships and 5 years for software development.

The estimated aggregate amortization expense for the remainder of fiscal 2016 and for each of the next five years and thereafter, is as follows (in thousands):

| | |
|--------------------------|---------|
| 2016 (Remainder of year) | \$1,104 |
| 2017 | 1,464 |
| 2018 | 1,396 |
| 2019 | 1,317 |
| 2020 | 794 |
| 2021 | 336 |
| Thereafter | 543 |

Note 6: Pension and Post-retirement Benefits

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

| | Three Months Ended | |
|--------------------------------|-----------------------|-----------|
| | 9/30/2015 | 9/30/2014 |
| Service cost | \$714 | \$694 |
| Interest cost | 1,768 | 1,690 |
| Expected return on plan assets | (1,594) | (1,740) |
| Amortization of net loss | 14 | 7 |
| | \$902 | \$651 |

Net periodic benefit costs for the Company's post-retirement medical plan and life insurance consists of the following (in thousands):

| | Three Months Ended | |
|--------------------------------------|-----------------------|-----------|
| | 9/30/2015 | 9/30/2014 |
| Service cost | \$26 | \$ 28 |
| Interest cost | 72 | 61 |
| Amortization of prior service credit | (195) | (200) |
| Amortization of net loss | 4 | - |
| | \$ (93) | \$ (111) |

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

Effective December 31, 2013, the Company terminated the eligibility of employees ages 55 - 64 years old to enter into the Post-retirement Medical Plan.

Note 7: Debt

Debt, including capitalized lease obligations, is comprised of the following (in thousands):

| | 9/30/2015 | 6/30/2015 |
|---|-----------|-----------|
| <u>Notes payable and current maturities of long term debt</u> | | |
| Loan and Security Agreement | \$ 1,491 | \$ 1,474 |
| Capitalized leases | 43 | 78 |
| | 1,534 | 1,552 |
| <u>Long-term debt</u> | | |
| Loan and Security Agreement | 18,773 | 18,552 |
| | \$ 20,307 | \$ 20,104 |

The Company completed the negotiations for an amended Loan and Security Agreement and executed the new agreement as of April 25, 2015. Borrowings under this agreement may not exceed \$23.0 million. The agreement

expires on April 30, 2018 and has an interest rate of LIBOR plus 1.5%. Based upon a new three year term, the Line of Credit has been classified as long-term. As of September 30, 2015, \$9.9 million was outstanding on the Line of Credit.

The material financial covenants of the amended Loan and Security Agreement were: 1) funded debt to EBITDA, excluding non-cash and retirement benefit expenses (“maximum leverage”), not to exceed 2.25 to 1. 2) annual capital expenditures not to exceed \$15.0 million, 3) maintain a Debt Service Coverage Rate of a minimum of 1.25 to 1 and 4) maintain consolidated cash plus liquid investments of not less than \$10.0 million at any time. The Company was in compliance with all debt covenants as of September 30, 2015.

On November 22, 2011, in conjunction with the Bytewise acquisition, the Company entered into a \$15.5 million term loan (the “Term Loan”) under the existing Loan and Security Agreement with TD Bank N.A. The term loan is a ten year loan bearing a fixed interest rate of 4.5% and is payable in fixed monthly payments of principal and interest of \$160,640. The term loan, which had a balance of \$10.4 million at September 30, 2015, is subject to the same financial covenants as the Loan and Security Agreement.

The effective interest rate on the Line of Credit under the Loan and Security Agreement for the three months ended September 30, 2015 and 2014 was 2.1% and 2.0%, respectively.

Note 8: Income Tax

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

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

The tax expense for the first quarter of fiscal 2016 was \$660,000 on a profit before tax of \$482,000 (an effective tax rate of 136.9%). The tax expense for the first quarter of fiscal 2015 was \$818,000 on a profit before tax for the quarter of \$1,741,000 (an effective tax rate of 47.0%). The tax rate is higher than the U.S. statutory rate primarily due to losses in some foreign jurisdictions for which no tax benefit is recognized. In the first quarter of fiscal 2016, there was a discrete reduction to tax expense of \$54,000 related to return to provision adjustments in the United Kingdom (UK). In the first quarter of fiscal 2015, there was a discrete reduction to tax expense of \$75,000 related to use of tax loss carryforwards and the reduction of the tax liability for audits related to the expiration of the statute of limitations.

U.S. Federal tax returns through fiscal 2011 are generally no longer subject to review by tax authorities; however, tax loss carryforwards from years before fiscal 2012 are still subject to adjustment. As of September 30, 2015, the Company has substantially resolved all open income tax audits and there were no other local or federal income tax audits in progress. In international jurisdictions including Australia, Brazil, Canada, China, Germany, Mexico, New Zealand, Singapore and the UK, which comprise a significant portion of the Company's operations, the years that may be examined vary by country. The Company's most significant foreign subsidiary in Brazil is subject to audit for the calendar years 2010 – 2014. During the next twelve months, it is possible that the Company will recognize a reduction of \$0.4 million in its long term tax obligations due to the lapse of the applicable statute of limitations.

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

No valuation allowance has been recorded for the Company's domestic federal net operating loss (NOL) carry-forwards. The Company continues to believe that due to forecasted future taxable income and certain tax planning strategies available, it is more likely than not that it will be able to utilize the U.S. federal NOL carryforwards. In certain other countries where Company operations are in a loss position, the deferred tax assets for tax loss carryforwards and other temporary differences are fully offset by a valuation allowance.

Note 9: Contingencies

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

ITEM 2.

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

RESULTS OF OPERATIONS

Three months Ended September 30, 2015 and September 30, 2014

Overview

As a multi-national company, our business operations are subject to global political, economic and currency volatility. Over the past quarter, the Company's domestic business was hurt by slowdowns in the oil and agricultural sectors, while the results from our international operations, particularly in Brazil and China, were negatively impacted by both significant economic challenges and currency devaluations. Management has implemented pricing and cost changes to address these issues, but has minimal control over currency fluctuations.

Net sales declined \$9.2 million or 15%. Operating income also declined \$0.9 million as \$3.3 million gross margin erosion was only partially offset by a \$2.4 million decrease in selling, general and administrative expenses. Net income declined \$1.1 million from income of \$0.9 million or \$0.13 per share in fiscal 2015 to a loss of \$0.2 million or (\$0.03) per share in fiscal 2016.

Net Sales

North American sales declined \$1.9 million or 6% from \$34.3 million in fiscal 2015 to \$32.4 million in fiscal 2016 as a 9% drop in precision hand tool sales more than offset continued growth in capital equipment shipments of 11%. International sales declined \$7.3 million or 28% from \$25.9 million in fiscal 2015 to \$18.6 million in fiscal 2016 principally due to a recession in Brazil and a currency weakening of the Brazilian Real. The devaluation of the Brazilian currency represented \$5.5 million or 75% of the international sales decline.

Gross Margin

Gross margin declined \$3.3 million from \$19.1 million in fiscal 2015 to \$15.8 million in fiscal 2016. North American fiscal 2016 gross margin of \$10.2 million was a \$0.2 million decline compared with fiscal 2015 principally due to lower sales which was partially offset by a favorable product mix related to sales growth in higher margin capital equipment. International gross margins declined \$3.1 million to \$5.7 million due to sales decline and currency devaluation representing \$1.4 and \$1.7 million, respectively.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased \$2.4 million or 13% with currency accounting for 90% of the reduction. North American expenses decreased \$0.6 million due to reduced information technology expenses and professional fees. International expenses decreased \$1.8 million as higher selling expenses were offset by a \$2.2 reduction related to currency.

Other Income

Other Income declined \$0.4 million from \$0.7 million in fiscal 2015 to \$0.3 million in fiscal 2016 as the devaluation of the Chinese Yuan in fiscal 2016 increased China's dollar denominated liabilities which were partially offset by gains related to the stronger U. S. dollar for dollar denominated assets, primarily accounts receivables related to export sales.

Income Tax Expense

The effective tax rates for the first quarter of fiscal 2016 and 2015 were 136.9% and 47.0%, respectively. The quarterly tax rate increased in both years due to losses in some foreign subsidiaries for which no tax benefit is recognized.

Net Income (Loss)

The Company recorded a net loss of \$0.2 million or (\$0.03) per share in the first quarter of fiscal 2016 compared to net earnings of \$0.9 million or \$0.13 per share in fiscal 2015 principally due to lower revenue and gross margins only partially offset by reduced selling, general and administrative expenses.

LIQUIDITY AND CAPITAL RESOURCES

| Cash flows (in thousands) | Three months | |
|---|--------------|----------|
| | Ended | |
| | 9/30/2015 | |
| | 9/30/2014 | |
| Cash provided by operating activities | \$4,857 | \$ 4,957 |
| Cash used in investing activities | (2,165) | (1,734) |
| Cash used in financing activities | (544) | (100) |
| Effect of exchange rate changes on cash | (317) | (1,033) |
| Net increase in cash | \$1,831 | \$ 2,090 |

Net cash increased \$1.8 million as improved working capital management was sufficient to offset outflows for capital equipment, debt, dividends and unfavorable exchanges rates. The \$0.3 million reduction in cash flow compared to the same period one year ago was primarily due to reduced profitability and higher capital expenditures.

Liquidity and Credit Arrangements

The Company believes it maintains sufficient liquidity and has the resources to fund its operations. In addition to its cash and investments, the Company maintains a \$23 million line of credit in connection with its Loan and Security Agreement, of which, \$9.9 million was outstanding as of September 30, 2015. Availability under the agreement is further reduced by open letters of credit totaling \$0.9 million. The Loan and Security Agreement was renewed in January of 2015. The Loan and Security Agreement contains financial covenants with respect to leverage, tangible net worth, and interest coverage, and also contains customary affirmative and negative covenants, including limitations on indebtedness, liens, acquisitions, asset dispositions and fundamental corporate changes, and certain customary events of default. As of September 30, 2015, the Company was in compliance with all debt covenants related to its Loan and Security Agreement. The Loan and Security Agreement expires on April 30, 2018 and the Company plans to negotiate an extension to the Agreement.

The effective interest rate on the short term borrowings under the Loan and Security Agreement during the three months ended September 30, 2015 was 2.07%.

OFF-BALANCE SHEET ARRANGEMENTS

The Company has no off-balance sheet arrangements, other than operating leases, that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

There have been no material changes in qualitative and quantitative disclosures about market risk from what was reported in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2015.

ITEM 4. CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Company's President and Chief Executive Officer and Chief Financial Officer, has evaluated the Company's disclosure controls and procedures as of September 30, 2015, and they have concluded that our disclosure controls and procedures were effective as of such

date. All information required to be filed in this report was recorded, processed, summarized and reported within the time period required by the rules and regulations of the Securities and Exchange Commission, and such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2015, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective.

There have been no changes in internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting during the quarter ended September 30, 2015..

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

SAFE HARBOR STATEMENT

UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Quarterly Report on Form 10-Q contains forward-looking statements about the Company's business, competition, sales, expenditures, foreign operations, plans for reorganization, interest rate sensitivity, debt service, liquidity and capital resources, and other operating and capital requirements. In addition, forward-looking statements may be included in future Company documents and in oral statements by Company representatives to securities analysts and investors. The Company is subject to risks that could cause actual events to vary materially from such forward-looking statements. You should carefully review and consider the information regarding certain factors which could materially affect our business, financial condition or future results set forth under Item 1A. "Risk Factors" in our Form 10-K for the year ended June 30, 2015. There have been no material changes from the factors disclosed in our Form 10-K for the year ended June 30, 2015.

ITEM 6. EXHIBITS

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

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

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

10.1 The L.S. Starrett Company 2012 Long-Term Incentive Plan (incorporated by reference to Exhibit 4.2 to The L.S. Starrett Company's Registration Statement on Form S-8 (File No. 333-184934) filed November 14, 2012).

The following materials from The L. S. Starrett Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2015 are furnished herewith, formatted in XBRL (Extensible Business Reporting Language): (i) the 101 Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Loss, (iv) the Consolidated Statement of Stockholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) Notes to Consolidated Financial Statements, tagged as blocks of text.

SIGNATURES

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

THE L. S. STARRETT COMPANY

(Registrant)

Date November 4, 2015 /S/R. Douglas A. Starrett
Douglas A. Starrett - President and CEO (Principal Executive Officer)

Date November 4, 2015 /S/R. Francis J. O'Brien
Francis J. O'Brien - Treasurer and CFO (Principal Accounting Officer)