II-VI INC
Form 10-Q
February 01, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended December 31, 2016

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: 0-16195

II-VI INCORPORATED

(Exact name of registrant as specified in its charter)

PENNSYLVANIA	25-1214948
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
375 Saxonburg Boulevard Saxonburg, PA	16056
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: 724-352-4455

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 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 “large accelerated filer,” “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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date:

At January 27, 2017, 62,561,471 shares of Common Stock, no par value, of the registrant were outstanding.

II-VI INCORPORATED

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PART I - FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

II-VI Incorporated and Subsidiaries

Condensed Consolidated Balance Sheets (Unaudited)

($000)

	December 31, 2016	June 30, 2016
Assets		
Current Assets		
Cash and cash equivalents	$246,195	$218,445
Accounts receivable - less allowance for doubtful accounts of $1,961 at December 31, 2016 and $2,016 at June 30, 2016	153,411	164,817
Inventories	183,062	175,133
Prepaid and refundable income taxes	5,685	6,535
Prepaid and other current assets	21,794	18,033
Total Current Assets	610,147	582,963
Property, plant & equipment, net	305,174	242,857
Goodwill	232,316	233,755
Other intangible assets, net	117,979	124,590
Investment	11,844	11,354
Deferred income taxes	5,161	7,848
Other assets	10,380	8,614
Total Assets	$1,293,001	$1,211,981
Liabilities and Shareholders' Equity		
Current Liabilities		
Current portion of long-term debt	$20,000	$20,000
Accounts payable	60,616	53,796
Accrued compensation and benefits	43,742	59,012
Accrued income taxes payable	10,945	12,588
Other accrued liabilities	25,395	25,846
Total Current Liabilities	160,698	171,242
Long-term debt	242,892	215,307
Capital lease obligation	23,964	-
Deferred income taxes	12,793	11,103
Other liabilities	33,608	31,991
Total Liabilities	473,955	429,643
Shareholders' Equity		
Preferred stock, no par value; authorized - 5,000,000 shares; none issued	-	-
Common stock, no par value; authorized - 300,000,000 shares; issued - 73,577,811 shares at December 31, 2016; 72,840,257 shares at June 30, 2016	258,215	243,812

Accumulated other comprehensive income (loss)	(28,852)	(14,017)
Retained earnings	692,985	652,788
	922,348	882,583
Treasury stock, at cost - 11,055,388 shares at December 31, 2016 and 10,965,925 shares at June 30, 2016	(103,302)	(100,245)
Total Shareholders' Equity	819,046	782,338
Total Liabilities and Shareholders' Equity	$1,293,001	$1,211,981

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Earnings (Unaudited)

($000 except per share data)

	Three Months Ended December 31,	
	2016	2015
Revenues		
Domestic	$74,216	$74,177
International	157,606	117,257
Total Revenues	231,822	191,434
Costs, Expenses and Other Expense (Income)		
Cost of goods sold	137,559	120,090
Internal research and development	23,632	12,155
Selling, general and administrative	43,495	37,408
Interest expense	1,365	597
Other expense (income), net	(6,045)	(994)
Total Costs, Expenses & Other Expense (Income)	200,006	169,256
Earnings Before Income Taxes	31,816	22,178
Income Taxes	7,913	3,187
Net Earnings	$23,903	$18,991
Basic Earnings Per Share	$0.38	$0.31
Diluted Earnings Per Share	$0.37	$0.30

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Earnings (Unaudited)

($000 except per share data)

	Six Months Ended December 31,	
	2016	2015
Revenues		
Domestic	$143,534	$144,928
International	309,808	235,713
Total Revenues	453,342	380,641
Costs, Expenses and Other Expense (Income)		
Cost of goods sold	271,477	238,108
Internal research and development	45,464	25,306
Selling, general and administrative	85,574	73,718
Interest expense	2,611	1,246
Other expense (income), net	(7,447)	(2,051)
Total Costs, Expenses & Other Expense (Income)	397,679	336,327
Earnings Before Income Taxes	55,663	44,314
Income Taxes	15,466	8,109
Net Earnings	$40,197	$36,205
Basic Earnings Per Share	$0.65	$0.59
Diluted Earnings Per Share	$0.63	$0.58

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income (Unaudited)

($000)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Net earnings	$23,903	$18,991	$40,197	$36,205
Other comprehensive income (loss):				
Foreign currency translation adjustments	(14,565)	(5,411)	(15,147)	(13,562)
Pension adjustment, net of taxes of $137 and $85 for the three and six months ended December 31, 2016, respectively, and $4 and $14 for the three and six months ended December 31, 2015, respectively	424	13	312	49
Comprehensive income	$9,762	$13,593	$25,362	$22,692

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

($000)

	Six Months Ended December 31, 2016	2015
Cash Flows from Operating Activities		
Net earnings	$40,197	$36,205
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	23,440	21,166
Amortization	6,358	5,958
Share-based compensation expense	5,697	6,949
Gains on foreign currency remeasurements and transactions	(4,664)	(951)
Earnings from equity investment	(490)	(429)
Deferred income taxes (benefit)	4,200	(3,788)
Excess tax benefits from share-based compensation expense	(503)	(112)
Increase (decrease) in cash excluding the effect of the purchase of acquisitions from changes in:		
Accounts receivable	11,889	10,520
Inventories	(12,909)	(7,833)
Accounts payable	1,399	(5,167)
Income taxes	385	2,540
Accrued compensation and benefits	(14,145)	(906)
Other operating net assets	(2,162)	(1,852)
Net cash provided by operating activities	58,692	62,300
Cash Flows from Investing Activities		
Additions to property, plant & equipment	(57,822)	(19,156)
Purchase of business	(580)	-
Other investing activities	186	39
Net cash used in investing activities	(58,216)	(19,117)
Cash Flows from Financing Activities		
Proceeds from borrowings	44,000	4,000
Payments on borrowings	(15,000)	(33,500)
Purchases of treasury stock	-	(6,284)
Proceeds from exercises of stock options	7,740	1,794
Payments in satisfaction of employees' minimum tax obligations	(2,271)	(1,981)
Debt issuance costs	(1,384)	-
Other financing activities	503	120
Net cash provided by (used in) financing activities	33,588	(35,851)
Effect of exchange rate changes on cash and cash equivalents	(6,314)	(3,882)
Net increase in cash and cash equivalents	27,750	3,450
Cash and Cash Equivalents at Beginning of Period	218,445	173,634
Cash and Cash Equivalents at End of Period	$246,195	$177,084

Cash paid for interest	$2,413	$1,226
Cash paid for income taxes	$10,390	$8,497
Non-cash transactions:		
Capital lease obligation incurred on facility lease	$25,000	$-
Additions to property, plant & equipment included in accounts payable	$6,715	$-

- See notes to condensed consolidated financial statements.

e II-VI Incorporated and Subsidiaries

Condensed Consolidated Statement of Shareholders' Equity (Unaudited)

(000)

	Common Stock		Accumulated Other Comprehensive	Retained	Treasury Stock		
	Shares	Amount	Income (Loss)	Earnings	Shares	Amount	Total
Balance - June 30, 2016	72,840	$243,812	$ (14,017)	$652,788	(10,966)	$(100,245)	$782,338
Shares issued under share-based compensation plans	701	7,740	-	-	(105)	(2,271)	5,469
Net earnings	-	-	-	40,197	-	-	40,197
Treasury stock under deferred compensation arrangements	37	786	-	-	16	(786)	-
Foreign currency translation adjustments	-	-	(15,147)	-	-	-	(15,147)
Share-based compensation expense	-	5,697	-	-	-	-	5,697
Pension adjustment, net of taxes of $85	-	-	312	-	-	-	312
Net tax benefits from share based compensation expense	-	180	-	-	-	-	180
Balance - December 31, 2016	73,578	$258,215	$ (28,852)	$692,985	(11,055)	$(103,302)	$819,046

- See notes to condensed consolidated financial statements.

II-VI Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1. Basis of Presentation

The condensed consolidated financial statements of II-VI Incorporated (“II-VI” or the “Company”) for the three and six months ended December 31, 2016 and 2015 are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation for the periods presented have been included. All adjustments are of a normal recurring nature unless disclosed otherwise. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2016. The consolidated results of operations for the three and six months ended December 31, 2016 are not necessarily indicative of the results to be expected for the full fiscal year. The June 30, 2016 Condensed Consolidated Balance Sheet information was derived from the Company’s audited financial statements.

During the quarter ended December 31, 2016, the Company purchased certain assets, mainly inventory and fixed assets, of DirectPhotonics Industries GmbH located in Berlin, Germany for approximately $0.6 million. This business was combined with the Company’s II-VI HIGHYAG division in the II-VI Laser Solutions segment. Due to the insignificant amount of the acquisition purchase price, certain business combinations disclosures typically required under U.S. GAAP have been omitted.

Note 2. Recent Accounting Pronouncements

Adopted Pronouncements

In April 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2015-03, Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. This ASU requires entities to present debt issuance costs in the balance sheet as a direct deduction from the carrying amount of the corresponding debt liability, consistent with debt discounts. The Company adopted ASU 2015-03, as clarified by ASU 2015-15, which did not have a material impact on the Company’s Consolidated Financial Statements other than corresponding reductions to total assets and total liabilities on the Condensed Consolidated Balance Sheets. Prior to adoption, the Company recorded deferred financing costs as Other assets on the Consolidated Balance Sheets. Upon adoption, the Company reclassified these costs as unamortized debt issuance costs that reduce long term debt on the Consolidated Balance Sheets and retrospectively reclassified $0.6 million that were previously presented as deferred financing costs, an asset on the Consolidated Balance Sheets as of June 30, 2016. There was no effect on the Consolidated Statements of Earnings as a result of the adoption.

In September 2015, the FASB issued ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments. This update requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The adoption of this standard did not have a material effect on the Company’s Consolidated Financial Statements.

In April 2015, the FASB issued ASU 2015-05, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. This update provides guidance about whether a cloud computing arrangement includes a software license. The adoption of this standard did not have a material effect on the Company's Consolidated Financial Statements.

In February 2015, the FASB issued ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis, which affects reporting organizations that are required to evaluate whether they should consolidate certain legal entities. The adoption of this standard did not have a material effect on the Company's Consolidated Financial Statements.

Pronouncements Currently Under Evaluation

In January 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350) Simplifying the Accounting for Goodwill Impairment. This standard removes the second step of the goodwill impairment test, where a determination of the fair value of individual assets and liabilities of a reporting unit were needed to measure the goodwill impairment. Under this updated standard, goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The Company will adopt this for any impairment test performed after July 1, 2017 as permitted under the standard.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740) Intra-Entity Transfers of Assets Other Than Inventory. This update requires that when intra-entity asset transfers occur, the entity must recognize tax effects in the period in which the transfer occurs. The standard will be effective for The Company’s 2019 fiscal year. The adoption of this ASU is not expected to have a material effect on the Company’s Consolidated Financial Statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The amendments in the update provide guidance on eight specific cash flow issues. The update will be effective for the Company’s 2019 fiscal year. Early adoption is permitted. The Company is evaluating the impact of this guidance on the Company’s Consolidated Financial Statements.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This update simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, and classification in the statement of cash flows. The standard will be effective for the Company’s 2018 fiscal year. Early adoption is permitted. The Company is evaluating the impact of this guidance on the Company’s Consolidated Financial Statements.

In March 2016, the FASB issued ASU 2016-07, Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting. This update requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The standard will be effective for the Company’s 2018 fiscal year. Early adoption is permitted. The adoption of this ASU is not expected to have a material effect on the Company’s Consolidated Financial Statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This update requires that a lessee recognize leased assets with terms greater than 12 months on the balance sheet for the rights and obligations created by those leases. The standard will be effective for the Company’s 2020 fiscal year. Early adoption is permitted. The Company is evaluating the impact of this guidance on the Company’s Consolidated Financial Statements.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Recognition and measurement of Financial Assets and Financial Liabilities (Topic 825). This update requires that public entities measure equity investments with readily determinable fair values, at fair value, with changes in their fair value recorded through net income. This ASU also clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale securities in combination with the entity’s other deferred tax assets. The standard will be effective for the Company’s 2018 fiscal year. The Company is evaluating the impact on the Company’s Consolidated Financial Statements.

In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. This update simplifies the measurement of inventory valuation at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The new inventory measurement requirements will be effective for the Company’s 2018 fiscal year and will replace the current inventory valuation guidance that requires the use of a lower of cost or market framework. The adoption of this ASU is not expected to have a material effect on the Company’s Consolidated Financial Statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements-Going Concern. This update provides U.S. GAAP guidance on management’s responsibility in evaluating whether there is substantial doubt about a company’s ability to continue as a going concern and about related footnote disclosures. For each reporting period, management will be required to evaluate whether there are conditions or events that raise substantial doubt about a company’s ability to continue as a going concern within one year from the date the financial statements are issued. The adoption of this standard is effective as of June 30, 2017. The adoption of this ASU is not expected to have a material effect on the Company’s Consolidated Financial Statements.

In May 2014, the FASB issued ASU 2014-09: Revenue from Contracts with Customers (Topic 606) which supersedes virtually all existing revenue recognition guidance under U.S. GAAP. The update's 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 update allows for the use of either the retrospective or modified retrospective approach of adoption. On July 9, 2015 the FASB approved a one year deferral of the effective date of the update. The update will be effective for the Company’s 2019 fiscal year. In May 2016, the FASB issued an amendment which did not change the core principles of the guidance in Topic 606. Rather, the amendments in this update affect only narrow aspects of Topic 606. We have not yet selected a transition method and are currently evaluating the impact of this guidance, along with the subsequent updates and clarifications will have on the Company’s Consolidated Financial Statements.

Note 3. Inventories
The components of inventories were as follows ($000):

	December 31, 2016	June 30, 2016
Raw materials	$72,682	$70,623
Work in progress	59,405	57,566
Finished goods	50,975	46,944
	$183,062	$175,133

Note 4. Property, Plant and Equipment
Property, plant and equipment consists of the following ($000):

	December 31, 2016	June 30, 2016
Land and improvements	$4,880	$4,990
Buildings and improvements	135,142	110,219
Machinery and equipment	429,556	409,551
Construction in progress	74,965	34,602
	644,543	559,362
Less accumulated depreciation	(339,369)	(316,505)
	$305,174	$242,857

Note 5. Goodwill and Other Intangible Assets
Changes in the carrying amount of goodwill were as follows ($000):

	Six Months Ended December 31, 2016			
	II-VI Laser Solutions	II-VI Photonics	II- VI Performance Products	Total
Balance-beginning of period	$84,105	$96,760	$ 52,890	$233,755
Foreign currency translation	(136)	(1,303)	-	(1,439)

Balance-end of period	$83,969	$95,457	$ 52,890	$232,316

Note 1 of the Notes to the Consolidated Financial Statements in the Company's most recent Annual Report on Form 10-K describes the significant accounting policies and methods used in the preparation of the Company's Consolidated Financial Statements. Management has evaluated goodwill for indicators of impairment and has concluded that there are no indicators of impairment as of December 31, 2016.

The gross carrying amount and accumulated amortization of the Company's intangible assets other than goodwill as of December 31, 2016 and June 30, 2016 were as follows ($000):

	December 31, 2016			June 30, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Technology and Patents	$53,941	$ (24,813)	$29,128	$54,344	$ (22,724)	$31,620
Trademarks	15,731	(1,275)	14,456	15,869	(1,209)	14,660
Customer Lists	111,745	(37,415)	74,330	112,141	(33,912)	78,229
Other	1,568	(1,503)	65	1,571	(1,490)	81
Total	$182,985	$ (65,006)	$117,979	$183,925	$ (59,335)	$124,590

Amortization expense recorded on the Company's intangible assets was $3.2 million and $6.4 million for the three and six months ended December 31, 2016, respectively, and was $3.0 million and $6.0 million for the three and six months ended December 31, 2015, respectively. Technology and patents are being amortized over a range of 60 to 240 months, with a weighted average remaining life of approximately 96 months. Customer lists are being amortized over a range of approximately 120 to 240 months with a weighted average remaining life of approximately 139 months. The gross carrying amount of trademarks includes $14.0 million of acquired trade names with indefinite lives that are not amortized but tested annually for impairment or more frequently if a triggering event occurs. Included in the gross carrying amount and accumulated amortization of the Company's intangible assets is the effect of foreign currency translation on that portion of the intangible assets relating to the Company's German and Chinese subsidiaries.

At December 31, 2016, the estimated amortization expense for existing intangible assets for each of the five succeeding fiscal years is as follows ($000):

Year Ending June 30,	
Remaining 2017	$6,342
2018	12,108
2019	11,789
2020	10,981
2021	10,125

Note 6. Debt

The components of debt for the periods indicated were as follows ($000):

	December 31,	June 30,

	2016	2016
Line of credit, interest at LIBOR, as defined, plus 1.5%	$167,000	$188,000
Term loan, interest at LIBOR, as defined, plus 1.5%	95,000	45,000
Yen denominated line of credit, interest at LIBOR, as defined, plus 0.625%	2,566	2,917
Total debt	264,566	235,917
Current portion of long-term debt	(20,000)	(20,000)
Unamortized debt issuance costs	(1,674)	(610)
Long-term debt, less current portion	$242,892	$215,307

On July 28, 2016, the Company amended and restated its existing credit agreement. The Third Amended and Restated Credit Agreement (the "Amended Credit Facility") provides for a revolving credit facility of $325 million, as well as a $100 million term loan. The term loan is being repaid in consecutive quarterly principal payments on the first business day of each January, April, July and October, with the first payment having commenced on October 1, 2016, as follows: (i) twenty consecutive quarterly installments of $5 million and (ii) a final installment of all remaining principal due and payable on the maturity date of July 27, 2021. Amounts borrowed under the revolving credit facility are due and payable on the maturity date. The Amended Credit Facility is unsecured, but is guaranteed by each existing and subsequently acquired or organized wholly-owned domestic subsidiary of the Company. The Company has the option to request an increase to the size of the revolving credit facility in an aggregate additional amount not to exceed $100 million. The Amended Credit Facility has a five-year term through July 27, 2021 and has an interest rate of either a Base Rate Option or a Euro-Rate Option, plus an Applicable Margin, as defined in the agreement governing the Amended Credit Facility. If the Base Rate option is selected for a borrowing, the Applicable Margin is 0.00% to 0.075% and if the Euro-Rate Option is selected for a borrowing, the Applicable Margin is 0.75% to 1.75%. The Applicable Margin is based on the Company's ratio of consolidated indebtedness to consolidated EBITDA. Additionally, the Credit Facility is subject to certain covenants, including those relating to minimum interest coverage and maximum leverage ratios. As of December 31, 2016, the Company was in compliance with all financial covenants under its Amended Credit Facility.

The Company's Yen denominated line of credit is a 500 million Yen (approximately $4.3 million) facility. The Yen line of credit matures in August 2020. The interest rate is equal to LIBOR, as defined in the loan agreement, plus 0.625% to 1.50%. At December 31, 2016 and June 30, 2016, the Company had 300 million Yen borrowed. Additionally, the facility is subject to certain covenants, including those relating to minimum interest coverage and maximum leverage ratios. As of December 31, 2016, the Company was in compliance with all financial covenants under its Yen facility.

The Company had aggregate availability of $158.5 million and $37.7 million under its lines of credit as of December 31, 2016 and June 30, 2016, respectively. The amounts available under the Company's lines of credit are reduced by outstanding letters of credit. As of December 31, 2016 and June 30, 2016, total outstanding letters of credit supported by these credit facilities were $1.2 million for both periods.

The weighted average interest rate of total borrowings was 2.1% and 1.5% for the six months ended December 31, 2016 and 2015, respectively.

Remaining annual principal payments under the Company's existing credit facilities as of December 31, 2016 were as follows:

Period	Term Loan	Yen Line of Credit	U.S. Dollar Line of Credit	Total
Year 1	$20,000	$-	$-	$20,000
Year 2	20,000	-	-	20,000
Year 3	20,000	-	-	20,000
Year 4	20,000	2,566	-	22,566
Year 5	15,000	-	167,000	182,000

Total	$95,000	$2,566	$167,000	$264,566

Note 7. Income Taxes

The Company's year-to-date effective income tax rate at December 31, 2016 and 2015 was 27.8% and 18.3%, respectively. The variations between the Company's effective tax rate and the U.S. statutory rate of 35% were primarily due to the consolidation of the Company's foreign operations, which are subject to income taxes at lower statutory rates.

U.S. GAAP clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. As of December 31, 2016 and June 30, 2016, the Company's gross unrecognized income tax benefit was $8.2 million and $5.6 million, respectively. The Company has classified the majority of the uncertain tax positions as noncurrent income tax liabilities, as the amounts are not expected to be paid within one year. If recognized, the majority of the gross unrecognized tax benefits at December 31, 2016 would impact the effective tax rate. The Company recognizes interest and penalties related to uncertain tax positions in the income tax provision on the Condensed Consolidated Statements of Earnings. The amount of accrued interest and penalties included in the gross unrecognized income tax benefit was $1.2 million and $0.1 million at December 31, 2016 and June 30, 2016, respectively. Fiscal years 2013 to 2017 remain open to examination by the United States Internal Revenue Service, fiscal years 2012 to 2017 remain open to examination by certain state jurisdictions, and fiscal years 2006 to 2017 remain open to examination by certain foreign taxing jurisdictions. The Company's fiscal year 2012 through 2015 New Jersey state income tax returns and fiscal years 2006 through 2014 Vietnam income tax returns are currently under examination. The Company believes its income tax reserves for these tax matters are adequate.

Note 8. Earnings Per Share

The following table sets forth the computation of earnings per share for the periods indicated. Weighted average shares issuable upon the exercises of stock options and the release of performance and restricted shares are not included in the calculation because they were anti-dilutive and totaled approximately 86,000 and 227,000 for the three and six months ended December 31, 2016, respectively, and 193,000 and 212,000 for the three and six months ended December 31, 2015, respectively ($000 except per share data):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2015	2016	2015
Net earnings	$23,903	$18,991	$40,197	$36,205
Divided by:				
Weighted average shares	62,390	61,165	62,205	61,194
Basic earnings per common share	$0.38	$0.31	$0.65	$0.59
Net earnings	$23,903	$18,991	$40,197	$36,205
Divided by:				
Weighted average shares	62,390	61,165	62,205	61,194
Dilutive effect of common stock equivalents	2,017	1,508	1,794	1,507
Diluted weighted average common shares	64,407	62,673	63,999	62,701
Diluted earnings per common share	$0.37	$0.30	$0.63	$0.58

Note 9. Segment Reporting

The Company reports its business segments using the “management approach” model for segment reporting. This means that the Company determines its reportable business segments based on the way the chief operating decision maker organizes business segments within the Company for making operating decisions and assessing performance.

The Company reports its financial results in the following three segments: (i) II-VI Laser Solutions, (ii) II-VI Photonics, and (iii) II-VI Performance Products, and the Company’s chief operating decision maker receives and reviews financial information based on these segments. The Company evaluates business segment performance based upon segment operating income, which is defined as earnings before income taxes, interest and other income or expense. The segments are managed separately due to the market, production requirements and facilities unique to each segment.

The accounting policies of the segments are the same as those of the Company. The Company’s corporate expenses are allocated to the segments. The Company evaluates segment performance based upon reported segment operating income, which is defined as earnings before income taxes, interest and other income or expense. Inter-segment sales and transfers are eliminated.

The following tables summarize selected financial information of the Company’s operations by segment ($000):

	Three Months Ended December 31, 2016				
	II-VI Laser Solutions	II-VI Photonics	II-VI Performance Products	Eliminations	Total
Revenues	$81,483	$100,906	$ 49,433	$ -	$231,822
Inter-segment revenues	8,760	3,161	2,645	(14,566)	-
Operating income	7,593	15,901	3,642	-	27,136
Interest expense	-	-	-	-	(1,365)
Other income (expense), net	-	-	-	-	6,045
Income taxes	-	-	-	-	(7,913)
Net earnings	-	-	-	-	23,903
Depreciation and amortization	5,662	4,976	4,278	-	14,916
Segment assets	528,505	482,866	281,630	-	1,293,001
Expenditures for property, plant & equipment	15,737	5,900	6,191	-	27,828
Investment	-	-	11,844	-	11,844

	Three Months Ended December 31, 2015				
	II-VI Laser Solutions	II-VI Photonics	II-VI Performance Products	Eliminations	Total
Revenues	$70,191	$74,264	$ 46,979	$ -	$191,434
Inter-segment revenues	4,850	2,766	1,543	(9,159)	-
Operating income	11,251	7,455	3,076	-	21,781
Interest expense	-	-	-	-	(597)
Other income (expense), net	-	-	-	-	994
Income taxes	-	-	-	-	(3,187)
Net earnings	-	-	-	-	18,991
Depreciation and amortization	3,691	4,980	5,148	-	13,819
Expenditures for property, plant & equipment	3,475	4,471	1,786	-	9,732

	Six Months Ended December 31, 2016				
	II-VI Laser Solutions	II-VI Photonics	II-VI Performance Products	Eliminations	Total
Revenues	$160,773	$196,725	$ 95,844	$ -	$453,342
Inter-segment revenues	14,700	6,599	4,378	(25,677)	-
Operating income	14,291	29,791	6,745	-	50,827
Interest expense	-	-	-	-	(2,611)
Other income (expense), net	-	-	-	-	7,447
Income taxes	-	-	-	-	(15,466)
Net earnings	-	-	-	-	40,197
Depreciation and amortization	11,312	9,824	8,662	-	29,798
Expenditures for property, plant & equipment	35,862	12,497	9,463	-	57,822

	Six Months Ended December 31, 2015 II-VI Laser Solutions	II-VI Photonics	II-VI Performance Products	Eliminations	Total
Revenues	$141,774	$146,159	$ 92,708	$ -	$380,641
Inter-segment revenues	9,380	5,797	3,938	(19,115)	-
Operating income	23,426	13,739	6,345	-	43,509
Interest expense	-	-	-	-	(1,246)
Other income (expense), net	-	-	-	-	2,051
Income taxes	-	-	-	-	(8,109)
Net earnings	-	-	-	-	36,205
Depreciation and amortization	7,395	10,073	9,656	-	27,124
Expenditures for property, plant & equipment	9,355	6,623	3,178	-	19,156

Note 10. Share-Based Compensation

The Board of Directors adopted the II-VI Incorporated Amended and Restated 2012 Omnibus Incentive Plan (the "Plan"), which was approved by the Company's shareholders. The Plan provides for the grant of performance-based cash incentive awards, non-qualified stock options, stock appreciation rights, restricted share awards, restricted share units, deferred share awards, performance share awards and performance share units to employees, officers and directors of the Company. The maximum number of shares of the Company's common stock authorized for issuance under the Plan is limited to 4,900,000 shares of common stock, not including any remaining shares forfeited under the predecessor plans that may be rolled into the Plan. The Company records share-based compensation expense for these awards in accordance with U.S. GAAP, which requires the recognition of grant-date fair value of share-based compensation in net earnings and over the requisite service period of the individual grantees, which generally equals the vesting period. The Company accounts for cash-based stock appreciation rights, cash-based restricted share unit awards and cash-based performance share unit awards as liability awards, in accordance with applicable accounting standards.

Share-based compensation expense is allocated approximately 20% to cost of goods sold and 80% to selling, general and administrative expense, based on the employee classification of the grantees. Share-based compensation expense for the periods indicated was as follows ($000):

	Three Months Ended		Six Months Ended	
December 31,	2016	2015	2016	2015
Stock Options and Cash-Based Stock Appreciation Rights	$1,431	$751	$3,094	$3,137
Restricted Share Awards and Cash-Based Restricted Share Unit Awards	1,682	1,554	3,560	2,785
Performance Share Awards and Cash-Based Performance Share Unit Awards	720	1,428	1,328	1,676
	$3,833	$3,733	$7,982	$7,598

Note 11. Fair Value of Financial Instruments

The FASB defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous markets for the asset and liability in an orderly transaction between market participants at the measurement date. The Company estimates fair value of its financial instruments utilizing an established three-level hierarchy in accordance with U.S. GAAP. The hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date as follows:

- Level 1 – Valuation is based upon unadjusted quoted prices for identical assets or liabilities in active markets.
- Level 2 – Valuation is based upon quoted prices for similar assets and liabilities in active markets, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instruments.
- Level 3 – Valuation is based upon other unobservable inputs that are significant to the fair value measurements.

The classification of fair value measurements within the hierarchy is based upon the lowest level of input that is significant to the measurement. At December 31, 2016, the Company had foreign currency forward contracts recorded at fair value. The fair values of these instruments were measured using valuations based upon quoted prices for similar assets and liabilities in active markets (Level 2) and are valued by reference to similar financial instruments, adjusted for credit risk, restrictions and other terms specific to the contracts. Foreign currency gain related to these contracts was $1.3 million and $1.7 million for the three and six months ended December 31, 2016, respectively. The Company had a contingent earnout arrangement related to the acquisition of EpiWorks recorded at fair value. The EpiWorks earnout arrangement provides up to a maximum of $6.0 million of additional cash payments based upon EpiWorks achieving certain agreed upon financial and operational targets for capacity, wafer output and gross margin, which if earned would be payable for the achievement of each specific target over the next three years. The fair value of the contingent earnout arrangement was measured using valuations based upon other unobservable inputs that are significant to the fair value measurement (Level 3).

The following table provides a summary by level of the fair value of financial instruments that are measured on a recurring basis for the periods presented ($000):

	Fair Value Measurements at December 31, 2016 Using:			
	December 31, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Foreign currency forward contracts	$1,163	$ -	$ 1,163	$ -
Liabilities:				
Contingent earnout arrangement	$5,225	$ -	$ -	$ 5,225

	Fair Value Measurements at June 30, 2016 Using:			
	June 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities:				
Foreign currency forward contracts	$511	$ -	$ 511	$ -
Contingent earnout arrangement	$4,352	$ -	$ -	$ 4,352

The Company’s policy is to report transfers into and out of Levels 1 and 2 of the fair value hierarchy at fair values as of the beginning of the period in which the transfers occur. There were no transfers in and out of Levels 1 and 2 of the fair value hierarchy during the three and six months ended December 31, 2016.

The following table presents a reconciliation of the beginning and ending fair value measurements of the Company's level 3 contingent earnout arrangement related to the acquisition of EpiWorks ($000):

	Significant Unobservable Inputs (Level 3)
Balance at July 1, 2016	$ 4,352
Payments	-
Changes in fair value	873
Balance at December 31, 2016	$ 5,225