KADANT INC
Form 10-Q
August 10, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 2, 2016

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 1-11406

KADANT INC.
(Exact name of registrant as specified in its charter)

Delaware	52-1762325
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

One Technology Park Drive	
Westford, Massachusetts	01886
(Address of Principal Executive Offices)	(Zip Code)

Registrant's telephone number, including area code: (978) 776-2000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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 x 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.
Large accelerated filer o Accelerated filer x Non-accelerated filer o Smaller reporting company o

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

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

Class	Outstanding at July 29, 2016
Common Stock, $.01 par value	10,897,252

PART 1 – FINANCIAL INFORMATION

Item 1 – Financial Statements

KADANT INC.
Condensed Consolidated Balance Sheet
(Unaudited)

Assets

(In thousands)	July 2, 2016	January 2, 2016
Current Assets:		
Cash and cash equivalents	$54,211	$65,530
Restricted cash (Note 1)	706	1,406
Accounts receivable, less allowances of $2,427 and $2,163 (Note 1)	65,897	64,321
Inventories (Note 1)	63,464	56,758
Unbilled contract costs and fees	5,776	6,580
Other current assets	11,423	10,525
Total Current Assets	201,477	205,120
Property, Plant, and Equipment, at Cost	126,405	118,014
Less: accumulated depreciation and amortization	77,466	75,721
	48,939	42,293
Other Assets	14,309	11,002
Intangible Assets, Net (Note 1)	58,584	38,032
Goodwill (Note 1)	157,473	119,051
Total Assets	$480,782	$415,498

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

KADANT INC.
Condensed Consolidated Balance Sheet (continued)
(Unaudited)

Liabilities and Stockholders' Equity

(In thousands, except share amounts)	July 2, 2016	January 2, 2016
Current Liabilities:		
Short-term obligations and current maturities of long-term obligations (Note 6)	$3,109	$5,250
Accounts payable	30,828	24,418
Customer deposits	24,340	20,123
Accrued payroll and employee benefits	16,960	19,583
Accrued income taxes	2,497	5,333
Other current liabilities	20,161	21,921
Total Current Liabilities	97,895	96,628
Long-Term Deferred Income Taxes	18,381	8,992
Other Long-Term Liabilities	22,089	15,933
Long-Term Obligations (Note 6)	61,206	26,000
Commitments and Contingencies (Note 13)	—	—
Stockholders' Equity:		
Preferred stock, $.01 par value, 5,000,000 shares authorized; none issued	—	—
Common stock, $.01 par value, 150,000,000 shares authorized; 14,624,159 shares issued	146	146
Capital in excess of par value	99,045	100,536
Retained earnings	308,312	297,258
Treasury stock at cost, 3,726,907 and 3,850,779 shares	(91,324)	(94,359)
Accumulated other comprehensive items (Note 9)	(36,570)	(36,972)
Total Kadant Stockholders' Equity	279,609	266,609
Noncontrolling interest	1,602	1,336
Total Stockholders' Equity	281,211	267,945
Total Liabilities and Stockholders' Equity	$480,782	$415,498

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

KADANT INC.
Condensed Consolidated Statement of Income
(Unaudited)

(In thousands, except per share amounts)	Three Months Ended July 2, 2016	July 4, 2015
Revenues (Note 12)	$111,828	$98,327
Costs and Operating Expenses:		
Cost of revenues	61,567	52,600
Selling, general, and administrative expenses	36,072	31,068
Research and development expenses	1,945	1,800
Restructuring costs	—	216
	99,584	85,684
Operating Income	12,244	12,643
Interest Income	66	43
Interest Expense	(340)	(231)
Income from Continuing Operations Before Provision for Income Taxes	11,970	12,455
Provision for Income Taxes	3,531	3,914
Income from Continuing Operations	8,439	8,541
Loss from Discontinued Operation (net of income tax benefit of $3)	—	(5)
Net Income	8,439	8,536
Net Income Attributable to Noncontrolling Interest	(128)	(72)
Net Income Attributable to Kadant	$8,311	$8,464
Amounts Attributable to Kadant:		
Income from Continuing Operations	$8,311	$8,469
Loss from Discontinued Operation	—	(5)
Net Income Attributable to Kadant	$8,311	$8,464
Earnings per Share from Continuing Operations Attributable to Kadant (Note 4):		
Basic	$0.76	$0.77
Diluted	$0.75	$0.76
Earnings per Share Attributable to Kadant (Note 4):		
Basic	$0.76	$0.77
Diluted	$0.75	$0.76
Weighted Average Shares (Note 4):		
Basic	10,870	10,948
Diluted	11,152	11,173

Cash Dividend Declared per Common Share	$0.19	$0.17

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

KADANT INC.
Condensed Consolidated Statement of Income
(Unaudited)

	Six Months Ended	
(In thousands, except per share amounts)	July 2, 2016	July 4, 2015
Revenues (Note 12)	$208,366	$190,578
Costs and Operating Expenses:		
Cost of revenues	114,129	100,514
Selling, general, and administrative expenses	68,568	63,290
Research and development expenses	3,649	3,460
Restructuring costs and other income (Note 3)	(317)	300
	186,029	167,564
Operating Income	22,337	23,014
Interest Income	121	96
Interest Expense	(609)	(462)
Income from Continuing Operations Before Provision for Income Taxes	21,849	22,648
Provision for Income Taxes (Note 5)	6,419	7,182
Income from Continuing Operations	15,430	15,466
Income from Discontinued Operation (net of income tax provision of $38)	—	60
Net Income	15,430	15,526
Net Income Attributable to Noncontrolling Interest	(243)	(165)
Net Income Attributable to Kadant	$15,187	$15,361
Amounts Attributable to Kadant:		
Income from Continuing Operations	$15,187	$15,301
Income from Discontinued Operation	—	60
Net Income Attributable to Kadant	$15,187	$15,361
Earnings per Share from Continuing Operations Attributable to Kadant (Note 4):		
Basic	$1.40	$1.40
Diluted	$1.37	$1.37
Earnings per Share Attributable to Kadant (Note 4):		
Basic	$1.40	$1.41
Diluted	$1.37	$1.38
Weighted Average Shares (Note 4):		
Basic	10,831	10,920

Diluted	11,085	11,130
Cash Dividends Declared per Common Share	$0.38	$0.34

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

KADANT INC.
Condensed Consolidated Statement of Comprehensive Income
(Unaudited)

	Three Months Ended		Six Months Ended	
(In thousands)	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Net Income	$8,439	$8,536	$15,430	$15,526
Other Comprehensive Items:				
Foreign currency translation adjustment	(5,194)	2,264	736	(9,838)
Pension and other post-retirement liability adjustments (net of tax provision (benefit) of $77 and $(159) in the three and six months ended July 2, 2016, respectively, and $63 and $155 in the three and six months ended July 4, 2015, respectively)	147	115	(271)	288
Deferred gain (loss) on hedging instruments (net of tax (benefit) provision of $(151) and $(223) in the three and six months ended July 2, 2016, respectively, and $61 and $78 in the three and six months ended July 4, 2015, respectively)	86	428	(40)	(80)
Other Comprehensive Items	(4,961)	2,807	425	(9,630)
Comprehensive Income	3,478	11,343	15,855	5,896
Comprehensive Income Attributable to Noncontrolling Interest	(92)	(98)	(266)	(59)
Comprehensive Income Attributable to Kadant	$3,386	$11,245	$15,589	$5,837

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

KADANT INC.
Condensed Consolidated Statement of Cash Flows
(Unaudited)

(In thousands)	Six Months Ended July 2, 2016	July 4, 2015
Operating Activities:		
Net income attributable to Kadant	$15,187	$15,361
Net income attributable to noncontrolling interest	243	165
Income from discontinued operation	—	(60)
Income from continuing operations	15,430	15,466
Adjustments to reconcile income from continuing operations to net cash provided by operating activities:		
Depreciation and amortization	7,477	5,663
Stock-based compensation expense	2,596	3,241
Tax benefits from stock-based compensation awards	—	(884)
Provision for losses on accounts receivable	320	219
Gain on the sale of property, plant, and equipment	(350)	(3)
Other items, net	289	(324)
Contributions to pension plan	(540)	(540)
Changes in current assets and liabilities, net of effects of acquisition:		
Accounts receivable	3,699	(1,988)
Unbilled contract costs and fees	818	1,040
Inventories	(2,498)	(10,843)
Other current assets	459	(2,427)
Accounts payable	172	2,000
Other current liabilities	(8,663)	1,520
Net cash provided by continuing operations	19,209	12,140
Net cash used in discontinued operation	—	(39)
Net cash provided by operating activities	19,209	12,101
Investing Activities:		
Acquisition, net of cash acquired	(56,617)	—
Purchases of property, plant, and equipment	(1,736)	(2,651)
Proceeds from sale of property, plant, and equipment	399	28
Net cash used in investing activities	(57,954)	(2,623)
Financing Activities:		
Proceeds from issuance of long-term obligations	46,046	15,000
Repayments of short-and long-term obligations	(12,250)	(12,361)
Purchases of Company common stock	—	(4,040)
Dividends paid	(3,894)	(3,494)
Tax withholding payments related to stock-based compensation	(2,435)	(2,499)
Payment of contingent consideration	(1,091)	—
Proceeds from issuance of Company common stock	1,374	285
Tax benefits from stock-based compensation awards	—	884
Change in restricted cash	724	(842)
Net cash provided by (used in) financing activities	28,474	(7,067)

Exchange Rate Effect on Cash and Cash Equivalents	(1,048)	(427)
(Decrease) Increase in Cash and Cash Equivalents	(11,319)	1,984
Cash and Cash Equivalents at Beginning of Period	65,530	45,378
Cash and Cash Equivalents at End of Period	$54,211	$47,362

See Note 1 for supplemental cash flow information.

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

KADANT INC.
Condensed Consolidated Statement of Stockholders' Equity
(Unaudited)

(In thousands, except share amounts)	Common Stock Shares	Amount	Capital in Excess of Par Value	Retained Earnings	Treasury Stock Shares	Amount	Accumulated Other Comprehensive Items	Noncontrolling Interest	Total Stockholders' Equity
Balance at January 3, 2015	14,624,159	$ 146	$ 98,769	$ 270,249	3,760,019	$ (87,727)	$ (17,146)	$ 1,168	$ 265,459
Net income	—	—	—	15,361	—	—	—	165	15,526
Dividends declared	—	—	—	(3,716)	—	—	—	—	(3,716)
Activity under stock plans	—	—	(1,505)	—	(115,427)	2,697	—	—	1,192
Tax benefits related to employees' and directors' stock plans	—	—	884	—	—	—	—	—	884
Purchases of Company common stock	—	—	—	—	86,518	(4,040)	—	—	(4,040)
Other comprehensive items	—	—	—	—	—	—	(9,524)	(106)	(9,630)
Balance at July 4, 2015	14,624,159	$ 146	$ 98,148	$ 281,894	3,731,110	$ (89,070)	$ (26,670)	$ 1,227	$ 265,675
Balance at January 2, 2016	14,624,159	$ 146	$ 100,536	$ 297,258	3,850,779	$ (94,359)	$ (36,972)	$ 1,336	$ 267,945
Net income	—	—	—	15,187	—	—	—	243	15,430
Dividends declared	—	—	—	(4,133)	—	—	—	—	(4,133)
Activity under stock plans	—	—	(1,491)	—	(123,872)	3,035	—	—	1,544
	—	—	—	—	—	—	402	23	425

Other comprehensive items									
Balance at July 2, 2016	14,624,159	$ 146	$ 99,045	$ 308,312	3,726,907	$ (91,324)	$ (36,570)	$ 1,602	$ 281,211

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

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KADANT INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1
1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations
Kadant Inc. (collectively, "we," "Kadant," "the Company," or "the Registrant") was incorporated in Delaware in November 1991 and currently trades on the New York Stock Exchange under the ticker symbol "KAI."

The Company and its subsidiaries' continuing operations include two reportable operating segments, Papermaking Systems and Wood Processing Systems, and a separate product line, Fiber-based Products.

Through its Papermaking Systems segment, the Company develops, manufactures, and markets a range of equipment and products primarily for the global papermaking, paper recycling, recycling and waste management, and other process industries. The Company's principal products in this segment include custom-engineered stock-preparation systems and equipment for the preparation of wastepaper for conversion into recycled paper and balers and related equipment used in the processing of recyclable and waste materials; fluid-handling systems used primarily in the dryer section of the papermaking process and during the production of corrugated boxboard, metals, plastics, rubber, textiles, chemicals, and food; doctoring systems and equipment and related consumables important to the efficient operation of paper machines; and cleaning and filtration systems essential for draining, purifying, and recycling process water and cleaning paper machine fabrics and rolls.

Through its Wood Processing Systems segment, the Company designs and manufactures stranders and related equipment used in the production of oriented strand board (OSB), an engineered wood panel product used primarily in home construction. This segment also supplies debarking and wood chipping equipment used in the forest products and the pulp and paper industries, and provides refurbishment and repair of pulping equipment for the pulp and paper industry.

Through its Fiber-based Products business, the Company manufactures and sells granules derived from papermaking byproducts primarily for use as agricultural carriers and for home lawn and garden applications, as well as for oil and grease absorption.

Interim Financial Statements
The interim condensed consolidated financial statements and related notes presented have been prepared by the Company, are unaudited, and, in the opinion of management, reflect all adjustments of a normal recurring nature necessary for a fair statement of the Company's financial position at July 2, 2016 and its results of operations, comprehensive income, cash flows, and stockholders' equity for the three and six month periods ended July 2, 2016 and July 4, 2015. Interim results are not necessarily indicative of results for a full year or for any other interim period.

The condensed consolidated balance sheet presented as of January 2, 2016 has been derived from the consolidated financial statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2016. The condensed consolidated financial statements and related notes are presented as permitted by the Securities and Exchange Commission (SEC) rules and regulations for Form 10-Q and do not contain certain information included in the annual consolidated financial statements and related notes of the Company. The condensed consolidated financial statements and notes included herein should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2016, filed with the SEC.

Financial Statement Presentation

Certain reclassifications have been made to prior periods to conform with current reporting. As a result of the adoption of the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2016-09, "Improvements to Employee Share-Based Payment Arrangements," tax withholding payments made related to stock-based compensation awards have been reclassified from other current liabilities within operating activities in the condensed consolidated statement of cash flows and presented separately within financing activities in the 2015 period.

Critical Accounting Policies

Critical accounting policies are defined as those that entail significant judgments and estimates, and could potentially result in materially different results under different assumptions and conditions. The Company believes that the most critical accounting policies upon which its financial position depends, and which involve the most complex or subjective decisions or assessments, concern revenue recognition and accounts receivable, warranty obligations, income taxes, the valuation of

KADANT INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies (continued)

goodwill and intangible assets, inventories and pension obligations. Discussions of the application of these and other accounting policies are included in Notes 1 and 3 to the consolidated financial statements in the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2016.

Use of Estimates
The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period.

Although the Company makes every effort to ensure the accuracy of the estimates and assumptions used in the preparation of its condensed consolidated financial statements or in the application of accounting policies, if business conditions were different, or if the Company were to use different estimates and assumptions, it is possible that materially different amounts could be reported in the Company's condensed consolidated financial statements.

Supplemental Cash Flow Information

	Six Months Ended	
(In thousands)	July 2, 2016	July 4, 2015
Non-Cash Investing Activities:		
Fair value of assets acquired	$86,555	$—
Cash paid for acquired business	(58,894)	—
Liabilities assumed of acquired business	$27,661	$—
Non-Cash Financing Activities:		
Issuance of Company common stock	$3,057	$2,967
Dividends declared but unpaid	$2,070	$1,852

Restricted Cash
As of July 2, 2016 and January 2, 2016, the Company had restricted cash of $706,000 and $1,406,000, respectively. This cash serves as collateral for bank guarantees primarily associated with providing assurance to customers that the Company will fulfill certain customer obligations entered into in the normal course of business. All of the bank guarantees will expire by the end of 2017.

Banker's Acceptance Drafts
The Company's Chinese subsidiaries may receive banker's acceptance drafts from customers as payment for outstanding accounts receivable. The banker's acceptance drafts are non-interest bearing obligations of the issuing bank and mature within six months of the origination date. The Company has the ability to sell the drafts at a discount to a third-party financial institution or transfer the drafts to vendors in settlement of current accounts payable prior to the scheduled maturity date. These drafts, which totaled $7,273,000 and $8,314,000 at July 2, 2016 and January 2, 2016, respectively, are included in accounts receivable in the accompanying condensed consolidated balance sheet until the subsidiary sells the drafts to a bank and receives a discounted amount, transfers the banker's acceptance drafts in settlement of accounts payable prior to maturity, or obtains cash payment on the scheduled maturity date.

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KADANT INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies (continued)

Inventories
The components of inventories are as follows:

(In thousands)	July 2, 2016	January 2, 2016
Raw Materials and Supplies	$23,911	$ 22,324
Work in Process	16,570	13,819
Finished Goods	22,983	20,615
Total Inventories	$63,464	$ 56,758

Intangible Assets, Net
Acquired intangible assets are as follows:

(In thousands)	July 2, 2016	January 2, 2016
Indefinite-Lived Intangible Asset	$8,100	$8,100
Definite-Lived Intangible Assets, Gross	$77,052	$77,052
Acquisition	24,623	—
Accumulated amortization	(45,373)	(40,908)
Currency translation	(5,818)	(6,212)
Definite-Lived Intangible Assets, Net	$50,484	$29,932
Total Intangible Assets, Net	$58,584	$38,032

Goodwill
The changes in the carrying amount of goodwill by segment are as follows:

(In thousands)	Papermaking Systems Segment	Wood Processing Systems Segment	Total
Balance at January 2, 2016			
Gross balance	$ 187,720	$ 16,840	$204,560
Accumulated impairment losses	(85,509)	—	(85,509)
Net balance	102,211	16,840	119,051
Acquisition	38,344	—	38,344
Currency Translation	(1,109)	1,187	78
Total 2016 Adjustments	37,235	1,187	38,422
Balance at July 2, 2016			
Gross balance	224,955	18,027	242,982
Accumulated impairment losses	(85,509)	—	(85,509)
Net balance	$ 139,446	$ 18,027	$157,473

Warranty Obligations
The Company provides for the estimated cost of product warranties at the time of sale based on the actual historical occurrence rates and repair costs, as well as knowledge of any specific warranty problems that indicate that projected

warranty costs may vary from historical patterns. The Company typically negotiates the terms regarding warranty coverage and length of warranty depending on the products and applications. While the Company engages in extensive product quality programs and processes, the Company's warranty obligation is affected by product failure rates, repair costs, service delivery costs incurred in correcting a product failure, and supplier warranties on parts delivered to the Company. Should actual product failure rates,

KADANT INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies (continued)

repair costs, service delivery costs, or supplier warranties on parts differ from the Company's estimates, revisions to the estimated warranty liability would be required.

The changes in the carrying amount of accrued warranty costs included in other current liabilities in the accompanying condensed consolidated balance sheet are as follows:

(In thousands)	Six Months Ended July 2, 2016	July 4, 2015
Balance at Beginning of Period	$3,670	$3,875
Provision charged to income	1,524	917
Usage	(1,623)	(1,252)
Acquisition	991	—
Currency translation	(20)	(153)
Balance at End of Period	$4,542	$3,387

Recent Accounting Pronouncements
Revenue from Contracts with Customers (Topic 606) Section A-Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs-Contracts with Customers (Subtopic 340-40). In May 2014, the FASB issued ASU No. 2014-09, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The new guidance provides a five-step analysis of transactions to determine when and how revenue is recognized. The ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective. In March 2016, the FASB issued ASU No. 2016-08, which further clarifies the guidance on the principal versus agent considerations within ASU No. 2014-09. In April 2016, the FASB issued ASU No. 2016-10 to expand the guidance on identifying performance obligations and licensing within ASU 2014-09. In May 2016, the FASB issued ASU No. 2016-11, which rescinds certain previously issued guidance, including, among other items, guidance relating to accounting for shipping and handling fees and freight services effective upon adoption of ASU No. 2014-09. Also in May 2016, the FASB issued ASU No. 2016-12, which narrowly amended the revenue recognition guidance regarding collectability, noncash consideration, presentation of sales tax and transition. These new ASUs are effective for the Company beginning in fiscal 2018. Early adoption is permitted in fiscal 2017. The guidance permits the use of either the retrospective or cumulative effect transition method. The Company is currently evaluating the effect that these ASUs will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

Compensation-Stock Compensation (Topic 718) Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. In June 2014, the FASB issued ASU No. 2014-12, which clarifies the proper method of accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. Under the new guidance, a performance target that affects vesting and could be achieved after completion of the service period should be treated as a performance condition under FASB Accounting Standards Codification (ASC) 718 and, as a result, should not be included in the estimation of the grant-date fair value of the award. An entity should recognize compensation cost for the award when it becomes probable that the performance target will be achieved. In the event that an entity determines that it is probable that a performance target will be achieved before the end of the service period, the compensation cost of the award should be recognized prospectively over the remaining service period. The Company adopted this guidance at the beginning of fiscal 2016. The adoption of this ASU did not have an impact on the Company’s condensed consolidated financial statements.

Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. In April 2015, the FASB issued ASU No. 2015-03, which requires 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 that debt liability, consistent with debt discounts. In addition, in June 2015, the FASB issued ASU No. 2015-15, which allows an entity to defer the requirements of ASU No. 2015-03 on deferred issuance costs related to line-of-credit arrangements. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in these ASUs. These new disclosure items are effective for the Company beginning in fiscal 2016. The Company adopted these ASUs at the beginning of fiscal 2016. Adoption of these ASUs did not have an impact on the Company’s condensed consolidated financial statements.

KADANT INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies (continued)

Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent). In May 2015, the FASB issued ASU No. 2015-07, which removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. This ASU also removes the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The Company adopted the disclosure requirements in this guidance at the beginning of fiscal 2016. As this ASU is disclosure-related only, its adoption did not have an effect on the Company's condensed consolidated financial statements.

Inventory (Topic 330), Simplifying the Measurement of Inventory. In July 2015, the FASB issued ASU No. 2015-11, which requires that an entity measure inventory within the scope of this ASU 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. Substantial and unusual losses that result from subsequent measurement of inventory should be disclosed in the financial statements. This new guidance is effective for the Company beginning in fiscal 2017. Early adoption is permitted. The Company is currently evaluating the effect that this ASU will have on its condensed consolidated financial statements.

Business Combinations (Topic 805), Simplifying the Accounting for Measurement-Period Adjustments. In September 2015, the FASB issued ASU No. 2015-16, which 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 acquirer is required to record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. In addition, an entity is required to present, separately on the face of the income statement or through disclosure in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The Company adopted this guidance at the beginning of fiscal 2016. Adoption of this ASU did not have an impact on the Company's condensed consolidated financial statements.

Leases (Topic 842). In February 2016, the FASB issued ASU No. 2016-02, which requires a lessee to recognize a right-of-use asset and a lease liability for operating leases, initially measured at the present value of the future lease payments, in its balance sheet. This ASU also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis. This new guidance is effective for the Company in fiscal 2019. Early adoption is permitted. The Company is currently evaluating the effects that the adoption of this ASU will have on its condensed consolidated financial statements.

Compensation -Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. In March 2016, the FASB issued ASU No. 2016-09, which simplifies 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 in the statement of cash flows. The Company early adopted this ASU at the beginning of fiscal 2016. This ASU requires that excess income tax benefits and tax deficiencies related to stock-based compensation arrangements be recognized as discrete items within the provision for income taxes instead of capital in excess of par value in the reporting period in which they occur. As a result of the adoption of this ASU, the Company recognized an income tax benefit of $191,000, or $0.02 per diluted share, and $396,000, or $0.04 per diluted share, in the Company's condensed consolidated statement of income in the second quarter and first six months of 2016, respectively. The Company prospectively adopted the requirement to classify the excess tax benefits from stock-compensation awards within operating activities in the condensed consolidated statement of cash flows in the first quarter of 2016. Prior period amounts were not restated. The Company also adopted the guidance in this ASU that requires that taxes paid related to the withholding of common stock upon the vesting of employee stock awards be presented separately within financing activities in the condensed consolidated statement of cash flows. The Company has retrospectively restated the 2015 period to reclassify the comparative amount, which was previously presented in other current liabilities within operating activities. There were no other material effects from adoption of this ASU on the Company's condensed consolidated financial statements.

Financial Instruments -Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. In June 2016, the FASB issued ASU No. 2016-13, which significantly changes the way entities recognize impairment of many financial

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1. Nature of Operations and Summary of Significant Accounting Policies (continued)

assets by requiring immediate recognition of estimated credit losses expected to occur over their remaining lives. This new guidance is effective for the Company in fiscal 2020. Early adoption is permitted beginning in fiscal 2019. The Company is currently evaluating the effects that the adoption of this ASU will have on its condensed consolidated financial statements.

2. Acquisition

On April 4, 2016, the Company acquired all of the outstanding shares of RT Holding GmbH, the parent corporation of a group of companies known as the PAALGROUP (PAAL) for approximately 49,713,000 euros, net of cash acquired, or approximately $56,617,000. The Company entered into a $29,866,000 euro-denominated borrowing under its unsecured revolving credit facility in the first quarter of 2016 to partially fund the acquisition. The remainder of the purchase price was funded from the Company's internal overseas cash. The Company incurred acquisition transaction costs of approximately $1,665,000 in the first six months of 2016, which were recorded in selling, general, and administrative expenses (SG&A).

PAAL, which is part of the Company's Papermaking Systems segment's Stock-Preparation product line, manufactures balers and related equipment used in the processing of recyclable and waste materials. This acquisition broadened the Company's product portfolio and extended its presence deeper into recycling and waste management. PAAL, headquartered in Germany, also has operations in the United Kingdom, France, and Spain. The Company anticipates several synergies in connection with this acquisition, including expanding sales of the products of the acquired business by leveraging Kadant's geographic presence to enter or further penetrate existing markets as well as sourcing and manufacturing efficiencies.

This acquisition has been accounted for by using the purchase method of accounting and PAAL’s results have been included in the accompanying financial statements from its date of acquisition. The excess of the purchase price for the acquisition of PAAL over the tangible and identifiable intangible assets was recorded as goodwill and amounted to approximately $38,344,000, which is not deductible for tax purposes. The fair values are subject to adjustment upon finalization of the valuation, and therefore the current measurements of intangible assets, acquired goodwill, and assumed assets and liabilities are subject to change.

The following table summarizes the purchase method of accounting for the acquisition of PAAL and the estimated fair values of assets acquired and liabilities assumed:

2016 Acquisition (In thousands)	Total
Net Assets Acquired:	
Cash and Cash Equivalents	$2,277
Accounts Receivable	5,441
Inventories	3,993
Property, Plant, and Equipment	7,173
Other Assets	4,704
Intangible Assets	24,623
Goodwill	38,344
Total assets acquired	86,555

Accounts Payable	5,535
Customer Deposits	2,471
Lease Obligations	4,222
Long-term Deferred Tax Liability	8,128
Other Liabilities	7,305
Total liabilities assumed	27,661
Net assets acquired	$58,894
Purchase Price:	
Cash	$29,028
Cash Paid to Seller Borrowed Under the Revolving Credit Facility	29,866
Total purchase price	$58,894

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2. Acquisition (continued)

Definite-lived intangible assets acquired related to the PAAL acquisition included $15,831,000 for customer relationships, $4,203,000 for product technology, $2,278,000 for tradenames, and $2,311,000 for other intangibles. The weighted-average amortization period for definite-lived intangible assets acquired is 12 years, which includes weighted-average amortization periods of 13 years for customer relationships, 9 years for product technology, and 14 years for tradenames.

Pro forma disclosures of the results of operations are not required, as the acquisition is not considered a material business combination as outlined in FASB ASC 805, "Business Combinations."

3. Restructuring Costs and Other Income

Other Income
In the first six months of 2016, other income consisted of a pre-tax gain of $317,000 from the sale of real estate in Sweden for cash proceeds of $368,000.

Restructuring Costs
In the first six months of 2015, the Company's Papermaking Systems segment recorded restructuring costs of $300,000 for severance costs associated with the reduction of nine employees in Canada and Sweden. These actions were taken to streamline the Company's operations in those locations.

4. Earnings per Share

Basic and diluted earnings per share (EPS) were calculated as follows:

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Amounts Attributable to Kadant:				
Income from Continuing Operations	$8,311	$8,469	$15,187	$15,301
(Loss) Income from Discontinued Operation	—	(5)	—	60
Net Income	$8,311	$8,464	$15,187	$15,361
Basic Weighted Average Shares	10,870	10,948	10,831	10,920
Effect of Stock Options, Restricted Stock Units and Employee Stock Purchase Plan	282	225	254	210
Diluted Weighted Average Shares	11,152	11,173	11,085	11,130
Basic Earnings per Share:				
Continuing operations	$0.76	$0.77	$1.40	$1.40
Discontinued operation	$—	$—	$—	$0.01
Net income per basic share	$0.76	$0.77	$1.40	$1.41
Diluted Earnings per Share:				

Continuing operations	$0.75	$0.76	$1.37	$1.37
Discontinued operation	$—	$—	$—	$0.01
Net income per diluted share	$0.75	$0.76	$1.37	$1.38

Unvested restricted stock units (RSUs) equivalent to approximately 41,000 shares of common stock for the second quarter of 2015, and approximately 73,000 and 44,000 shares of common stock for the first six months of 2016 and 2015, respectively, were not included in the computation of diluted EPS because either the effect of their inclusion would have been anti-dilutive, or for unvested performance-based RSUs, the performance conditions had not been met as of the end of the reporting period.

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5. Provision for Income Taxes

The provision for income taxes was $6,419,000 and $7,182,000 in the first six months of 2016 and 2015, respectively, and represented 29% and 32% of pre-tax income. The effective tax rate of 29% in the first six months of 2016 was lower than the Company's statutory tax rate primarily due to the distribution of the Company's worldwide earnings and the adoption of ASU No. 2016-09 that resulted in a favorable adjustment for the net excess income tax benefits from stock-based compensation arrangements. These items were offset in part by an increase in tax related to non-deductible expenses and state taxes. The effective tax rate of 32% in the first six months of 2015 was lower than the Company's statutory tax rate primarily due to the distribution of the Company's worldwide earnings, and was offset in part by an increase in state taxes, tax expense related to an increase in non-deductible expenses, and the U.S. tax cost of foreign operations.

6. Short- and Long-Term Obligations

Short- and long-term obligations are as follows:

(In thousands)	July 2, 2016	January 2, 2016
Revolving Credit Facility, due 2018	$64,315	$26,000
Commercial Real Estate Loan, due 2016	—	5,250
Total Short- and Long-Term Obligations	64,315	31,250
Less: Short-Term Obligations and Current Maturities	(3,109)	(5,250)
Long-Term Obligations	$61,206	$26,000

The weighted average interest rate for the Company's short-and long-term obligations was 1.37% as of July 2, 2016.

Revolving Credit Facility
The Company entered into a five-year unsecured revolving credit facility (2012 Credit Agreement) in the aggregate principal amount of up to $100,000,000 on August 3, 2012 and amended it on November 1, 2013 and March 29, 2016. The 2012 Credit Agreement also includes an uncommitted unsecured incremental borrowing facility of up to an additional $50,000,000. The principal on any borrowings made under the 2012 Credit Agreement is due on November 1, 2018. Interest on any loans outstanding under the 2012 Credit Agreement accrues and is payable quarterly in arrears at one of the following rates selected by the Company: (i) the highest of (a) the federal funds rate plus 0.50% plus an applicable margin of 0% to 1%, (b) the prime rate, as defined, plus an applicable margin of 0% to 1% and (c) the Eurocurrency rate, as defined, plus 0.50% plus an applicable margin of 0% to 1% or (ii) the Eurocurrency rate, as defined, plus an applicable margin of 1% to 2%. The applicable margin is determined based upon the ratio of the Company's total debt to earnings before interest, taxes, depreciation, and amortization, as defined in the 2012 Credit Agreement. For this purpose, total debt is defined as total debt less up to $25,000,000 of unrestricted U.S. cash.

The obligations of the Company under the 2012 Credit Agreement may be accelerated upon the occurrence of an event of default under the 2012 Credit Agreement, which includes customary events of default including without limitation payment defaults, defaults in the performance of affirmative and negative covenants, the inaccuracy of representations or warranties, bankruptcy- and insolvency-related defaults, defaults relating to such matters as the

Employment Retirement Income Security Act, unsatisfied judgments, the failure to pay certain indebtedness, and a change of control default. In addition, the 2012 Credit Agreement contains negative covenants applicable to the Company and its subsidiaries, including financial covenants requiring the Company to comply with a maximum consolidated leverage ratio of 3.5 to 1, a minimum consolidated interest coverage ratio of 3 to 1, and restrictions on liens, indebtedness, fundamental changes, dispositions of property, making certain restricted payments (including dividends and stock repurchases), investments, transactions with affiliates, sale and leaseback transactions, swap agreements, changing its fiscal year, arrangements affecting subsidiary distributions, entering into new lines of business, and certain actions related to the discontinued operation. As of July 2, 2016, the Company was in compliance with these covenants.

Loans under the 2012 Credit Agreement are guaranteed by certain domestic subsidiaries of the Company pursuant to a Guarantee Agreement, effective August 3, 2012.

KADANT INC.
Notes to Condensed Consolidated Financial Statements
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6. Short- and Long-Term Obligations (continued)

The Company borrowed $41,046,000 under the 2012 Credit Agreement in the first quarter of 2016, of which $29,866,000 was a euro-denominated borrowing used to fund the PAAL acquisition, which occurred at the beginning of the second quarter of 2016. As of July 2, 2016, the outstanding balance under the 2012 Credit Agreement was $64,315,000. As of July 2, 2016, the Company had $35,096,000 of borrowing capacity available under the committed portion of its 2012 Credit Agreement. The amount the Company is able to borrow under the 2012 Credit Agreement is the total borrowing capacity of $100,000,000 less any outstanding borrowings, letters of credit and multi-currency borrowings issued under the 2012 Credit Agreement.

Commercial Real Estate Loan
In the first six months of 2016, the Company repaid the outstanding principal balance on the commercial real estate loan.

7. Stock-Based Compensation

The Company recognized stock-based compensation expense of $1,273,000 and $1,653,000 in the second quarters of 2016 and 2015, respectively, and $2,596,000 and $3,241,000 in the first six months of 2016 and 2015, respectively, within SG&A expenses in the accompanying condensed consolidated statement of income. The Company recognizes compensation cost for all stock-based awards granted to employees and directors based on the grant date estimate of fair value for those awards. The fair value of RSUs is based on the grant date trading price of the Company's common stock, reduced by the present value of estimated dividends foregone during the requisite service period. For time-based RSUs, compensation expense is recognized ratably over the requisite service period for the entire award net of forfeitures. For performance-based RSUs, compensation expense is recognized ratably over the requisite service period for each separately-vesting portion of the award net of forfeitures and remeasured at each reporting period until the total number of RSUs to be issued is known. During the first quarter of 2016, the Company granted stock-based compensation to executive officers and employees consisting of 53,811 shares of performance-based RSUs and 58,438 shares of time-based RSUs and granted 20,000 shares of time-based RSUs to its non-employee directors. Unrecognized compensation expense related to stock-based compensation totaled approximately $6,522,000 at July 2, 2016, and will be recognized over a weighted average period of 1.8 years.

8. Employee Benefit Plans

The Company sponsors a noncontributory defined benefit retirement plan for the benefit of eligible employees at its Kadant Solutions division and its corporate office (included in the table below under "Pension Benefits"). The Company also sponsors a restoration plan for the benefit of certain executive officers who also participate in the noncontributory defined benefit retirement plan (included in the table below under "Other Benefits"). In addition, employees at certain of the Company's subsidiaries participate in defined benefit retirement and post-retirement welfare benefit plans (included in the table below under "Other Benefits").

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8. Employee Benefit Plans (continued)

The components of net periodic benefit cost for the pension benefits and other benefits plans are as follows:

(In thousands, except percentages)	Three Months Ended July 2, 2016 Pension Benefits	Three Months Ended July 2, 2016 Other Benefits	Three Months Ended July 4, 2015 Pension Benefits	Three Months Ended July 4, 2015 Other Benefits
Components of Net Periodic Benefit Cost:				
Service cost	$181	$60	$211	$55
Interest cost	318	64	307	63
Expected return on plan assets	(322)	(7)	(356)	(10)
Recognized net actuarial loss	124	22	127	18
Amortization of prior service cost	14	23	14	24
Net Periodic Benefit Cost	$315	$162	$303	$150

The weighted average assumptions used to determine net periodic benefit cost are as follows:

Discount Rate	4.22 %	4.09 %	3.87 %	3.75 %
Expected Long-Term Return on Plan Assets	5.00 %	—	5.25 %	—
Rate of Compensation Increase	3.00 %	3.01 %	3.00 %	2.99 %

(In thousands, except percentages)	Six Months Ended July 2, 2016 Pension Benefits	Six Months Ended July 2, 2016 Other Benefits	Six Months Ended July 4, 2015 Pension Benefits	Six Months Ended July 4, 2015 Other Benefits
Components of Net Periodic Benefit Cost:				
Service cost	$362	$118	$422	$112
Interest cost	636	128	614	128
Expected return on plan assets	(644)	(14)	(712)	(21)
Recognized net actuarial loss	248	44	254	35
Amortization of prior service cost	28	47	28	46
Settlement loss	—	114	—	—
Net Periodic Benefit Cost	$630	$437	$606	$300

The weighted average assumptions used to determine net periodic benefit cost are as follows:

Discount Rate	4.22 %	4.08 %	3.87 %	3.75 %
Expected Long-Term Return on Plan Assets	5.00 %	—	5.25 %	—
Rate of Compensation Increase	3.00 %	3.01 %	3.00 %	2.99 %

The Company made cash contributions of $540,000 to its Kadant Solutions division's noncontributory defined benefit retirement plan in the first six months of 2016 and expects to make cash contributions of $540,000 over the remainder of 2016. For the remaining pension and post-retirement welfare benefits plans, the Company does not expect to make any cash contributions other than to fund current benefit payments in 2016.

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9. Accumulated Other Comprehensive Items

Comprehensive income combines net income and other comprehensive items, including foreign currency translation adjustments, deferred losses and unrecognized prior service cost associated with pension and other post-retirement plans, and deferred losses on hedging instruments.

Changes in each component of accumulated other comprehensive items (AOCI), net of tax, in the accompanying condensed consolidated balance sheet are as follows:

(In thousands)	Foreign Currency Translation Adjustment	Unrecognized Prior Service Cost	Deferred Loss on Pension and Other Post-Retirement Plans	Deferred Loss on Hedging Instruments	Accumulated Other Comprehensive Items
Balance at January 2, 2016	$ (27,932)	$ (489)	$ (8,322)	$ (229)	$ (36,972)
Other Comprehensive Income (Loss) Before Reclassifications	713	(1)	(583)	(317)	(188)
Reclassifications from AOCI	—	48	265	277	590
Net Current Period Other Comprehensive Income (Loss)	713	47	(318)	(40)	402
Balance at July 2, 2016	$ (27,219				