

Knowles Corp
Form 10-Q
July 31, 2017
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 June 30, 2017.

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: 001-36102

Knowles Corporation
(Exact name of registrant as specified in its charter)

Delaware 90-1002689
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

1151 Maplewood Drive
Itasca, Illinois 60143
(Address of principal executive offices) (Zip Code)

(630) 250-5100
(Registrant's telephone number, including area code)

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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

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

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

Yes No

The number of shares outstanding of the registrant's common stock as of July 27, 2017 was 89,413,549.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

KNOWLES CORPORATION

CONSOLIDATED STATEMENTS OF EARNINGS

(in millions, except share and per share amounts)

(unaudited)

	Three Months		Six Months Ended	
	Ended June 30,		June 30,	
	2017	2016	2017	2016
Revenues	\$190.2	\$ 190.3	\$383.9	\$ 375.6
Cost of goods sold	117.7	117.2	239.5	234.5
Impairment charges	1.4	—	1.4	—
Restructuring charges - cost of goods sold	(0.6)	0.2	3.7	1.4
Gross profit	71.7	72.9	139.3	139.7
Research and development expenses	26.7	25.8	52.9	51.9
Selling and administrative expenses	38.7	45.2	76.8	88.3
Impairment charges	19.9	—	19.9	—
Restructuring charges	2.8	3.7	3.5	7.2
Operating expenses	88.1	74.7	153.1	147.4
Operating loss	(16.4)	(1.8)	(13.8)	(7.7)
Interest expense, net	5.1	5.8	10.3	9.5
Other expense (income), net	1.5	(2.2)	3.8	(1.7)
Loss before income taxes and discontinued operations	(23.0)	(5.4)	(27.9)	(15.5)
Provision for income taxes	7.3	1.4	7.1	3.8
Loss from continuing operations	(30.3)	(6.8)	(35.0)	(19.3)
Earnings (loss) from discontinued operations, net	0.6	(17.8)	2.1	(34.7)
Net loss	\$(29.7)	\$(24.6)	\$(32.9)	\$(54.0)
Loss per share from continuing operations:				
Basic	\$(0.34)	\$(0.08)	\$(0.39)	\$(0.22)
Diluted	\$(0.34)	\$(0.08)	\$(0.39)	\$(0.22)
Earnings (loss) per share from discontinued operations:				
Basic	\$0.01	\$(0.20)	\$0.02	\$(0.39)
Diluted	\$0.01	\$(0.20)	\$0.02	\$(0.39)
Net loss per share:				
Basic	\$(0.33)	\$(0.28)	\$(0.37)	\$(0.61)
Diluted	\$(0.33)	\$(0.28)	\$(0.37)	\$(0.61)
Weighted average common shares outstanding:				
Basic	89,361,358	88,652,453	89,168,498	88,594,597
Diluted	89,361,358	88,652,453	89,168,498	88,594,597

See accompanying Notes to Consolidated Financial Statements

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KNOWLES CORPORATION
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

(in millions)

(unaudited)

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2017	2016	2017	2016
Net loss	\$(29.7)	\$(24.6)	\$(32.9)	\$(54.0)
Other comprehensive earnings (loss), net of tax				
Foreign currency translation	5.4	(4.0)	20.1	9.9
Changes in fair value of cash flow hedges:				
Unrealized net gains (losses) arising during period	1.0	(2.2)	1.6	(0.5)
Net losses reclassified into earnings	0.3	0.3	1.7	0.2
Total cash flow hedges	1.3	(1.9)	3.3	(0.3)
Other comprehensive earnings (loss), net of tax	6.7	(5.9)	23.4	9.6
Comprehensive loss	\$(23.0)	\$(30.5)	\$(9.5)	\$(44.4)

See accompanying Notes to Consolidated Financial Statements

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KNOWLES CORPORATION
 CONSOLIDATED BALANCE SHEETS
 (in millions, except share and per share amounts)
 (unaudited)

	June 30, 2017	December 31, 2016
Current assets:		
Cash and cash equivalents	\$48.6	\$ 66.2
Receivables, net of allowances of \$1.6 and \$1.7	129.7	145.1
Inventories, net	142.7	108.2
Prepaid and other current assets	13.8	10.6
Total current assets	334.8	330.1
Property, plant and equipment, net	191.5	186.2
Goodwill	907.8	894.6
Intangible assets, net	59.2	77.4
Other assets and deferred charges	22.5	25.8
Assets of discontinued operations	0.7	0.9
Total assets	\$1,516.5	\$ 1,515.0
Current liabilities:		
Current maturities of long-term debt	\$13.3	\$ 9.7
Accounts payable	79.0	71.8
Accrued compensation and employee benefits	29.5	34.7
Other accrued expenses	29.6	26.0
Federal and other taxes on income	5.4	6.8
Total current liabilities	156.8	149.0
Long-term debt	284.8	288.5
Deferred income taxes	22.3	21.7
Other liabilities	40.8	41.4
Liabilities of discontinued operations	1.9	6.0
Commitments and contingencies (Note 14)		
Stockholders' equity:		
Preferred stock - \$0.01 par value; 10,000,000 shares authorized; none issued	—	—
Common stock - \$0.01 par value; 400,000,000 shares authorized; 89,409,233 and 88,737,284 shares issued at June 30, 2017 and December 31, 2016, respectively	0.9	0.9
Additional paid-in capital	1,510.8	1,499.8
Accumulated deficit	(393.1)	(360.2)
Accumulated other comprehensive loss	(108.7)	(132.1)
Total stockholders' equity	1,009.9	1,008.4
Total liabilities and stockholders' equity	\$1,516.5	\$ 1,515.0

See accompanying Notes to Consolidated Financial Statements

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KNOWLES CORPORATION
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(in millions)
(unaudited)

	Common Stock	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balance at December 31, 2016	\$ 0.9	\$ 1,499.8	\$ (360.2)	\$ (132.1)	\$ 1,008.4
Net loss	—	—	(32.9)	—	(32.9)
Other comprehensive earnings, net of tax	—	—	—	23.4	23.4
Stock-based compensation expense	—	12.4	—	—	12.4
Common stock issued for exercise of stock options	—	3.1	—	—	3.1
Tax on restricted stock unit vesting	—	(4.5)	—	—	(4.5)
Balance at June 30, 2017	\$ 0.9	\$ 1,510.8	\$ (393.1)	\$ (108.7)	\$ 1,009.9

See accompanying Notes to Consolidated Financial Statements

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KNOWLES CORPORATION
 CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Six Months Ended June 30, 2017		2016	
Operating Activities				
Net loss	\$ (32.9)		\$ (54.0)	
Adjustments to reconcile net loss to cash from operating activities:				
Depreciation and amortization	29.9		39.4	
Impairment of intangibles	16.2		—	
Stock-based compensation	12.4		11.2	
Impairment charges on fixed and other assets	5.1		—	
Non-cash interest expense and amortization of debt issuance costs	3.7		2.0	
Deferred income taxes	0.8		2.2	
Loss on disposal of fixed assets	0.1		1.3	
Other, net	3.2		4.4	
Cash effect of changes in assets and liabilities (excluding effects of foreign exchange):				
Receivables, net	17.1		53.5	
Inventories, net	(32.3 )	)	(8.2))
Prepaid and other current assets	(2.4 )	)	(4.2))
Accounts payable	2.9		(29.1))
Accrued compensation and employee benefits	(5.8 )	)	(5.3))
Other accrued expenses	3.9		(0.6))
Accrued and deferred taxes, net	(3.0 )	)	0.4	
Other non-current assets and non-current liabilities	2.5		(2.8))
Net cash provided by operating activities	21.4		10.2	

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Investing Activities			
Proceeds from the sale of investment	—		2.0
Proceeds from the sale of property, plant and equipment	0.1		0.7
Acquisition of business (net of cash acquired)	(2.5))	—
Additions to property, plant and equipment	(31.4)	)	(20.2)
Net cash used in investing activities	(33.8)	)	(17.5)
Financing Activities			
Payments under revolving credit facility	—		(20.0)
Borrowings under revolving credit facility	—		20.0
Principal payments on term loan debt	(3.6)	)	(166.5)
Proceeds from issuance of convertible senior notes	—		172.5
Proceeds from issuance of warrants	—		39.1
Purchase of convertible note hedges	—		(44.5)
Debt issuance costs	—		(6.7)
Net proceeds from exercise of stock-based awards	3.1		—
Payments of capital lease obligations	(0.7)	)	(1.6)
Payment of taxes related to net share settlement of equity awards	(4.5)	)	(0.9)
Net cash used in financing activities	(5.7)	)	(8.6)
Effect of exchange rate changes on cash and cash equivalents	0.5		(0.2)
Net decrease in cash and cash equivalents	(17.6)	)	(16.1)
Cash and cash equivalents at beginning of period	66.2		63.3
Cash and cash equivalents at end of	\$ 48.6		\$ 47.2

period

See accompanying Notes to Consolidated Financial Statements

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(unaudited)

1. Basis of Presentation

Description of Business - Knowles Corporation (NYSE: KN) is a market leader and global supplier of advanced micro-acoustic, audio processing, and precision device solutions, serving the mobile consumer electronics, communications, medical, military, aerospace and industrial markets. Knowles uses its leading position in MEMS (micro-electro-mechanical systems) microphones and strong capabilities in audio processing technologies to optimize audio systems and improve the user experience in smartphones, tablets and wearables. Knowles is also the leader in acoustics components used in hearing aids and has a strong position in high-end oscillators (timing devices) and capacitors. The Company's focus on its customer, combined with its unique technology, proprietary manufacturing techniques, rigorous testing and global scale, enables the Company to deliver innovative solutions that optimize the user experience. References to "Knowles," "the Company," "we," "our" and "us" refer to Knowles Corporation and its consolidated subsidiaries.

Financial Statement Presentation - The accompanying unaudited interim Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the SEC for quarterly reports on Form 10-Q and do not include all of the information and note disclosures required by U.S. generally accepted accounting principles ("GAAP" or "U.S. GAAP") for complete financial statements. These unaudited interim Consolidated Financial Statements should therefore be read in conjunction with the Consolidated Financial Statements and Notes thereto for the year ended December 31, 2016 included in the Company's Annual Report on Form 10-K.

The accompanying unaudited interim Consolidated Financial Statements have been prepared in accordance with U.S. GAAP, which requires management to make estimates and assumptions that affect amounts reported in the Consolidated Financial Statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may differ from those estimates. The unaudited interim Consolidated Financial Statements reflect all adjustments of a normal, recurring nature that are, in the opinion of management, necessary for a fair statement of results for these interim periods. During the first quarter of 2017, the Company recorded a correcting entry of \$1.1 million related to inventory reserves and incentive compensation accruals. These items, which decreased loss before income taxes and discontinued operations, are not material to the Consolidated Financial Statements for any impacted period.

During the first quarter of 2017, the Company adopted the Accounting Standard Update ("ASU") 2016-16 issued in October 2016. The ASU requires the Company to recognize the income tax consequences of an intra-entity transfer of an asset, other than inventory, when the transfer occurs. The Company adopted this standard utilizing the modified retrospective approach and recognized the cumulative effect of the change, which resulted in the Company increasing the beginning balance of the Accumulated deficit line item by \$0.1 million on the Consolidated balance sheet. In addition, Other assets and deferred charges decreased by \$0.1 million as a result of this adoption. Refer to Note 16. Recent Accounting Standards for additional details.

In January 2017, the Company changed its allocation of resources and its internal reporting structure to facilitate delivering growth in its core business. Given these changes, beginning in January 2017, the Company's two reportable segments were as follows:

★Audio Segment

Our Audio group designs and manufactures innovative audio products, including acoustics like microphones and balanced armature speakers, signal processing technologies, and software and algorithms used in applications that

serve the mobile, ear and Internet of Things (IoT) markets. Its transducer products are used principally in hearing aid applications within the commercial audiology market. Locations include the corporate office in Itasca, Illinois; sales, support and engineering facilities in North America, Europe and Asia; and manufacturing facilities in Asia.

Precision Devices ("PD") Segment

Our PD group specializes in the design and manufacture of specialized electronic components used in medical and life science applications, as well as high-performance solutions and components used in communications infrastructure and a wide variety of other markets. Its oscillator products predominantly serve the telecom infrastructure market and its capacitor products are used in applications including radio, radar, satellite, power supplies, transceivers and medical implants serving the defense, aerospace, telecommunication and life sciences markets. Locations include the corporate office in Itasca, Illinois; and sales, support, engineering and manufacturing facilities in North America, Europe and Asia.

Financial reporting under this new structure is included within this report on Form 10-Q and historical financial segment information has been recast to conform to this new presentation within our financial statements.

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(unaudited)

On January 11, 2017, the Company completed an acquisition of certain assets of a capacitors manufacturer for cash consideration of \$4.0 million, of which \$2.5 million was paid during the first quarter of 2017, with the remaining \$1.5 million to be paid quarterly in equal installments from 2018 through 2019, less any purchase price adjustments. This acquisition's operations are included in the PD segment. The financial results of this acquisition were included in the Company's consolidated statements of earnings, comprehensive earnings and statement of cash flows beginning January 11, 2017.

As discussed in Note 2. Disposed and Discontinued Operations, the Company completed its sale of the speaker and receiver product line on July 7, 2016 ("speaker and receiver product line"). In accordance with Accounting Standards Codification ("ASC") No. 205-20, Presentation of Financial Statements - Discontinued Operations, the results of operations and related assets and liabilities for the speaker and receiver product line have been reclassified as discontinued operations for all periods presented.

Non-cash Investing Activities - Purchases of property, plant and equipment included in accounts payable at June 30, 2017 and 2016 were \$2.9 million and \$6.3 million, respectively. These non-cash amounts are not reflected as outflows to Additions to property, plant and equipment within investing activities of the Consolidated Statements of Cash Flows for the respective periods.

2. Disposed and Discontinued Operations

Management and the Board of Directors conduct strategic reviews of its businesses periodically. On February 11, 2016, the Company announced its intention to sell the speaker and receiver product line, and as a result, reclassified the speaker and receiver product line within the Audio segment to discontinued operations in the first quarter of 2016. On July 7, 2016, the Company completed the sale of its speaker and receiver product line for \$45.0 million in cash, less purchase price adjustments for a net amount received of \$40.6 million. The Company recorded a loss of \$25.6 million as a result of the sale, which included \$26.9 million of loss amounts reclassified from Accumulated other comprehensive loss into earnings related to currency translation adjustments. The results of discontinued operations for the three and six months ended June 30, 2017 and 2016 reflect the net earnings (loss) of the speaker and receiver product line.

Summarized results of the Company's discontinued operations are as follows:

(in millions)	Three Months		Six Months	
	Ended June 30, 2017	2016	Ended June 30, 2017	2016
Revenues	\$—	\$24.7	\$—	\$45.1
Cost of goods sold	(0.1)	27.1	(0.1)	55.7
Restructuring charges - cost of goods sold	—	7.2	—	9.3
Gross profit (loss)	0.1	(9.6)	0.1	(19.9)
Research and development expenses	—	3.2	—	6.7
Selling and administrative expenses	(0.4)	4.9	(0.5)	8.1
Restructuring charges	—	1.4	—	1.8
Operating (income) expenses	(0.4)	9.5	(0.5)	16.6
Earnings (loss) from discontinued operations before taxes	0.5	(19.1)	0.6	(36.5)
Benefit from income taxes	(0.1)	(1.3)	(1.5)	(1.8)
Earnings (loss) from discontinued operations, net of tax	\$0.6	\$(17.8)	\$2.1	\$(34.7)

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(unaudited)

Assets and liabilities of discontinued operations are summarized below:

(in millions)	June 30, December 31,	
	2017	2016
Assets of Discontinued Operations:		
Accounts receivable	\$ 0.7	\$ 0.6
Prepaid and other current assets	—	0.3
Total current assets	0.7	