

TWIN DISC INC
Form 10-Q
February 04, 2015

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 quarter ended December 26, 2014

Commission File Number 1-7635

TWIN DISC, INCORPORATED
(Exact name of registrant as specified in its charter)

Wisconsin
(State or other jurisdiction of
Incorporation or organization)

39-0667110
(I.R.S. Employer
Identification No.)

1328 Racine Street, Racine, Wisconsin 53403
(Address of principal executive offices)

(262) 638-4000
(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 website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition 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

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At January 28, 2015, the registrant had 11,285,328 shares of its common stock outstanding.

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

TWIN DISC, INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)
(UNAUDITED)

| | December 26, 2014 | June 30, 2014 |
|--|-------------------------|------------------|
| Assets | | |
| Current assets: | | |
| Cash | \$25,173 | \$24,757 |
| Trade accounts receivable, net | 40,727 | 40,219 |
| Inventories, net | 90,777 | 97,579 |
| Deferred income taxes | 4,705 | 4,779 |
| Other | 12,357 | 12,763 |
| Total current assets | 173,739 | 180,097 |
| Property, plant and equipment, net | 57,745 | 60,267 |
| Goodwill, net | 13,093 | 13,463 |
| Deferred income taxes | 1,384 | 2,556 |
| Intangible assets, net | 2,491 | 2,797 |
| Other assets | 6,587 | 7,805 |
| Total assets | \$255,039 | \$266,985 |
| Liabilities and Equity | | |
| Current liabilities: | | |
| Short-term borrowings and current maturities of long-term debt | \$3,575 | \$3,604 |
| Accounts payable | 21,226 | 22,111 |
| Accrued liabilities | 30,788 | 31,265 |
| Total current liabilities | 55,589 | 56,980 |
| Long-term debt | 13,172 | 14,800 |
| Accrued retirement benefits | 31,724 | 37,006 |
| Deferred income taxes | 1,453 | 1,778 |
| Other long-term liabilities | 2,961 | 4,110 |
| Total liabilities | 104,899 | 114,674 |
| Commitments and contingencies (Note D) | | |
| Equity | | |
| Twin Disc shareholders' equity: | | |
| Preferred shares authorized: 200,000; issued: none; no par value | - | - |
| Common shares authorized: 30,000,000; issued: 13,099,468; no par value | 11,697 | 11,973 |
| Retained earnings | 189,455 | 183,695 |
| Accumulated other comprehensive loss | (23,778) | (15,943) |

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| | | |
|---|-----------|-----------|
| | 177,374 | 179,725 |
| Less treasury stock, at cost (1,814,140 and 1,837,595 shares, respectively) | 27,782 | 28,141 |
| Total Twin Disc shareholders' equity | 149,592 | 151,584 |
| Noncontrolling interest | 548 | 727 |
| Total equity | 150,140 | 152,311 |
| Total liabilities and equity | \$255,039 | \$266,985 |

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

TWIN DISC, INCORPORATED
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (IN THOUSANDS, EXCEPT PER SHARE DATA)
 (UNAUDITED)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | Dec. 26, 2014 | Dec. 27, 2013 | Dec. 26, 2014 | Dec. 27, 2013 |
| Net sales | \$72,691 | \$63,212 | \$137,515 | \$129,638 |
| Cost of goods sold | 50,588 | 44,668 | 93,023 | 90,427 |
| Gross profit | 22,103 | 18,544 | 44,492 | 39,211 |
| Marketing, engineering and administrative expenses | 16,507 | 17,185 | 32,417 | 32,702 |
| Restructuring of operations | - | - | - | 1,094 |
| Earnings from operations | 5,596 | 1,359 | 12,075 | 5,415 |
| Interest expense | 150 | 223 | 314 | 477 |
| Other (income) expense, net | (142) | (119) | (482) | (153) |
| | 8 | 104 | (168) | 324 |
| Earnings before income taxes and noncontrolling interest | 5,588 | 1,255 | 12,243 | 5,091 |
| Income taxes | 1,788 | 689 | 4,381 | 3,161 |
| Net earnings | 3,800 | 566 | 7,862 | 1,930 |
| Less: Net earnings attributable to noncontrolling interest, net of tax | (53) | (48) | (72) | (135) |
| Net earnings attributable to Twin Disc | \$3,747 | \$518 | \$7,790 | \$1,795 |
| Dividends per share | \$0.09 | \$0.09 | \$0.18 | \$0.18 |
| Earnings per share data: | | | | |
| Basic earnings per share attributable to Twin Disc common shareholders | \$0.33 | \$0.05 | \$0.69 | \$0.16 |
| Diluted earnings per share attributable to Twin Disc common shareholders | \$0.33 | \$0.05 | \$0.69 | \$0.16 |
| Weighted average shares outstanding data: | | | | |
| Basic shares outstanding | 11,280 | 11,264 | 11,276 | 11,251 |
| Dilutive stock awards | 4 | 6 | 5 | 6 |
| Diluted shares outstanding | 11,284 | 11,270 | 11,281 | 11,257 |
| Comprehensive income: | | | | |

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| | | | | |
|--|----------|---------|----------|---------|
| Net earnings | \$3,800 | \$566 | \$7,862 | \$1,930 |
| Benefit plan adjustments, net of income taxes of \$305, \$354, \$595 and \$706, respectively | 515 | 528 | 1,003 | 978 |
| Foreign currency translation adjustment | (4,542) | 1,119 | (8,870) | 2,999 |
| Comprehensive (loss) income | (227) | 2,213 | (5) | 5,907 |
| Less: comprehensive income attributable to noncontrolling interest | (13) | (53) | (41) | (94) |
| Comprehensive (loss) income attributable to Twin Disc | \$(240) | \$2,160 | \$(46) | \$5,813 |

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

TWIN DISC, INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

| | Six Months Ended | |
|---|-------------------------|-------------------------|
| | December 26, 2014 | December 27, 2013 |
| Cash flows from operating activities: | | |
| Net earnings | \$7,862 | \$1,930 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 5,171 | 5,198 |
| Restructuring of operations | - | 1,094 |
| Other non-cash changes, net | 1,057 | (18) |
| Net change in operating assets and liabilities | (4,646) | 11,413 |
| Net cash provided by operating activities | 9,444 | 19,617 |
| Cash flows from investing activities: | | |
| Acquisitions of fixed assets | (4,520) | (3,004) |
| Proceeds from sale of fixed assets | 101 | 46 |
| Other, net | 1,553 | (244) |
| Net cash used by investing activities | (2,866) | (3,202) |
| Cash flows from financing activities: | | |
| Payments of notes payable | (28) | (39) |
| Borrowings under revolving loan agreement | 40,225 | 31,200 |
| Repayments under revolving loan agreement | (41,850) | (37,252) |
| Proceeds from exercise of stock options | 15 | - |

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| | | |
|---|----------|-----------|
| Dividends paid to shareholders | (2,030) | (2,031) |
| Dividends paid to noncontrolling interest | (219) | (486) |
| Excess tax (shortfall) benefits from stock compensation | (36) | 524 |
| Payments of withholding taxes on stock compensation | (313) | (2,170) |
| Net cash used by financing activities | (4,236) | (10,254) |
| Effect of exchange rate changes on cash | (1,926) | 239 |
| Net change in cash | 416 | 6,400 |
| Cash: | | |
| Beginning of period | 24,757 | 20,724 |
| End of period | \$25,173 | \$27,124 |

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

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

A. Basis of Presentation

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

During the first quarter of fiscal 2014, the Company recorded out-of-period adjustments related to the correction of errors identified late in the year-end closing process of fiscal 2013 that were deemed immaterial for adjustment to the fiscal 2013 financial statements. The impact of these corrections to the fiscal 2014 first quarter was to increase earnings before income taxes and noncontrolling interest by \$437,000 and increase net earnings attributable to Twin Disc by \$69,000 (after considering applicable tax effects). The nature of these errors is as follows:

- The Company had over accrued for certain payroll related items totaling \$337,000 as of June 30, 2013, resulting in an increase to earnings from operations in the first quarter of fiscal 2014.
- The Company had overstated its warranty accrual by \$217,000 as of June 30, 2013, resulting in an increase to earnings from operations in the first quarter of fiscal 2014.
- The Company determined that work-in-process inventory had been overstated by \$117,000 as of June 30, 2013. As a result, additional cost of goods sold was recorded in the first quarter of fiscal 2014, resulting in a decrease to earnings from operations in the first quarter of fiscal 2014.
- The Company’s deferred tax liabilities were understated by \$285,000 as of June 30, 2013, resulting in additional tax expense in the first quarter of fiscal 2014.

The Company does not believe these errors were material to its financial statements for any prior period, nor that the correction of these errors was material to the six months ended December 27, 2013.

New Accounting Releases

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

In June 2014, the FASB issued stock compensation guidance requiring that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 (the Company’s fiscal 2017). The adoption of this guidance is not expected to have a material impact on the Company’s financial disclosures.

In May 2014, the FASB issued updated guidance on revenue from contracts with customers. This revenue recognition guidance supersedes existing US GAAP guidance, including most industry-specific guidance. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance identifies steps to apply in achieving this principle. This updated guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016 (the Company's fiscal 2018). The Company is currently evaluating the potential impact of this guidance on the Company's financial disclosures and results.

In April 2014, the FASB issued updated guidance on the reporting for discontinued operations. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. The new guidance also requires expanded financial disclosures about discontinued operations. The amendments in this updated guidance are effective for the first quarter of the Company's fiscal 2016. The adoption of this guidance is not expected to have a material impact on the Company's financial disclosures.

In July 2013, the FASB issued guidance stating that, except in certain defined circumstances, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2013 (the Company's fiscal 2015). The adoption of this guidance did not have a material impact on the Company's financial disclosures.

B. Inventory

The major classes of inventories were as follows (in thousands):

| | December 26, 2014 | June 30, 2014 |
|-----------------|-------------------------|------------------|
| Inventories: | | |
| Finished parts | \$59,235 | \$66,418 |
| Work in process | 12,128 | 12,419 |
| Raw materials | 19,414 | 18,742 |
| | \$90,777 | \$97,579 |

C. Warranty

The Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its suppliers. However, its warranty obligation is affected by product failure rates, the number of units affected by the failure and the expense involved in satisfactorily addressing the situation. The warranty reserve is established based on our best estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. When evaluating the adequacy of the reserve for warranty costs, management takes into consideration the term of the warranty coverage, historical claim rates and costs of repair, knowledge of the type and volume of new products and economic trends. While we believe the warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due and payable in the future could differ materially from what actually transpires. The following is a listing of the activity in the warranty reserve during the three and six month periods ended December 26, 2014 and December 27, 2013 (in thousands):

| Three Months Ended | | Six Months Ended | |
|--------------------|----------|------------------|----------|
| Dec. 26, | Dec. 27, | Dec. 26, | Dec. 27, |

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| | 2014 | 2013 | 2014 | 2013 |
|--------------------------------------|---------|---------|---------|---------|
| Reserve balance, beginning of period | \$5,835 | \$5,664 | \$5,968 | \$5,701 |
| Current period expense | 683 | 771 | 1,230 | 1,142 |
| Payments or credits to customers | (487) | (767) | (1,029) | (1,148) |
| Translation | (79) | 132 | (217) | 105 |
| Reserve balance, end of period | \$5,952 | \$5,800 | \$5,952 | \$5,800 |

The current portion of the warranty accrual (\$3,934,000) is reflected in accrued liabilities, while the long-term portion (\$2,018,000) is included in other long-term liabilities on the Consolidated Balance Sheets as of December 26, 2014.

D. Contingencies

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

E. Business Segments

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

The Company has two reportable segments: manufacturing and distribution. These segments are managed separately because each provides different services and requires different technology and marketing strategies. The accounting practices of the segments are the same as those described in the summary of significant accounting policies. Transfers among segments are at established inter-company selling prices. Management evaluates the performance of its segments based on net earnings.

Information about the Company's segments is summarized as follows (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | Dec. 26, 2014 | Dec. 27, 2013 | Dec. 26, 2014 | Dec. 27, 2013 |
| Manufacturing segment sales | \$63,350 | \$57,010 | \$123,624 | \$110,268 |
| Distribution segment sales | 28,975 | 30,563 | 52,986 | 61,577 |
| Inter/Intra segment elimination - manufacturing | (17,067) | (21,088) | (34,461) | (36,220) |
| Inter/Intra segment elimination - distribution | (2,567) | (3,273) | (4,634) | (5,987) |
| Net sales | \$72,691 | \$63,212 | \$137,515 | \$129,638 |
| Manufacturing segment net earnings | \$4,034 | \$1,653 | \$9,204 | \$3,670 |
| Distribution segment net earnings | 1,777 | 1,422 | 2,956 | 3,303 |
| Corporate and eliminations | (2,064) | (2,557) | (4,370) | (5,178) |

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| | | | | |
|---|-----------|-----------|---------|---------|
| Net earnings attributable to Twin Disc | \$3,747 | \$518 | \$7,790 | \$1,795 |
| | Dec. 26, | June 30, | | |
| Assets | 2014 | 2014 | | |
| Manufacturing segment assets | \$252,529 | \$254,652 | | |
| Distribution segment assets | 56,015 | 57,233 | | |
| Corporate assets and elimination of inter-company assets | (53,505) | (44,900) | | |
| Total assets | \$255,039 | \$266,985 | | |

F. Stock-Based Compensation

In the first half of fiscal 2015 and 2014, the Company granted a target number of 15,561 and 43,154 performance stock unit awards, respectively, to various employees of the Company, including executive officers. The performance stock unit awards granted in fiscal 2015 will vest if the Company achieves a specified target objective relating to consolidated economic profit (as defined in the Performance Stock Unit Award Grant Agreement) in the cumulative three fiscal year period ending June 30, 2017. The performance stock unit awards granted in fiscal 2015 are subject to adjustment if the Company's economic profit for the period falls below or exceeds the specified target objective, and the maximum number of performance stock units that can be awarded if the target objective is exceeded is 15,796. Based upon actual results to date and the low probability of achieving the threshold performance levels, the Company is currently not accruing the performance stock unit awards granted in fiscal 2015. The performance stock unit awards granted in fiscal 2014 will vest if the Company achieves a specified target objective relating to consolidated economic profit (as defined in the Performance Stock Unit Award Grant Agreement) in the cumulative three fiscal year period ending June 30, 2016. The performance stock unit awards granted in fiscal 2014 are subject to adjustment if the Company's economic profit for the period falls below or exceeds the specified target objective, and the maximum number of performance stock units that can be awarded if the target objective is exceeded is 23,862. Based upon actual results to date and the low probability of achieving the threshold performance levels, the Company is currently not accruing the performance stock unit awards granted in fiscal 2014. There were 52,041 and 54,874 unvested stock unit awards outstanding at December 26, 2014 and December 27, 2013, respectively. The weighted average grant date fair value of the unvested awards at December 26, 2014 was \$24.99. The performance stock unit awards are remeasured at fair-value based upon the Company's stock price at the end of each reporting period. The fair-value of the stock unit awards are expensed over the performance period for the shares that are expected to ultimately vest. There was no compensation expense for the three and six months ended December 26, 2014 and December 27, 2013, related to the performance stock unit award grants. At December 26, 2014, the Company had \$1,030,000 of unrecognized compensation expense related to the unvested shares that would vest if the specified target objective was achieved for the fiscal 2015, 2014 and 2013 awards. The total fair value of performance stock unit awards vested as of December 26, 2014 and December 27, 2013 were \$0. The performance stock unit awards are cash based, and would therefore be recorded as a liability on the Company's Consolidated Balance Sheets. As of December 26, 2014, these awards are \$0. As of June 30, 2014, there were no awards included in "Liabilities" due to actual results to date and the low probability of achieving any of the threshold performance levels.

In the first half of fiscal 2015 and 2014, the Company granted a target number of 15,561 and 17,312 performance stock awards, respectively, to various employees of the Company, including executive officers. The performance stock awards granted in fiscal 2015 will vest if the Company achieves a specified target objective relating to consolidated economic profit (as defined in the Performance Stock Award Grant Agreement) in the cumulative three fiscal year period ending June 30, 2017. The performance stock awards granted in fiscal 2015 are subject to adjustment if the Company's economic profit for the period falls below or exceeds the specified target objective, and the maximum number of performance shares that can be awarded if the target objective is exceeded is 15,796. Based

upon actual results to date and the low probability of achieving the threshold performance levels, the Company is currently not accruing the performance stock awards granted in fiscal 2015. The performance stock awards granted in fiscal 2014 will vest if the Company achieves a specified target objective relating to consolidated economic profit (as defined in the Performance Stock Award Grant Agreement) in the cumulative three fiscal year period ending June 30, 2016. The performance stock awards granted in fiscal 2014 are subject to adjustment if the Company's economic profit for the period falls below or exceeds the specified target objective, and the maximum number of performance shares that can be awarded if the target objective is exceeded is 18,694. Based upon actual results to date and the low probability of achieving the threshold performance levels, the Company is currently not accruing the performance stock awards granted in fiscal 2014. There were 54,863 and 59,453 unvested stock awards outstanding at December 26, 2014 and December 27, 2013, respectively. The fair value of the stock awards (on the date of grant) is expensed over the performance period for the shares that are expected to ultimately vest. There was no compensation expense for the three and six months ended December 26, 2014 and December 27, 2013, related to performance stock awards. The weighted average grant date fair value of the unvested awards at December 26, 2014 was \$24.39. At December 26, 2014, the Company had \$1,338,000 of unrecognized compensation expense related to the unvested shares that would vest if the specified target objective was achieved for the fiscal 2015, 2014 and 2013 awards. The total fair value of performance stock awards vested as of December 26, 2014 and December 27, 2013 were \$0.

In addition to the performance shares mentioned above, the Company has unvested restricted stock outstanding that will vest if certain service conditions are fulfilled. The fair value of the restricted stock grants is recorded as compensation over the vesting period, which is generally 1 to 4 years. During the first half of fiscal 2015 and 2014, the Company granted 51,716 and 51,004 service based restricted shares, respectively, to employees in each year. There were 115,106 and 119,297 unvested shares outstanding at December 26, 2014 and December 27, 2013, respectively. The compensation expense for the three and six months ended December 26, 2014, related to these service-based awards approximated \$309,000 and \$417,000, respectively. The compensation expense for the three and six months ended December 27, 2013, related to these service-based awards approximated \$308,000 and \$626,000, respectively. The total fair value of restricted stock grants vested as of December 26, 2014 and December 27, 2013 was \$941,000 and \$3,053,000, respectively. As of December 26, 2014, the Company had \$1,695,000 of unrecognized compensation expense related to restricted stock which will be recognized over the next three years.

G. Pension and Other Postretirement Benefit Plans

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

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|--------------------|------------------|------------------|------------------|
| | Dec. 26, 2014 | Dec. 27, 2013 | Dec. 26, 2014 | Dec. 27, 2013 |
| Pension Benefits: | | | | |
| Service cost | \$120 | \$135 | \$239 | \$267 |
| Interest cost | 1,224 | 1,356 | 2,446 | 2,711 |
| Expected return on plan assets | (1,683) | (1,648) | (3,364) | (3,294) |
| Amortization of transition obligation | 10 | 19 | 19 | 38 |
| Amortization of net loss | 609 | 714 | 1,218 | 1,427 |
| Net periodic benefit cost | \$280 | \$576 | \$558 | \$1,149 |
| Postretirement Benefits: | | | | |
| Service cost | \$7 | \$9 | \$15 | \$19 |
| Interest cost | 145 | 164 | 290 | 329 |

| | | | | |
|------------------------------------|-------|-------|-------|-------|
| Amortization of net actuarial loss | 159 | 151 | 318 | 301 |
| Net periodic benefit cost | \$311 | \$324 | \$623 | \$649 |

The Company expects to contribute approximately \$6,172,000 to its pension plans in fiscal 2015. As of December 26, 2014, \$4,506,000 in contributions have been made.

The Company has reclassified \$515,000 (net of \$305,000 in taxes) and \$1,003,000 (net of \$595,000 in taxes) of benefit plan adjustments from accumulated other comprehensive loss into earnings during the three and six months ended December 26, 2014. The Company has reclassified \$528,000 (net of \$354,000 in taxes) and \$978,000 (net of \$706,000 in taxes) of benefit plan adjustments from accumulated other comprehensive loss during the three and six months ended December 27, 2013. These reclassifications are included in the computation of net periodic benefit cost.

H. Income Taxes

For the six months ended December 26, 2014 and December 27, 2013, the Company's effective income tax rate was 35.8% and 62.1% respectively. Both periods were impacted by non-deductible operating losses in a certain foreign jurisdiction that is subject to a full valuation allowance. The fiscal 2015 rate reflects increased domestic earnings offset by the Section 199 credit and benefits from the cumulative effect of the reinstatement of the federal research and development tax credit. During the second quarter of fiscal 2015 the Company also recognized previously unrecognized tax benefits due to the resolution of a state income tax audit, as discussed below. The fiscal 2014 rate reflects the impact of reduced domestic earnings base offset by a limited Section 199 credit and reduced research and development tax credit resulting from the expiration of the credit.

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

The Company has not provided for additional U.S. income taxes on cumulative earnings of consolidated foreign subsidiaries that are considered to be reinvested indefinitely. The Company reaffirms its position that these earnings remain permanently invested, and has no plans to repatriate funds to the U.S. for the foreseeable future. Such earnings could become taxable upon the sale or liquidation of these foreign subsidiaries or upon dividend repatriation. It is not practicable to estimate the amount of unrecognized withholding taxes and deferred tax liability on such earnings. The Company's intent is for such earnings to be reinvested by the foreign subsidiaries.

Accounting policies for interim reporting require the Company to adjust its effective tax rate each quarter to be consistent with the estimated annual effective tax rate. Under this effective tax rate methodology, the Company applies an estimated annual income tax rate to its year-to-date ordinary earnings to derive its income tax provision each quarter. The impact of the Company's operations in certain foreign locations is removed from the overall effective tax rate methodology and recorded directly based upon year-to-date results as these operations anticipate net operating losses for the year for which no tax benefit can be recognized.

The Company has approximately \$803,000 of unrecognized tax benefits, including related interest and penalties, as of December 26, 2014, which, if recognized, could favorably impact the effective tax rate. During the second quarter of fiscal 2015 the Company finalized a \$1,300,000 audit settlement with the state of Wisconsin for fiscal years 2001 through 2009 which resulted in a decrease in unrecognized tax benefits of \$1,100,000. Additionally, in the third

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quarter of fiscal 2015, the Company will file the associated amended state returns for fiscal years 2010 through 2013, resulting in an additional decrease in unrecognized tax benefits of \$100,000. The Company does not anticipate any further significant changes to unrecognized tax benefits in the next twelve months, other than changes from the expiration of statutes of limitations.

Annually, the Company files income tax returns in various taxing jurisdictions inside and outside the United States. In general, the tax years that remain subject to examination are 2009 through 2013 for the major operations in Italy, Canada, Belgium, and Japan. The tax years open to examination in the U.S. are for years subsequent to fiscal 2011. The Company has not been notified of any tax examination covering open periods.

I. Goodwill and Other Intangibles

The changes in the carrying amount of goodwill, all of which is allocated to the manufacturing segment, for the six months ended December 26, 2014 were as follows (in thousands):

| | Gross Carrying Amount | Accumulated Impairment | Net Book Value |
|---------------------------------|-----------------------------|---------------------------|----------------------|
| Balance at June 30, 2014 | \$ 17,133 | (\$ 3,670) | \$ 13,463 |
| Translation adjustment | (370) | - | (370) |
| Balance at December 26, 2014 | \$ 16,763 | (\$ 3,670) | \$ 13,093 |

The gross carrying amount and accumulated amortization of the Company's intangible assets that have definite useful lives and are subject to amortization as of December 26, 2014 and June 30, 2014 were as follows (in thousands):

| | December 26, 2014 | | | |
|---------------------------|-----------------------------|-----------------------------|---------------------------|-------------------|
| | Gross Carrying Amount | Accumulated Amortization | Accumulated Impairment | Net Book Value |
| Licensing agreements | \$ 3,015 | (\$ 2,475) | \$ - | \$ 540 |
| Non-compete agreements | 2,128 | (2,045) | (83) | - |
| Trade name | 1,846 | (148) | - | 1,698 |
| Other | 6,476 | (5,236) | (1,194) | 46 |
| | \$13,465 | (\$ 9,904) | (\$ 1,277) | \$ 2,284 |

| | June 30, 2014 | | | |
|---------------------------|-----------------------------|-----------------------------|---------------------------|-------------------|
| | Gross Carrying Amount | Accumulated Amortization | Accumulated Impairment | Net Book Value |
| Licensing agreements | \$ 3,015 | (\$ 2,445) | \$ - | \$ 570 |
| Non-compete agreements | 2,128 | (2,045) | (83) | - |
| Trade name | 2,009 | (100) | - | 1,909 |

| | | | | |
|-------|----------|------------|------------|----------|
| Other | 6,482 | (5,193) | (1,194) | 95 |
| | \$13,634 | (\$ 9,783) | (\$ 1,277) | \$ 2,574 |

The weighted average remaining useful life of the intangible assets included in the table above is approximately 16 years.

Intangible amortization expense was \$59,000 and \$121,000 for the three and six months ended December 26, 2014, and \$119,000 and \$235,000 for the three and six months ended December 27, 2013, respectively. Estimated intangible amortization expense for the remainder of fiscal 2015 and each of the next five fiscal years is as follows (in thousands):

| Fiscal Year | |
|-------------|-------|
| 2015 | \$118 |
| 2016 | 156 |
| 2017 | 152 |
| 2018 | 152 |
| 2019 | 152 |
| 2020 | 152 |

The gross carrying amount of the Company's intangible assets that have indefinite lives and are not subject to amortization as of December 26, 2014 and June 30, 2014 are \$207,000 and \$223,000, respectively. These assets are comprised of acquired trade names.

J. Long-term Debt

Long-term debt at December 26, 2014 and June 30, 2014 consisted of the following (in thousands):

| | December 26, 2014 | June 30, 2014 |
|--|----------------------|------------------|
| Revolving loan | \$9,575 | \$11,200 |
| 10-year unsecured senior notes | 7,143 | 7,143 |
| Other | 29 | 61 |
| Subtotal | 16,747 | 18,404 |
| Less: current maturities and short-term borrowings | (3,575) | (3,604) |
| Total long-term debt | \$13,172 | \$14,800 |

The revolving loan and unsecured senior notes listed above are subject to certain covenants, including restrictions on investments, acquisitions and indebtedness. Financial covenants, as defined, include a minimum consolidated net worth, a minimum EBITDA for the most recent four fiscal quarters, and a maximum total funded debt to EBITDA ratio. As of December 26, 2014, the Company was in compliance with these covenants.

The fair value of long-term debt is estimated by discounting the future cash flows at rates offered to the Company for similar debt instruments of comparable maturities. This rate was represented by the US Treasury Three-Year Yield Curve Rate (1.19% and 0.88% for December 26, 2014 and June 30, 2014, respectively), plus the current add-on related to the revolving loan agreement (1.00% for December 26, 2014 and June 30, 2014) resulting in a total rate of 2.19% and 1.88% for December 26, 2014 and June 30, 2014, respectively. The fair value of the Company's 10-year unsecured senior notes due April 10, 2016 was approximately \$7,441,000 and \$7,605,000 at December 26, 2014 and June 30, 2014, respectively. The Company's revolving loan agreement approximates fair value at December 26, 2014 and June 30, 2014. If measured at fair value in the financial statements, long-term debt (including the current portion)

would be classified as Level 2 in the fair value hierarchy.

K. Shareholders' Equity

On February 1, 2008, the Board of Directors authorized the purchase of 500,000 shares of Common Stock at market values. On July 27, 2012, the Board of Directors authorized the purchase of an additional 375,000 shares of Common Stock at market values. These authorizations have no expiration. The Company made open market purchases of 125,000 shares of its outstanding Common Stock during fiscal 2012 and 185,000 shares during fiscal 2013.

The following is a reconciliation of the Company's equity balances for the first fiscal six months of 2014 and 2015 (in thousands):

| | Twin Disc, Inc. Shareholders' Equity | | | | | |
|--|--------------------------------------|-----------|---------------|------------|-------------|-----------|
| | Accumulated | | | | | |
| | Common | Retained | Other | Treasury | Non- | Total |
| | Stock | Earnings | Comprehensive | Stock | Controlling | Equity |
| | | | Income (Loss) | | Interest | |
| Balance-June 30, 2013 | \$13,183 | \$184,110 | (\$25,899) | (\$28,890) | \$1,058 | \$143,562 |
| Net income | | 1,795 | | | 135 | 1,930 |
| Translation adjustments | | | 3,039 | | (40) | 2,999 |
| Benefit plan adjustments, net of tax | | | 978 | | | 978 |
| Cash dividends | | (2,031) | | | (486) | (2,517) |
| Compensation expense and windfall tax benefits | 1,150 | | | | | 1,150 |
| Shares (acquired) issued, net | (2,965) | | | 795 | | (2,170) |
| Balance-December 27, 2013 | \$11,368 | \$183,874 | (\$21,882) | (\$28,095) | \$667 | \$145,932 |

| | Twin Disc, Inc. Shareholders' Equity | | | | | |
|--|--------------------------------------|-----------|---------------|------------|-------------|-----------|
| | Accumulated | | | | | |
| | Common | Retained | Other | Treasury | Non- | Total |
| | Stock | Earnings | Comprehensive | Stock | Controlling | Equity |
| | | | Income (Loss) | | Interest | |
| Balance-June 30, 2014 | \$11,973 | \$183,695 | (\$15,943) | (\$28,141) | \$727 | \$152,311 |
| Net income | | 7,790 | | | 72 | 7,862 |
| Translation adjustments | | | (8,838) | | (32) | (8,870) |
| Benefit plan adjustments, net of tax | | | 1,003 | | | 1,003 |
| Cash dividends | | (2,030) | | | (219) | (2,249) |
| Compensation expense and windfall tax benefits | 381 | | | | | 381 |
| Shares (acquired) issued, net | (657) | | | 359 | | (298) |
| Balance-December 26, 2014 | \$11,697 | \$189,455 | (\$23,778) | (\$27,782) | \$548 | \$150,140 |

Reconciliations for the changes in accumulated other comprehensive income (loss), net of tax, by component for the three months ended September 26, and December 26, 2014, and September 27, and December 27, 2013 are as follows:

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| | Translation Adjustment | Benefit Plan Adjustment |
|--|------------------------|-------------------------|
| Balance at June 30, 2014 | \$ 20,779 | (\$36,722) |
| Other comprehensive loss before reclassifications | (4,337) | - |
| Amounts reclassified from accumulated other comprehensive income | - | 488 |
| Net current period other comprehensive income | (4,337) | 488 |
| Balance at September 26, 2014 | \$ 16,442 | (\$36,234) |
| Other comprehensive loss before reclassifications | (4,501) | 27 |
| Amounts reclassified from accumulated other comprehensive income | - | 488 |
| Net current period other comprehensive income | (4,501) | 515 |
| Balance at December 26, 2014 | \$ 11,941 | (\$35,719) |

| | Translation Adjustment | Benefit Plan Adjustment |
|--|------------------------|-------------------------|
| Balance at June 30, 2013 | \$ 16,949 | (\$42,848) |
| Other comprehensive loss before reclassifications | 1,926 | (62) |
| Amounts reclassified from accumulated other comprehensive income | - | 512 |
| Net current period other comprehensive income | 1,926 | 450 |
| Balance at September 27, 2013 | \$ 18,875 | (\$42,398) |
| Other comprehensive loss before reclassifications | 1,113 | 14 |
| Amounts reclassified from accumulated other comprehensive income | - | 514 |
| Net current period other comprehensive income | 1,113 | 528 |
| Balance at December 27, 2013 | \$ 19,988 | (\$41,870) |

Reconciliations for the reclassifications out of accumulated other comprehensive income (loss), net of tax for the three and six months ended December 26, 2014 are as follows:

| | Amount Reclassified Three Months Ended December 26, 2014 | Amount Reclassified Six Months Ended December 26, 2014 |
|--|--|--|
| Amortization of benefit plan items | | |
| Actuarial losses | \$ 768 | \$ 1,536 |
| | (a) | (a) |
| Transition asset and prior service benefit | 10 | 19 |
| Total before tax benefit | 778 | 1,555 |
| Tax benefit | 290 | 579 |
| Total reclassification net of tax | \$ 488 | \$ 976 |

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

Reconciliations for the reclassifications out of accumulated other comprehensive income (loss), net of tax for the three and six months ended December 27, 2013 are as follows:

| | Amount Reclassified Three Months Ended December 27, 2013 | Amount Reclassified Six Months Ended December 27, 2013 |
|--|--|--|
| Amortization of benefit plan items | | |
| Actuarial losses | \$ 865 | \$ 1,728 |
| | (a) | (a) |
| Transition asset and prior service benefit | 19 | 38 |
| Total before tax benefit | 884 | 1,766 |
| Tax benefit | 370 | 740 |
| Total reclassification net of tax | \$ 514 | \$ 1,026 |

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

L. Restructuring of Operations

During the first quarter of fiscal 2014, the Company recorded a pre-tax restructuring charge of \$1,094,000 representing the incremental cost above the minimum legal indemnity for a targeted workforce reduction at its Belgian operation, following finalization of negotiations with the local labor union. The minimum legal indemnity of \$548,000 was recorded in the fourth quarter of fiscal 2013, upon announcement of the intended restructuring action. During fiscal 2014, the Company made cash payments of \$857,000, resulting in an accrual balance at June 30, 2014 of \$785,000. The Company made additional payments of \$11,000 in the first half of fiscal 2015, resulting in a December 26, 2014 balance of \$688,000 after a foreign exchange impact of \$86,000. This remaining obligation relates to increased pension benefits agreed to as part of the restructuring and is expected to be paid out over the next several years.

Item 2. Management Discussion and Analysis

In the financial review that follows, we discuss our results of operations, financial condition and certain other information. This discussion should be read in conjunction with our consolidated fiscal 2014 financial statements and related notes.

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

In addition to the assumptions and information referred to specifically in the forward-looking statements, other factors, including but not limited to those factors discussed under Item 1A, Risk Factors, of the Company's Annual Report filed on Form 10-K for June 30, 2014 could cause actual results to be materially different from what is presented here.

Results of Operations

(In thousands)

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| | Three Months Ended | | | | Six Months Ended | | | |
|--|----------------------|-------|----------------------|-------|----------------------|-------|----------------------|-------|
| | December 26, 2014 | % | December 27, 2013 | % | December 26, 2014 | % | December 27, 2013 | % |
| Net sales | \$72,691 | | \$63,212 | | \$137,515 | | \$129,638 | |
| Cost of goods sold | 50,588 | | 44,668 | | 93,023 | | 90,427 | |
| Gross profit | 22,103 | 30.4% | 18,544 | 29.3% | 44,492 | 32.4% | 39,211 | 30.2% |
| Marketing, engineering and administrative expenses | 16,507 | 22.7% | 17,185 | 27.2% | 32,417 | 23.6% | 32,702 | 25.2% |
| Restructuring of operations | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 1,094 | 0.8% |
| Earnings from operations | \$5,596 | 7.7% | \$1,359 | 2.1% | \$12,075 | 8.8% | \$5,415 | 4.2% |

Comparison of the Second Quarter of FY 2015 with the Second Quarter of FY 2014

Net sales for the second quarter increased 15.0%, or \$9.5 million, to \$72.7 million from \$63.2 million in the same period a year ago. Compared to the second quarter of fiscal 2014, on average, the U.S. dollar strengthened against the euro and Asian currencies. The net translation effect of this on foreign operations was to decrease revenues by approximately \$1.5 million versus the prior year, before eliminations. The increase in sales was primarily due to increased shipments at the Company's North American manufacturing and distribution operations across most product markets, only partially offset by moderating demand in the Company's Asian markets for commercial marine and oil and gas products. Demand from customers in Europe remains weak and has moderated somewhat in Asia, while overall demand in North America remains stable influenced by the Company's commercial marine, industrial products, and oil and gas markets. In the second fiscal quarter, sales to North American customers were approximately 53% of total consolidated net sales compared to 45% for all of fiscal 2014. Sales to Asia Pacific, which were at record levels and reached nearly 29% of total consolidated sales for all of fiscal 2014, were 23% in the second fiscal quarter of 2015, as the Company experienced lower shipments to oil and gas and commercial marine customers in China (which represented 9.1% of sales in the second fiscal quarter compared to 12.8% for all of fiscal 2014).

Sales at our manufacturing segment were up 11.1%, or \$6.3 million, versus the same period last year. In the current fiscal year's second quarter, our U.S. manufacturing operation, the largest, experienced a 17.1% increase in sales versus the second fiscal quarter of 2014. The primary driver for this increase was increased shipments of pressure pumping transmissions for the North American oil and gas market, increased aftermarket sales and growth in the Company's North American commercial marine markets. This was only partially offset by lower shipments of pressure pumping and commercial marine transmissions for the Asian market, primarily China. The Company's Italian manufacturing operations, which had been adversely impacted by the softness in the European mega yacht and industrial markets, experienced a 11.1% increase in sales compared to the prior fiscal year's second quarter, primarily driven by increased sales of marine transmissions versus the prior fiscal year's second quarter. The Company's Belgian manufacturing operation has been adversely impacted by the softness in the global mega yacht market. This operation saw a 4.1% decrease in sales versus the prior fiscal year's second quarter, primarily driven by foreign currency translation due to the weakening of the euro. The Company's Swiss manufacturing operation, which supplies customized propellers for the global mega yacht and patrol boat markets, experienced a 27% decrease in sales, primarily due to continued softness in, and the timing of shipments for, the global patrol boat and Italian mega yacht markets.

Our distribution segment experienced a 5.2%, or \$1.6 million, decrease in sales compared to the second quarter of fiscal 2014. Compared to the second quarter of fiscal 2014, on average, the U.S. dollar strengthened against most Asian currencies. The net translation effect of this on foreign operations was to decrease revenues by approximately \$1.3 million versus the prior year, before eliminations. The Company's distribution operation in Singapore, its largest Company-owned distribution operation, saw a 17% decrease in sales compared to the prior fiscal year's second quarter. This operation acts as the Company's master distributor for Asia and has experienced record results in recent years as the Company's products gain greater acceptance in the market. In the second fiscal quarter, this operation saw a significant decrease in shipments of pressure pumping and commercial marine transmissions for the Chinese market. The Company expects some of the softness experienced in the first half of the fiscal year to be recovered in the balance of the fiscal year. The Company's distribution operation in the Northwest of the United States and Southwest of Canada experienced an increase in sales of over 50%. The year over year increase was driven by increased shipments of pressure pumping transmissions and increased aftermarket business (parts and service) for the Canadian oil and gas market as well as increased sales of industrial products. The Company's distribution operation in Italy, which provides boat accessories and propulsion systems for the pleasure craft market, saw sales decline over 51%. In fiscal 2013's fourth quarter, the Company committed to a plan to exit the third party distribution agreement of this operation and entered negotiations to sell the inventory back to the parent supplier. Those negotiations were completed in the third fiscal quarter of 2014. The Company's distribution operation in Australia, which provides boat accessories, propulsion and marine transmission systems for the pleasure craft market, saw flat sales compared to the prior fiscal year's second quarter, buoyed by stable shipments in the Australian mega yacht market compared to the prior year.

The elimination for net inter/intra segment sales decreased \$4.8 million, accounting for the remainder of the net change in sales versus the same period last year.

Gross profit as a percentage of sales increased 110 basis points to 30.4% of sales, compared to 29.3% of sales for the same period last year. Gross profit for fiscal 2015's second quarter was favorably impacted by higher sales volume (approximately \$4.5 million) driven by increased shipments to the Company's North American manufacturing and distribution customers across most product markets and increased service and parts sales, only partially offset by moderating demand in the Company's Asian markets for commercial marine and oil and gas products, and reduced pension expense (\$0.2 million).

For the fiscal 2015 second quarter, marketing, engineering and administrative (ME&A) expenses, as a percentage of sales, were 22.7%, compared to 27.2% for the fiscal 2014 second quarter. ME&A expenses decreased \$0.7 million versus the same period last fiscal year. The net impact of foreign currency movement year over year was to reduce ME&A expenses by \$0.5 million, driven by the strengthening of the U.S. dollar versus the euro and most Asian currencies. The net remaining decrease in ME&A expenses of \$0.2 million for the quarter relates to increased bonus expense (\$0.5 million) and general inflationary increases in salaries, wages and benefits, more than offset by lower pension expense (\$0.1 million), controlled spending at the Company's global operations and lower corporate expenses.

During the first quarter of fiscal 2014, the Company recorded a pre-tax restructuring charge of \$1.1 million, representing the incremental cost above the minimum legal indemnity for a targeted workforce reduction at its Belgian operation, following finalization of negotiations with the local labor union. The minimum legal indemnity of \$0.5 million was recorded in the fourth quarter of fiscal 2013, upon announcement of the intended restructuring action. During fiscal 2014, the Company made cash payments of \$0.9 million, resulting in an accrual balance at June 30, 2014 of \$0.8 million. The Company made additional payments of \$11,000 in the first half of fiscal 2015, resulting in a December 26, 2014 balance of \$0.7 million after a foreign exchange impact of \$0.1 million. This remaining obligation relates to increased pension benefits agreed to as part of the restructuring and is expected to be paid out over the next several years.

Interest expense of \$0.2 million for the quarter was down 32.7% versus last year's second quarter. Total interest on the Company's \$60 million revolving credit facility ("revolver") decreased 26% to \$41,364 in fiscal 2015's second

quarter. The average borrowing on the revolver, computed monthly, increased to \$12.5 million in fiscal 2015's second quarter, compared to \$11.4 million in the same period a year ago. The interest rate on the revolver decreased from a range of 1.82% to 1.83% in the prior fiscal year's second quarter to a range of 1.16% to 1.18% in the current year. On June 30, 2014, the Company entered into a revolving loan agreement (the "Credit Agreement") with Wells Fargo Bank, National Association. This was the primary driver of the lower interest rate. The interest expense on the Company's \$25 million Senior Note decreased 33%, at a fixed rate of 6.05%, to \$0.1 million, due to a lower remaining principal balance.

Other income for the fiscal 2015 second quarter was slightly higher than the prior year second quarter as an increased exchange gain, along with a foreign subsidy for research activities, was nearly offset by an increased loss on asset disposals.

The effective tax rate for the fiscal 2015 second quarter was 32.0%, significantly lower than the prior year second quarter rate of 54.9%. However, the effective rates are inflated due to the non-deductibility of operating losses in a certain foreign jurisdiction that is subject to a full valuation allowance. Adjusting both periods for the non-deductible losses, the fiscal 2015 second quarter rate would have been 28.9%, which is slightly lower than 29.8% for the prior year second quarter. The fiscal 2015 second quarter effective rate benefited from the reinstatement of the federal research and development credit. See Note H "Income Taxes" for discussion of unrecognized tax benefits, including an audit settlement with the state of Wisconsin that had only a minor impact on our effective tax rate.

Comparison of the First Six Months of FY 2015 with the First Six Months of FY 2014

Net sales for the first six months increased 6.1%, or \$7.9 million, to \$137.5 million from \$129.6 million in the same period a year ago. Compared to the first half of fiscal 2014, on average, the U.S. dollar strengthened against the euro and Asian currencies. The net translation effect of this on foreign operations was to decrease revenues by approximately \$1.6 million versus the prior year, before eliminations. The increase in sales was primarily due to increased shipments at the Company's North American manufacturing and distribution operations for the land-based transmission and industrial product markets, only partially offset by moderating demand in the Company's Asian markets for commercial marine and oil and gas products. Demand from customers in Europe remains weak and has moderated somewhat in Asia, while overall demand in North America remains stable influenced by the Company's commercial marine, industrial products, and oil and gas markets. In the first half of fiscal 2015, sales to North American customers were approximately 56% of total consolidated net sales compared to 45% for all of fiscal 2014. Sales to Asia Pacific, which were at record levels and reached nearly 29% of total consolidated sales for all of fiscal 2014, were 22% in the first half of 2015, as the Company experienced lower shipments to oil and gas and commercial marine customers in China (which represented 7.7% of sales in the first half of fiscal 2015 compared to 12.8% for all of fiscal 2014).

Sales at our manufacturing segment were up 12.1%, or \$13.4 million, versus the same period last year. In the current fiscal year's first half, our U.S. manufacturing operation, the largest, experienced a 16.2% increase in sales versus the first half of 2014. The primary driver for this increase was increased shipments of pressure pumping transmissions for the North American oil and gas market, increased aftermarket sales and growth in the Company's North American industrial products markets. This was only partially offset by lower shipments of pressure pumping and commercial marine transmissions for the Asian market, primarily China. The Company's Italian manufacturing operations, which had been adversely impacted by the softness in the European mega yacht and industrial markets, experienced a 10.7% increase in sales compared to the prior fiscal year's first half, primarily driven by increased sales of marine transmissions versus the prior fiscal year's first half. The Company's Belgian manufacturing operation, which had experienced a brief strike at its facility in the first quarter of fiscal 2014, also has been adversely impacted by the softness in the global mega yacht market. This operation saw a 2.2% increase in sales versus the prior fiscal year's first half, primarily driven by impact of the strike at the facility in the prior fiscal year. The Company's Swiss manufacturing operation, which supplies customized propellers for the global mega yacht and patrol boat markets, experienced a 13% decrease in sales, primarily due to continued softness in and the timing of shipments for the global

patrol boat and Italian mega yacht markets.

Our distribution segment experienced a 14.0%, or \$8.6 million, decrease in sales compared to the first half of 2014. Compared to the first half of fiscal 2014, on average, the U.S. dollar strengthened against most Asian currencies. The net translation effect of this on foreign operations was to decrease revenues by approximately \$1.4 million versus the prior year, before eliminations. The Company's distribution operation in Singapore, its largest Company-owned distribution operation, saw a 30% decrease in sales compared to the prior fiscal year's first half. This operation acts as the Company's master distributor for Asia and has experienced record results in recent years as the Company's products gain greater acceptance in the market. In the first half of fiscal 2015, this operation saw a significant decrease in shipments of pressure pumping and commercial marine transmissions for the Chinese market. The Company expects some of the softness experienced in the first half of the fiscal year to be recovered in the balance of the fiscal year. The Company's distribution operation in the Northwest of the United States and Southwest of Canada experienced an increase in sales of nearly 38%. The year over year increase was driven by increased shipments of pressure pumping transmissions and increased aftermarket business (parts and service) for the Canadian oil and gas market as well as increased sales of industrial products. The Company's distribution operation in Italy, which provides boat accessories and propulsion systems for the pleasure craft market, saw sales decline over 52%. In fiscal 2013's fourth quarter, the Company committed to a plan to exit the third party distribution agreement of this operation and entered negotiations to sell the inventory back to the parent supplier. Those negotiations were completed in the third fiscal quarter of 2014. The Company's distribution operation in Australia, which provides boat accessories, propulsion and marine transmission systems for the pleasure craft market, saw an increase in sales of nearly 6% compared to the prior fiscal year's first half, driven by strong shipments in the Australian mega yacht market compared to the prior year, primarily in the first quarter of fiscal 2015.

The elimination for net inter/intra segment sales decreased \$3.1 million, accounting for the remainder of the net change in sales versus the same period last year.

Gross profit as a percentage of sales increased 220 basis points to 32.4% of sales, compared to 30.2% of sales for the same period last year. Gross profit for fiscal 2015's first six months was favorably impacted by higher sales volume compared to the fiscal 2014 first half (approximately \$3.5 million), a more profitable product mix (approximately \$1.0 million) driven by higher sales of the Company's oil and gas transmission products (approximately \$0.5 million), and improved absorption (approximately \$1.1 million).

For the fiscal 2015 first half, marketing, engineering and administrative (ME&A) expenses, as a percentage of sales, were 23.6%, compared to 25.2% for the fiscal 2014 first half. ME&A expenses decreased \$0.3 million versus the same period last fiscal year. The net impact of foreign currency movement year over year was to reduce ME&A expenses by \$0.5 million, driven by the strengthening of the U.S. dollar versus the euro and most Asian currencies. The net remaining increase in ME&A expenses of \$0.2 million for the first half relates to increased bonus expense (\$0.9 million) and general inflationary increases in salaries, wages and benefits, partially offset by lower pension expense (\$0.2 million), controlled spending at the Company's global operations and lower corporate expenses.

During the first quarter of fiscal 2014, the Company recorded a pre-tax restructuring charge of \$1.1 million, representing the incremental cost above the minimum legal indemnity for a targeted workforce reduction at its Belgian operation, following finalization of negotiations with the local labor union. The minimum legal indemnity of \$0.5 million was recorded in the fourth quarter of fiscal 2013, upon announcement of the intended restructuring action. During fiscal 2014, the Company made cash payments of \$0.9 million, resulting in an accrual balance at June 30, 2014 of \$0.8 million. The Company made additional payments of \$11,000 in the first half of fiscal 2015, resulting in a December 26, 2014 balance of \$0.7 million after a foreign exchange impact of \$0.1 million. This remaining obligation relates to increased pension benefits agreed to as part of the restructuring and is expected to be paid out over the next several years.

Interest expense of \$0.3 million for the first half of fiscal 2015 was down 34.2% versus last year's first six months. Total interest on the Company's \$60 million revolving credit facility ("revolver") decreased 36% to \$82,049 in fiscal 2015's first half. The average borrowing on the revolver, computed monthly, decreased to \$12.4 million in fiscal 2015's first half, compared to \$12.9 million in the same period a year ago. The interest rate on the revolver decreased from a range of 1.82% to 1.85% in the prior fiscal year's first half to a range of 1.16% to 1.18% in the current year. On June 30, 2014, the Company entered into a revolving loan agreement (the "Credit Agreement") with Wells Fargo Bank, National Association. This was the primary driver of the lower interest rate. The interest expense on the Company's \$25 million Senior Note decreased 33%, at a fixed rate of 6.05%, to \$0.2 million, due to a lower remaining principal balance.

Other income for the fiscal 2015 first half exceeded the prior year due to a combination of the foreign subsidy for research activities, increased exchange gains and lower bank fees offsetting an increase in losses on asset disposals.

The effective tax rate for the fiscal 2015 first half was 35.8%, significantly lower than the prior year first half rate of 62.1%. Adjusting both for the non-deductible losses, the first half fiscal 2015 rate would have been 32.9%, compared to 37.0% for the fiscal 2014 first half. The fiscal 2014 rate is somewhat higher due to unfavorable discrete items recorded in the first quarter related to adjustments to tax. See Note H "Income Taxes" for discussion of unrecognized tax benefits, including an audit settlement with the state of Wisconsin that had only a minor impact on our effective tax rate.

Financial Condition, Liquidity and Capital Resources

Comparison between December 26, 2014 and June 30, 2014

As of December 26, 2014, the Company had net working capital of \$118.2 million, which represents a decrease of \$4.9 million, or 4.0%, from the net working capital of \$123.1 million as of June 30, 2014.

Cash increased \$0.4 million, or 1.7%, to \$25.2 million as of December 26, 2014, versus \$24.8 million as of June 30, 2014. The majority of the cash as of December 26, 2014 is at our overseas operations in Europe (\$14.0 million) and Asia-Pacific (\$10.3 million). Year to date, the effect of exchange rate changes on cash was to reduce cash by \$1.9 million.

Trade receivables of \$40.7 million were up \$0.5 million, or 1.3%, when compared to last fiscal year-end. The impact of foreign currency translation was to decrease accounts receivable by \$1.8 million versus June 30, 2014. The net remaining increase is consistent with the sales volume increase experienced at the end of the second fiscal quarter of 2015.

Net inventory decreased by \$6.8 million, or 7.0%, versus June 30, 2014 to \$90.8 million. The impact of foreign currency translation was to decrease net inventory by \$4.9 million versus June 30, 2014. After adjusting for the impact of foreign currency translation, the net decrease of \$1.9 million primarily came at the Company's North American manufacturing and distribution locations. On a consolidated basis, as of December 26, 2014, the Company's backlog of orders to be shipped over the next six months approximates \$58.3 million, compared to \$66.1 million at June 30, 2014 and \$56.2 million at December 27, 2013. The decrease versus the end of the prior fiscal year is being experienced at the Company's domestic manufacturing location primarily due to strong shipments in the second quarter to customers in the pressure pumping sector of the North American oil and gas, and commercial marine markets. This was partially offset by strong order activity in the Company's aftermarket parts business. As a percentage of six month backlog, inventory has increased from 148% at June 30, 2014 to 156% at December 26, 2014.

Net property, plant and equipment (PP&E) decreased \$2.5 million versus June 30, 2014. This includes the addition of \$4.5 million in capital expenditures, primarily at the Company's Racine-based manufacturing operation, which was more than offset by depreciation of \$5.1 million. The net remaining decrease is due to foreign currency translation

effects. In total, the Company expects to invest between \$10 and \$15 million in capital assets in fiscal 2015. These anticipated expenditures reflect the Company's plans to continue investing in modern equipment and facilities, its global sourcing program and new products as well as expanding capacities at facilities around the world. The Company continues to review its capital plans based on overall market conditions and availability of capital, and may make changes to its capital plans accordingly. In addition, the quoted lead times on certain manufacturing equipment purchases may push some of the capital expenditures into the next fiscal year. In fiscal 2014, the Company spent \$7.2 million for capital expenditures, up from \$6.6 million in fiscal 2013. In fiscal 2012, the Company spent \$13.7 million for capital expenditures, up from \$12.0 million and \$4.5 million in fiscal years 2011 and 2010, respectively. The Company's capital program is focused on modernizing key core manufacturing, assembly and testing processes and expanding capacity at its facilities around the world.

Accounts payable as of December 26, 2014 of \$21.2 million were down \$0.9 million, or 4.0%, from June 30, 2014. The impact of foreign currency translation was to decrease accounts payable by \$1.0 million versus June 30, 2014. This decrease is consistent with the timing of certain payments, the Company's lower six month backlog levels and the reduction in inventories experienced at the Company's domestic manufacturing operation in the quarter (down \$2.4 million).

Total borrowings and long-term debt as of December 26, 2014 decreased by \$1.7 million, or roughly 9%, to \$16.7 million versus June 30, 2014. This decrease was driven primarily by strong operating cash flows generated year to date of \$9.4 million only partially offset by capital expenditures and dividends paid to shareholders. During the first six months, the Company generated positive free cash flow (defined as operating cash flow less acquisitions of fixed assets) of \$4.9 million and ended the quarter with total debt, net of cash, of (\$8.4) million, compared to (\$6.4) million at June 30, 2014, for a net positive change of \$2.0 million.

Total equity decreased \$2.2 million, or 1.4%, to \$150.1 million as of December 26, 2014. Retained earnings increased by \$5.8 million. The net increase in retained earnings included \$7.8 million in net earnings for the first six months offset by \$2.0 million in dividend payments. Net unfavorable foreign currency translation of \$8.9 million was reported. The net remaining increase in equity of \$1.0 million primarily represents an adjustment for the amortization of net actuarial loss and prior service cost on the Company's defined benefit pension plans.

On June 30, 2014, the Company entered into a revolving loan agreement (the "Credit Agreement") with Wells Fargo Bank, National Association. Pursuant to the Credit Agreement, the Company may, from time to time, enter into revolving credit loans in amounts not to exceed, in the aggregate, Wells Fargo's revolving credit commitment of \$60,000,000. The revolving credit commitment may be increased under the agreement by an additional \$10,000,000 in the event that the conditions for "Incremental Loans" (as defined in the agreement) are satisfied. In general, outstanding revolving credit loans will bear interest at LIBOR plus 1.00%. The rate was 1.18% at December 26, 2014. In addition to principal and interest payments, the Borrowers will be responsible for paying monthly commitment fees equal to 0.15% of the unused revolving credit commitment. The Company has the option of making additional prepayments subject to certain limitations. The Credit Agreement is scheduled to expire on May 31, 2018. The outstanding balance of \$9,575,000 at December 26, 2014 is classified as long-term debt. This agreement contains certain covenants, including restrictions on investments, acquisitions and indebtedness. Financial covenants include a minimum consolidated adjusted net worth, a minimum EBITDA for the most recent four fiscal quarters of \$11,000,000, and a maximum total funded debt to EBITDA ratio of 3.0. As of December 26, 2014, the Company was in compliance with these financial covenants with a four quarter EBITDA total of \$26,488,000 and a funded debt to EBITDA ratio of 0.63 (compared to \$19,463,000 and 0.95 as of June 30, 2014, respectively). The minimum adjusted net worth covenant fluctuates based upon actual earnings and the Company's compliance with that covenant is based on the Company's shareholders' equity as adjusted by certain pension accounting items. As of December 26, 2014, the minimum adjusted equity requirement was \$123,557,000 compared to an actual result of \$183,592,000 after all required adjustments.

Prior to June 30, 2014, the Company had a \$40,000,000 revolving loan agreement with BMO Harris Bank, N.A. (“BMO”). The Company originally entered into this revolving loan agreement in December 2002 with M&I Marshall & Ilsley Bank, predecessor to BMO. At that time, the revolving loan agreement was for \$20,000,000 and had an expiration date of October 31, 2005. Through a series of amendments, the last of which was agreed to during the fourth quarter of fiscal 2011, the total commitment was increased to \$40,000,000 and the term was extended to May 31, 2015. This agreement contained certain covenants, including restrictions on investments, acquisitions and indebtedness. Financial covenants included a minimum consolidated adjusted net worth amount, as defined, a minimum EBITDA for the most recent four fiscal quarters, and a maximum total funded debt to EBITDA ratio. As of June 30, 2014, the Company was in compliance with these financial covenants. The outstanding balances of \$0 and \$16,300,000 at June 30, 2014 and June 30, 2013, respectively, were classified as long-term debt. In accordance with the loan agreement as amended, the Company could borrow at LIBOR plus an additional “Add-On,” between 1.5% and 2.5%, depending on the Company’s Total Funded Debt to EBITDA ratio. The rate was 1.80% and 1.84% at June 30, 2014 and June 30, 2013, respectively. On June 20, 2014, the Company provided written notice to BMO of its intent to terminate the revolving credit agreement with a termination date of June 30, 2014. On June 30, 2014, the agreement was terminated and the facility was paid off.

Prior to June 30, 2014, the Company and its wholly-owned subsidiary Twin Disc International, S.A. had a multi-currency revolving Credit Agreement with Wells Fargo Bank, National Association (the “Prior Credit Agreement”). The Company entered into this agreement on November 19, 2012. Pursuant to the Prior Credit Agreement, the Company could, from time to time, enter into revolving credit loans in amounts not to exceed, in the aggregate, Wells Fargo’s revolving credit commitment of \$15,000,000. In general, outstanding revolving credit loans (other than foreign currency loans) would bear interest at one of the following rates, as selected by the Company: (1) a “Base Rate,” which is equal to the highest of (i) the prime rate; (ii) the federal funds rate plus 0.50%; or (iii) LIBOR plus 1.00%; or (2) a “LIBOR Rate” (which is equal to LIBOR divided by the difference between 1.00 and the Eurodollar Reserve Percentage (as defined in the Prior Credit Agreement)) plus 1.50%. Outstanding revolving credit loans that are foreign currency loans would bear interest at the LIBOR Rate plus 1.50%, plus an additional “Mandatory Cost,” which was designed to compensate Wells Fargo for the cost of compliance with the requirements of the Bank of England and/or the Financial Services Authority, or the requirements of the European Central Bank. In addition to principal and interest payments, the Borrowers were responsible for paying monthly commitment fees equal to .25% of the unused revolving credit commitment. The Company had the option of making additional prepayments subject to certain limitations. The Prior Credit Agreement included financial covenants regarding minimum net worth, minimum EBITDA for the most recent four fiscal quarters of \$11,000,000, and a maximum total funded debt to EBITDA ratio of 3.0. As of June 30, 2014, the Company was in compliance with these financial covenants. The Prior Credit Agreement also included certain restrictive covenants that limited, among other things, certain investments, acquisitions and indebtedness. The Prior Credit Agreement provided that it automatically included any covenants or events of default not previously included in the Prior Credit Agreement to the extent such covenants or events of default are granted to any other lender of an amount in excess of \$1,000,000. The Prior Credit Agreement also included customary events of default, including events of default under the BMO agreement or the Prudential Note Agreement. Following an event of default, Wells Fargo could accelerate all amounts outstanding under any revolving credit notes or the Prior Credit Agreement. The Prior Credit Agreement was scheduled to expire on May 31, 2015. However, on June 30, 2014, the Company entered into the new agreement with Wells Fargo discussed above, which includes the ability to borrow up to \$15 million in certain foreign currencies. As of June 30, 2014, there were no borrowings under the Prior Credit Agreement.

On June 30, 2014, the Company entered into an Amended and Restated Note Purchase and Private Shelf Agreement (the “Prudential Agreement”). Among other things, the Prudential Agreement: (a) amends and restates the “Note Agreement” between the Company and Purchasers dated as of April 10, 2006, as it has been amended from time to time (the “2006 Note Agreement”); and (b) sets forth the terms of the potential sale and purchase of up to \$50,000,000 in “Shelf Notes” as defined in the Prudential Agreement (the “Shelf Notes”) by the Company to Prudential. The notes sold by the Company to the Existing Holders under the 2006 Agreement (the “2006 Notes”) are deemed outstanding under, and are governed by, the terms of the Prudential Agreement. The 2006 Notes bear interest on the outstanding

principal balance at a fixed rate of 6.05% per annum and mature and become due and payable in full on April 10, 2016 (the "Payment Date"). Prior to the Payment Date, the Company is obligated to make quarterly payments of interest during the term of the 2006 Notes, plus prepayments of principal of \$3,571,429 on April 10 of each year from 2010 to 2015, inclusive. The outstanding balance was \$7,142,857 at December 26, 2014 and June 30, 2014, respectively. Of the outstanding balance, \$3,571,429 was classified as a current maturity of long-term debt at December 26, 2014 and June 30, 2014, respectively. The remaining \$3,571,429 is classified as long-term debt. In addition to the interest payments and any mandatory principal payments required under the terms of the Shelf Note, the Company will pay an issuance fee of 0.10% of the aggregate principal balance of each of the Shelf Notes sold to, and purchased by, Prudential. In addition the Company agreed to pay a one-time structuring fee of \$25,000 on or before September 30, 2014, unless there was an acceptance of a sale of Shelf Notes prior to such date, in which case the structuring fee would have been waived. On September 29, 2014, the Company paid the \$25,000 structuring fee. The Company may prepay the Shelf Notes or the 2006 Notes, subject to certain limitations. At no time during the term of the Prudential Agreement may the aggregate outstanding principal amount of the 2006 Notes and the Shelf Notes exceed \$35,000,000. The Prudential Agreement includes financial covenants regarding minimum net worth, minimum EBITDA for the most recent four (4) fiscal quarters of \$11,000,000 and a maximum total funded debt to EBITDA ratio of 3.0. As of December 26, 2014, the Company was in compliance with these financial covenants. As part of the agreement, the Company will be required to make an offer to purchase the 2006 Notes and Shelf Notes upon a change of control, and any such offer must include the payment of a Yield-Maintenance Amount. The Prudential Agreement also includes certain covenants that limit, among other things, certain indebtedness, acquisitions and investments. The Prudential Agreement also has a most favored lender provision whereby the Prudential Agreement shall be automatically modified to include any additional covenant or event of default that is included in any agreement evidencing, securing, guarantying or otherwise related to other indebtedness in excess of \$1,000,000.

Four quarter EBITDA, total funded debt, and adjusted net worth are non-GAAP measures, and are included herein for the purpose of disclosing the status of the Company's compliance with the four quarter EBITDA, total funded debt to four quarter EBITDA ratio, and adjusted net worth covenants described above. In accordance with the Company's revolving loan agreements and the Prudential Agreement:

- "Four quarter EBITDA" is defined as "the sum of (i) Net Income plus, to the extent deducted in the calculation of Net Income, (ii) interest expense, (iii) depreciation and amortization expense, and (iv) income tax expense;" and
- "Total funded debt" is defined as "(i) all Indebtedness for borrowed money (including without limitation, Indebtedness evidenced by promissory notes, bonds, debentures and similar interest-bearing instruments), plus (ii) all purchase money Indebtedness, plus (iii) the principal portion of capital lease obligations, plus (iv) the maximum amount which is available to be drawn under letters of credit then outstanding, all as determined for the Company and its consolidated Subsidiaries as of the date of determination, without duplication, and in accordance with generally accepted accounting principles applied on a consistent basis."
- "Total funded debt to four quarter EBITDA" is defined as the ratio of total funded debt to four quarter EBITDA calculated in accordance with the above definitions.
- "Adjusted net worth" means the Company's reported shareholder equity, excluding adjustments that result from (i) changes to the assumptions used by the Company in determining its pension liabilities or (ii) changes in the market value of plan assets up to an aggregate amount of adjustments equal to \$34,000,000 ("Permitted Benefit Plan Adjustments") for purposes of computing net worth at any time.

The Company's total funded debt as of December 26, 2014 and June 30, 2014 was equal to the total debt reported on the Company's December 26, 2014 and June 30, 2014 Consolidated Balance Sheet, and therefore no reconciliation is included herein. The following table sets forth the reconciliations of the Company's reported Net Earnings to the calculation of four quarter EBITDA for the four quarters ended December 26, 2014 and June 30, 2014:

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| | For the Four Quarters Ended | For the Four Quarters Ended |
|---|--------------------------------|-----------------------------------|
| Four Quarter EBITDA Reconciliation | December 26, 2014 | June 30, 2014 |
| Net Earnings Attributable to Twin Disc | \$ 9,639,000 | \$ 3,644,000 |
| Depreciation & Amortization | 10,630,000 | 10,657,000 |
| Interest Expense | 773,000 | 936,000 |
| Income Taxes | 5,446,000 | 4,226,000 |
| Four Quarter EBITDA | \$ 26,488,000 | \$ 19,463,000 |
| Total Funded Debt to Four Quarter EBITDA | | |
| Total Funded Debt | \$ 16,747,000 | \$ 18,404,000 |
| Divided by: Four Quarter EBITDA | 26,488,000 | 19,463,000 |
| Total Funded Debt to Four Quarter EBITDA | 0.63 | 0.95 |

The following table sets forth the reconciliations of the Company's reported shareholders' equity to the calculation of adjusted net worth for the quarters ended December 26, 2014 and June 30, 2014:

| | As of December 26, 2014 | As of June 30, 2014 |
|--------------------------------------|-------------------------------|------------------------|
| Total Twin Disc Shareholders' Equity | \$149,592,000 | \$151,584,000 |
| Permitted Benefit Plan Adjustments | 34,000,000 | 34,000,000 |
| Adjusted Net Worth | \$183,592,000 | \$185,584,000 |

As of December 26, 2014, the Company was in compliance with all of the covenants described above. As of December 26, 2014, the Company's backlog of orders scheduled for shipment during the next six months (six-month backlog) was \$58.3 million, or approximately 12% lower than the six-month backlog of \$66.1 million as of June 30, 2014, but up 4% from the end of the second fiscal quarter of 2014. The Company does not expect to violate any of its financial covenants in fiscal 2015. The current margins surrounding ongoing compliance with the above covenants, in particular, minimum EBITDA for the most recent four fiscal quarters and total funded debt to EBITDA, are expected to increase in fiscal 2015 compared to fiscal 2014. Based on its annual financial plan, the Company believes it is well positioned to generate sufficient EBITDA levels throughout fiscal 2015 in order to maintain compliance with the above covenants. However, as with all forward-looking information, there can be no assurance that the Company will achieve the planned results in future periods due to the uncertainties in certain of its markets. Please see the factors discussed under Item 1A, Risk Factors, of the Company's Annual Report filed on Form 10-K for June 30, 2014 which could cause actual results to be materially different from what is presented here.

The Company's balance sheet remains very strong, there are no off-balance-sheet arrangements other than the operating leases listed below, and we continue to have sufficient liquidity for near-term needs. The Company had \$50.4 million of available borrowings on our \$60 million revolving loan agreement as of December 26, 2014. The Company expects to continue to generate enough cash from operations to meet our operating and investing needs. As of December 26, 2014, the Company also had cash of \$25.2 million, primarily at its overseas operations. These funds, with some restrictions and tax implications, are available for repatriation as deemed necessary by the Company. The Company has provided for deferred taxes on the earnings at the foreign operations for which an indefinite reinvestment assertion has not been made. In fiscal 2015, the Company expects to contribute \$6.2 million to its defined benefit pension plans, the minimum contributions required. However, if the Company elects to make

voluntary contributions in fiscal 2015, it intends to do so using cash from operations and, if necessary, from available borrowings under existing credit facilities.

Net working capital decreased \$4.9 million, or 4.0%, in fiscal 2015's first half, and the current ratio decreased slightly from 3.2 at June 30, 2014 to 3.1 at December 26, 2014. The decrease in net working capital was primarily driven the net impact of foreign currency movements on net working capital due to the strengthening of the U.S. dollar versus the euro and most Asian currencies in the first half of the fiscal year.

The Company expects capital expenditures to be between \$10 million and \$15 million in fiscal 2015, of which \$4.5 million has already been spent. These anticipated expenditures reflect the Company's plans to continue investing in modern equipment and facilities, its global sourcing program and new products as well as expanding capacity at facilities around the world.

Management believes that available cash, the credit facility, cash generated from future operations, existing lines of credit and potential access to debt markets will be adequate to fund the Company's capital requirements for the foreseeable future.

As of December 26, 2014, the Company has obligations under non-cancelable operating lease contracts and loan and senior note agreements for certain future payments. A summary of those commitments follows (in thousands):

| Contractual Obligations | Total | Less than 1 year | 1-3 Years | 3-5 Years | After 5 Years |
|-------------------------|----------|---------------------|--------------|--------------|------------------|
| Revolver borrowing | \$9,575 | | | \$9,575 | |
| Long-term debt | \$7,172 | \$3,575 | \$3,571 | | \$26 |
| Operating leases | \$7,376 | \$2,719 | \$3,334 | \$1,302 | \$21 |
| Total obligations | \$24,123 | \$6,294 | \$6,905 | \$10,877 | \$47 |

The table above does not include tax liabilities related to uncertain income tax positions totaling \$0.8 million, excluding related interest and penalties, as the timing of their resolution cannot be estimated. See Note H of the Condensed Consolidated Financial Statements for disclosures surrounding uncertain income tax positions.

The Company maintains defined benefit pension plans for some of its operations in the United States and Europe. The Company has established the Pension Committee to manage the operations and administration of the defined benefit plans. The Company estimates that fiscal 2015 contributions to all defined benefit plans will total \$6.2 million. As of December 26, 2014, \$4.5 million in contributions have been made.

New Accounting Releases

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

In June 2014, the FASB issued stock compensation guidance requiring that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The amendments in this guidance are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 (the Company's fiscal 2017). The adoption of this guidance is not expected to have a material impact on the Company's financial disclosures.

In May 2014, the FASB issued updated guidance on revenue from contracts with customers. This revenue recognition guidance supersedes existing US GAAP guidance, including most industry-specific guidance. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance identifies steps to apply in achieving this principle. This updated guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016 (the Company's fiscal 2018). The Company is currently evaluating the potential impact of this guidance on the Company's financial disclosures and results.

In April 2014, the FASB issued updated guidance on the reporting for discontinued operations. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. The new guidance also requires expanded financial disclosures about discontinued operations. The amendments in this updated guidance are effective for the first quarter of the Company's fiscal 2016. The adoption of this guidance is not expected to have a material impact on the Company's financial disclosures.

In July 2013, the FASB issued guidance stating that, except in certain defined circumstances, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2013 (the Company's fiscal 2015). The adoption of this guidance did not have a material impact on the Company's financial disclosures.

Critical Accounting Policies

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

Twin Disc's critical accounting policies are described in Item 7 of the Company's Annual Report filed on Form 10-K for June 30, 2014. There have been no significant changes to those accounting policies subsequent to June 30, 2014.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

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

Interest rate risk - The Company's earnings exposure related to adverse movements of interest rates is primarily derived from outstanding floating rate debt instruments that are indexed to the LIBOR interest rate. In accordance with the \$60,000,000 revolving loan agreement expiring May 31, 2018, the Company has the option of borrowing at LIBOR plus an additional "Add-On" of 1.0%. Due to the relative stability of interest rates, the Company did not utilize any financial instruments at December 26, 2014 to manage interest rate risk exposure. A 10 percent increase or decrease in the applicable interest rate would result in a change in pretax interest expense of approximately \$11,000.

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

Currency risk - The Company has exposure to foreign currency exchange fluctuations. Approximately 22% of the Company's revenues in the six months ended December 26, 2014 were denominated in currencies other than the U.S. dollar. Of that total, approximately 65% was denominated in euros with the balance composed of Japanese yen, the Swiss franc, Indian rupee and the Australian and Singapore dollars. The Company does not hedge the translation exposure represented by the net assets of its foreign subsidiaries. Foreign currency translation adjustments are recorded as a component of shareholders' equity. Forward foreign exchange contracts are occasionally used to hedge the currency fluctuations on significant transactions denominated in foreign currencies.

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

The Company primarily enters into forward exchange contracts to reduce the earnings and cash flow impact of non-functional currency denominated receivables and payables. These contracts are highly effective in hedging the cash flows attributable to changes in currency exchange rates. Gains and losses resulting from these contracts offset the foreign exchange gains or losses on the underlying assets and liabilities being hedged. The maturities of the forward exchange contracts generally coincide with the settlement dates of the related transactions. Gains and losses on these contracts are recorded in Other expense, net in the Condensed Consolidated Statement of Operations as the changes in the fair value of the contracts are recognized and generally offset the gains and losses on the hedged items in the same period. The primary currency to which the Company was exposed in fiscal 2015 and 2014 was the euro. The Company had no outstanding forward exchange contracts at December 26, 2014 or June 30, 2014.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

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

(b) Changes in Internal Control Over Financial Reporting

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

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in response to Item 1A to Part I of our 2014 Annual Report on Form 10-K.

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

(a) Unregistered Sales of Equity Securities

There were no securities of the Company sold by the Company during the three months ended December 26, 2014, which were not registered under the Securities Act of 1933, in reliance upon an exemption from registration provided by Section 4 (2) of the Act.

(b) Use of Proceeds

Not applicable.

(c) Issuer Purchases of Equity Securities

Issuer Purchases of Equity Securities

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|-------------------------------|--------------------------------------|----------------------------------|--|--|
| Sep. 27, 2014 – Oct. 31, 2014 | 0 | NA | 0 | 315,000 |
| Nov. 1, 2014 – Nov. 28, 2014 | 0 | NA | 0 | 315,000 |
| Nov. 29, 2014 – Dec. 26, 2014 | 0 | NA | 0 | 315,000 |
| Total | 0 | NA | 0 | 315,000 |

The Company did not purchase any shares of Common Stock during the quarter ended December 26, 2014, pursuant to our publicly announced program (described below).

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

Item 3. Defaults Upon Senior Securities

None.

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Item 5. Other Information

None.

Item 6. Exhibits

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

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

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

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

101.INS XBRL Instance Document

101.SCH XBRL Schema

101.CAL XBRL Calculation Linkbase

101.DEF XBRL Definition Linkbase

101.LAB XBRL Label Linkbase

101.PRE XBRL Presentation Linkbase

SIGNATURE

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

TWIN DISC, INCORPORATED
(Registrant)

Date: February 4, 2015

/s/ JEFFREY S. KNUTSON
Jeffrey S. Knutson
Corporate Controller and Secretary
Chief Accounting Officer
