QUAKER CHEMICAL CORP
Form 10-Q
November 01, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from______ to______

Commission file number 001-12019

QUAKER CHEMICAL CORPORATION

(Exact name of Registrant as specified in its charter)

Pennsylvania	**23-0993790**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
One Quaker Park, 901 E. Hector Street, Conshohocken, Pennsylvania	**19428 – 2380**
(Address of principal executive offices)	**(Zip Code)**

Registrant's telephone number, including area code: 610-832-4000

Not Applicable

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 [X] No [ ]

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer", "smaller reporting company", and "emerging growth company" in Rule 12b-2 of the Exchange Act.

	Large accelerated filer [X]		Accelerated filer [ ]	
	Non-accelerated filer [ ]		Smaller reporting company [ ]	
	Emerging growth company [ ]			

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

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

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

Number of Shares of Common Stock	
Outstanding on September 30, 2018	**13,334,364**

QUAKER CHEMICAL CORPORATION AND CONSOLIDATED SUBSIDIARIES

PART I

FINANCIAL INFORMATION

Item 1. **Financial Statements (Unaudited).**

Quaker Chemical Corporation

Condensed Consolidated Statements of Income

(Dollars in thousands, except per share data)

	Unaudited			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net sales	$ 222,022	$ 212,918	$ 656,039	$ 609,010
Cost of goods sold	140,929	138,142	418,562	391,512
Gross profit	81,093	74,776	237,477	217,498
Selling, general and administrative expenses	53,270	51,092	157,360	148,740
Combination-related expenses	2,904	9,675	12,404	23,088
Operating income	24,919	14,009	67,713	45,670
Other (expense) income, net	(523)	249	(631)	(1,427)
Interest expense	(1,510)	(793)	(4,804)	(2,229)
Interest income	521	762	1,581	1,825
Income before taxes and equity in net income of associated companies	23,407	14,227	63,859	43,839
Taxes on income before equity in net income of associated companies	4,330	3,140	13,554	14,229
Income before equity in net income of associated companies	19,077	11,087	50,305	29,610
Equity in net income of associated companies	694	617	1,623	2,049
Net income	19,771	11,704	51,928	31,659
Less: Net income attributable to noncontrolling interest	81	562	260	1,619
Net income attributable to Quaker Chemical Corporation	$ 19,690	$ 11,142	$ 51,668	$ 30,040
Per share data:				
Net income attributable to Quaker Chemical Corporation				
Common Shareholders – basic	$ 1.48	$ 0.84	$ 3.88	$ 2.26

Net income attributable to Quaker Chemical Corporation Common Shareholders – diluted	$ 1.47	$ 0.83	$ 3.87	$ 2.25
Dividends declared	$ 0.370	$ 0.355	$ 1.095	$ 1.055

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

Quaker Chemical Corporation

Condensed Consolidated Statements of Comprehensive Income

(Dollars in thousands)

	Unaudited			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	$ 19,771	$ 11,704	$ 51,928	$ 31,659
Other comprehensive (loss) income, net of tax				
Currency translation adjustments	(6,859)	5,764	(17,111)	18,528
Defined benefit retirement plans	678	62	2,258	2,171
Unrealized gain (loss) on available-for-sale securities	162	286	(493)	453
Other comprehensive (loss) income	(6,019)	6,112	(15,346)	21,152
Comprehensive income	13,752	17,816	36,582	52,811
Less: Comprehensive income attributable to noncontrolling interest	(43)	(409)	(146)	(2,037)
Comprehensive income attributable to Quaker Chemical Corporation	$ 13,709	$ 17,407	$ 36,436	$ 50,774

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

Quaker Chemical Corporation

Condensed Consolidated Balance Sheets

(Dollars in thousands, except par value and share amounts)

	Unaudited September 30, 2018	December 31, 2017
ASSETS		
Current assets		
Cash and cash equivalents	$ 99,810	$ 89,879
Accounts receivable, net	214,056	208,358
Inventories		
Raw materials and supplies	49,913	44,439
Work-in-process and finished goods	46,692	42,782
Prepaid expenses and other current assets	17,446	21,128
Total current assets	427,917	406,586
Property, plant and equipment, at cost	254,881	255,990
Less accumulated depreciation	(172,724)	(169,286)
Net property, plant and equipment	82,157	86,704
Goodwill	83,695	86,034
Other intangible assets, net	65,912	71,603
Investments in associated companies	22,471	25,690
Non-current deferred tax assets	15,072	15,661
Other assets	32,065	30,049
Total assets	$ 729,289	$ 722,327
LIABILITIES AND EQUITY		
Current liabilities		
Short-term borrowings and current portion of long-term debt	$ 5,673	$ 5,736
Accounts and other payables	96,053	97,732
Accrued compensation	24,099	22,846
Other current liabilities	31,485	29,384
Total current liabilities	157,310	155,698
Long-term debt	46,875	61,068
Non-current deferred tax liabilities	9,543	9,653
Other non-current liabilities	82,925	87,044
Total liabilities	296,653	313,463
Commitments and contingencies (Note 18)		
Equity		
Common stock, $1 par value; authorized 30,000,000 shares; issued and outstanding 2018 – 13,334,364 shares; 2017 – 13,307,976 shares	13,334	13,308
Capital in excess of par value	96,121	93,528

Retained earnings	402,255	365,182
Accumulated other comprehensive loss	(80,332)	(65,100)
Total Quaker shareholders’ equity	431,378	406,918
Noncontrolling interest	1,258	1,946
Total equity	432,636	408,864
Total liabilities and equity	$ 729,289	$ 722,327

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

Quaker Chemical Corporation

Condensed Consolidated Statements of Cash Flows

(Dollars in thousands)

	Unaudited Nine Months Ended September 30, 2018	2017
Cash flows from operating activities		
Net income	$ 51,928	$ 31,659
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	9,386	9,464
Amortization	5,525	5,490
Equity in undistributed earnings of associated companies, net of dividends	2,658	(1,919)
Deferred compensation and other, net	(898)	(1,190)
Share-based compensation	2,847	3,269
Gain on disposal of property, plant, equipment and other assets	(680)	(50)
Insurance settlement realized	(680)	(542)
Combination-related expenses, net of payments	(349)	10,367
Pension and other postretirement benefits	(1,113)	608
(Decrease) increase in cash from changes in current assets and current liabilities, net of acquisitions:		
Accounts receivable	(14,029)	(12,946)
Inventories	(12,719)	(9,272)
Prepaid expenses and other current assets	2,196	(5,217)
Accounts payable and accrued liabilities	6,824	11,755
Restructuring liabilities	—	(675)
Net cash provided by operating activities	50,896	40,801
Cash flows from investing activities		
Investments in property, plant and equipment	(8,815)	(8,032)
Payments related to acquisitions, net of cash acquired	(500)	(5,363)
Proceeds from disposition of assets	803	67
Insurance settlement interest earned	102	35
Net cash used in investing activities	(8,410)	(13,293)
Cash flows from financing activities		
Proceeds from long-term debt	—	4,472
Repayments of long-term debt	(11,518)	(488)
Dividends paid	(14,385)	(13,893)
Stock options exercised, other	(227)	(2,594)
Distributions to noncontrolling affiliate shareholders	(834)	—
Net cash used in financing activities	(26,964)	(12,503)

Effect of foreign exchange rate changes on cash	(6,168)	4,758
Net increase in cash, cash equivalents and restricted cash	9,354	19,763
Cash, cash equivalents and restricted cash at the beginning of the period	111,050	110,701
Cash, cash equivalents and restricted cash at the end of the period	$ 120,404	$ 130,464

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

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

Note 1 – Condensed Financial Information

The condensed consolidated financial statements included herein are unaudited and have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP") for interim financial reporting and the United States Securities and Exchange Commission ("SEC") regulations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the financial statements reflect all adjustments (consisting only of normal recurring adjustments, except certain material adjustments, as discussed below) which are necessary for a fair statement of the financial position, results of operations and cash flows for the interim periods. The results for the three and nine months ended September 30, 2018, respectively, are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Company's Annual Report filed on Form 10-K for the year ended December 31, 2017.

During the first quarter of 2018, the Company adopted guidance regarding the accounting for and disclosure of net sales and revenue recognition. The Company's adoption, using the modified retrospective adoption approach, resulted in certain adjustments to its Condensed Consolidated Balance Sheet as of December 31, 2017. In addition, during the first quarter of 2018, the Company adopted an accounting standard update requiring that the statement of cash flows explain both the change in total cash and cash equivalents and also the amounts generally described as restricted cash or restricted cash equivalents. The guidance in this accounting standard update was required to be applied retrospectively which resulted in certain adjustments to the Company's Condensed Consolidated Statement of Cash Flows for the Nine months ended September 30, 2017. See Note 3 of Notes to Condensed Consolidated Financial Statements.

Hyper-inflationary economies

Economies that have a cumulative three-year rate of inflation exceeding 100 percent are considered hyper-inflationary under U.S. GAAP. A legal entity which operates within an economy deemed to be hyper-inflationary is required to remeasure its monetary assets and liabilities to the applicable published exchange rates and record the associated gains or losses resulting from the remeasurement directly to the Condensed Consolidated Statements of Income. The Company has a 50-50 joint venture in a Venezuelan affiliate, Kelko Quaker Chemical, S.A. Venezuela's economy has been considered hyper-inflationary under U.S. GAAP since 2010. As of June 30, 2018, the Company's investment in Kelko Quaker Chemical S.A. was less than $0.1 million. Due to heightened foreign exchange controls and restrictions currently present within Venezuela, during the third quarter of 2018 the Company concluded that it no longer had significant influence over this affiliate. Based on various indices or index compilations currently being used to monitor inflation in Argentina as well as recent economic instability, effective July 1, 2018, Argentina's economy was considered hyper-inflationary under U.S. GAAP. As a result, the Company began applying hyper-inflationary accounting with respect to the Company's wholly owned Argentina subsidiary beginning July 1, 2018. As of, and for the nine months ended September 30, 2018, the Company's Argentina subsidiary represented less than 1% of the Company's consolidated total assets and less than 1% of the Company's consolidated net sales. During the three and nine months ended September 30, 2018, the Company recorded $0.5 million and $0.8 million of remeasurement losses associated with the applicable currency conversions related to Venezuela and Argentina. During the three and nine months ended September 30, 2017, the Company recorded less than $0.1 million and $0.4 million of remeasurement losses related to Venezuela.

Note 2 – Houghton Combination

On April 4, 2017, Quaker entered into a share purchase agreement with Gulf Houghton Lubricants, Ltd. to purchase the entire issued and outstanding share capital of Houghton International, Inc. ("Houghton") (herein referred to as "the Combination"). The shares will be bought for aggregate purchase consideration consisting of: (i) $172.5 million in cash; (ii) a number of shares of common stock, $1.00 par value per share, of the Company comprising 24.5% of the common stock outstanding upon the closing of the Combination; and (iii) the Company's assumption of Houghton's net indebtedness as of the closing of the Combination, which was approximately $690 million at signing. At closing, the total aggregate purchase consideration is dependent on the Company's stock price and the level of Houghton's indebtedness.

The Company secured $1.15 billion in commitments from Bank of America Merrill Lynch and Deutsche Bank to fund the Combination and to provide additional liquidity, and has since replaced these commitments with a syndicated bank agreement ("the New Credit Facility") with a group of lenders for $1.15 billion. The New Credit Facility is contingent upon and will not be effective until the closing of the Combination. During the third quarter of 2018 the Company extended the bank commitment for the New Credit Facility through December 15, 2018. The New Credit Facility is comprised of a $400.0 million multicurrency revolver, a $600.0 million USD term loan and a $150.0 million EUR equivalent term loan, each with a five-year term from the date the New Credit Facility becomes effective. The maximum amount available under the New Credit Facility can be increased by $200.0 million at the Company's option if the lenders agree and the Company satisfies certain conditions. Borrowings under the New Credit Facility will bear interest at a base rate or LIBOR rate plus a margin. The Company currently estimates the annual floating rate cost will be in the 3.50% to 3.75% range based on current market interest rates. The New Credit Facility will be subject to certain financial and other covenants, including covenants that the Company's consolidated net debt to adjusted EBITDA ratio cannot initially exceed 4.25 to 1 and the Company's consolidated adjusted EBITDA to interest expense ratio cannot be less than 3.0 to 1. Both the USD and EUR equivalent term loans will have quarterly principal amortization during their respective five-year terms, with 5% amortization of the principal balance due in years 1 and 2, 7.5% in year 3, and 10% in years 4 and 5, with the remaining principal amounts due at maturity. Until closing, the Company will incur certain interest costs paid to maintain the bank commitment ("ticking fees"), which began to accrue on September 29, 2017 and bear an interest rate of 0.30% per annum.

The Company received regulatory approval for the Combination from China and Australia in 2017. In addition, at a shareholder meeting held during the third quarter of 2017, the Company's shareholders overwhelmingly approved the issuance of the new shares of the Company's common stock at closing of the Combination. Currently, the closing of the Combination is contingent upon customary closing conditions and the remaining regulatory approvals in the United States and Europe. The Company has presented a remedy to the European Commission and the United States Federal Trade Commission and expects to receive approval from both regulatory authorities and close the Combination in December 2018 or January 2019.

The Company incurred total costs of $3.8 million and $14.4 million during the three and nine months ended September 30, 2018, and $9.7 million and $23.1 million during the three and nine months ended September 30, 2017, respectively, related to the Combination. These costs included legal, environmental, financial, and other advisory and consultant costs related to due diligence, regulatory and shareholder approvals and integration planning associated with the Combination, as well as ticking fees. As of September 30, 2018 and December 31, 2017, the Company had current liabilities related to the Combination of approximately $5.1 million and $5.5 million, respectively, primarily recorded within other current liabilities on its Condensed Consolidated Balance Sheets.

Note 3 – Recently Issued Accounting Standards

The Financial Accounting Standards Board ("FASB") issued an accounting standard update in August 2018 that modifies certain disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The amendments in this accounting standard update remove disclosures that are no longer considered cost beneficial, clarify the specific requirements of certain disclosures, and add new disclosure requirements as relevant. The guidance within this accounting standard update is effective for annual periods beginning after December 15, 2020, and should be applied retrospectively to all periods presented. Early adoption is permitted. The Company has not early adopted the guidance and is currently evaluating its implementation.

The FASB issued an accounting standard update in August 2018 that clarifies the accounting for implementation costs incurred in a cloud computing arrangement under a service contract. This guidance generally aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement under a service contract with the requirements for capitalizing implementation costs related to internal-use software. The guidance within this accounting standard update is effective for annual periods beginning after December 15, 2019, and should be applied either retrospectively or prospectively to all implementation costs incurred after the date of adoption. Early adoption is permitted. The

Company has not early adopted the guidance and is currently evaluating its implementation.

The FASB issued an accounting standard update in August 2018 that modifies certain disclosure requirements for fair value measurements. The guidance removes certain disclosure requirements regarding transfers between levels of the fair value hierarchy as well as the valuation processes for certain fair value measurements. Further, the guidance added certain disclosure requirements including unrealized gains and losses and significant unobservable inputs used to develop certain fair value measurements. The guidance within this accounting standard update is effective for annual and interim periods beginning after December 15, 2019, and should be applied prospectively in the initial year of adoption or prospectively to all periods presented, depending on the amended disclosure requirement. Early adoption is permitted. The Company has not early adopted the guidance and is currently evaluating its implementation.

The FASB issued an accounting standard update in June 2018 to simplify the accounting for share-based payment transactions with non-employees of the Company. The guidance within this accounting standard update generally requires that share-based payment transactions for acquiring goods or services from non-employees of the Company be accounted for under the same guidance and model as all other share-based payment transactions, including employees of the Company. The guidance within this accounting standard update is effective for annual and interim periods beginning after December 15, 2018. Early adoption is permitted. The Company elected to early adopt the guidance within this accounting standard updated in the second quarter of 2018 with no impact to its financial statements.

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements - Continued

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

The FASB issued an accounting standard update in February 2018 that allows a reclassification from accumulated other comprehensive income ("AOCI") to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act enacted in December 2017. The guidance within this accounting standard update is effective for annual and interim periods beginning after December 15, 2018, and should be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. Early adoption is permitted. The Company has not early adopted the guidance and is currently evaluating its implementation.

The FASB issued an accounting standard update in January 2017 to clarify the definition of a business with the objective of adding guidance to assist companies with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendments in this accounting standard update provided a more robust framework to use in determining when a set of assets and activities is a business. The guidance within this accounting standard update was effective for annual and interim periods beginning after December 15, 2017. Early adoption was permitted in limited circumstances, and the amendments in this accounting standard update were required to be applied prospectively, with no disclosures required at transition. The Company adopted the guidance in the first quarter of 2018, as required, with no impact to its financial statements.

The FASB issued an accounting standard update in November 2016 requiring that the statement of cash flows explain both the change in the total cash and cash equivalents, and also the amounts generally described as restricted cash or restricted cash equivalents. This required amounts generally described as restricted cash or restricted cash equivalents be included with cash and cash equivalents when reconciling the beginning and ending amounts shown on the statement of cash flows. The guidance within this accounting standard update was effective for annual and interim periods beginning after December 15, 2017. Early adoption was permitted and the guidance required application using a retrospective transition method to each period presented when adopted. The Company adopted the guidance in the first quarter of 2018, as required. Adoption of the guidance did not have an impact on the Company's earnings or balance sheet but did result in changes to certain disclosures within the statement of cash flows, including cash flows from investing activities and total cash, cash equivalents and restricted cash. See Note 12 of Notes to Condensed Consolidated Financial Statements.

The FASB issued an accounting standard update in October 2016 to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. The provisions in this update allowed an entity to recognize current and deferred income taxes of an intra-entity transfer of an asset other than inventory when the transfer occurs rather than when the asset has been sold to an outside party. The guidance within this accounting standard update was effective for annual and interim periods beginning after December 15, 2017. Early adoption was permitted and the guidance required application on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company adopted the guidance in the first quarter of 2018, as required, with no impact to its financial statements.

The FASB issued an accounting standard update in August 2016 to standardize how certain transactions are classified in the statement of cash flows. Specific transactions covered by the accounting standard update include debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate and bank owned life insurance policies, distributions received from equity method investments and beneficial interest in securitization transactions. The guidance within this accounting standard update was effective for annual and interim periods beginning after December 15, 2017. Early adoption was permitted, provided that all of the amendments were adopted in the same period. The guidance required application using a retrospective transition method. The Company adopted the guidance in the first quarter of 2018 as required, with no impact to its financial statements.

The FASB issued an accounting standard update in February 2016 regarding the accounting and disclosure for leases. During 2018, the FASB issued a series of accounting standard updates to clarify and expand on the original 2016 implementation guidance, including certain targeted improvements around comparative reporting requirements and accounting for lease and non-lease components by lessors as well as other technical corrections and improvements. The amendments in these 2018 updates did not change the core principles of the guidance previously issued in February 2016. The guidance within all of the leasing accounting standard updates are effective for annual and interim periods beginning after December 15, 2018, and should be applied on a modified retrospective basis, applying the transition requirements either (a) at the beginning of the earliest period presented in the financial statements in the year of adoption (i.e. January 1, 2017) or (b) in the period of adoption (i.e. January 1, 2019). Early adoption is permitted, but the Company has not early adopted. The Company expects to adopt the guidance in the first quarter of 2019, as required, using a modified retrospective transition approach The Company currently anticipates electing to apply the transition requirements in the period of adoption (i.e. as of January 1, 2019), as permitted. As such the Company will neither restate comparative periods for the effects of this lease accounting guidance or provide the disclosures requirements for comparative periods. While the Company's decisions are not finalized, the Company anticipates electing to apply certain of the permitted practical expedients within the new lease accounting guidance, and, also, the Company anticipates making certain accounting policy elections as a result of adopting the new lease accounting guidance.

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements - Continued

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

As of September 30, 2018, the Company has substantially completed its implementation planning and has made significant progress towards completing its impact assessment. Work performed to date includes developing a detailed project plan, identifying and establishing a cross-functional implementation team and developing pre-adoption internal controls. In addition, the Company has gathered an inventory of the Company's explicit outstanding leases globally, performed certain review procedures to ensure completeness of its lease population and began abstracting critical lease information from the lease population for inclusion within the Company's leasing software. Also, the Company has begun preliminary considerations for how the new lease accounting guidance may impact Houghton, as it pertains to the potential Combination. The Company anticipates using the remainder of 2018 to further develop its considerations for the potential Houghton Combination as well as finalize its impact assessment and implementation including completing the abstraction of critical lease information for inclusion within the Company's leasing software and calculating a preliminary transition adjustment that will be reflected in the Company's financial statements starting after the effective date of January 1, 2019. While the Company's implementation of this lease accounting guidance is still on-going, the Company anticipates adoption of this guidance will have a material impact on its balance sheet as it expects the majority of its leases will be recorded on its balance sheet by establishing right of use assets and associated lease liabilities. The Company previously disclosed in its Annual Report filed on Form 10-K for the year ended December 31, 2017 that its undiscounted contractual obligations associated with operating leases were $27.6 million in the aggregate, which will be one of the significant inputs used in calculating the amount of right of use assets and associated lease liabilities the Company will record on its Condensed Consolidated Balance Sheet as of January 1, 2019 upon adoption of this lease accounting guidance.

The FASB issued an accounting standard update in May 2014 regarding the accounting for and disclosure of revenue recognition. Specifically, the update outlined a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers, which will be common to both U.S. GAAP and International Financial Reporting Standards. The guidance was effective for annual and interim periods beginning after December 15, 2016, and allowed for full retrospective adoption of prior period data or a modified retrospective adoption. Early adoption was not permitted. In August 2015, the FASB issued an accounting standard update to delay the effective date of the new revenue standard by one year, or, in other words, to be effective for annual and interim periods beginning after December 15, 2017. Entities were permitted to adopt the new revenue standard early but not before the original effective date. During 2016 and 2017, the FASB issued a series of accounting standard updates to clarify and expand on the implementation guidance, including principal versus agent considerations, identification of performance obligations, licensing, other technical corrections and adding certain practical expedients. The amendments in these 2016 and 2017 updates did not change the core principles of the guidance previously issued in May 2014.

As part of the Company's impact assessment for the implementation of the new revenue recognition guidance, the Company reviewed its historical accounting policies and practices to identify potential differences with the requirements of the new revenue recognition standard as it related to the Company's contracts and sales arrangements. In addition, the impact assessment and work performed included global and cross functional interviews and questionnaires, sales agreement and other sales document reviews, as well as technical considerations for the Company's future transactional accounting, financial reporting and disclosure requirements. The Company has also progressed its assessment of how the new revenue recognition guidance may impact Houghton, as it pertains to the pending Combination.

The Company adopted the guidance in the first quarter of 2018 as required, electing to use a modified retrospective adoption approach applied to those contracts which were not completed as of January 1, 2018. Comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. In addition, the Company elected to apply certain of the permitted practical expedients within the revenue recognition guidance and make certain accounting policy elections including those related to significant financing components, sales taxes and shipping and handling activities. Adoption of the revenue recognition guidance did not have a material impact on the Company's reported earnings or cash flows, however, adoption did increase the amount and level of disclosures concerning the Company's net sales and did result in one adjustment to the Company's balance sheet. As a result of the Company's impact assessment and adoption using the modified retrospective adoption approach, the Company recorded an adjustment to its Condensed Consolidated Balance Sheet as of December 31, 2017 to adjust the Company's estimate of variable consideration relating to customers' expected rights to return product. This adjustment resulted in an increase to other current liabilities of $1.0 million, an increase to non-current deferred tax assets of $0.2 million and a decrease to retained earnings of $0.8 million. There were no other impacts recorded as a result of adopting the revenue recognition guidance. The impact of adoption of the new revenue recognition guidance was immaterial for the three and nine months ended September 30, 2018 and the Company expects the impact to be immaterial on an ongoing basis. See Note 4 of Notes to Condensed Consolidated Financial Statements.

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements - Continued

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

Note 4 – Net Sales and Revenue Recognition

Business Description

The Company develops, produces, and markets a broad range of formulated chemical specialty products and offers chemical management services ("CMS") for various heavy industrial and manufacturing applications in a global portfolio throughout its four regions: North America, Europe, Middle East and Africa ("EMEA"), Asia/Pacific and South America. The major product lines in the Company's global portfolio include: (i) rolling lubricants (used by manufacturers of steel in the hot and cold rolling of steel and by manufacturers of aluminum in the hot rolling of aluminum); (ii) machining and grinding compounds (used by metalworking customers in cutting, shaping, and grinding metal parts which require special treatment to enable them to tolerate the manufacturing process, achieve closer tolerance, and improve tool life); (iii) corrosion preventives (used by steel and metalworking customers to protect metal during manufacture, storage, and shipment); (iv) hydraulic fluids (used by steel, metalworking, and other customers to operate hydraulic equipment); (v) specialty greases (used in automotive and aerospace production processes and applications, the manufacturing of steel, and various other applications); and (vi) metal finishing compounds (used to prepare metal surfaces for special treatments such as galvanizing and tin plating and to prepare metal for further processing).

A substantial portion of the Company's sales worldwide are made directly through its own employees and its CMS programs, with the balance being handled through distributors and agents. The Company's employees visit the plants of customers regularly, work on site, and, through training and experience, identify production needs which can be resolved or alleviated either by adapting the Company's existing products or by applying new formulations developed in its laboratories. The chemical specialty industry comprises many companies of similar size as well as companies larger and smaller than Quaker. The offerings of many of the Company's competitors differ from those of Quaker; some offer a broad portfolio of fluids, including general lubricants, while others have a more specialized product range. All competitors provide different levels of technical services to individual customers. Competition in the industry is based primarily on the ability to provide products that meet the needs of the customer, render technical services and laboratory assistance to the customer and, to a lesser extent, on price.

As part of the Company's CMS, certain third-party product sales to customers are managed by the Company. Where the Company acts as a principal, revenues are recognized on a gross reporting basis at the selling price negotiated with its customers. Where the Company acts as an agent, revenue is recognized on a net reporting basis at the amount of the administrative fee earned by the Company for ordering the goods. In determining whether the Company is acting as a principal or an agent in each arrangement, the Company considers whether it is primarily responsible for fulfilling the promise to provide the specified good, has inventory risk before the specified good has been transferred to the customer and has discretion in establishing the prices for the specified goods. Third-party products transferred under arrangements resulting in net reporting totaled $11.7 million and $35.8 million for the three and nine months ended September 30, 2018, respectively, and $11.2 million and $33.0 million for the three and nine months ended September 30, 2017, respectively.

A significant portion of the Company's revenues are realized from the sale of process fluids and services to manufacturers of steel, automobiles, aircraft, appliances, and durable goods, and, therefore, the Company is subject to the same business cycles as those experienced by these manufacturers and their customers. The Company's financial performance is generally correlated to the volume of global production within the industries it serves, rather than discretely related to financial performance of such industries. Furthermore, steel customers typically have limited manufacturing locations compared to other metalworking customers and generally use higher volumes of products at a single location. As previously disclosed in its Annual Report filed on Form 10-K for the year ended December 31, 2017, during 2017 the Company's five largest customers (each composed of multiple subsidiaries or divisions with semiautonomous purchasing authority) accounted for approximately 18% of consolidated net sales, with its largest customer accounting for approximately 8% of consolidated net sales.

Revenue Recognition Model

The Company applies the FASB's guidance on revenue recognition which requires the Company to recognize revenue in an amount that reflects the consideration to which the Company expects to be entitled in exchange for goods or services transferred to its customers. To do this, the Company applies the five-step model in the FASB's guidance, which requires the Company to: (i) identify the contract with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when, or as, the Company satisfies a performance obligation.

The Company identifies a contract with a customer when a sales agreement indicates approval and commitment of the parties; identifies the rights of the parties; identifies the payment terms; has commercial substance; and it is probable that the Company will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In most instances, the Company's contract with a customer is the customer's purchase order. For certain customers, the Company may also enter into a sales agreement which outlines a framework of terms and conditions which apply to all future and subsequent purchase orders for that customer. In these situations, the Company's contract with the customer is both the sales agreement as well as the specific customer purchase order. Because the Company's contract with a customer is typically for a single transaction or customer purchase order, the duration of the contract is almost always one year or less. As a result, the Company has elected to apply certain practical expedients and omit certain disclosures of remaining performance obligations for contracts which have an initial term of one year or less as permitted by the FASB.

The Company identifies a performance obligation in a contract for each promised good or service that is separately identifiable from other promises in the contract and for which the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer. The Company determines the transaction price as the amount of consideration it expects to be entitled to in exchange for fulfilling the performance obligations, including the effects of any variable consideration, significant financing elements, amounts payable to the customer or noncash consideration. For any contracts that have more than one performance obligation, the Company allocates the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the Company expects to be entitled in exchange for satisfying each performance obligation.

In accordance with the last step of the FASB's guidance, the Company recognizes revenue when, or as, it satisfies the performance obligation in a contract by transferring control of a promised good or service to the customer. The Company recognizes revenue over time whenever the customer simultaneously receives and consumes the benefits provided by the Company's performance; the Company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or the Company's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment, including a profit margin, for performance completed to date. For performance obligations not satisfied over time, the Company determines the point in time at which a customer obtains control of a promised asset and the Company satisfies a performance obligation by considering when the Company has a right to payment for the asset; the customer has legal title to the asset; the Company has transferred physical possession of the asset; the customer has the significant risks and rewards of ownership of the asset; or the customer has accepted the asset.

The Company typically satisfies its performance obligations and recognizes revenue at a point in time for product sales, generally when products are shipped or delivered to the customer, depending on the terms underlying each arrangement. In circumstances where the Company's products are on consignment, revenue is generally recognized upon usage or consumption by the customer. For any CMS or other services provided by the Company to the customer, the Company typically satisfies its performance obligations and recognizes revenue over time, as the promised services are performed. The Company uses input methods to recognize revenue over time related to these services, including labor costs and time incurred. The Company believes that these input methods represent the most indicative measure of the CMS or other service work performed by the Company.

Other Considerations

The Company does not have standard payment terms for all customers globally, however the Company's general payment terms require customers to pay for products or services provided after the performance obligation is satisfied. The Company does not have significant financing arrangements with its customers. The Company does not have significant amounts of variable consideration in its contracts with customers and where applicable, the Company's estimates of variable consideration are not constrained. The Company records certain third-party license fees in other income (expense), net, in its Condensed Consolidated Statement of Income, which generally include sales-based royalties in exchange for the license of intellectual property. These license fees are recognized in accordance with their agreed-upon terms and when performance obligations are satisfied, which is generally when the third party has a subsequent sale.

Practical Expedients and Accounting Policy Elections

The Company made certain accounting policy elections and elected to use certain practical expedients as permitted by the FASB in applying the guidance on revenue recognition. It is the Company's policy to not adjust the promised amount of consideration for the effects of a significant financing component as the Company expects, at contract inception, that the period between when the Company transfers a promised good or service to the customer and when the customer pays for that good or service will be one year or less. In addition, it is the Company's policy to expense costs to obtain a contract as incurred when the expected period of benefit, and therefore the amortization period, is one year or less. It is also the Company's accounting policy to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer, including sales, use, value added, excise and various other taxes. Lastly, the Company has elected to account for shipping and handling activities that occur after the customer has obtained control of a good as a fulfilment cost rather than an additional promised service.

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements - Continued

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

Contract Assets and Liabilities

The Company recognizes a contract asset or receivable on its Condensed Consolidated Balance Sheet when the Company performs a service or transfers a good in advance of receiving consideration. A receivable is the Company's right to consideration that is unconditional and only the passage of time is required before payment of that consideration is due. A contract asset is the Company's right to consideration in exchange for goods or services that the Company has transferred to a customer. The Company had no contract assets recorded on its Condensed Consolidated Balance Sheets as of September 30, 2018 or December 31, 2017.

A contract liability is recognized when the Company receives consideration, or if it has the unconditional right to receive consideration, in advance of performance. A contract liability is the Company's obligation to transfer goods or services to a customer for which the Company has received consideration, or a specified amount of consideration is due, from the customer. The Company's contract liabilities primarily represent deferred revenue recorded for customer payments received by the Company prior to the Company satisfying the associated performance obligation. Deferred revenues are presented within other current liabilities in the Company's Condensed Consolidated Balance Sheets. The Company had approximately $1.6 million and $1.5 million of deferred revenue as of September 30, 2018 and December 31, 2017, respectively. During the three and nine months ended September 30, 2018 the Company satisfied the associated performance obligations and recognized revenue of $1.6 million and $4.4 million, respectively, related to advance customer payments previously received.

Disaggregated Revenue

The Company sells its various industrial process fluids, its chemical specialties and its technical expertise as a global product portfolio. The Company generally manages and evaluates its performance by geography first, and then by customer industry, rather than by individual product lines. The Company has provided annual net sales information for its product lines greater than 10% in its previously filed Form 10-K for the year ended December 31, 2017, and those annual percentages are generally consistent with the current year's net sales by product line. Also, net sales of each of the Company's major product lines are generally spread throughout all four of the Company's regions, and in most cases are relatively proportionate to the level of total sales in each region.

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements - Continued

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

The following disaggregates the Company's net sales by region, customer industry, and timing of revenue recognized for the three and nine months ended September 30, 2018:

	Three Months Ended September 30, 2018				
	North America	**EMEA**	**Asia/Pacific**	**South America**	**Consolidated Total**
Net sales	$ 101,706	$ 55,498	$ 55,757	$ 9,061	$ 222,022
Customer Industries					
Primary metals	$ 40,448	$ 24,188	$ 35,108	$ 4,781	$ 104,525
Metalworking	45,189	27,986	19,585	3,768	96,528
Coatings and other	16,069	3,324	1,064	512	20,969
	$ 101,706	$ 55,498	$ 55,757	$ 9,061	$ 222,022
Timing of Revenue Recognized					
Product sales at a point in time	$ 98,965	$ 55,437	$ 53,998	$ 8,992	$ 217,392
Services transferred over time	2,741	61	1,759	69	4,630
	$ 101,706	$ 55,498	$ 55,757	$ 9,061	$ 222,022

	Nine Months Ended September 30, 2018				
	North America	**EMEA**	**Asia/Pacific**	**South America**	**Consolidated Total**
Net sales	$ 290,918	$ 177,719	$ 159,882	$ 27,520	$ 656,039
Customer Industries					
Primary metals	$ 117,174	$ 77,692	$ 101,026	$ 15,115	$ 311,007
Metalworking	128,709	88,909	56,486	11,416	285,520
Coatings and other	45,035	11,118	2,370	989	59,512
	$ 290,918	$ 177,719	$ 159,882	$ 27,520	$ 656,039
Timing of Revenue Recognized					
Product sales at a point in time	$ 282,513	$ 177,546	$ 153,863	$ 27,298	$ 641,220
Services transferred over time	8,405	173	6,019	222	14,819
	$ 290,918	$ 177,719	$ 159,882	$ 27,520	$ 656,039

Note 5 – Business Segments

The Company's reportable operating segments are organized by geography as follows: (i) North America, (ii) EMEA, (iii) Asia/Pacific and (iv) South America. Operating earnings, excluding indirect operating expenses, for the Company's reportable operating segments is comprised of revenues less cost of goods sold ("COGS") and selling, general and administrative expenses ("SG&A") directly related to the respective region's product sales. The indirect operating expenses consist of SG&A not directly attributable to the product sales of each respective reportable operating segment. Other items not specifically identified with the Company's reportable operating segments include interest expense, interest income, license fees from non-consolidated affiliates, amortization expense and other (expense) income, net.

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements - Continued

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

The following table presents information about the performance of the Company's reportable operating segments for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	**2017**	**2018**	**2017**
Net sales				
North America	$ 101,706	$ 90,450	$ 290,918	$ 268,122
EMEA	55,498	58,775	177,719	167,209
Asia/Pacific	55,757	54,200	159,882	147,074
South America	9,061	9,493	27,520	26,605
Total net sales	$ 222,022	$ 212,918	$ 656,039	$ 609,010
Operating earnings, excluding indirect operating expenses				
North America	$ 24,558	$ 18,888	$ 68,160	$ 59,146
EMEA	8,577	8,862	27,966	26,325
Asia/Pacific	14,761	13,963	41,524	36,018
South America	1,214	965	2,963	2,826
Total operating earnings, excluding indirect operating expenses	49,110	42,678	140,613	124,315
Combination-related expenses	(2,904)	(9,675)	(12,404)	(23,088)
Indirect operating expenses	(19,460)	(17,108)	(54,971)	(50,067)
Amortization expense	(1,827)	(1,886)	(5,525)	(5,490)
Consolidated operating income	24,919	14,009	67,713	45,670
Other (expense) income, net	(523)	249	(631)	(1,427)
Interest expense	(1,510)	(793)	(4,804)	(2,229)
Interest income	521	762	1,581	1,825
Consolidated income before taxes and equity in net income of associated companies	$ 23,407	$ 14,227	$ 63,859	$ 43,839

Inter-segment revenues for the three and nine months ended September 30, 2018 were $2.5 million and $7.4 million for North America, $5.9 million and $16.9 million for EMEA, less than $0.1 million and $0.5 million for Asia/Pacific, respectively, and less than $0.1 million for South America in both periods. Inter-segment revenues for the three and nine months ended September 30, 2017 were $2.8 million and $7.4 million for North America, $6.2 million and $16.0 million for EMEA, $0.2 million and $0.3 million for Asia/Pacific, respectively, and less than $0.1 million for South America in both periods. However, all inter-segment transactions have been eliminated from each reportable operating segment's net sales and earnings for all periods presented above.

Note 6 – Restructuring and Related Activities

As previously disclosed in its Annual Report filed on Form 10-K for the year ended December 31, 2017, in the fourth quarter of 2015 Quaker's management approved a global restructuring plan (the "2015 Program") to reduce its operating costs. The 2015 Program included provisions for the reduction of total headcount of approximately 65 employees globally. The Company completed all of the remaining initiatives under the 2015 Program during the first half of 2017 and does not expect to incur further restructuring charges under this program. Restructuring activity recognized by reportable operating segment in connection with the 2015 Program during the nine months ended September 30, 2017 is as follows:

	North America	EMEA	Total
Accrued restructuring as of December 31, 2016	$ 196	$ 474	$ 670
Restructuring charges and adjustments	(126)	126	—
Cash payments	(70)	(605)	(675)
Currency translation adjustments	—	5	5
Accrued restructuring as of September 30, 2017	$ —	$ —	$ —

There were no accrued restructuring liabilities as of December 31, 2017 and no associated cash payments or other restructuring activity during the nine months ended September 30, 2018.

Quaker Chemical Corporation

Notes to Condensed Consolidated Financial Statements - Continued

(Dollars in thousands, except share and per share amounts, unless otherwise stated)

(Unaudited)

Note 7 – Share-Based Compensation

The Company recognized the following share-based compensation expense in SG&A in its Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	**2017**	**2018**	**2017**
Stock options	$ 267	$ 243	$ 785	$ 714
Nonvested stock awards and restricted stock units	550	717	1,901	2,314
Employee stock purchase plan	24	22	68	66
Non-elective and elective 401(k) matching contribution in stock	—	8	—	72
Director stock ownership plan	31	34	93	103
Total share-based compensation expense	$ 872	$ 1,024	$ 2,847	$ 3,269

During the first quarter of 2018, the Company granted stock options under its long-term incentive plan ("LTIP") that are subject only to time vesting over a three-year period. For the purposes of determining the fair value of stock option awards, the Company used the Black-Scholes option pricing model and the assumptions set forth in the table below:

Number of options granted	35,842
Dividend yield	1.37%
Expected volatility	24.73%
Risk-free interest rate	2.54%
Expected term (years)	4.0

The fair value of these options is amortized on a straight-line basis over the vesting period. As of September 30, 2018, unrecognized compensation expense related to options granted was $1.5 million, to be recognized over a weighted average remaining period of 1.9 years. There were no stock options granted in the second or third quarters of 2018.

During the first nine months of 2018, the Company granted 16,166 nonvested restricted shares and 1,480 nonvested restricted stock units under its LTIP plan that are subject only to time vesting, generally over a three-year period. The fair value of these awards is based on the trading price of the Company's common stock on the date of grant. The Company adjusts the grant date fair value of these awards for expected forfeitures based on historical experience. As of September 30, 2018, unrecognized compensation expense related to the nonvested shares was $2.7 million, to be recognized over a weighted average remaining period of 1.8 years, and unrecognized compensation expense related to nonvested restricted stock units was $0.2 million, to be recognized over a weighted average remaining period of 2.0 years.

Note 8 – Pension and Other Postretirement Benefits

The components of net periodic benefit cost for the three and nine months ended September 30, 2018 and 2017 are as follows:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	Pension Benefits		Other Postretirement Benefits		Pension Benefits		Other Postretirement Benefits	
	2018	2017	2018	2017	2018	2017	2018	2017
Service cost	$ 938	$ 921	$ —	$ 2	$ 2,886	$ 2,710	$ 5	$ 6
Interest cost	1,015	994	31	36	3,096	3,005	97	108
Expected return on plan assets	(1,229)	(1,276)	—	—	(3,793)	(3,857)		