MATERION Corp
Form 10-Q
November 02, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 28, 2012

¨ 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 001-15885

MATERION CORPORATION

(Exact name of Registrant as specified in charter)

Ohio	**34-1919973**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6070 Parkland Blvd., Mayfield Hts., Ohio	**44124**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code:

216-486-4200

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 þ 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 þ 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 the definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ 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 þ

As of October 26, 2012, there were 20,432,597 common shares, no par value, outstanding.

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PART I FINANCIAL INFORMATION

MATERION CORPORATION AND SUBSIDIARIES

Item 1. Financial Statements

The consolidated financial statements of Materion Corporation and its subsidiaries for the third quarter and first nine months ended September 28, 2012 are as follows:

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Materion Corporation and Subsidiaries

Consolidated Statements of Income

(Unaudited)

(Thousands, except per share amounts)	Third Quarter Ended Sept. 28, 2012	Third Quarter Ended Sept. 30, 2011	Nine Months Ended Sept. 28, 2012	Nine Months Ended Sept. 30, 2011
Net sales	$ 290,601	$ 392,794	$ 969,319	$ 1,192,309
Cost of sales	238,232	335,444	814,507	1,016,487
Gross margin	52,369	57,350	154,812	175,822
Selling, general and administrative expense	32,832	32,322	98,938	98,012
Research and development expense	3,019	2,821	9,310	7,946
Other net	3,129	5,016	10,846	13,752
Operating profit	13,389	17,191	35,718	56,112
Interest expense net	779	807	2,297	2,005
Income before income taxes	12,610	16,384	33,421	54,107
Income tax expense	4,496	2,857	11,260	14,890
Net income	$ 8,114	$ 13,527	$ 22,161	$ 39,217
Basic earnings per share:				
Net income per share of common stock	$ 0.40	$ 0.66	$ 1.08	$ 1.92
Diluted earnings per share:				
Net income per share of common stock	$ 0.39	$ 0.65	$ 1.07	$ 1.89
Cash dividends per share	$ 0.075	$ 0.00	$ 0.15	$ 0.00
Weighted-average number of shares of common stock outstanding				
Basic	20,432	20,377	20,434	20,385
Diluted	20,697	20,749	20,639	20,792

See Notes to Consolidated Financial Statements.

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Materion Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

	Third Quarter Ended		Nine Months Ended	
(Thousands)	**Sept. 28, 2012**	**Sept. 30, 2011**	**Sept. 28, 2012**	**Sept. 30, 2011**
Net income	$ 8,114	$ 13,527	$ 22,161	$ 39,217
Other comprehensive income:				
Foreign currency translation adjustment	1,271	(224)	449	1,845
Derivative and hedging activity, net of tax	(521)	1,332	(858)	921
Pension and post employment benefit adjustment, net of tax	835	343	2,504	1,463
Net change in accumulated other comprehensive income	1,585	1,451	2,095	4,229
Comprehensive income	$ 9,699	$ 14,978	$ 24,256	$ 43,446

See Notes to Consolidated Financial Statements.

Materion Corporation and Subsidiaries

Consolidated Balance Sheets

(Unaudited)

(Thousands)	**Sept. 28, 2012**	**Dec. 31, 2011**
Assets		
Current assets		
Cash and cash equivalents	$ 10,894	$ 12,255
Accounts receivable	138,877	117,761
Other receivables	209	4,602
Inventories	211,443	187,176
Prepaid expenses	44,610	39,739
Deferred income taxes	10,099	9,368
Total current assets	416,132	370,901
Related-party notes receivable	51	73
Long-term deferred income taxes	11,627	11,627
Property, plant and equipment cost	769,985	753,326
Less allowances for depreciation, depletion and amortization	(501,382)	(489,513)
Property, plant and equipment net	268,603	263,813
Intangible assets	30,131	34,580
Other assets	5,348	7,073
Goodwill	86,467	84,036
Total assets	$ 818,359	$ 772,103
Liabilities and shareholders equity		
Current liabilities		
Short-term debt	$ 57,455	$ 40,944
Accounts payable	31,831	39,385
Other liabilities and accrued items	55,581	56,309
Unearned revenue	1,717	3,033
Total current liabilities	146,584	139,671
Other long-term liabilities	16,762	16,488
Retirement and post-employment benefits	98,421	105,115
Unearned income	57,859	62,540
Long-term income taxes	1,385	1,793
Deferred income taxes	2,193	51
Long-term debt	65,028	40,463
Shareholders equity	430,127	405,982
Total liabilities and shareholders equity	$ 818,359	$ 772,103

See Notes to Consolidated Financial Statements.

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Materion Corporation and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

	Nine Months Ended	
(Thousands)	**Sept. 28, 2012**	**Sept. 30, 2011**
Cash flows from operating activities:		
Net income	$ 22,161	$ 39,217
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation, depletion and amortization	28,923	32,355
Amortization of deferred financing costs in interest expense	487	341
Stock-based compensation expense	4,343	3,593
Changes in assets and liabilities net of acquired assets and liabilities:		
Decrease (increase) in accounts receivable	(20,451)	(16,337)
Decrease (increase) in other receivables	4,393	1,500
Decrease (increase) in inventory	(23,795)	(38,291)
Decrease (increase) in prepaid and other current assets	(4,852)	(10,633)
Decrease (increase) in deferred income taxes	(812)	(40)
Increase (decrease) in accounts payable and accrued expenses	(12,805)	(4,825)
Increase (decrease) in unearned revenue	(1,316)	(363)
Increase (decrease) in interest and taxes payable	(577)	(4,185)
Increase (decrease) in long-term liabilities	(3,618)	(10,916)
Other-net	545	(3,134)
Net cash used in operating activities	(7,374)	(11,718)
Cash flows from investing activities:		
Payments for purchase of property, plant and equipment	(25,335)	(18,722)
Payments for mine development	(4,992)	(302)
Reimbursements for capital equipment under government contracts	991	2,917
Payments for purchase of business net of cash received	(3,894)	
Proceeds from sale of property, plant and equipment		33
Other investments-net	1,742	13
Net cash used in investing activities	(31,488)	(16,061)
Cash flows from financing activities:		
Proceeds from issuance (repayments) of short-term debt	16,505	(1,240)
Proceeds from issuance of long-term debt	32,305	92,510
Repayment of long-term debt	(7,740)	(65,175)
Debt issuance costs		(2,554)
Principal payments under capital lease obligations	(580)	(547)
Repurchase of common stock	(119)	(3,776)
Cash dividends paid	(3,083)	
Issuance of common stock under stock option plans	144	720
Tax benefit from stock compensation realization	77	389
Net cash provided from financing activities	37,509	20,327
Effects of exchange rate changes	(8)	313
Net change in cash and cash equivalents	(1,361)	(7,139)
Cash and cash equivalents at beginning of period	12,255	16,104

Cash and cash equivalents at end of period	$ 10,894	$ 8,965

See Notes to Consolidated Financial Statements.

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Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note A Accounting Policies

In management s opinion, the accompanying consolidated financial statements contain all adjustments necessary to present fairly the financial position as of September 28, 2012 and December 31, 2011 and the results of operations for the third quarter and nine months ended September 28, 2012 and September 30, 2011. All adjustments were of a normal and recurring nature.

Note B Inventories

Inventories on the Consolidated Balance Sheets are summarized as follows:

(Thousands)	Sept. 28, 2012	Dec. 31, 2011
Principally average cost:		
Raw materials and supplies	$ 48,680	$ 42,969
Work in process	200,599	179,445
Finished goods	57,131	57,645
Gross inventories	306,410	280,059
Excess of average cost over LIFO inventory value	94,967	92,883
Net inventories	$ 211,443	$ 187,176

Note C Pensions and Other Post-employment Benefits

The following is a summary of the third quarter and first nine months of 2012 and 2011 net periodic benefit cost for the domestic defined benefit pension plans, supplemental retirement plans and the domestic retiree medical plan.

	Pension Benefits Third Quarter Ended		Other Benefits Third Quarter Ended	
(Thousands)	Sept. 28, 2012	Sept. 30, 2011	Sept. 28, 2012	Sept. 30, 2011
Components of net periodic benefit cost				
Service cost	$ 1,932	$ 1,516	$ 71	$ 71
Interest cost	2,336	2,309	360	399
Expected return on plan assets	(2,926)	(2,685)		
Amortization of prior service cost (benefit)	(84)	(118)	22	(9)
Amortization of net loss	1,402	982		
Net periodic benefit cost	$ 2,660	$ 2,004	$ 453	$ 461

	Pension Benefits Nine Months Ended		Other Benefits Nine Months Ended	
	Sept. 28,	Sept. 30,		Sept. 30,

(Thousands)	2012	2011	Sept. 28, 2012	2011
Components of net periodic benefit cost				
Service cost	$ 5,796	$ 4,549	$ 213	$ 213
Interest cost	7,008	6,927	1,080	1,197
Expected return on plan assets	(8,777)	(8,056)		
Amortization of prior service cost (benefit)	(251)	(354)	65	(27)
Amortization of net loss	4,206	2,945		
Net periodic benefit cost	$ 7,982	$ 6,011	$ 1,358	$ 1,383

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Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note C Pensions and Other Post-employment Benefits (Continued)

The Company made contributions to the domestic defined benefit pension plan of $10.1 million in the first nine months of 2012.

The Company closed the domestic defined benefit pension plan to new entrants as of May 26, 2012. Employees currently eligible under the domestic defined benefit pension plan will continue to accrue benefits under existing formulas. Employees not eligible for the domestic defined benefit pension plan will receive additional contributions under the defined contribution plan.

Note D Contingencies

Materion Brush Inc., one of the Company s wholly owned subsidiaries, is a defendant from time to time in legal proceedings where the plaintiffs allege they have contracted chronic beryllium disease (CBD) or related ailments as a result of exposure to beryllium. The Company will record a reserve for CBD or other litigation when a loss from either settlement or verdict is probable and estimable. Claims filed by third-party plaintiffs where the alleged exposure occurred prior to December 31, 2007 may be covered by insurance subject to an annual deductible of $1.0 million. Reserves are recorded for asserted claims only and defense costs are expensed as incurred. Late in the third quarter 2012, the Company received notice that the spouse of a former employee has filed a claim alleging she has contracted chronic beryllium disease. The Company had not yet been served with the complaint and therefore the claim had not been evaluated and no loss reserve was established as of the end of the third quarter 2012. There were no other CBD claims asserted or settled during the first nine months of 2012.

The Company has an active environmental compliance program and records reserves for the probable cost of identified environmental remediation projects. The reserves are established based upon analyses conducted by the Company s engineers and outside consultants and are adjusted from time to time based upon ongoing studies, the difference between actual and estimated costs and other factors. The reserves may also be affected by rulings and negotiations with regulatory agencies. The undiscounted reserve balance was $5.4 million as of September 28, 2012 and $5.3 million as of December 31, 2011. Environmental projects tend to be long-term and the final actual remediation costs may differ from the amounts currently recorded.

Note E Segment Reporting

(Thousands)	Advanced Material Technologies	Performance Alloys	Beryllium and Composites	Technical Materials	Subtotal	All Other	Total
Third Quarter 2012							
Sales to external customers	$ 190,508	$ 68,700	$ 14,418	$ 16,975	$ 290,601	$	$ 290,601
Intersegment sales	520	599	245	119	1,483		1,483
Operating profit (loss)	9,212	5,404	(515)	1,135	15,236	(1,847)	13,389
Third Quarter 2011							
Sales to external customers	$ 274,640	$ 81,739	$ 15,340	$ 20,983	$ 392,702	$ 92	$ 392,794
Intersegment sales	679	838	96	789	2,402		2,402
Operating profit (loss)	11,177	5,907	364	2,393	19,841	(2,650)	17,191
First Nine Months 2012							
Sales to external customers	$ 654,245	$ 216,434	$ 43,102	$ 55,459	$ 969,240	$ 79	$ 969,319
Intersegment sales	1,691	1,968	574	590	4,823		4,823
Operating profit (loss)	22,011	18,349	(3,823)	4,995	41,532	(5,814)	35,718
Assets	366,190	257,825	134,787	23,094	781,896	36,463	818,359

First Nine Months 2011							
Sales to external customers	$ 818,565	$ 262,824	$ 47,027	$ 63,598	$ 1,192,014	$ 295	$ 1,192,309
Intersegment sales	2,203	2,741	318	1,494	6,756		6,756
Operating profit (loss)	32,550	24,125	1,556	6,916	65,147	(9,035)	56,112
Assets	344,577	252,157	129,520	25,110	751,364	36,968	788,332

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Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note F Stock-based Compensation Expense

Stock-based compensation expense was $1.5 million in the third quarter 2012 and $1.4 million in the third quarter 2011. For the first nine months of the year, stock-based compensation expense was $4.3 million in 2012 and $3.6 million in 2011.

The Company granted approximately 182,000 stock appreciation rights (SARs) to certain employees in the first quarter 2012 at a strike price of $29.45 per share. The fair value of the SARs, which was determined on the grant date using a Black-Scholes model, was $16.35 per share and will be amortized over the vesting period of three years. The SARs expire in seven years from the date of the grant.

The Company granted approximately 52,000 shares of restricted stock to certain employees in the first quarter 2012 at a weighted-average fair value of $29.40 per share. The fair value was determined using the closing price of the Company s stock on the grant dates and will be amortized over the vesting period of three years. The holders of the restricted stock will forfeit their shares should their employment be terminated prior to the end of the vesting period.

The Company granted approximately 51,000 shares of performance restricted stock to certain employees in the first quarter 2012 at a fair value of $25.55 per share. The fair value will be expensed over the vesting period of three years. The final share payout to the employees will be based upon the Company s total return to shareholders over the vesting period relative to a peer group s performance over the same period.

The Company received $0.1 million for the exercise of approximately 14,000 options during the first nine months of 2012 and $0.7 million for the exercise of approximately 51,000 options during the first nine months of 2011. Exercises of SARs totaled approximately 27,000 in the first nine months of 2012 and 7,000 in the first nine months of 2011.

Note G Other-net

Other-net income (expense) for the third quarter and first nine months of 2012 and 2011 is summarized as follows:

	Third Quarter Ended		**First Nine Months Ended**	
(Thousands)	**Sept. 28, 2012**	**Sept. 30, 2011**	**Sept. 28, 2012**	**Sept. 30, 2011**
Foreign currency exchange/translation gain (loss)	$ 629	$ (865)	$ 1,049	$ (1,885)
Amortization of intangible assets	(1,408)	(1,510)	(4,278)	(4,528)
Metal consignment fees	(2,140)	(2,563)	(7,009)	(7,362)
Other items	(210)	(78)	(608)	23
Total	$ (3,129)	$ (5,016)	$ (10,846)	$ (13,752)

Note H Income Taxes

The tax expense of $4.5 million in the third quarter 2012 was calculated by applying a rate of 35.7% against income before income taxes while the tax expense of $2.9 million in the third quarter 2011 was calculated by applying a rate of 17.4% against the income before income taxes in that period. In the first nine months of 2012, the tax expense of $11.3 million was calculated using a tax rate of 33.7% against the income before income taxes. In the first nine months of 2011, a tax rate of 27.5% was used to calculate a tax expense of $14.9 million.

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Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note H Income Taxes (Continued)

The differences between the statutory and effective rates in the third quarter and first nine months of each year was due to the impact of percentage depletion, the production deduction, foreign source income and deductions, executive compensation, state and local taxes and other factors. In addition, the tax expense in the third quarter 2012 included favorable discrete events totaling $0.5 million, while the tax expense in the third quarter 2011 included favorable discrete events totaling $2.2 million. The discrete events in both periods included adjustments to the tax reserves resulting from the lapse of the statute of limitations and final adjustments to the prior years tax returns.

The effective tax rate, prior to the impact of the discrete items, was higher in the third quarter 2012 than it was in the first half of 2012. The impact of the higher tax rate increased tax expense and reduced net income by $1.0 million, or $0.05 per share, in the third quarter 2012.

Note I Pebble Plant Capitalization

The Company has a Title III contract with the Department of Defense (DoD) for the design and development of a primary beryllium production facility. Construction of the facility would not have been economically feasible without assistance from the government. The cost of the project, which included equipment, building and other costs that were not capitalizable as fixed assets, totaled approximately $100.0 million. Reimbursements received by the Company from the Department of Defense included $63.5 million for its share of the cost of equipment that was purchased by the Company and installed in the facility. The Company capitalized $14.6 million of fixed assets and $10.0 million of capital leases as a portion of the Company s cost share for the project. The cost paid by the Company was recorded in property, plant and equipment and the reimbursement from the government was recorded as unearned income on the Consolidated Balance Sheets. The unearned income liability will be reduced and credited to income ratably with the depreciation expense recorded over the useful life of the equipment.

The equipment was placed in service during the third quarter 2012. Depreciation expense on the portion of the equipment whose cost was reimbursed by the DoD was $1.1 million in the third quarter. Accordingly, unearned income was reduced by $1.1 million and credited to cost of sales on the Consolidated Statement of Income in the third quarter 2012, offsetting the impact of the depreciation expense on the Company s cost of sales and gross margin.

The depreciation, depletion and amortization expense of $28.9 million shown on the Consolidated Statement of Cash Flows for the nine month period ending September 28, 2012 is net of the $1.1 million benefit from the reduction of the unearned income liability.

Note J Fair Value of Financial Instruments

The Company measures and records financial instruments at their fair values. A fair value hierarchy is used for those instruments measured at fair value that distinguishes between assumptions based on market data (observable inputs) and the Company s assumptions (unobservable inputs). The hierarchy consists of three levels:

Level 1 Quoted market prices in active markets for identical assets and liabilities;

Level 2 Inputs other than Level 1 inputs that are either directly or indirectly observable; and,

Level 3 Unobservable inputs developed using estimates and assumptions developed by the Company, which reflect those that a market participant would use.

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Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note J Fair Value of Financial Instruments (Continued)

The following table summarizes the financial instruments measured at fair value in the Consolidated Balance Sheet as of September 28, 2012:

(Thousands) **Financial Assets**	**Total**	**Fair Value Measurements** **Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Directors deferred compensation investments	$ 714	$ 714	$	$
Foreign currency forward contracts	298		298	
Total	$ 1,012	$ 714	$ 298	$
Financial Liabilities				
Directors deferred compensation liability	$ 714	$ 714	$	$
Foreign currency forward contracts	69		69	
Precious metal swaps	99		99	
Total	$ 882	$ 714	$ 168	$

The Company uses a market approach to value the assets and liabilities for outstanding derivative contracts in the table above. Foreign currency forward contracts and precious metal hedge contracts are valued through models that utilize market observable inputs including both spot and forward prices for the same underlying currencies and metals. The carrying values of the other working capital items and debt on the Consolidated Balance Sheet approximate their fair values as of September 28, 2012.

Note K Derivative Instruments and Hedging Activity

The Company uses derivative contracts to hedge portions of its foreign currency and precious metal exposures. The objectives for using derivatives in these areas are as follows:

Foreign Currency. The Company sells products to overseas customers in their local currencies, primarily the euro and yen. The Company uses foreign currency derivatives, mainly forward contracts and options, to hedge these anticipated sales transactions. The purpose of the hedge program is to protect against the reduction in dollar value of the foreign currency sales from adverse exchange rate movements. Should the dollar strengthen significantly, the decrease in the translated value of the foreign currency sales should be partially offset by gains on the hedge contracts. Depending upon the methods used, the hedge contract may limit the benefits from a weakening U.S. dollar.

The use of forward contracts locks in a firm rate and eliminates any downside from an adverse rate movement as well as any benefit from a favorable rate movement. The Company may from time to time choose to hedge with options or a tandem of options known as a collar. These hedging techniques can limit or eliminate the downside risk but can allow for some or all of the benefit from a favorable rate movement to be realized. Unlike a forward contract, a premium is paid for an option; collars, which are a combination of a put and call option, may have a net premium but they can be structured to be cash neutral. The Company will primarily hedge with forward contracts due to the relationship between the cash outlay and the level of risk.

The use of foreign currency derivative contracts is governed by policies approved by the Audit Committee of the Board of Directors. A team consisting of senior financial managers reviews the

Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note K Derivative Instruments and Hedging Activity (Continued)

estimated exposure levels, as defined by budgets, forecasts and other internal data, and determines the timing, amounts and instruments to use to hedge that exposure within the confines of the policy. Management analyzes the effective hedged rates and the actual and projected gains and losses on the hedging transactions against the program objectives, targeted rates and levels of risk assumed. Hedge contracts are typically layered in at different times for a specified exposure period in order to minimize the impact of rate movements.

Precious Metals. The Company maintains the majority of its precious metal production requirements on consignment in order to reduce the working capital investment and the exposure to metal price movements. When a precious metal product is fabricated and ready for shipment to the customer, the metal is purchased out of consignment at the current market price and that price forms the basis for the price to be charged to the customer.

In certain circumstances, a customer may want to establish the price for the precious metal when the sales order is placed rather than at the time of the shipment. Setting the selling price at a difference date than when the material would be purchased potentially creates an exposure to movements in the market price of the metal. Therefore, in these limited situations, the Company may elect to enter into a forward contract to purchase a stated quantity of precious metal at a fixed price on a specified date in the future. The price in the forward contract serves as the basis for the price to be charged to the customer. By so doing, the selling and purchase prices are matched and the Company s market price exposure is reduced.

The Company refines precious metal-containing materials for its customers and typically will purchase the refined metal from the customer at current market prices. In limited circumstances, the customer may want to fix the price to be paid at the time of the order as opposed to when the material is refined. The customer may also want to fix the price to be paid for a number of orders over a period of time. The Company may then enter into a hedge contract, either a forward contract or a swap, to fix the price for the estimated quantity of refined metal to be purchased thereby reducing the exposure to adverse movements in the market price of the metal.

The Company will only enter into a derivative contract if there is an underlying identified exposure. Contracts are typically held until maturity. The Company does not engage in derivative trading activities and does not use derivatives for speculative purposes. The Company only uses currency hedge contracts that are denominated in the same currency as the underlying exposure and precious metal hedge contracts denominated in the same metal as the underlying exposure.

All derivatives are recorded on the balance sheet at their fair values. If the derivative is designated and effective as a cash flow hedge, changes in the fair value of the derivative are recognized in other comprehensive income (OCI) until the hedged item is recognized in earnings. The ineffective portion of a derivative s fair value, if any, is recognized in earnings immediately. If a derivative is not a hedge, changes in the fair value are adjusted through income. The fair values of the outstanding derivatives are recorded on the balance sheet as assets (if the derivatives are in a gain position) or liabilities (if the derivatives are in a loss position). The fair values will also be classified as short-term or long-term depending upon their maturity dates.

The outstanding foreign currency forward contracts had a notional value of $22.3 million while the outstanding precious metal forward contracts and swaps had a notional value of $0.9 million as of September 28, 2012. All of these contracts were designated and effective as cash flow hedges. There was no ineffectiveness

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Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note K Derivative Instruments and Hedging Activity (Continued)

associated with the outstanding contracts. The fair values of these contracts were recorded on the Consolidated Balance Sheet as of September 28, 2012, as applicable, as gains of $0.3 million in prepaid expenses and losses of $0.2 million in other liabilities and accrued items.

A summary of the hedging relationships of the outstanding derivative financial instruments designated as cash flow hedges as of September 28, 2012 and September 30, 2011 and the amounts transferred into income for the three month periods then ended is as follows:

(Thousands)	Effective Portion of Hedge			Ineffective Portion of Hedge	
	Recognized In OCI at	Reclassified From OCI Into Income During Period		Recognized in Income on Derivative During Period	
Gain (loss)	End of Period	Location	Amount	Location	Amount
Third Quarter 2012					
Foreign currency contracts	$ 229	Other-net	$ 650	Other-net	$
Precious metal contracts	(99)	Cost of sales	(157)	Cost of sales	
Total	$ 130		$ 493		$
Third Quarter 2011					
Foreign currency contracts	$ (126)	Other-net	$ (948)	Other-net	$
Precious metal contracts		Cost of sales		Cost of sales	
Total	$ (126)		$ (948)		$
Nine Months Ended 2012					
Foreign currency contracts		Other-net	$ 1,527	Other-net	$
Precious metal contracts		Cost of sales	(499)	Cost of sales	
Total			$ 1,028		$
Nine Months Ended 2011					
Foreign currency contracts		Other-net	$ (2,183)	Other-net	$
Precious metal contracts		Cost of sales	0	Cost of sales	
Total			$ (2,183)		$

During 2011, the Company secured various forward contracts to sell specified quantities of gold. The contracts served as economic hedges of gold purchased and held in inventory for use in manufacturing products for sale in the normal course of business. No hedge designations were assigned to the contracts since they matured in the same quarter as they were initially secured. The recognized loss upon maturity of the contracts totaled $1.1 million in the third quarter 2011 and $1.2 million in the first nine months of 2011. The losses were recorded in cost of sales on the Consolidated Statements of Income. Equal and offsetting gains were recorded in cost of sales as a result of the sale of the underlying gold inventory.

Note L Acquisition

The Company acquired all of the outstanding stock of Aerospace Metal Composites Limited (AMC) of Farnborough, England for $3.3 million, net of $1.5 million cash acquired, in the first quarter 2012. AMC manufactures high performance ultrafine particulate reinforced metal matrix composites, primarily aluminum materials, that are used in performance automotive, aerospace, defense and precision high speed machinery applications.

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Materion Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

Note L Acquisition (Continued)

A portion of the purchase price was held in escrow pending resolution of various matters as detailed in the purchase agreement. The assessment of the assets and liabilities acquired, including any goodwill or intangible assets, was not finalized as of the end of the third quarter. Goodwill was preliminarily valued at $1.8 million.

The pro forma impact of AMC s operating results on the Company s sales, income before income taxes and net income for 2011 and 2012 was immaterial.

The Company increased goodwill by $0.6 million from the acquisition of EIS Optics Limited in the fourth quarter 2011 as a result of the final working capital adjustments in the first quarter 2012 as detailed in the purchase agreement.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

We are an integrated producer of high performance advanced engineered materials used in a variety of electrical, electronic, thermal and structural applications. Our products are sold into numerous markets, including consumer electronics, industrial components and commercial aerospace, defense and science, energy, medical, automotive electronics, telecommunications infrastructure and appliance.

Sales of $290.6 million in the third quarter 2012 were 26% lower than sales in the third quarter 2011, while sales in the first nine months of 2012 of $969.3 million were 19% lower than sales in the first nine months of 2011. Demand from a number of key markets, including consumer electronics, remained soft throughout the majority of the first nine months of 2012. Sales in the third quarter 2012 were also adversely affected by an increase in the use of customer-supplied precious metal. This change in metal source did not materially impact margins since the precious metal is a pass-through. Operating profit was lower in the third quarter and first nine months of 2012 than the respective periods of 2011 and was reflective of the reduced sales volume and other factors. While the diluted earnings per share of $0.39 was less than the $0.65 generated in the third quarter 2011, diluted earnings per share has improved in each of the last three quarters over the immediately preceding quarter.

Our Board of Directors implemented a quarterly dividend of $0.075 per share in the second quarter 2012 as a reflection of our ability to grow the company long term while also returning cash to our shareholders. Dividend payouts of approximately $1.6 million were made in each of the second and third quarters of 2012.

In March 2012, we acquired all of the outstanding shares of Aerospace Metal Composites Limited (AMC) of Farnborough, England. AMC, a small manufacturing operation with long-term growth potential, produces high performance metal matrix composites that are sold into the automotive, aerospace and defense, precision machinery and other markets.

Total debt increased $41.1 million in the first nine months of 2012 over the year-end 2011 balance in order to fund the change in working capital, capital expenditures, the AMC acquisition and quarterly dividends. The debt-to-debt-plus-equity ratio was 22% as of the end of the third quarter 2012.

RESULTS OF OPERATIONS

	Third Quarter Ended		Nine Months Ended	
(Millions, except per share data)	Sept. 28, 2012	Sept. 30, 2011	Sept. 28, 2012	Sept. 30, 2011
Sales	$ 290.6	$ 392.8	$ 969.3	$ 1,192.3
Operating profit	13.4	17.2	35.7	56.1
Income before income taxes	12.6	16.4	33.4	54.1
Net income	8.1	13.5	22.2	39.2
Diluted earnings per share	$ 0.39	$ 0.65	$ 1.07	$ 1.89

Sales were $290.6 million in the third quarter 2012, a decline of $102.2 million, or 26%, from sales of $392.8 million in the third quarter 2011. For the first nine months of 2012, sales of $969.3 million were down $223.0 million, or 19%, from sales of $1.2 billion in the first nine months of 2011.

Sales to the majority of our key markets declined in the third quarter 2012 from the third quarter 2011 and in the first nine months of 2012 from the first nine months of 2011. Sales to the *consumer electronics market*, our largest market accounting for approximately 40% of total sales, were soft once again in the third quarter 2012. For the first nine months of 2012 sales to this market were down approximately 14% from the same period in 2011. End-use applications for our materials in the consumer electronics market include cell phones, tablets, gaming systems and other hand-held devices. As a material supplier several steps removed from the final

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consumer, our sales to this market in a given period are affected by inventory levels, production schedules and changes in market share of the intermediaries within the supply chain and not necessarily by changes in sales of the final product in that period.

Sales to the *defense and science market* improved in the third quarter 2012 over the second quarter 2012, primarily in our traditional beryllium business, but total defense and science sales were still below the levels from the third quarter 2011. Sales to this market were 23% lower in the first nine months of 2012 than the first nine months of 2011, largely due to government spending reductions and push-outs of orders.

Sales to the *energy market*, which account for approximately 7% of our total sales, softened at a double-digit rate in both the third quarter and first nine months of 2012 from the respective periods in 2011 largely due to lower sales for architectural glass applications. Solar energy sales also were down due to weaker end-use market conditions while oil and gas sales softened from the strong levels over the past four quarters due to a reduction in rig count.

Sales to the *automotive electronics market* were 11% lower in the third quarter 2012 and 10% lower in the first nine months of 2012 than the respective periods of 2011. The automotive electronics market accounts for approximately 7% of our total sales. Sales to the *appliance market*, which are predominately in Europe, were down 29% in the third quarter and 50% in the first nine months of 2012 from the comparable periods in 2011.

Underlying sales volumes to the *industrial components and commercial aerospace market*, after adjusting for differences in precious metal mix and make-up, improved in the third quarter and first nine months of 2012 over the same periods in 2011. This growth was primarily in our Performance Alloys segment and included improved sales of our non-beryllium-containing Toughmet® products used in heavy equipment and other applications. Sales to this market from our other units were flat to down in the first three quarters of 2012 from the comparable periods of 2011.

Sales to the *medical market,* which represent approximately 8% of our total sales, showed modest growth in the third quarter 2012 over the third quarter 2011. Sales to this market in the first nine months of 2012 were 24% higher than in the first nine months of 2011 mainly due to the strengthening of shipments for blood glucose test strip applications. Sales for medical x-ray applications also improved in the third quarter 2012 over the third quarter 2011. These improvements were partially offset by a decline in sales for other minor applications in this market.

Total sales order entry in the third quarter 2012 was lower than either of the first two quarters of the year, but was slightly higher than sales in the third quarter. Order entry was approximately 3% higher than sales in the first nine months of 2012.

We manufacture precious metal products using our metal that we sell to the customer or on a toll basis using metal that the customer supplies to us. Shifts in the relationship between the use of owned versus customer-supplied metal can affect the sales comparisons between periods. During the third quarter and first nine months of 2012, there was an increase in the amount of customer-supplied metal compared to the same periods in the prior year. This shift in the source of metal reduced our sales of precious metal by an estimated $46.1 million in the third quarter and $60.5 million in the first nine months of 2012 from the comparable periods in 2011. Since the precious metal is a pass-through, a change in the metal s source does not have a significant impact on gross margin.

We use gold, silver, platinum, palladium, copper and ruthenium in the manufacture of various products. Our sales are affected by the prices for these metals, as changes in our purchase prices are passed on to our customers in the form of higher or lower selling prices. The net average prices for these metals were lower during the third quarter 2012 than the third quarter 2011, resulting in an estimated $8.5 million reduction in sales in the third quarter 2012. Metal prices on average had been slightly higher in the first half of 2012 than the first half of 2011, but average prices for the first nine months of 2012 were lower than the same period in 2011 and resulted in an estimated $4.5 million decrease in sales in the first nine months of 2012.

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The acquisition of EIS Optics Limited (EIS) in the fourth quarter 2011 provided a small benefit to sales and gross margin in the third quarter and first nine months of 2012. The AMC acquisition had a minimal impact on our sales and gross margin in the third quarter and first nine months of 2012.

Domestic sales were 36% lower in the third quarter 2012 than the third quarter 2011 and 24% lower in the first nine months of 2012 than the first nine months of 2011. International sales increased 5% in the third quarter 2012 but declined 3% in the first nine months of 2012 from the respective periods in 2011. Sales to Asia improved in the third quarter 2012 over a weak third quarter 2011, partially due to the acquisition of EIS, and were essentially unchanged in the first nine months of 2012 from the first nine months of 2011. European sales were down 10% over the first nine months of 2012 from the comparable period of 2011.

Gross margin was $52.4 million, or 18% of sales, in the third quarter 2012 compared to $57.4 million, or 15% of sales, in the third quarter 2011. Gross margin was $154.8 million in the first nine months of 2012, a decline of $21.0 million from the gross margin of $175.8 million in the first nine months of 2011. Gross margin was 16% of sales in the first nine months of 2012 and 15% of sales in the first nine months of 2011.

The major cause for the reduced gross margin on a dollar basis in both the third quarter and first nine months of 2012 was the lower sales volume. The resulting lower production volumes led to inefficiencies and other costs charged to cost of sales in portions of our business throughout the first nine months of 2012. The change in product mix was unfavorable in both the third quarter and first nine months of 2012 from the comparable periods in 2011, partially due to the lower sales to the consumer electronics market.

Price increases in parts of our business offset a portion of the negative impact the above items had on gross margin. In addition, manufacturing process improvements for various precious metal products provided a margin benefit in the third quarter and first nine months of 2012 while yields and rework levels on certain nickel-containing products improved throughout the first nine months of 2012. Manufacturing overhead costs from the existing operations (excluding the impact of the EIS and AMC acquisitions) were lower in the third quarter and first nine months of 2012 compared to the same periods in 2011.

Start-up activities and the associated costs for the new beryllium facility in Elmore, Ohio continued during the first three quarters of 2012. The facility produced a limited quantity of beryllium metal in the third quarter 2012 and a higher level of output is expected in the fourth quarter 2012. The net start-up costs, including the cost of higher-priced purchased material, were $0.2 million lower in the third quarter and $0.1 million lower in the first nine months of 2012 than the associated start-up costs in the comparable periods of 2011.

Selling, general and administrative (SG&A) expenses were $32.8 million in the third quarter 2012 compared to $32.3 million in the third quarter 2011. SG&A expenses in the first nine months of 2012 were $98.9 million, a 1% increase from the expense total of $98.0 million in the first nine months of 2011. SG&A expenses were 10% of sales in the first nine months of 2012 and 8% of sales in the first nine months of 2011.

Legal, administrative and marketing costs associated with changing the company s name to Materion Corporation totaled $0.7 million in the third quarter 2011 and $3.4 million in the first nine months of 2011. This program was largely completed during 2011 and the associated expenses in the third quarter and first nine months of 2012 were immaterial.

Incentive compensation expense under cash-based plans was $1.3 million lower in the third quarter 2012 than the third quarter 2011 and $4.8 million lower in the first nine months of 2012 than the first nine months of 2011 due to differences in the levels of projected profitability relative to the plan targets.

Stock-based compensation expense was $0.1 million higher in the third quarter 2012 than the third quarter 2011 and $0.8 million higher in the first nine months of 2012 than the first nine months of 2011.

SG&A expenses as a result of the two recent acquisitions totaled $1.7 million in the third quarter and $4.6 million in the first nine months of 2012.

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The expense for the domestic defined benefit pension plan was $0.4 million higher in the third quarter 2012 than the third quarter 2011 and $1.3 million higher in the first nine months of 2012 than the first nine months of 2011. The increased cost was primarily caused by changes in the discount rate and expected rate of return on plan asset assumptions. The impact of this cost increase was recorded primarily in SG&A expense and cost of sales, with a minor amount recorded in research and development (R&D) expense.

Other corporate costs also increased in the third quarter and first nine months of 2012 over the comparable periods in 2011. A portion of the higher costs was due to various initiatives, including a new centralized procurement function, that are designed to produce long-term savings and improve profitability across the organization. Other costs, including human resources, business development and communications, have increased in order to support a larger and more diverse organization.

R&D expenses were $3.0 million in the third quarter 2012 compared to $2.8 million in the third quarter 2011. R&D expenses of $9.3 million in the first nine months of 2012 were $1.4 million higher than the expense of $7.9 million in the first nine months of 2011. R&D expenses were 1% of sales in the first nine months of 2012 and less than 1% of sales in the first nine months of 2011. Expenses incurred by EIS accounted for the majority of the increased R&D expense in both the third quarter and first nine months of 2012. The higher expense in the first nine months of the year was also due to additional costs to support precision optic product growth opportunities.

Other-net expense was $3.1 million in the third quarter 2012 compared to $5.0 million in the third quarter 2011. For the first nine months of 2012, other-net expense totaled $10.8 million, a decrease of $3.0 million from the net expense of $13.8 million in the first nine months of 2011. See Note G to the Consolidated Financial Statements for the details of the major components of other-net expense.

Exchange and translation gains and losses are a function of the movement in the value of the U.S. dollar versus certain other currencies and in relation to the strike prices in currency hedge contracts. The differences in exchange and translation gains and losses accounted for the majority of the change in other-net expense between the third quarter and first nine months of 2012 and the comparable periods in 2011.

The amortization of intangible assets of $1.4 million in the third quarter 2012 and $4.3 million in the first nine months of 2012 was slightly lower than the respective periods in the prior year due to various assets becoming fully amortized.

The metal consignment fees of $2.1 million in the third quarter 2012 and $7.0 million in the first nine months of 2012 were slightly lower than the comparable periods in 2011 partially due to differences in the average consignment fee rates.

Other-net also includes bad debt expense, gains and losses on the disposal of fixed assets, cash discounts and other miscellaneous items.

Operating profit was $13.4 million in the third quarter 2012 versus $17.2 million in the third quarter 2011. The reduced level of profitability was primarily due to the decline in gross margin as a result of the lower sales volume and other factors. Operating profit was $35.7 million in the first nine months of 2012, a decline of $20.4 million from the operating profit of $56.1 million in the first nine months of 2011.

Interest expense net was $0.8 million in both the third quarter 2012 and 2011. For the first nine months of 2012, interest expense net was $2.3 million, an increase of $0.3 million over the expense in the first nine months of 2011 of $2.0 million. Average debt levels were higher in the third quarter and first nine months of 2012 than the comparable periods of 2011. The effective borrowing rate was approximately the same in the third quarter 2012 as it was in the third quarter 2011, but it was higher over the first nine months of 2012 than the first nine months of 2011.

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Income before income taxes and ***income tax expense*** for the third quarter and first nine months of 2012 and 2011 were as follows:

	Third Quarter Ended		Nine Months Ended	
(Dollars in millions)	Sept. 28, 2012	Sept. 30, 2011	Sept. 28, 2012	Sept. 30, 2011
Income before income taxes	$ 12.6	$ 16.4	$ 33.4	$ 54.1
Income tax expense	4.5	2.9	11.2	14.9
Effective tax rate	35.7%	17.4%	33.7%	27.5%

The effects of percentage depletion, the production deduction, executive compensation, foreign source income and deductions, state and local taxes and other items were major factors for the difference between the effective and statutory rates in the third quarter and first nine months of 2012 and 2011. In addition, discrete items, including the final adjustments to the 2011 tax returns and adjustments to the tax reserves due to the lapse of the statute of limitations, reduced the tax expense by $0.5 million in the third quarter 2012. The tax expense in the third quarter and first nine months of 2011 included a net favorable discrete item of $2.2 million due to a combination of a reduction to the tax reserves as a result of the lapse of the statute of limitations, adjustments to the 2010 tax returns that were finalized in the third quarter 2011 and other items.

The effective tax rate, prior to the impact of discrete items, was higher in the third quarter 2012 than the first half of 2012 largely due to an increase in projected foreign losses that cannot be currently utilized. The impact of the higher tax rate increased tax expense and reduced net income by $1.0 million, or $0.05 per share, diluted in the third quarter 2012.

Net income was $8.1 million (or $0.39 per share, diluted) in the third quarter 2012 compared to $13.5 million (or $0.65 per share, diluted) in the third quarter 2011. For the first nine months of 2012, net income was $22.2 million (or $1.07 per share, diluted) versus net income of $39.2 million (or $1.89 per share, diluted) for the first nine months of 2011.

Segment Results

Results by segment are depicted in Note E to the Consolidated Financial Statements. The results for Materion Services Inc., a wholly owned subsidiary that provides administrative and financial services on a cost-plus basis to other units within the organization, and other corporate costs are included in the All Other column of our segment reporting.

The operating loss within All Other was $0.8 million lower in the third quarter 2012 than the third quarter 2011 and $3.2 million lower in the first nine months of 2012 than the first nine months of 2011. The reduced loss in the third quarter and first nine months of 2012 was due to the company name change costs incurred in 2011, lower incentive compensation in 2012 as a result of our performance and increased charges out to the units, partially offset by increases in various corporate costs and other factors.

Advanced Material Technologies

	Third Quarter Ended		Nine Months Ended	
(Millions)	Sept. 28, 2012	Sept. 30, 2011	Sept. 28, 2012	Sept. 30, 2011
Sales	$ 190.5	$ 274.6	$ 654.2	$ 818.6
Operating profit	9.2	11.2	22.0	32.6

Advanced Material Technologies manufactures precious, non-precious and specialty metal products, including vapor deposition targets, frame lid assemblies, clad and precious metal preforms, high temperature braze materials, ultra-fine wire, advanced chemicals, optics, performance coatings and microelectronic packages. These products are used in wireless, semiconductor, photonic, hybrid and other microelectronic applications within the consumer electronics and telecommunications infrastructure markets. Other key markets for these products include medical, defense and science, energy and industrial components. Advanced Material Technologies also has metal cleaning operations and in-house refineries that allow for the reclaim of precious metals from internally generated or customers scrap. This segment has domestic facilities in New York, Connecticut, Wisconsin, New Mexico, Massachusetts and California and international facilities in Asia and Europe.

Sales from Advanced Material Technologies of $190.5 million in the third quarter 2012 were 31% lower than sales of $274.6 million in the third quarter 2011, while sales of $654.2 million in the first nine months of 2012 were 20% lower than sales of $818.6 million in the first nine months of 2011.

Advanced Material Technologies adjusts its selling prices daily to reflect the current cost of the precious and certain other metals that are sold. The cost of the metal is generally a pass-through to the customer and a margin is generated on the fabrication efforts irrespective of the type or cost of the metal used in a given application. Therefore, the cost and mix of metals sold will affect sales but not necessarily the margins generated by those sales. The prices of gold, silver, platinum, palladium and ruthenium were lower on average in the third quarter 2012 than the third quarter 2011 and resulted in an estimated $5.4 million reduction in sales between periods. Metal prices on average were higher in the first nine months of 2012 than the first nine months of 2011 (due to higher prices during the first quarter 2012) and resulted in an estimated $3.1 million increase in sales between periods.

Sales of precious metal products, including targets, slugs, wire and lids, for semiconductor, wireless and other microelectronic applications within the consumer electronics market (the segment s largest market) declined in the third quarter and first nine months of 2012 compared to the same periods of 2011 due to softer demand, competitive pressures on pricing, and changes in the product mix. The previous discussed changes in the level customer-supplied metal also impacted the reported sales from this segment.

A portion of the soft demand from the consumer electronics market was due to the slower than anticipated growth in end-use consumer demand for LED products driven by the high price to the final customer. As a result, manufacturers of LED products are developing lower-performing applications in order to reduce their production costs, which in turn allows them to lower their selling prices. This change has an adverse impact on our sales as the lower-performing LED products use less of our materials.

Sales of optics from EIS, which was acquired subsequent to the third quarter 2011, offset a portion of the decline in consumer electronics sales in the third quarter and first nine months of 2012.

Refine revenue was lower in the third quarter and first nine months of 2012 than the comparable periods in 2011 in part due to fewer ounces in the supply chain to be refined. We are expanding our shield kit cleaning capabilities and capacity in order to provide additional services for our customers and capture additional market share.

Sales of large area coatings, primarily precision coated polymer films, improved approximately 38% in the third quarter 2012 over the third quarter 2011 and 51% in the first nine months 2012 over the first nine months of 2011 after adjusting for differences in metal prices. These products are primarily sold into the medical market for blood glucose test strip applications. Sales to a key customer in the first quarter 2011 were adversely affected by lower manufacturing yields and the inability to hold tolerances. Process improvements were subsequently made throughout 2011 and into 2012 and shipment levels have grown accordingly. Sales to other customers also improved throughout the first nine months of 2012 due to market share gains.

Advanced chemical sales declined approximately 43% in the third quarter 2012 from the third quarter 2011 and 20% in the first nine months of 2012 from the first nine months of 2011. The decline in sales in the third quarter and first nine months of the year was primarily due to sales for architectural glass applications in the energy market. After growing in the second quarter 2012 over the second quarter 2011, sales for these applications in the third quarter 2012 were less than half of the third quarter 2011 sales level.

Sales of precision optics to the defense and science market declined in the third quarter and first nine months of 2012 from the respective periods in 2011 as government budget revisions and spending cutbacks have resulted in order delays and program reductions. Sales of precious metal products to the defense and science

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market were also lower in the first nine months of 2012 than the first nine months of 2011. Precision optics sales to the automotive electronics market, primarily for infrared camera applications, declined in the third quarter 2012 from the third quarter 2011 due to a key customer s excess inventory position.

Sales of microelectronic packages, one of this segment s smaller product lines, declined approximat