FARMER BROTHERS CO
Form 10-Q
November 07, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2013
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: 001-34249
FARMER BROS. CO.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	95-0725980
(State of Incorporation)	(I.R.S. Employer Identification No.)

20333 South Normandie Avenue, Torrance, California 90502
(Address of Principal Executive Offices; Zip Code)
310-787-5200
Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:
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 ý 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 ý NO £
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer	£	Accelerated filer	ý
Non-accelerated filer	£ (Do not check if a smaller reporting company)	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 ý
As of November 6, 2013 the registrant had 16,454,212 shares outstanding of its common stock, par value $1.00 per share, which is the registrant's only class of common stock.

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FARMER BROS. CO.
CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)	September 30, 2013	June 30, 2013
ASSETS	(Unaudited)	
Current assets:		
Cash and cash equivalents	$4,930	$2,678
Restricted cash	6,260	8,084
Short-term investments	20,425	20,546
Accounts and notes receivable, net	42,840	43,922
Inventories	68,682	60,867
Income tax receivable	226	409
Prepaid expenses	2,748	3,243
Total current assets	146,111	139,749
Property, plant and equipment, net	90,225	92,159
Intangible assets, net	6,061	6,277
Other assets	5,402	5,484
Deferred income taxes	467	467
Total assets	$248,266	$244,136
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$29,374	27,740
Accrued payroll expenses	19,871	19,757
Short-term borrowings under revolving credit facility	10,138	9,654
Short-term obligations under capital leases	3,430	3,409
Short-term derivative liability	9,350	9,896
Deferred income taxes	923	923
Other current liabilities	6,309	5,171
Total current liabilities	79,395	76,550
Long-term borrowings under revolving credit facility	10,000	10,000
Long-term derivative liability	687	1,129
Accrued postretirement benefits	16,267	16,076
Other long-term liabilities—capital leases	8,505	8,759
Accrued pension liabilities	43,797	43,800
Accrued workers' compensation liabilities	5,082	5,132
Deferred income taxes	888	852
Total liabilities	$164,621	$162,298
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $1.00 par value, 500,000 shares authorized and none issued	$—	$—
Common stock, $1.00 par value, 25,000,000 shares authorized; 16,454,212 and 16,454,422 issued and outstanding at September 30, 2013 and June 30, 2013, respectively	16,454	16,454
Additional paid-in capital	35,561	34,654
Retained earnings	95,885	94,080
Unearned ESOP shares	(20,836)	(20,836)
Less accumulated other comprehensive loss	(43,419)	(42,514)
Total stockholders' equity	$83,645	$81,838

Total liabilities and stockholders’ equity	$248,266	$244,136

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

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share data)

	Three Months Ended September 30,	
	2013	2012
	(Unaudited)	
Net sales	$128,561	$119,153
Cost of goods sold	79,089	74,532
Gross profit	49,472	44,621
Selling expenses	37,335	37,271
General and administrative expenses	9,246	8,769
Operating expenses	46,581	46,040
Income (loss) from operations	2,891	(1,419)
Other (expense) income:		
Dividend income	268	259
Interest income	108	92
Interest expense	(372)	(457)
Other, net	(783)	4,945
Total other (expense) income	(779)	4,839
Income before taxes	2,112	3,420
Income tax expense	306	441
Net income	$1,806	$2,979
Net income per common share—basic	$0.11	$0.19
Net income per common share—diluted	$0.11	$0.19
Weighted average common shares outstanding—basic	15,802,160	15,490,365
Weighted average common shares outstanding—diluted	15,860,365	15,490,365

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

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Three Months Ended September 30,	
	2013	2012
	(Unaudited)	
Net income	$1,806	$2,979
Other comprehensive income, net of tax:		
Deferred losses on derivatives designated as cash flow hedges	(3,125)	—
Reclassification of deferred losses on derivatives designated as cash flow hedges to cost of goods sold	2,219	—
Total comprehensive income, net of tax	$900	$2,979

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

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Three Months Ended September 30,	
	2013	2012
	(Unaudited)	
Cash flows from operating activities:		
Net income	$1,806	$2,979
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,424	8,340
Provision for (recovery of) doubtful accounts	73	(922)
Deferred income taxes	37	—
Net gains on sales of assets	(123)	(3,213)
ESOP and share-based compensation expense	904	823
Net losses (gains) on derivatives and investments	1,549	(802)
Change in operating assets and liabilities:		
Restricted cash	1,824	1,483
Short-term investments	(1,429)	52
Accounts and notes receivable	1,009	(1,481)
Inventories	(7,816)	(3,943)
Income tax receivable	183	393
Prepaid expenses and other assets	578	120
Accounts payable	1,907	2,268
Accrued payroll expenses and other liabilities	(199)	(1,542)
Accrued postretirement benefits	190	288
Other long-term liabilities	(644)	(1,191)
Net cash provided by operating activities	$7,273	$3,652
Cash flows from investing activities:		
Purchases of property, plant and equipment	(4,757)	(3,572)
Proceeds from sales of property, plant and equipment	292	3,786
Net cash (used in) provided by investing activities	$(4,465)	$214
Cash flows from financing activities:		
Proceeds from revolving credit facility	9,810	4,800
Repayments on revolving credit facility	(9,600)	(9,250)
Payments of capital lease obligations	(768)	(777)
Proceeds from stock option exercises	2	—
Net cash used in financing activities	$(556)	$(5,227)
Net increase (decrease) in cash and cash equivalents	$2,252	$(1,361)
Cash and cash equivalents at beginning of period	2,678	3,906
Cash and cash equivalents at end of period	$4,930	$2,545

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

FARMER BROS. CO.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Organization

Farmer Bros. Co., a Delaware corporation (including its consolidated subsidiaries unless the context otherwise requires, the “Company,” or “Farmer Bros.”), is a manufacturer, wholesaler and distributor of coffee, tea and culinary products. The Company is a direct distributor of coffee to restaurants, hotels, casinos, offices, quick service restaurants ("QSR's"), convenience stores, healthcare facilities and other foodservice providers, as well as private brand retailers in the QSR, grocery, drugstore, restaurant, convenience store and independent coffeehouse channels. The Company was founded in 1912, was incorporated in California in 1923, and reincorporated in Delaware in 2004. The Company operates in one business segment.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States (“GAAP”) for complete consolidated financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals, unless otherwise indicated) considered necessary for a fair presentation of the interim financial data have been included. Operating results for the three months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2014. Events occurring subsequent to September 30, 2013 have been evaluated for potential recognition or disclosure in the unaudited consolidated financial statements for the three months ended September 30, 2013.

The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2013, filed with the Securities and Exchange Commission (the “SEC”) on October 9, 2013.

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company reviews its estimates on an ongoing basis using currently available information. Changes in facts and circumstances may result in revised estimates and actual results may differ from those estimates.

Derivative Instruments

The Company purchases various derivative instruments as investments or to create economic hedges of its commodity price risk and interest rate risk. These derivative instruments consist primarily of futures and swaps. The Company reports the fair value of derivative instruments on its consolidated balance sheets in "Short-term investments," "Other assets," "Short-term derivative liability," or "Long-term derivative liability." The Company determines the current and noncurrent classification based on the timing of expected future cash flows of individual trades and reports these amounts on a gross basis. Additionally, the Company reports cash held on deposit in margin accounts for coffee-related derivative instruments on a gross basis.

The accounting for the changes in fair value of the Company's derivative instruments can be summarized as follows:

Derivative Treatment	Accounting Method
Normal purchases and normal sales exception	Accrual accounting
Designated in a qualifying hedging relationship	Hedge accounting
All other derivatives	Mark-to-market accounting

The Company enters into green coffee purchase commitments at a fixed price or at a price to be fixed (“PTF”). PTF contracts are purchase commitments whereby the quality, quantity, delivery period, price differential to the coffee "C" market price and other negotiated terms are agreed upon, but the price at which the base “C” market price will be fixed has not yet been established. The coffee "C" market price is fixed at some point after the purchase contract date and before the futures market closes for the delivery month and may be fixed either at the direction of the Company to the vendor, or by the application of a derivative that was separately purchased as a hedge. For both fixed-price and PTF contracts, the Company expects to take delivery of and to utilize the coffee in a reasonable period of time and in the conduct of normal business. Accordingly, these purchase commitments qualify as normal purchases and are not recorded at fair value on the Company's consolidated balance sheets.

Prior to April 1, 2013, the Company had no derivative instruments that were designated as accounting hedges. Beginning April 1, 2013, the Company implemented procedures following the guidelines of ASC 815, "Derivatives and Hedging" ("ASC 815"), to enable it to account for certain coffee-related derivatives as accounting hedges in order to minimize the volatility created in the Company's quarterly results from utilizing these derivative contracts and to improve comparability between reporting periods. For a derivative to qualify for designation in a hedging relationship, it must meet specific criteria and the Company must maintain appropriate documentation. The Company establishes hedging relationships pursuant to its risk management policies. The hedging relationships are evaluated at the inception of the hedging relationship and on an ongoing basis to determine whether the hedging relationship is, and is expected to remain, highly effective in achieving offsetting changes in fair value or cash flows attributable to the underlying risk being hedged. The Company also regularly assesses whether the hedged forecasted transaction is probable of occurring. If a derivative ceases to be or is no longer expected to be highly effective, or if the Company believes the likelihood of occurrence of the hedged forecasted transaction is no longer probable, hedge accounting is discontinued prospectively, and future changes in the fair value of the derivative are recognized currently in “Other, net.”

For commodity derivatives designated as cash flow hedges, the effective portion of the change in fair value of the derivative is reported as accumulated other comprehensive income (“AOCI”) and subsequently reclassified into cost of goods sold in the period or periods when the hedged transaction affects earnings. Any ineffective portion of the derivative's change in fair value is recognized currently in “Other, net.” Gains or losses deferred in AOCI associated with terminated derivatives, derivatives that cease to be highly effective hedges, derivatives for which the forecasted transaction is reasonably possible but no longer probable of occurring, and cash flow hedges that have been otherwise discontinued remain in AOCI until the hedged item affects earnings. If it becomes probable that the forecasted transaction designated as the hedged item in a cash flow hedge will not occur, any gain or loss deferred in AOCI is recognized in “Other, net” at that time. For derivative instruments that are not designated in a hedging relationship, and for which the normal purchases and normal sales exception has not been elected, the changes in fair value are reported in “Other, net.”

The following gains and losses on derivative instruments are netted together and reported in “Other, net” in the Company's consolidated statement of operations:

- Gains and losses on all derivatives that are not designated as cash flow hedges and for which the normal purchases and normal sales exception has not been elected; and
- The ineffective portion of unrealized gains and losses on derivatives that are designated as cash flow hedges.

The fair value of derivative instruments is based upon broker quotes. At September 30, 2013, approximately 90% of the Company's outstanding coffee-related derivative instruments were designated as cash flow hedges (see Note 2). At September 30, 2012, no derivative instruments were designated as accounting hedges.

Coffee Brewing Equipment and Service

The Company classifies certain expenses related to coffee brewing equipment provided to customers as cost of goods sold. These costs include the cost of the equipment as well as the cost of servicing that equipment (including service employees’ salaries, cost of transportation and the cost of supplies and parts) and are considered directly attributable to the generation of revenues from its customers. Accordingly, such costs included in cost of goods sold in the accompanying consolidated financial statements for the three months ended September 30, 2013 and 2012 are $6.5 million and $5.8 million, respectively.

The Company has capitalized coffee brewing equipment in the amounts of $3.1 million and $1.9 million in the three months ended September 30, 2013 and 2012, respectively. During the three months ended September 30, 2013 and

2012, the Company had depreciation expense related to the capitalized coffee brewing equipment reported as cost of goods sold in the amounts of $2.9 million and $3.3 million, respectively.

Revenue Recognition

Most product sales are made “off-truck” to the Company’s customers at their places of business by the Company’s sales representatives. Revenue is recognized at the time the Company’s sales representatives physically deliver products to customers and title passes or when it is accepted by the customer when shipped by third-party delivery.

The Company sells roast and ground coffee and tea to The J.M. Smucker Company ("J.M. Smucker") pursuant to a co–packing agreement. The Company recognizes revenue from the co-packing arrangement for the sale of tea on a net basis, net of direct costs of revenue, since the Company acts as an agent of J.M. Smucker in such transactions. As of September 30, 2013 and June 30, 2013, the Company had $0.4 million and $0.3 million, respectively, of receivables relating to this arrangement which are included in "Other receivables" (see Note 6).

Earnings (Loss) Per Common Share

Basic earnings (loss) per share (“EPS”) represents net earnings attributable to common stockholders divided by the weighted-average number of common shares outstanding for the period, excluding unallocated shares held by the Company's Employee Stock Ownership Plan ("ESOP"). Diluted EPS represents net earnings attributable to common stockholders divided by the weighted-average number of common shares outstanding, inclusive of the dilutive impact of common equivalent shares outstanding during the period. However, nonvested restricted stock awards (referred to as participating securities) are excluded from the dilutive impact of common equivalent shares outstanding in accordance with authoritative guidance under the two-class method. The nonvested restricted stockholders are entitled to participate in dividends declared on common stock as if the shares were fully vested and hence are deemed to be participating securities. Under the two-class method, earnings (loss) attributable to nonvested restricted stockholders are excluded from net earnings (loss) attributable to common stockholders for purposes of calculating basic and diluted EPS. Computation of EPS for the three months ended September 30, 2013 and 2012 includes the dilutive effect of 58,205 and 0 shares, respectively, issuable under stock options (see Note 12).

Dividends Declared

Although historically the Company has paid a dividend to stockholders, in light of the Company’s current financial position, the Company’s Board of Directors has omitted the payment of a quarterly dividend since the third quarter of fiscal 2011. The amount, if any, of dividends to be paid in the future will depend upon the Company’s then available cash, anticipated cash needs, overall financial condition, loan agreement restrictions, future prospects for earnings and cash flows, as well as other relevant factors.

Impairment of Indefinite-lived Intangible Assets

The Company performs its annual impairment test of goodwill and/or other indefinite-lived intangible assets as of June 30. Goodwill and other indefinite-lived intangible assets are not amortized but instead are reviewed for impairment annually and on an interim basis if events or changes in circumstances between annual tests indicate that an asset might be impaired. Indefinite-lived intangible assets are tested for impairment by comparing their fair values to their carrying values.

In addition to an annual test, indefinite-lived intangible assets must also be tested on an interim basis if events or circumstances indicate that the estimated fair value of such assets has decreased below their carrying value. There were no such events or circumstances during the three months ended September 30, 2013.

Long-Lived Assets, Excluding Indefinite-lived Intangible Assets

The Company reviews the recoverability of its long-lived assets whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Long-lived assets evaluated for impairment are grouped with other assets to the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The estimated future cash flows are based upon, among other things, assumptions about expected future operating performance, and may differ from actual cash flows. If the sum of the projected undiscounted cash flows (excluding interest) is less than the carrying value of the assets, the assets will be written down to the estimated fair value in the period in which the determination is made. There were no such events or circumstances during the three months ended September 30, 2013.

Recently Adopted Accounting Standards

In February 2013, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2013-02, “Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income” ("ASU 2013-02"), an update to the authoritative guidance related to the reporting of amounts reclassified out of accumulated other comprehensive income. This new requirement about presenting information about amounts reclassified out of accumulated other comprehensive income and their corresponding effect on net income will present, in one place, information about significant amounts reclassified and, in some cases, cross-references to related footnote disclosures. The disclosure amendments in this update are effective prospectively for fiscal years (and interim periods within those years) beginning after December 15, 2012 and early adoption is permitted. The Company adopted ASU 2013-02 beginning July 1, 2013. Adoption of ASU 2013-02 did not have a material effect on the results of operations, financial position or cash flows of the Company.

In February 2013, the FASB issued ASU No. 2013-01, “Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities” ("ASU 2013-01"). The amendments limit the scope of ASU No. 2011-11, “Disclosures about Offsetting Assets and Liabilities” ("ASU 2011-11"), to certain derivative instruments (including bifurcated embedded derivatives), repurchase agreements and reverse repurchase agreements, and securities borrowing and lending arrangements that are either (1) offset on the balance sheet or (2) subject to an enforceable master netting arrangement or similar agreement. The requirements as initially written in ASU 2011-11 would have applied more broadly than intended. The disclosure amendments in this update are effective prospectively for fiscal years (and interim periods within those years) beginning after January 1, 2013. The amendments will be applied retrospectively for all comparative periods presented on the balance sheet. The Company adopted ASU 2013-01 beginning July 1, 2013. Adoption of ASU 2013-01 did not have a material effect on the results of operations, financial position or cash flows of the Company.

In July 2012, the FASB issued ASU No. 2012-02, “Testing Indefinite-Lived Intangible Assets for Impairment” ("ASU 2012-02"), an update to the authoritative guidance related to the impairment testing of indefinite-lived intangible assets. Similar to the guidance for goodwill impairment testing, companies will have the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of the indefinite-lived intangible asset is less than its carrying value. The guidance provides companies with a revised list of examples of events and circumstances to consider, in their totality, to determine whether it is more likely than not that the fair value of the asset is less than its carrying amount. If a company concludes that this is the case, the company is required to perform the quantitative impairment test by comparing the fair value with the carrying value. Otherwise, a company can skip the quantitative test. Companies are not required to perform the qualitative assessment and are permitted to skip the qualitative assessment for any indefinite-lived asset in any period and proceed directly to the quantitative impairment test. The company may resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The Company adopted ASU 2012-02 beginning July 1, 2013. Adoption of ASU 2012-02 did not to have a material effect on the results of operations, financial position or cash flows of the Company.

New Accounting Pronouncements

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" ("ASU 2013-11"). An entity is required to present unrecognized tax benefits as a decrease in net operating loss, similar tax loss or tax credit carryforward if certain criteria are met. The determination of whether a deferred tax asset is available is based on the unrecognized tax benefit and the deferred tax asset that exists at the reporting date and presumes disallowance of the tax position at the reporting date. The guidance will eliminate the diversity in practice in the presentation of unrecognized tax benefits but will not alter the way in which entities assess deferred tax assets for realizability. This update is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2013 and will be effective for the Company beginning July 1, 2014. Adoption of ASU 2013-11 is not expected to have a material effect on the results of operations, financial position or cash flows of the Company.

Note 2. Derivative Instruments

Derivative Instruments Held

Coffee-Related Derivative Instruments

The Company is exposed to commodity price risk associated with its PTF green coffee purchase contracts, which are described further in Note 1. The Company utilizes futures contracts and options to manage exposure to the variability in expected future cash flows from forecasted purchases of green coffee attributable to commodity price risk, in some instances, as much as 18 months prior to the actual delivery date. Certain of these coffee-related derivative instruments utilized for risk management purposes have been designated as cash flow hedges, while other coffee-related derivative instruments have not been designated as cash flow hedges or do not qualify for hedge accounting despite hedging the Company's future cash flows on an economic basis.

At September 30, 2013, approximately 90% of the Company's outstanding coffee-related derivative instruments, representing 47.9 million pounds of forecasted green coffee purchases, were designated as cash flow hedges. At September 30, 2012 no coffee-related derivative instruments were designated as accounting hedges.

For the three months ended September 30, 2013, the Company recorded coffee-related net derivative losses in OCI in the amount of $3.1 million. No coffee-related net derivative gains or losses were recorded in OCI for the three months ended September 30, 2012.

Interest Rate Swap

Effective December 1, 2012, the Company entered into an interest rate swap transaction utilizing a notional amount of $10.0 million and a maturity date of March 1, 2015. The Company entered into the swap transaction to effectively fix the future interest rate during the applicable period on a portion of its borrowings under the revolving credit facility. The swap transaction is intended to manage the Company's interest rate risk related to its revolving credit facility and requires the Company to pay a fixed rate of 0.48% per annum in exchange for a variable interest rate based on 1-month USD LIBOR-BBA. The interest rate swap is not designated as an accounting hedge.

Effect of Derivative Instruments on the Financial Statements

Balance Sheet

Fair values of derivative instruments on the consolidated balance sheets (in thousands):

	Derivatives Designated as Cash Flow Hedges		Derivatives Not Designated as Accounting Hedges	
	September 30, 2013 (Unaudited)	June 30, 2013	September 30, 2013 (Unaudited)	June 30, 2013
Financial Statement Location:				
Short-term investments:				
Coffee-related derivatives	$—	$—	$—	$4
Short-term derivative liability:				
Coffee futures	$8,718	$9,331	$632	$565
Other current liabilities:				
Interest rate swap	$—			