

GRAHAM CORP
Form 10-Q
February 03, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2016

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 1-8462

GRAHAM CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---------------------------------|---------------------|
| Delaware | 16-1194720 |
| (State or other jurisdiction of | (I.R.S. Employer |
| incorporation or organization) | Identification No.) |

20 Florence Avenue, Batavia, New York 14020
(Address of principal executive offices) (Zip Code)
585-343-2216

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer

Accelerated filer

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

As of January 27, 2017, there were outstanding 9,729,090 shares of the registrant's common stock, par value \$.10 per share.

Graham Corporation and Subsidiaries

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As of December 31, 2016 and March 31, 2016 and for the Three and Nine-Month Periods Ended December 31, 2016 and 2015

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GRAHAM CORPORATION AND SUBSIDIARIES

FORM 10-Q

DECEMBER 31, 2016

PART I – FINANCIAL INFORMATION

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Item 1. Unaudited Condensed Consolidated Financial Statements
 GRAHAM CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|---|------------|----------------------|------------|
| | December 31, 2016 | 2015 | December 31, 2016 | 2015 |
| | (Amounts in thousands, except per share data) | | | |
| Net sales | \$ 22,654 | \$ 17,323 | \$ 66,145 | \$ 67,738 |
| Cost of products sold | 16,353 | 13,799 | 50,723 | 49,042 |
| Gross profit | 6,301 | 3,524 | 15,422 | 18,696 |
| Other expenses and income: | | | | |
| Selling, general and administrative | 3,746 | 3,680 | 10,462 | 12,447 |
| Selling, general and administrative – amortization | 58 | 58 | 175 | 175 |
| Restructuring charge | — | — | 630 | — |
| Interest income | (100) | (72) | (272) | (177) |
| Interest expense | 3 | 4 | 7 | 8 |
| Other income | — | (1,784) | — | (1,784) |
| Total other expenses and income | 3,707 | 1,886 | 11,002 | 10,669 |
| Income before provision for income taxes | 2,594 | 1,638 | 4,420 | 8,027 |
| Provision for income taxes | 754 | 364 | 1,198 | 2,416 |
| Net income | 1,840 | 1,274 | 3,222 | 5,611 |
| Retained earnings at beginning of period | 108,655 | 108,895 | 109,013 | 106,178 |
| Dividends | (876) | (795) | (2,616) | (2,415) |
| Retained earnings at end of period | \$ 109,619 | \$ 109,374 | \$ 109,619 | \$ 109,374 |
| Per share data | | | | |
| Basic: | | | | |
| Net income | \$ 0.19 | \$ 0.13 | \$ 0.33 | \$ 0.56 |
| Diluted: | | | | |
| Net income | \$ 0.19 | \$ 0.13 | \$ 0.33 | \$ 0.56 |
| Weighted average common shares outstanding: | | | | |
| Basic | 9,727 | 9,922 | 9,709 | 10,051 |
| Diluted | 9,733 | 9,927 | 9,714 | 10,059 |
| Dividends declared per share | \$ 0.09 | \$ 0.08 | \$ 0.27 | \$ 0.24 |

See Notes to Condensed Consolidated Financial Statements.

GRAHAM CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|----------|-----------------------------------|----------|
| | 2016 | 2015 | 2016 | 2015 |
| | (Amounts in thousands) | | (Amounts in thousands) | |
| Net income | \$ 1,840 | \$ 1,274 | \$ 3,222 | \$ 5,611 |
| Other comprehensive income: | | | | |
| Foreign currency translation adjustment | (135) | (73) | (283) | (184) |
| Defined benefit pension and other postretirement plans net of income tax of \$123 and \$107, for the three months ended December 31, 2016 and 2015, respectively, and \$369 and \$322 for the nine months ended December 31, 2016 and 2015, respectively | 225 | 197 | 674 | 589 |
| Total other comprehensive income | 90 | 124 | 391 | 405 |
| Total comprehensive income | \$ 1,930 | \$ 1,398 | \$ 3,613 | \$ 6,016 |

See Notes to Condensed Consolidated Financial Statements.

GRAHAM CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

| | December 31, 2016 | March 31, 2016 |
|--|----------------------|----------------------|
| (Amounts in thousands, except per share data) | | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$37,677 | \$24,072 |
| Investments | 35,000 | 41,000 |
| Trade accounts receivable, net of allowances (\$30 and \$91 at December 31 and March 31, 2016, respectively) | 11,490 | 12,730 |
| Unbilled revenue | 14,503 | 11,852 |
| Inventories | 9,109 | 10,811 |
| Prepaid expenses and other current assets | 1,060 | 613 |
| Income taxes receivable | 550 | 1,652 |
| Total current assets | 109,389 | 102,730 |
| Property, plant and equipment, net | 17,384 | 18,747 |
| Goodwill | 6,938 | 6,938 |
| Permits | 10,300 | 10,300 |
| Other intangible assets, net | 4,113 | 4,248 |
| Other assets | 204 | 168 |
| Total assets | \$148,328 | \$143,131 |
| Liabilities and stockholders' equity | | |
| Current liabilities: | | |
| Current portion of capital lease obligations | \$55 | \$55 |
| Accounts payable | 8,071 | 10,325 |
| Accrued compensation | 4,977 | 5,317 |
| Accrued expenses and other current liabilities | 3,486 | 3,826 |
| Customer deposits | 15,095 | 8,400 |
| Total current liabilities | 31,684 | 27,923 |
| Capital lease obligations | 119 | 157 |
| Accrued compensation | 11 | — |
| Deferred income tax liability | 3,967 | 3,546 |
| Accrued pension liability | 797 | 1,338 |
| Accrued postretirement benefits | 809 | 787 |
| Total liabilities | 37,387 | 33,751 |
| Commitments and contingencies (Note 11) | | |
| Stockholders' equity: | | |
| Preferred stock, \$1.00 par value, 500 shares authorized | | |
| Common stock, \$.10 par value, 25,500 shares authorized | 1,054 | 1,047 |

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10,545 and 10,468 shares issued and 9,729 and 9,646 shares

outstanding at December 31 and March 31, respectively

| | | |
|---|-----------|-----------|
| Capital in excess of par value | 22,843 | 22,315 |
| Retained earnings | 109,619 | 109,013 |
| Accumulated other comprehensive loss | (10,285) | (10,676) |
| Treasury stock (816 and 822 shares at December 31 and March 31, respectively) | (12,290) | (12,319) |
| Total stockholders' equity | 110,941 | 109,380 |
| Total liabilities and stockholders' equity | \$148,328 | \$143,131 |

See Notes to Condensed Consolidated Financial Statements.

GRAHAM CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| | Nine Months Ended December 31, | |
|--|-----------------------------------|----------|
| | 2016 | 2015 |
| Operating activities: | (Dollar amounts in thousands) | |
| Net income | \$3,222 | \$5,611 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 1,571 | 1,675 |
| Amortization | 175 | 175 |
| Amortization of unrecognized prior service cost and actuarial losses | 1,043 | 911 |
| Stock-based compensation expense | 433 | 540 |
| Loss (gain) on disposal or sale of property, plant and equipment | 1 | (1) |
| Deferred income taxes | 10 | 596 |
| (Increase) decrease in operating assets: | | |
| Accounts receivable | 1,126 | 6,329 |
| Unbilled revenue | (2,651) | 10,152 |
| Inventories | 1,697 | 2,186 |
| Prepaid expenses and other current and non-current assets | (489) | (420) |
| Income taxes payable/receivable | 1,109 | (2,531) |
| Prepaid pension asset | — | (917) |
| Increase (decrease) in operating liabilities: | | |
| Accounts payable | (2,173) | (2,216) |
| Accrued compensation, accrued expenses and other current and non-current liabilities | (558) | (3,795) |
| Customer deposits | 6,699 | 3,944 |
| Long-term portion of accrued compensation, accrued pension liability and accrued postretirement benefits | (508) | (68) |
| Net cash provided by operating activities | 10,707 | 22,171 |
| Investing activities: | | |
| Purchase of property, plant and equipment | (241) | (883) |
| Proceeds from disposal of property, plant and equipment | — | 4 |
| Purchase of investments | (39,000) | (36,000) |
| Redemption of investments at maturity | 45,000 | 27,000 |
| Net cash provided (used) by investing activities | 5,759 | (9,879) |
| Financing activities: | | |
| Principal repayments on capital lease obligations | (38) | (42) |
| Issuance of common stock | 79 | 97 |
| Dividends paid | (2,616) | (2,415) |
| Purchase of treasury stock | (29) | (5,852) |

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| | | |
|---|----------|----------|
| Excess tax (deficiency) benefit on stock awards | (26) | 5 |
| Net cash used by financing activities | (2,630) | (8,207) |
| Effect of exchange rate changes on cash | (231) | (141) |
| Net increase in cash and cash equivalents | 13,605 | 3,944 |
| Cash and cash equivalents at beginning of year | 24,072 | 27,271 |
| Cash and cash equivalents at end of period | \$37,677 | \$31,215 |

See Notes to Condensed Consolidated Financial Statements.

GRAHAM CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Amounts in thousands, except per share data)

NOTE 1 – BASIS OF PRESENTATION:

Graham Corporation's (the "Company's") Condensed Consolidated Financial Statements include its (i) wholly-owned foreign subsidiary located in Suzhou, China and (ii) wholly-owned domestic subsidiary located in Lapeer, Michigan. The Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the U.S. ("GAAP") for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, each as promulgated by the Securities and Exchange Commission. The Company's Condensed Consolidated Financial Statements do not include all information and notes required by GAAP for complete financial statements. The unaudited Condensed Consolidated Balance Sheet as of March 31, 2016 presented herein was derived from the Company's audited Consolidated Balance Sheet as of March 31, 2016. For additional information, please refer to the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2016 ("fiscal 2016"). In the opinion of management, all adjustments, including normal recurring accruals considered necessary for a fair presentation, have been included in the Company's Condensed Consolidated Financial Statements.

The Company's results of operations and cash flows for the three and nine months ended December 31, 2016 are not necessarily indicative of the results that may be expected for the current fiscal year, which ends March 31, 2017 ("fiscal 2017").

NOTE 2 – REVENUE RECOGNITION:

The Company recognizes revenue on all contracts with a planned manufacturing process in excess of four weeks (which approximates 575 direct labor hours) using the percentage-of-completion method. The majority of the Company's revenue is recognized under this methodology. The Company has established the systems and procedures essential to developing the estimates required to account for contracts using the percentage-of-completion method. The percentage-of-completion method is determined by comparing actual labor incurred to a specific date to management's estimate of the total labor to be incurred on each contract or completion of operational milestones assigned to each contract. Contracts in progress are reviewed monthly by management, and sales and earnings are adjusted in current accounting periods based on revisions in the contract value and estimated costs at completion. Losses on contracts are recognized immediately when evident to management.

Revenue on contracts not accounted for using the percentage-of-completion method is recognized utilizing the completed contract method. The majority of the Company's contracts (as opposed to revenue) have a planned manufacturing process of less than four weeks and the results reported under this method do not vary materially from the percentage-of-completion method. The Company recognizes revenue and all related costs on these contracts upon substantial completion or shipment to the customer. Substantial completion is consistently defined as at least 95% complete with regard to direct labor hours. Customer acceptance is generally required throughout the construction

process and the Company has no further material obligations under its contracts after the revenue is recognized.

Receivables billed but not paid under retainage provisions in the Company's customer contracts were \$859 and \$2,071 at December 31, 2016 and March 31, 2016, respectively.

NOTE 3 – INVESTMENTS:

Investments consist of certificates of deposits with financial institutions. All investments have original maturities of greater than three months and less than one year and are classified as held-to-maturity, as the Company believes it has the intent and ability to hold the securities to maturity. Investments are stated at amortized cost which approximates fair value. All investments held by the Company at December 31, 2016 are scheduled to mature on or before September 14, 2017.

NOTE 4 – INVENTORIES:

Inventories are stated at the lower of cost or market, using the average cost method. Unbilled revenue in the Condensed Consolidated Balance Sheets represents revenue recognized that has not been billed to customers on contracts accounted for on the percentage-of-completion method. For contracts accounted for on the percentage-of-completion method, progress payments are netted against unbilled revenue to the extent the payment is less than the unbilled revenue for the applicable contract. Progress payments exceeding unbilled revenue are netted against inventory to the extent the payment is less than or equal to the inventory balance relating to the applicable contract, and the excess is presented as customer deposits in the Condensed Consolidated Balance Sheets.

Major classifications of inventories are as follows:

| | December 31, 2016 | March 31, 2016 |
|----------------------------|----------------------|----------------------|
| Raw materials and supplies | \$ 3,159 | \$3,178 |
| Work in process | 11,296 | 11,615 |
| Finished products | 978 | 659 |
| | 15,433 | 15,452 |
| Less - progress payments | 6,324 | 4,641 |
| Total | \$ 9,109 | \$10,811 |

NOTE 5 – INTANGIBLE ASSETS:

Intangible assets are comprised of the following:

| | Gross | | Net |
|--|----------|--------------|----------|
| | Carrying | Accumulated | Carrying |
| | Amount | Amortization | Amount |
| At December 31, 2016 | | | |
| Intangibles subject to amortization: | | | |
| Customer relationships | \$2,700 | \$ 1,087 | \$1,613 |
| Intangibles not subject to amortization: | | | |
| Permits | \$10,300 | \$ — | \$10,300 |
| Tradename | 2,500 | — | 2,500 |
| | \$12,800 | \$ — | \$12,800 |
| At March 31, 2016 | | | |
| Intangibles subject to amortization: | | | |
| Customer relationships | \$2,700 | \$ 952 | \$1,748 |
| Intangibles not subject to amortization: | | | |
| Permits | \$10,300 | \$ — | \$10,300 |
| Tradename | 2,500 | — | 2,500 |

\$ 12,800 \$ — \$ 12,800

Intangible assets are amortized on a straight line basis over the estimated useful lives. Intangible amortization expense for each of the three-month periods ended December 31, 2016 and 2015 was \$45. Intangible amortization expense for each of the nine-month periods ended December 31, 2016 and 2015 was \$135. As of December 31, 2016, amortization expense is estimated to be \$45 for the remainder of fiscal 2017 and \$180 in each of the fiscal years ending March 31, 2018, 2019, 2020 and 2021.

NOTE 6 – STOCK-BASED COMPENSATION:

The Amended and Restated 2000 Graham Corporation Incentive Plan to Increase Shareholder Value, as approved by the Company's stockholders at the Annual Meeting on July 28, 2016, provides for the issuance of up to 1,375 shares of common stock in connection with grants of incentive stock options, non-qualified stock options, stock awards and performance awards to officers, key employees and outside directors. As of December 31, 2016, 310 shares remain available for future awards under the plan, 225 of which may be used for awards other than stock options. Stock options may be granted at prices not less than the fair market value at the date of grant and expire no later than ten years after the date of grant.

No restricted stock awards were granted in the three-month periods ended December 31, 2016 and 2015. Restricted stock awards granted in the nine-month periods ended December 31, 2016 and 2015 were 82 and 34, respectively. Restricted shares of 43 and 15 granted to officers in fiscal 2017 and fiscal 2016, respectively, vest 100% on the third anniversary of the grant date subject to the satisfaction of the performance metrics for the applicable three-year period. Restricted shares of 31 and 12 granted to officers and

key employees in fiscal 2017 and fiscal 2016, respectively, vest 33 % per year over a three-year term. Restricted shares of 8 and 7 granted to directors in fiscal 2017 and fiscal 2016, respectively, vest 100% on the first year anniversary of the grant date. No stock option awards were granted in the three-month or nine-month periods ended December 31, 2016 and 2015.

During the three months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs related to stock option and restricted stock awards of \$200 and \$148, respectively. The income tax benefit recognized related to stock-based compensation was \$70 and \$52 for the three months ended December 31, 2016 and 2015, respectively. During the nine months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs related to stock option and restricted stock awards of \$427 and \$505, respectively. The income tax benefit recognized related to stock-based compensation was \$151 and \$178 for the nine months ended December 31, 2016 and 2015, respectively.

The Company has an Employee Stock Purchase Plan (the "ESPP"), which allows eligible employees to purchase shares of the Company's common stock at a discount of up to 15% of its fair market value on the (1) last, (2) first or (3) lower of the last or first day of the six-month offering period. A total of 200 shares of common stock may be purchased under the ESPP. During the three months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs of \$0 and \$14, respectively, related to the ESPP and \$0 and \$5, respectively, of related tax benefits. During the nine months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs of \$6 and \$35, respectively, related to the ESPP and \$2 and \$13, respectively, of related tax benefits.

NOTE 7 – INCOME PER SHARE:

Basic income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted income per share is calculated by dividing net income by the weighted average number of common shares outstanding and, when applicable, potential common shares outstanding during the period. A reconciliation of the numerators and denominators of basic and diluted income per share is presented below:

| | Three Months Ended December 31, 2016 | | Nine Months Ended December 31, 2015 | |
|--|---|---------|--|---------|
| Basic income per share | | | | |
| Numerator: | | | | |
| Net income | \$1,840 | \$1,274 | \$3,222 | \$5,611 |
| Denominator: | | | | |
| Weighted average common shares outstanding | 9,727 | 9,922 | 9,709 | 10,051 |
| Basic income per share | \$.19 | \$.13 | \$.33 | \$.56 |
| Diluted income per share | | | | |
| Numerator: | | | | |
| Net income | \$1,840 | \$1,274 | \$3,222 | \$5,611 |
| Denominator: | | | | |
| Weighted average common shares outstanding | 9,727 | 9,922 | 9,709 | 10,051 |

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| | | | | |
|--|-------|-------|-------|--------|
| Stock options outstanding | 6 | 5 | 5 | 8 |
| Weighted average common and potential common | | | | |
| shares outstanding | 9,733 | 9,927 | 9,714 | 10,059 |
| Diluted income per share | \$.19 | \$.13 | \$.33 | \$.56 |

Options to purchase a total of 16 and 54 shares of common stock were outstanding at December 31, 2016 and 2015, respectively, but were not included in the above computation of diluted income per share given their exercise prices as they would not be dilutive upon issuance.

NOTE 8 – PRODUCT WARRANTY LIABILITY:

The reconciliation of the changes in the product warranty liability is as follows:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|---------------------------------------|--------|--------------------------------------|--------|
| | 2016 | 2015 | 2016 | 2015 |
| Balance at beginning of period | \$ 582 | \$ 504 | \$ 686 | \$ 653 |
| (Income) expense for product warranties | (81) | (158) | 31 | (45) |
| Product warranty claims paid | (4) | (11) | (220) | (273) |
| Balance at end of period | \$ 497 | \$ 335 | \$ 497 | \$ 335 |

Income of \$81 and \$158 for product warranties in the three months ended December 31, 2016 and 2015, respectively, and the income of \$45 in the nine months ended December 31, 2015 resulted from the reversal of provisions made that were no longer required due to lower claims experience.

The product warranty liability is included in the line item "Accrued expenses and other current liabilities" in the Condensed Consolidated Balance Sheets.

NOTE 9 - CASH FLOW STATEMENT:

Interest paid was \$7 and \$8 in the nine-month periods ended December 31, 2016 and 2015, respectively. Income taxes paid for the nine months ended December 31, 2016 and 2015 were \$104 and \$4,348, respectively.

During the nine months ended December 31, 2016 and 2015, respectively, stock option awards were exercised and restricted stock awards vested. In connection with such stock option exercises and vesting, the related income tax benefit realized was (less) greater than the tax benefit that had been recorded pertaining to the compensation cost recognized by \$(26) and \$5, respectively, for such periods. This excess tax (deficiency) benefit has been separately reported under "Financing activities" in the Condensed Consolidated Statements of Cash Flows. Also, in the nine months ended December 31, 2016 and 2015, non-cash activities included the issuance of treasury stock valued at \$107 and \$124, respectively, to the Company's Employee Stock Purchase Plan.

At December 31, 2016 and 2015, respectively, there were \$31 and \$20 of capital purchases that were recorded in accounts payable and are not included in the caption "Purchase of property, plant and equipment" in the Condensed Consolidated Statements of Cash Flows.

NOTE 10 – EMPLOYEE BENEFIT PLANS:

The components of pension cost (benefit) are as follows:

| | Three Months Ended December 31, 2016 | | Nine Months Ended December 31, 2015 | |
|--------------------------------|---|---------|--|---------|
| Service cost | \$151 | \$130 | \$451 | \$391 |
| Interest cost | 362 | 360 | 1,087 | 1,078 |
| Expected return on assets | (718) | (795) | (2,155) | (2,385) |
| Amortization of actuarial loss | 337 | 293 | 1,013 | 880 |
| Net pension cost (benefit) | \$132 | \$(12) | \$396 | \$(36) |

The Company made no contributions to its defined benefit pension plan during the nine months ended December 31, 2016 and does not expect to make any contributions to the plan for the balance of fiscal 2017.

The components of the postretirement benefit cost are as follows:

| | Three Months Ended December 31, 2016 | | Nine Months Ended December 31, 2015 | |
|---------------------------------|---|-------|--|-------|
| Interest cost | \$ 5 | \$ 7 | \$ 19 | \$ 20 |
| Amortization of actuarial loss | 11 | 10 | 30 | 30 |
| Net postretirement benefit cost | \$ 16 | \$ 17 | \$ 49 | \$ 50 |

The Company paid no benefits related to its postretirement benefit plan during the nine months ended December 31, 2016. The Company expects to pay benefits of approximately \$88 for the balance of fiscal 2017.

The Company self-funds the medical insurance coverage it provides to its U.S. based employees. The Company maintains a stop loss insurance policy in order to limit its exposure to claims. The liability of \$178 and \$176 on December 31, 2016 and March 31, 2016, respectively, related to the self-insured medical plan is primarily based upon claim history and is included in the caption "Accrued compensation" as a current liability in the Condensed Consolidated Balance Sheets.

NOTE 11 – COMMITMENTS AND CONTINGENCIES:

The Company has been named as a defendant in lawsuits alleging personal injury from exposure to asbestos allegedly contained in, or accompanying, products made by the Company. The Company is a co-defendant with numerous other defendants in these lawsuits and intends to vigorously defend itself against these claims. The claims in the Company's current lawsuits are similar to those made in previous asbestos-related suits that named the Company as defendant, which either were dismissed when it was shown that the Company had not supplied products to the plaintiffs' places of work or were settled for immaterial amounts.

As of December 31, 2016, the Company was subject to the claims noted above, as well as other legal proceedings and potential claims that have arisen in the ordinary course of business.

Although the outcome of the lawsuits, legal proceedings or potential claims to which the Company is, or may become, a party to cannot be determined and an estimate of the reasonably possible loss or range of loss cannot be made, management does not believe that the outcomes, either individually or in the aggregate, will have a material effect on the Company's results of operations, financial position or cash flows.

NOTE 12 – INCOME TAXES:

The Company files federal and state income tax returns in several domestic and international jurisdictions. In most tax jurisdictions, returns are subject to examination by the relevant tax authorities for a number of years after the returns have been filed. The Company is subject to U.S. federal examination for the tax years 2014 through 2016 and examination in state tax jurisdictions for the tax years 2012 through 2016. The Company is subject to examination in the People's Republic of China for tax years 2013 through 2015.

There was no liability for unrecognized tax benefits at each of December 31, 2016 and March 31, 2016.

NOTE 13 – CHANGES IN ACCUMULATED OTHER COMPREHENSIVE LOSS:

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The changes in accumulated other comprehensive loss by component for the nine months ended December 31, 2016 and 2015 are as follows:

| | Pension and | | |
|---|----------------|----------|------------|
| | Other | Foreign | |
| | Postretirement | Currency | |
| | Benefit Items | Items | Total |
| Balance at April 1, 2016 | \$ (10,932) | \$ 256 | \$(10,676) |
| Other comprehensive income before reclassifications | — | (283) | (283) |
| Amounts reclassified from accumulated other comprehensive | | | |
| loss | 674 | — | 674 |
| Net current-period other comprehensive income | 674 | (283) | 391 |
| Balance at December 31, 2016 | \$ (10,258) | \$ (27) | \$(10,285) |

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| | Pension and Other Postretirement Benefit Items | Foreign Currency Items | Total |
|---|---|------------------------------|-----------|
| Balance at April 1, 2015 | \$ (9,462) | \$ 406 | \$(9,056) |
| Other comprehensive income before reclassifications | — | (184) | (184) |
| Amounts reclassified from accumulated other comprehensive loss | 589 | — | 589 |
| Net current-period other comprehensive income | 589 | (184) | 405 |
| Balance at December 31, 2015 | \$ (8,873) | \$ 222 | \$(8,651) |

The reclassifications out of accumulated other comprehensive loss by component for the three and nine months ended December 31, 2016 and 2015 are as follows:

| | Amount Reclassified from Accumulated Other Comprehensive Loss Components | Affected Line Item in the Condensed Consolidated Statements of Operations and Retained Earnings |
|---|--|---|
| Pension and other postretirement benefit items: | | |
| Amortization of actuarial loss | \$ (348) ⁽¹⁾ | \$ (304) ⁽¹⁾ Income before provision for income taxes |
| | (123) | (107) Provision for income taxes |
| | \$ (225) | \$ (197) Net income |

| | Amount Reclassified from Accumulated Other Comprehensive Loss Components | Affected Line Item in the Condensed Consolidated Statements of Operations and Retained Earnings |
|---|--|---|
| Pension and other postretirement benefit items: | | |
| Amortization of actuarial loss | \$ (1,043) ⁽¹⁾ | \$ (911) ⁽¹⁾ Income before provision for income taxes |

| | | |
|-----------|-----------|----------------------------|
| (369) | (322) | Provision for income taxes |
| \$ (674) | \$ (589) | Net income |

⁽¹⁾These accumulated other comprehensive loss components are included within the computation of pension and other postretirement benefit costs. See Note 10.

NOTE 14 – RESTRUCTURING CHARGE:

In fiscal 2017, the Company’s workforce was aligned with market conditions by eliminating certain management, office and manufacturing positions. As a result, a restructuring charge of \$630 was recognized, which included severance and related employee benefit costs. This charge is included in the caption “Restructuring Charge” in the Condensed Consolidated Statement of Operations and Retained Earnings for the nine months ended December 31, 2016. The reconciliation of the changes in the restructuring reserve is as follows:

| | Nine Months Ended December 31, 2016 |
|--------------------------------|--|
| Balance at beginning of period | \$ 74 |
| Expense for restructuring | 630 |
| Amounts paid for restructuring | (549) |
| Balance at end of period | \$ 155 |

The current portion of the liability of \$144 and \$74 at December 31, 2016 and March 31, 2016 respectively, is included in the caption “Accrued Compensation” in the Condensed Consolidated Balance Sheets. The long-term portion of \$11 at December 31, 2016 is separately presented in the Condensed Consolidated Balance Sheet.

NOTE 15 – OTHER INCOME:

During the three and nine months ended December 31, 2015, certain orders from customers were cancelled. The contracts for the cancelled orders included provisions that entitled the Company to cancellation charges. The amount of the cancellation charges were negotiated and settled with the customers. This income, net of costs incurred on the contracts, of \$1,784 is presented in the caption “Other Income” in the Condensed Consolidated Statements of Operations and Retained Earnings for the three and nine months ended December 31, 2015.

NOTE 16 – ACCOUNTING AND REPORTING CHANGES:

In the normal course of business, management evaluates all new accounting pronouncements issued by the Financial Accounting Standards Board (“FASB”), the Securities and Exchange Commission, the Emerging Issues Task Force, the American Institute of Certified Public Accountants or other authoritative accounting bodies to determine the potential impact they may have on the Company's consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers.” This guidance establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from a company’s contracts with customers. The guidance requires companies to apply a five-step model when recognizing revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. The guidance also includes a comprehensive set of disclosure requirements regarding revenue recognition. The guidance allows two methods of adoption: (1) a full retrospective approach where historical financial information is presented in accordance with the new standard and (2) a modified retrospective approach where the guidance is applied to the most current period presented in the financial statements. In August 2015, the FASB issued ASU No 2015-14 “Revenue from Contracts with Customers: Deferral of the Effective Date,” which deferred the effective date of ASU 2014-09 to annual reporting periods beginning after December 15, 2017, with earlier application permitted as of annual reporting periods beginning after December 15, 2016. In March 2016, the FASB issued ASU No. 2016-08, “Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net),” to clarify the implementation guidance on principal versus agent. In April 2016, the FASB issued ASU No. 2016-10, “Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing,” which clarifies the identifying performance obligations and licensing implementation guidance. In May 2016, the FASB issued ASU No. 2016-12, “Revenue from Contracts with Customers (Topic 606): Narrow Scope Improvements and Practical Expedients,” which clarifies the implementation guidance related to collectability, presentation of sales tax, noncash consideration, contract modifications and completed contracts at transition. The Company is currently evaluating the impact of adopting these ASU’s and the methods of adoption; however, given the scope of the new standards, the Company is currently unable to provide a reasonable estimate regarding the financial impact or which method of adoption will be elected. See Note 2 for a

description of the Company's current revenue recognition policy.

In July 2015, the FASB issued ASU No. 2015-11, "Simplifying the Measurement of Inventory," which simplifies the subsequent measurement of inventory by requiring inventory to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This ASU is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. The Company is currently evaluating the impact that the adoption of this ASU will have on its Consolidated Financial Statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)," which requires companies to recognize all leases as assets and liabilities on the consolidated balance sheet. This ASU retains a distinction between finance leases and operating leases, and the classification criteria for distinguishing between finance leases and operating leases are substantially similar to the classification criteria for distinguishing between capital leases and operating leases in the current accounting guidance. As a result, the effect of leases on the consolidated statement of comprehensive income and a consolidated statement of cash flows is largely unchanged from previous generally accepted accounting principles. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Earlier application is permitted. The Company is currently evaluating the impact that the adoption of this ASU will have on its Consolidated Financial Statements.

In March 2016, the FASB issued ASU 2016-09, "Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." ASU 2016-09 changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as

well as classification in the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, including interim periods within those annual periods. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period and the entity must adopt all of the amendments from ASU 2016-09 in the same period. The Company does not expect the adoption of this ASU will have a material effect on its Consolidated Financial Statements.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230)," which clarifies the presentation and classification of eight specific issues on the cash flow statement. This ASU is effective for public businesses for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company does not expect the adoption of this ASU will have a material effect on its Consolidated Financial Statements.

Management does not expect any other recently issued accounting pronouncements, which have not already been adopted, to have a material impact on the Company's consolidated financial statements.

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

(Dollar amounts in thousands, except per share data)

Overview

We are a global business that designs, manufactures and sells critical equipment for the energy, defense and chemical/petrochemical industries. Our energy markets include oil refining, cogeneration, nuclear and alternative power. For the defense industry, our equipment is used in nuclear propulsion power systems for the U.S. Navy. For the chemical and petrochemical industries, our equipment is used in fertilizer, ethylene, methanol and downstream chemical facilities.

Graham's global brand is built upon our world-renowned engineering expertise in vacuum and heat transfer technology, responsive and flexible service and high quality standards. We design and manufacture custom-engineered ejectors, vacuum pumping systems, surface condensers and vacuum systems. We are also a leading nuclear code accredited fabrication and specialty machining company. We supply components used inside reactor vessels and outside containment vessels of nuclear power facilities. Our equipment can also be found in other diverse applications such as metal refining, pulp and paper processing, water heating, refrigeration, desalination, food processing, pharmaceutical, heating, ventilating and air conditioning.

Our corporate headquarters are located in Batavia, New York. We have production facilities co-located with our headquarters in Batavia and also at our wholly-owned subsidiary, Energy Steel & Supply Co. ("Energy Steel"), located in Lapeer, Michigan. We also have a wholly-owned foreign subsidiary, Graham Vacuum and Heat Transfer Technology (Suzhou) Co., Ltd. ("GVHTT"), located in Suzhou, China. GVHTT provides sales and engineering support for us in the People's Republic of China and management oversight throughout Southeast Asia.

Our current fiscal year (which we refer to as "fiscal 2017") ends March 31, 2017.

Highlights

Highlights for the three and nine months ended December 31, 2016 include:

• Net sales for the third quarter of fiscal 2017 were \$22,654, up 31% compared with \$17,323 for the third quarter of the fiscal year ended March 31, 2016 (we refer to the fiscal year ended March 31, 2016 as "fiscal 2016"). Net sales for the first nine months of fiscal 2017 were \$66,145, down 2% compared with net sales of \$67,738 for the first nine months of fiscal 2016.

• Net income and income per diluted share for the third quarter of fiscal 2017 were \$1,840 and \$0.19, compared with \$1,274 and \$0.13, respectively, for the third quarter of fiscal 2016. Net income and income per diluted share for the first nine months of fiscal 2017 were \$3,222 and \$0.33, respectively, compared with net income of \$5,611 and income per diluted share of \$0.56 for the first nine months of fiscal 2016.

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Orders booked in the third quarter of fiscal 2017 were \$17,699, down 21% compared with the third quarter of fiscal 2016 when orders were \$22,263. Orders booked in the first nine months of fiscal 2017 were \$57,123, down 15% compared with the first nine months of fiscal 2016, when orders were \$66,840.

Backlog was \$99,104 at December 31, 2016, compared with \$104,015 at September 30, 2016 and \$107,963 at March 31, 2016.

Gross profit margin and operating margin for the third quarter of fiscal 2017 were 28% and 11%, respectively, compared with 20% and 9%, respectively, for the third quarter of fiscal 2016. Gross profit margin and operating margin for the first nine months of fiscal 2017 were 23% and 6% compared with 28% and 12%, respectively, for the first nine months of fiscal 2016.

Cash and short-term investments at December 31, 2016 were \$72,677, compared with \$66,274 on September 30, 2016 and \$65,072 at March 31, 2016.

Forward-Looking Statements

This report and other documents we file with the Securities and Exchange Commission include “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended.

These statements involve known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from any future results implied by the forward-looking statements. Such factors include, but are not limited to, the risks and uncertainties identified by us under the heading "Risk Factors" in Item 1A of our Annual Report on Form 10-K for fiscal 2016.

Forward-looking statements may also include, but are not limited to, statements about:

- the current and future economic environments affecting us and the markets we serve;
- expectations regarding investments in new projects by our customers;
- sources of revenue and anticipated revenue, including the contribution from anticipated growth;

- expectations regarding achievement of revenue and profitability expectations;

- plans for future products and services and for enhancements to existing products and services;

- our operations in foreign countries;
- political instability in regions in which our customers are located;
- our ability to affect our growth and acquisition strategy;
- our ability to expand nuclear power work into new markets;
- our ability to maintain or expand nuclear power work for the U.S. Navy;
- our ability to successfully execute our existing contracts;
- estimates regarding our liquidity and capital requirements;
- timing of conversion of backlog to sales;
- our ability to attract or retain customers;
- the outcome of any existing or future litigation; and
- our ability to increase our productivity and capacity.

Forward-looking statements are usually accompanied by words such as “anticipate,” “believe,” “estimate,” “may,” “might,” “intend,” “interest,” “appear,” “expect,” “suggest,” “plan,” “encourage,” “potential” and similar expressions. Actual results can materially differ from historical results or those implied by the forward-looking statements contained in this report.

Undue reliance should not be placed on our forward-looking statements. Except as required by law, we undertake no obligation to update or announce any revisions to forward-looking statements contained in this report, whether as a result of new information, future events or otherwise.

Current Market Conditions

Demand for our products and services to the oil refining and chemical industries depends on capital investment for new capacity, retrofit and debottlenecking projects and for planned or unplanned maintenance activity. Increased volatility and significant reduction in global crude oil prices beginning in the second half of calendar 2014 created continuing uncertainty in the oil refining and chemical industries. Such dramatic price reduction and increased volatility in global crude oil prices together with uncertainty of the mid- and long-term outlook caused our customers in these markets to alter their investment timing over the past year. Capital investment within global refining and chemical industries contracted during fiscal 2016 compared with fiscal 2015 and has continued to contract in fiscal 2017. While oil prices have stabilized over the past two quarters and have increased since the U. S. election, the near term uncertainty has not yet changed. We continue to believe that the catalyst for increased investment would be higher or more stable crude oil prices, though a period of longer than six months is likely required. However, even if crude oil prices remain low for a sustained period, we believe that increased global energy and petrochemical demand as well as the need to maintain and replace current equipment will eventually drive additional customer investment.

Demand for our products and services in the nuclear power utility market is affected by investment in maintenance, repair, life extension and nuclear regulatory mandated investment, along with global investment in new capacity. Global investment in new capacity is affected by regional legislative policy and cost per unit of power output compared with other energy sources, such as natural gas, oil, coal or alternative energies. Because the nuclear market which we serve is very fragmented, we continue to believe that it provides an important opportunity for

growth.

Demand in our naval nuclear propulsion market is tied to aircraft carrier and submarine vessel construction schedules of the primary shipyards who service the U.S. Navy. We expect growth in our naval nuclear propulsion business, based on anticipated demand and our strategic initiatives which are intended to increase our market share.

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Oil refining and chemicals are expected to remain important end markets, notwithstanding the severity of the current downturn in these industries. We intend to maintain our focus in these sectors and continue to implement strategies that expand participation and our market share. We believe that long-term demand drivers for energy requirements are unchanged and have not been affected by the decline in the price of crude oil. We believe that such demand, which is driven by population growth and an expanding middle class in emerging markets, requires an increase in global energy and petrochemical capacity and investment which will be partially offset by technological innovation. Our strategy is to continue to leverage our investments and expand our capabilities and execution capacity to grow market share in the oil refining, chemical and nuclear markets, as well as our business with the U.S. Navy. For more information, refer to the heading "Strategy and Outlook" within this Item 2 of this Quarterly Report on Form 10-Q.

We believe the long-term outlook in our key markets supports our strategy to grow our revenue to over \$200,000 across the next business cycle in our markets. In the near term, new order levels are expected to remain volatile, resulting in both relatively strong and weak periods.

The chart below shows the impact of our diversification strategy over the last ten years. Over 60% of our current backlog is from markets not served by us in the Fiscal 2007-2009 time frame.

Results of Operations

To better understand the significant factors that influenced our performance during the periods presented, the following discussion should be read in conjunction with our Condensed Consolidated Financial Statements and the notes to our Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q.

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The following table summarizes our results of operations for the periods indicated:

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------|-------------------|-----------|
| | December 31, | | December 31, | |
| | 2016 | 2015 | 2016 | 2015 |
| Net sales | \$22,654 | \$17,323 | \$66,145 | \$67,738 |
| Gross profit | \$6,301 | \$3,524 | \$15,422 | \$18,696 |
| Gross profit margin | 28 | % 20 | % 23 | % 28 |
| SG&A expense ⁽¹⁾ | \$3,804 | \$3,738 | \$10,637 | \$12,622 |
| SG&A as a percent of sales | 17 | % 22 | % 16 | % 19 |
| Net income | \$1,840 | \$1,274 | \$3,222 | \$5,611 |
| Diluted income per share | \$0.19 | \$0.13 | \$0.33 | \$0.56 |
| Total assets | \$148,328 | \$151,009 | \$148,328 | \$151,009 |
| Total assets excluding cash, cash equivalents and investments | \$75,651 | \$77,794 | \$75,651 | \$77,794 |

⁽¹⁾Selling, general and administrative expense is referred to as "SG&A".

The Third Quarter and First Nine Months of Fiscal 2017 Compared With the Third Quarter and First Nine Months of Fiscal 2016

Sales for the third quarter of fiscal 2017 were \$22,654, a 31% increase as compared with sales of \$17,323 for the third quarter of fiscal 2016. Our domestic sales, as a percentage of aggregate sales, were 77% in the third quarter of fiscal 2017 compared with 62% in the third quarter of fiscal 2016. Domestic sales year-over-year increased \$6,638, or 61%. International sales decreased \$1,307, or 20%, in the third quarter of fiscal 2017 compared with the third quarter of fiscal 2016, driven by decreases in the Middle East and Canada. Sales in the three months ended December 31, 2016 were 28% to the refining industry, 19% to the chemical and petrochemical industries, 19% to the power industry, including the nuclear market, and 34% to other commercial and industrial applications, including the U.S.

Navy. Sales in the three months ended December 31, 2015 were 36% to the refining industry, 28% to the chemical and petrochemical industries, 16% to the power industry, including the nuclear market, and 20% to other commercial and industrial applications, including the U.S. Navy. Fluctuation in sales among markets, products and geographic locations varies, sometimes significantly, from quarter-to-quarter based on timing and magnitude of projects. See also "Current Market Conditions," above. For additional information on anticipated future sales and our markets, see "Orders and Backlog" below.

Sales for the first nine months of fiscal 2017 were \$66,145, a decrease of \$1,593, or 2% compared with sales of \$67,738 for the first nine months of fiscal 2016. The decrease in fiscal year-to-date sales was due to much weaker international sales, especially in the Middle East and Canada, offset by an increase in domestic sales. Our domestic sales, as a percentage of aggregate product sales, were 74% in the first nine months of fiscal 2017 compared with 65% in the same period in fiscal 2016. Domestic sales increased \$5,469, or 13%, while international sales decreased by \$7,062, or 29%. International sales accounted for 26% and 35% of total sales for the first nine months of fiscal 2017 and fiscal 2016, respectively. Sales in the first nine months of fiscal 2017 were 31% to the refining industry, 22% to the chemical and petrochemical industries, 23% to the power industry, including the nuclear market, and 24% to other

commercial and industrial applications, including the U.S. Navy. Sales in the first nine months of fiscal 2016 were 31% to the refining industry, 35% to the chemical and petrochemical industries, 14% to the power industry, including the nuclear market, and 20% to other commercial and industrial applications, including the U.S. Navy.

Our gross profit margin for the third quarter of fiscal 2017 was 28% compared with 20% for the third quarter of fiscal 2016. Gross profit for the third quarter of fiscal 2017 increased 79% compared with fiscal 2016, to \$6,301 from \$3,524. Gross profit and margin were favorably impacted by higher volume as well as a large non-typical order that began converting in the quarter. The third quarter of the prior year, fiscal 2016, included a very unfavorable mix of projects which were converted.

Our gross profit margin for the first nine months of fiscal 2017 was 23% compared with 28% for the first nine months of fiscal 2016. Gross profit for the first nine months of fiscal 2017 decreased 18% compared with fiscal 2016, to \$15,422 from \$18,696. The decrease in gross margin reflects lower pricing due to the deteriorating market conditions experienced over the past two years.

SG&A expenses as a percent of sales for the three and nine-month periods ended December 31, 2016 were 17% and 16%, respectively. SG&A expenses in the third quarter of fiscal 2017 were \$3,804, an increase of \$66, or 2%, compared with the third quarter of fiscal 2016 SG&A of \$3,738. SG&A expenses in the first nine months of fiscal 2017 were \$10,637, a decrease of \$1,985, or 16%, compared with the first nine months of fiscal 2016 SG&A of \$12,622. This decrease was principally due to lower commissions, lower compensation costs and other actions taken to reduce costs as well as the benefit of insurance proceeds in the second quarter.

Other income in the three and nine-month periods ended December 31, 2016 was \$0. This compares to \$1,784 in the three and nine-month periods ended December 31, 2015. The amount in the prior fiscal year, fiscal 2016, resulted from the cancellation charges received from customers for two orders cancelled in the year.

Interest income for the three and nine-month periods ended December 31, 2016 was \$100 and \$272, respectively, compared with \$72 and \$177, respectively, for the same periods ended December 31, 2015. Interest expense for the three and nine-month periods ended December 31, 2016 was \$3 and \$7, respectively, compared with \$4 and \$8, respectively, for the same periods ended December 31, 2015.

The effective tax rate in the current quarter was 29%, and 27% in the first nine months of fiscal 2017. The effective tax rates for the comparable three and nine month periods of fiscal 2016 were 22% and 30%, respectively.

Net income for the three and nine months ended December 31, 2016 was \$1,840 and \$3,222, respectively, compared with \$1,274 and \$5,611, respectively, for the same periods in the prior fiscal year. Income per diluted share in fiscal 2017 was \$0.19 and \$0.33 for the three and nine-month periods, compared with \$0.13 and \$0.56 for the same three and nine-month periods of fiscal 2016. Excluding the restructuring charge taken in the second quarter of fiscal 2017, net income for the nine months ended December 31, 2016 was \$3,663, respectively, and income per diluted share was \$0.38.

Liquidity and Capital Resources

The following discussion should be read in conjunction with our Condensed Consolidated Statements of Cash Flows:

| | December 31, 2016 | March 31, 2016 |
|--|----------------------|----------------------|
| Cash and investments | \$ 72,677 | \$65,072 |
| Working capital | 77,705 | 74,807 |
| Working capital ratio ⁽¹⁾ | 3.5 | 3.7 |
| Working capital excluding cash and investments | 5,028 | 9,735 |

⁽¹⁾Working capital ratio equals current assets divided by current liabilities.

Net cash generated by operating activities for the first nine months of fiscal 2017 was \$10,707, compared with \$22,171 for the first nine months of fiscal 2016. The decrease in cash generation year over year was attributable to lower net income and lower benefit from unbilled revenue and higher accounts receivable, partially offset by an increase in customer deposits and accrued compensation and income taxes payable.

Dividend payments and capital expenditures in the first nine months of fiscal 2017 were \$2,616 and \$241, respectively, compared with \$2,415 and \$883, respectively, for the first nine months of fiscal 2016. The higher dividend payment was due to the increase in dividends per share announced in January 2016.

Capital expenditures for fiscal 2017 are expected to be approximately \$500. Approximately 85% of our fiscal 2017 capital expenditures are expected to be for productivity-enhancing machinery and equipment, with the remaining amounts expected to be used for information technology upgrades and other items.

Cash and investments were \$72,677 on December 31, 2016 compared with \$65,072 on March 31, 2016, up \$7,605.

We invest net cash generated from operations in excess of cash held for near-term needs in short-term, less than 365 days, certificates of deposit, money market accounts or U.S. government instruments, generally with maturity periods of up to 180 days. Our money market account is used to securitize our outstanding letters of credit, which reduces our cost on those letters of credit. Approximately 95% of our cash and investments are held in the U.S. The remaining 5% is invested in our China operations.

Our revolving credit facility with JP Morgan Chase provides us with a line of credit of \$25,000, including letters of credit and bank guarantees. In addition, our JP Morgan Chase agreement allows us to increase the line of credit, at our discretion, up to another \$25,000, for total availability of \$50,000. Borrowings under this credit facility are secured by all of our assets. We also have a \$5,000 unsecured line of credit with HSBC, N.A. Letters of credit outstanding on December 31, 2016 and March 31, 2016 were \$9,984 and \$11,982, respectively. The outstanding letters of credit as of December 31, 2016 were issued by JP Morgan Chase, HSBC, as well as Bank of America (under our previous credit facility). There were no other amounts outstanding on our credit facilities at December 31, 2016 and March 31, 2016. The borrowing rate under our JP Morgan Chase facility as of December 31, 2016 was the bank's prime rate, or 3.75%. Availability under the JP Morgan Chase and HSBC lines of credit was \$25,381 and \$26,330 at December 31, 2016

and March 31, 2016, respectively. We believe that cash generated from operations, combined with our investments and available financing capacity under our credit facility, will be adequate both to meet our cash needs for the immediate future and to support our growth strategies.

Orders and Backlog

Orders for the three-month period ended December 31, 2016 were \$17,699 compared with \$22,263 for the same period in the prior year, a decrease of 21%. Orders represent written communications received from customers requesting us to supply products and/or services. Domestic orders were 59% of total orders, or \$10,396, and international orders were 41% of total orders, or \$7,303, in the current quarter compared with the third quarter of fiscal 2016, when domestic orders were 42%, or \$9,442, of total orders, and international orders were 58%, or \$12,821, of total orders.

During the first nine months of fiscal 2017, orders were \$57,123, compared with \$66,840 for the same period of fiscal 2016, a decrease of 15%. For the first nine months of fiscal 2017, power orders decreased by \$9,713, refining by \$7,424 and chemical and petrochemical by \$4,765. These decreases were partially offset by orders in other commercial and industrial applications, including the U.S. Navy which increased by \$12,185. See “Current Market Conditions” for additional information.

Backlog was \$99,104 at December 31, 2016, compared with \$104,015 at September 30, 2016, a 5% decrease, and down 8% from \$107,963 at March 31, 2016. Backlog is defined as the total dollar value of orders received for which revenue has not yet been recognized. Approximately 50% to 55% of orders currently in our backlog are expected to be converted to sales within one year, 5% to 10% are expected to ship between 12 and 24 months, and 35% to 40% beyond two years. The majority of the orders that are expected to convert beyond twelve months are for the U.S. Navy. At December 31, 2016, 17% of our backlog was attributable to equipment for refinery project work, 14% for chemical and petrochemical projects, 9% for power projects, including nuclear, 57% for U.S. Navy projects and 3% for other industrial applications. At December 31, 2015, 24% of our backlog was attributed to equipment for refinery project work, 13% for chemical and petrochemical projects, 15% for power projects, 44% for U.S. Navy projects and 4% for other industrial applications. In the third quarter of fiscal 2017, an order for \$399 which had been on hold, was moved into active status. At December 31, 2016, we had two projects for an aggregate of \$6,461 on hold.

Strategy and Outlook

Ongoing weakness in the global energy markets is expected to continue to impact our business for the remainder of fiscal 2017. The decrease in requests for quotations and orders, as well as a number of cancellations which occurred in fiscal 2016 are resulting in a challenging fiscal 2017. Our pipeline has contracted over the past year as our oil refining and chemical market customers have further reduced their capital spending plans. We believe that the reduction in quoting activity from our customers is in reaction to continued low and volatile oil prices. The expected duration of this downturn is uncertain.

Despite the current downturn, we believe in the long-term potential of the energy and petrochemical markets we serve. Coupled with our diversification strategy for the U.S. Navy and the power market, we believe this long-term strength will support our strategy to significantly grow our business. We have invested in capacity to serve our commercial customers as well as to expand the work we do for the U.S. Navy. We continue to look for organic growth opportunities as well as acquisitions or other business combinations that we believe will allow us to expand our presence in both our existing and ancillary markets. We are focused on reducing earnings volatility, growing our business and diversifying our business and product lines.

We expect revenue in fiscal 2017 to be between \$88,000 and \$92,000. We project that 50% to 55% of our December 31, 2016 backlog will convert to sales over the next twelve months. The backlog that is expected to convert beyond twelve months includes a combination of U.S. Navy orders that have a long conversion cycle (up to five years) as well as certain commercial orders, the conversion of which has been extended by our customers.

We expect gross profit margin in fiscal 2017 to be in the 21% to 23% range. We believe that production overhead absorption will continue to be weak, which in turn puts pressure on our gross profit margins.

SG&A spending during fiscal 2017 is expected to be between \$15,000 and \$15,500, inclusive of the \$630 restructuring charge which occurred in the first and second quarters, or approximately 16% and 18% of sales. Our effective tax rate during fiscal 2017 is expected to be between 28% and 30%.

Cash flow in fiscal 2017 will be much more moderate than fiscal 2016. In the first nine months of fiscal 2017 cash flow has been strong due to an influx of customer deposits which are expected to unwind over the next couple of quarters. Fiscal 2016 cash flow benefited from a build-up of accounts receivable and unbilled revenue which occurred in the latter portion of fiscal 2015 and that was converted to cash in fiscal 2016.

We continue to believe in the long-term outlook for the energy and petrochemical markets. We plan to continue to look toward future growth while being mindful of near term profitability, given short-term challenges.

Contingencies and Commitments

We have been named as a defendant in lawsuits alleging personal injury from exposure to asbestos allegedly contained in or accompanying our products. We are a co-defendant with numerous other defendants in these lawsuits and intend to vigorously defend ourselves against these claims. The claims in our current lawsuits are similar to those made in previous asbestos lawsuits that named us as a defendant. Such previous lawsuits either were dismissed when it was shown that we had not supplied products to the plaintiffs' places of work or were settled by us for immaterial amounts.

As of December 31, 2016, we are subject to the claims noted above, as well as other legal proceedings and potential claims that have arisen in the ordinary course of business. Although the outcome of the lawsuits, legal proceedings or potential claims to which we are or may become a party cannot be determined and an estimate of the reasonably possible loss or range of loss cannot be made, we do not believe that the outcomes, either individually or in the aggregate, will have a material effect on our results of operations, financial position or cash flows.

Critical Accounting Policies, Estimates, and Judgments

Our unaudited condensed consolidated financial statements are based on the selection of accounting policies and the application of significant accounting estimates, some of which require management to make significant assumptions. We believe that the most critical accounting estimates used in the preparation of our condensed consolidated financial statements relate to labor hour estimates and establishment of operational milestones which are used to recognize revenue under the percentage-of-completion method, fair value estimates of identifiable tangible and intangible assets acquired in business combinations, accounting for contingencies, under which we accrue a loss when it is probable that a liability has been incurred and the amount can be reasonably estimated, and accounting for pensions and other postretirement benefits. For further information, refer to Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8 "Financial Statements and Supplementary Data" included in our Annual Report on Form 10-K for the year ended March 31, 2016.

Off Balance Sheet Arrangements

We did not have any off balance sheet arrangements as of December 31, 2016 or March 31, 2016, other than operating leases and letters of credit.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The principal market risks (i.e., the risk of loss arising from market changes) to which we are exposed are foreign currency exchange rates, price risk and project cancellation risk.

The assumptions applied in preparing the following qualitative and quantitative disclosures regarding foreign currency exchange rate, price risk and project cancellation risk are based upon volatility ranges experienced by us in relevant historical periods, our current knowledge of the marketplace, and our judgment of the probability of future volatility based upon the historical trends and economic conditions of the markets in which we operate.

Foreign Currency

International consolidated sales for the three months and nine months ended December 31, 2016 were 23% and 26%, respectively, of total sales compared with 38% and 35%, respectively, for the same period of fiscal 2016. Operating in markets throughout the world exposes us to movements in currency exchange rates. Currency movements can

affect sales in several ways, the foremost being our ability to compete for orders against foreign competitors that base their prices on relatively weaker currencies. Business lost due to competition for orders against competitors using a relatively weaker currency cannot be quantified. In addition, cash can be adversely impacted by the conversion of sales made by us in a foreign currency to U.S. dollars. In the first three and nine months of fiscal 2017, sales in foreign currencies represented 0% and 2%, respectively, of total sales by us and our wholly-owned subsidiaries. In the first three and nine months of fiscal 2016, all sales by us and our wholly-owned subsidiaries, for which we were paid, were denominated in the local currency of the respective subsidiary (U.S. dollars or Chinese RMB).

We have limited exposure to foreign currency purchases. In the first three and nine months of fiscal 2017, our purchases in foreign currencies represented 2% and 3% of cost of products sold, respectively. In the first three and nine months of 2016, our purchases in foreign currencies represented less than 1% of cost of products sold. At certain times, we may enter into forward foreign currency exchange agreements to hedge our exposure against potential unfavorable changes in foreign currency values on significant

sales and purchase contracts negotiated in foreign currencies. Forward foreign currency exchange contracts were not used in the periods being reported on in this Quarterly Report on Form 10-Q and as of December 31, 2016 and March 31, 2016, we held no forward foreign currency contracts.

Price Risk

Operating in a global marketplace requires us to compete with other global manufacturers which, in some instances, benefit from lower production costs and more favorable economic conditions. Although we believe that our customers differentiate our products on the basis of our manufacturing quality and engineering experience and excellence, among other things, such lower production costs and more favorable economic conditions mean that certain of our competitors are able to offer products similar to ours at lower prices. In market downturns, such as we are currently experiencing, we typically see depressed price levels. Moreover, the cost of metals and other materials used in our products have experienced significant volatility. Such factors, in addition to the global effects of the ongoing volatility and disruption of the capital and credit markets, have resulted in downward demand and pricing pressure on our products.

Project Cancellation and Project Continuation Risk

Open orders are reviewed continuously through communications with customers. If it becomes evident to us that a project is delayed well beyond its original shipment date, management will move the project into "placed on hold" (i.e., suspended) category. Furthermore, if a project is cancelled by our customer, it is removed from our backlog. We attempt to mitigate the risk of cancellation by structuring contracts with our customers to maximize the likelihood that progress payments made to us for individual projects cover the costs we have incurred. As a result, we do not believe we have a significant cash exposure to projects which may be cancelled. In the third quarter of fiscal 2017, an order for \$399 which had been on hold, was moved into active status. At December 31, 2016, we had two projects for an aggregate of \$6,461 on hold.

Item 4. Controls and Procedures

Conclusion regarding the effectiveness of disclosure controls and procedures

Our President and Chief Executive Officer (principal executive officer) and Vice President-Finance & Administration and Chief Financial Officer (principal financial officer) each have evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, and as of such date, our President and Chief Executive Officer and Vice President-Finance & Administration and Chief Financial Officer concluded that our disclosure controls and procedures were effective in all material respects.

Changes in internal control over financial reporting

There has been no change to our internal control over financial reporting during the quarter covered by this Quarterly Report on Form 10-Q that has materially affected, or that is reasonably likely to materially affect, our internal control over financial reporting.

GRAHAM CORPORATION AND SUBSIDIARIES

FORM 10-Q

DECEMBER 31, 2016

PART II - OTHER INFORMATION

Item 6. Exhibits

See index to exhibits on page 26 of this report.

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SIGNATURES

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

GRAHAM CORPORATION

By: /s/ Jeffrey Glajch
Jeffrey Glajch
Vice President-Finance & Administration and
Chief Financial Officer

Date: February 3, 2017

INDEX TO EXHIBITS

(31) Rule 13a-14(a)/15d-14(a)
Certifications

+ 31.1 Certification
of Principal
Executive
Officer

+ 31.2 Certification
of Principal
Financial
Officer

(32) Section 1350 Certification

+ 32.1 Section 1350
Certifications

(101) Interactive Data File

+ 101.INS XBRL
Instance
Document

+ 101.SCH XBRL
Taxonomy
Extension
Schema
Document

+ 101.CAL XBRL
Taxonomy
Extension
Calculation
Linkbase
Document

+ 101.DEF XBRL
Taxonomy
Extension

| | | |
|---|---------|---|
| | | Definition Linkbase Document |
| + | 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| + | 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| | + | Exhibit filed with this report. |