

SYPRIS SOLUTIONS INC  
Form 10-Q  
August 05, 2014

**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 June 29, 2014

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: 0-24020**

**SYPRIS SOLUTIONS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware** **61-1321992**  
State or other jurisdiction (I.R.S. Employer  
of incorporation or organization) Identification No.)

**101 Bullitt Lane, Suite 450**  
**Louisville, Kentucky 40222** **(502) 329-2000**  
(Address of principal executive (Registrant's telephone number,  
offices) (Zip code) 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 reports). 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 the definitions 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 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 July 25, 2014 the Registrant had 20,521,059 shares of common stock outstanding.

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**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****SYPRIS SOLUTIONS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except for per share data)**

|                                      | <b>Three Months Ended</b> |                      | <b>Six Months Ended</b> |                      |
|--------------------------------------|---------------------------|----------------------|-------------------------|----------------------|
|                                      | <b>June 29, 2014</b>      | <b>June 30, 2013</b> | <b>June 29, 2014</b>    | <b>June 30, 2013</b> |
|                                      | <b>(Unaudited)</b>        |                      | <b>(Unaudited)</b>      |                      |
| Net revenue:                         |                           |                      |                         |                      |
| Outsourced services                  | \$83,233                  | \$74,373             | \$159,753               | \$146,456            |
| Products                             | 9,880                     | 7,793                | 17,604                  | 14,121               |
| Total net revenue                    | 93,113                    | 82,166               | 177,357                 | 160,577              |
| Cost of sales:                       |                           |                      |                         |                      |
| Outsourced services                  | 73,816                    | 67,380               | 141,797                 | 132,590              |
| Products                             | 8,470                     | 6,450                | 14,169                  | 11,575               |
| Total cost of sales                  | 82,286                    | 73,830               | 155,966                 | 144,165              |
| Gross profit                         | 10,827                    | 8,336                | 21,391                  | 16,412               |
| Selling, general and administrative  | 9,141                     | 7,598                | 17,133                  | 14,756               |
| Research and development             | 10                        | 1,419                | 161                     | 2,296                |
| Amortization of intangible assets    | 0                         | 8                    | 0                       | 30                   |
| Impairment of goodwill               | 0                         | 0                    | 0                       | 6,900                |
| Operating income (loss)              | 1,676                     | (689 )               | 4,097                   | (7,570 )             |
| Interest expense, net                | 155                       | 120                  | 287                     | 266                  |
| Other expense (income), net          | 75                        | (259 )               | (453 )                  | (1,454 )             |
| Income (loss) before taxes           | 1,446                     | (550 )               | 4,263                   | (6,382 )             |
| Income tax expense                   | 1,076                     | 944                  | 2,241                   | 1,571                |
| Net income (loss)                    | \$370                     | \$(1,494 )           | \$2,022                 | \$(7,953 )           |
| Income (loss) per share:             |                           |                      |                         |                      |
| Basic                                | \$0.02                    | \$(0.08 )            | \$0.10                  | \$(0.41 )            |
| Diluted                              | \$0.02                    | \$(0.08 )            | \$0.10                  | \$(0.41 )            |
| Weighted average shares outstanding: |                           |                      |                         |                      |
| Basic                                | 19,622                    | 19,347               | 19,525                  | 19,255               |
| Diluted                              | 19,682                    | 19,347               | 19,566                  | 19,255               |

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Dividends declared per common share \$0.02 \$0.02 \$0.04 \$0.04

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**SYPRIS SOLUTIONS, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(in thousands)**

|  | <b>Three Months<br/>Ended</b>                |                              | <b>Six Months<br/>Ended</b>                  |  |
|--|--|------------------------------|--|--|
|  | <b>June<br/>29,<br/>2014<br/>(Unaudited)</b> | <b>June<br/>30,<br/>2013</b> | <b>June<br/>29,<br/>2014<br/>(Unaudited)</b> | <b>June<br/>30,<br/>2013<br/>(Unaudited)</b> |
| Net income (loss)                        | \$370  | \$(1,494)                    | \$2,022                                      | \$(7,953)                                    |
| Other comprehensive income (loss):       |  |                              |  |  |
| Foreign currency translation adjustments | 73   | (1,264)                      | 99   | 452  |
| Total comprehensive income (loss)        | \$443  | (2,758)                      | \$2,121                                      | \$(7,501)                                    |

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

**SYPRIS SOLUTIONS, INC.****CONSOLIDATED BALANCE SHEETS****(in thousands, except for share data)**

|   | <b>June 29,<br/>2014<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2013</b> |
|---|--|----------------------------------|
| <b>ASSETS</b>   |  |                                  |
| Current assets:   |  |                                  |
| Cash and cash equivalents   | \$ 18,420                                | \$ 18,674                        |
| Accounts receivable, net  | 64,926                                   | 38,533                           |
| Inventory, net  | 35,008                                   | 34,422                           |
| Other current assets  | 4,553                                    | 5,403                            |
| Total current assets  | 122,907                                  | 97,032                           |
| Property, plant and equipment, net  | 42,331                                   | 44,683                           |
| Other assets  | 4,634                                    | 4,568                            |
| Total assets  | \$ 169,872                               | \$ 146,283                       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |  |                                  |
| Current liabilities:  |  |                                  |
| Accounts payable  | \$ 60,870                                | \$ 36,684                        |
| Accrued liabilities   | 23,259                                   | 23,806                           |
| Total current liabilities   | 84,129                                   | 60,490                           |
| Long-term debt  | 23,000                                   | 24,000                           |
| Other liabilities   | 4,912                                    | 5,541                            |
| Total liabilities   | 112,041                                  | 90,031                           |
| Stockholders' equity:   |  |                                  |
| Preferred stock, par value \$0.01 per share, 975,150 shares authorized; no shares issued  | 0  | 0                                |
| Series A preferred stock, par value \$0.01 per share, 24,850 shares authorized; no shares issued  | 0  | 0                                |
| Common stock, non-voting, par value \$0.01 per share, 10,000,000 shares authorized; no shares issued  | 0  | 0                                |
| Common stock, par value \$0.01 per share, 30,000,000 shares authorized; 20,612,779 shares issued and 20,542,297 outstanding in 2014 and 20,448,007 shares issued and 20,399,649 outstanding in 2013 | 206                                      | 204                              |
| Additional paid-in capital  | 150,831                                  | 150,569                          |
| Retained deficit  | (75,570 )                                | (76,786 )                        |
| Accumulated other comprehensive loss  | (17,635 )                                | (17,734 )                        |
| Treasury stock, 70,482 and 48,358 shares in 2014 and 2013, respectively   | (1 )                                     | (1 )                             |
| Total stockholders' equity  | 57,831                                   | 56,252                           |
| Total liabilities and stockholders' equity  | \$ 169,872                               | \$ 146,283                       |



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

**SYPRIS SOLUTIONS, INC.****CONSOLIDATED CASH FLOW STATEMENTS****(in thousands)**

|  | <b>Six Months Ended</b> |                 |
|--|-------------------------|-----------------|
|  | <b>June 29,</b>         | <b>June 30,</b> |
|  | <b>2014</b>             | <b>2013</b>     |
|  | <b>(Unaudited)</b>      |                 |
| Cash flows from operating activities:  |                         |                 |
| Net income (loss)  | \$2,022                 | \$(7,953 )      |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                         |                 |
| Depreciation and amortization  | 5,396                   | 6,168           |
| Stock-based compensation expense   | 914                     | 1,002           |
| Deferred revenue recognized  | (4,329 )                | (4,000 )        |
| Deferred loan costs recognized   | 39                      | 39              |
| Gain on sale of assets   | (4 )                    | (1,682 )        |
| Provision for excess and obsolete inventory  | 445                     | 926             |
| Goodwill impairment  | 0                       | 6,900           |
| Other noncash items  | 81                      | 472             |
| Contributions to pension plans   | (441 )                  | (217 )          |
| Changes in operating assets and liabilities:   |                         |                 |
| Accounts receivable  | (26,343)                | (14,375)        |
| Inventory  | (1,032 )                | (5,121 )        |
| Other current assets   | 755                     | 931             |
| Accounts payable   | 23,581                  | 16,101          |
| Accrued and other liabilities  | 3,593                   | (144 )          |
| Net cash provided by (used in) operating activities  | 4,677                   | (953 )          |
| Cash flows from investing activities:  |                         |                 |
| Capital expenditures, net  | (2,474 )                | (1,526 )        |
| Proceeds from sale of assets   | 8                       | 2,160           |
| Net cash (used in) provided by investing activities  | (2,466 )                | 634             |
| Cash flows from financing activities:  |                         |                 |
| Net change in debt under revolving credit agreements   | (1,000 )                | 1,000           |
| Common stock repurchases   | (236 )                  | 0               |
| Indirect repurchase of shares of minimum statutory tax withholdings                                | (419 )                  | (554 )          |
| Cash dividends paid  | (814 )                  | (400 )          |
| Proceeds from issuance of common stock   | 4                       | 0               |
| Net cash (used in) provided by financing activities  | (2,465 )                | 46              |

|  |          |          |
|--|----------|----------|
| Net decrease in cash and cash equivalents        | (254 )   | (273 )   |
| Cash and cash equivalents at beginning of period | 18,674   | 18,664   |
| Cash and cash equivalents at end of period       | \$18,420 | \$18,391 |

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

**SYPRIS SOLUTIONS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Nature of Business**

All references to “Sypris,” the “Company,” “we” or “our” include Sypris Solutions, Inc. and its wholly-owned subsidiaries. Sypris is a diversified provider of outsourced services and specialty products. The Company performs a wide range of manufacturing, engineering, design, and other technical services, typically under multi-year, sole-source contracts with corporations and government agencies in the markets for truck components and assemblies and aerospace and defense electronics. The Company provides such services through its Industrial and Electronics Groups (see Note 12 “Segment Data” to the consolidated financial statements).

**(2) Basis of Presentation**

The accompanying unaudited consolidated financial statements include the accounts of Sypris Solutions, Inc. and its wholly-owned subsidiaries, and have been prepared by the Company in accordance with the rules and regulations of the Securities and Exchange Commission. The Company’s operations are domiciled in the United States (U.S.), Mexico, Denmark and the United Kingdom (“U.K.”) and serve a wide variety of domestic and international customers. All intercompany transactions and accounts have been eliminated. These unaudited consolidated financial statements reflect, in the opinion of management, all material adjustments (which include only normal recurring adjustments) necessary to fairly state the results of operations, financial position and cash flows for the periods presented, and the disclosures herein are adequate to make the information presented not misleading. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results for the three and six months ended June 29, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements, and notes thereto, for the year ended December 31, 2013 as presented in the Company’s Annual Report on Form 10-K.

**(3) Recent Accounting Pronouncements**

In July 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“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,” which states that entities should present the unrecognized tax benefit as a reduction of the deferred tax asset for a net operating loss (“NOL”) or similar tax loss or tax credit carryforward rather

than as a liability when the uncertain tax position would reduce the NOL or other carryforward under the tax law. The Company will be required to adopt this new standard on a prospective basis in the first interim reporting period of fiscal 2015, though, early adoption is permitted as is a retrospective application. We do not anticipate that the adoption of this standard will have a material effect on the Company's results of operations, financial position or cash flows.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers." This ASU supersedes the revenue recognition requirements in "Accounting Standard Codification 605 - Revenue Recognition" and most industry-specific guidance. The standard requires that entities recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which a company expects to be entitled in exchange for those goods or services. This ASU is effective for fiscal years beginning after December 15, 2016, and for interim periods within those fiscal years. The Company is currently assessing the impact of the adoption of ASU 2014-09 on its results of operations, financial position and cash flows.

#### **(4) Customer Contract Negotiations**

Our supply agreement with Dana Holding Corporation ("Dana") expires on December 31, 2014 and our supply agreements with Meritor, Inc. ("Meritor") expire on December 31, 2014 and May 2, 2015. For the six months ended June 29, 2014, Dana and Meritor represented approximately 58% and 16%, of our net revenue, respectively.

In July 2013, Sypris and Dana signed an amended and restated supply agreement, the binding effect of which is currently in dispute. Dana has repudiated this agreement and purported to exercise its rights under the parties' prior agreement to begin exploring alternative supply relationships with third parties, including the right to sign new supply agreements, authorize tooling expenditures and engage in certain production part approval processes ("PPAP") with respect to the goods currently supplied by Sypris. Sypris disputes Dana's ability to exercise such rights.

The parties have also asserted various damages claims against each other arising out of their prior supply agreement and have sought the assistance of a mediator and an arbitrator in connection with these disputes. Dana initiated an ancillary action in Ohio state court challenging the arbitrability of the existence and enforceability of the amended and restated supply agreement on January 17, 2014. In addition, Dana has notified us that it intends to terminate its supply relationship with us effective December 31, 2014 and to transition over 2,000 active part numbers, which we currently manufacture for Dana, to alternative suppliers at the expiration date of the original supply agreement. The failure to resolve this dispute with Dana on acceptable terms would have a material adverse effect on our financial condition and financial performance.

In addition, the failure to enter into an agreement with Meritor on acceptable terms, or the entry into agreements for fewer products or reduced volumes or prices would have a material adverse effect on our financial condition and financial performance.

The Company is exploring alternatives to address the various range of potential outcomes for both the Dana and Meritor supply agreements, including the complete or partial renewal of either or both supply agreements, pursuing new business opportunities with existing and potential customers, identifying alternative uses for the related assets and certain other contingency plans. The Company expects to have plans established and initiated prior to December 31, 2014 to mitigate the impact of the potential loss of a significant amount of business and to support the Company's operations and provide sufficient liquidity to finance its operations for the remainder of 2014 and the foreseeable future.

## **(5) Goodwill**

Goodwill is tested for impairment annually as of December 31 or more frequently if impairment indicators arise. If impairment indicators arise, a step one assessment is performed to identify any possible goodwill impairment in the period in which the indicator is identified. Beginning in March 2013, we noted certain indicators relating to our Electronics Group reporting unit that were significant enough to conclude that an impairment indicator existed as of March 31, 2013. Specifically, the Company experienced emerging uncertainty regarding certain key programs within the Electronics Group's space business beginning in the latter part of the first quarter of 2013, as one key customer communicated its strategic sourcing decision to begin insourcing programs that had been previously outsourced to the Electronics Group. Overall, the Electronics Group has been more impacted by declines in the overall government defense market than originally anticipated as the effects of sequestration became clearer after its initial effective date on March 1, 2013. For example, sales of certain data recording products were significantly reduced due to the impact

of sequestration on our customers, and the loss of commercial space business was due in part to our customer's efforts to offset unrelated losses of government business due to sequestration. As a result, the Electronics Group's short term revenue forecasts were materially affected. Further, the Company experienced a decline in the market value of its equity subsequent to March 31, 2013.

The first step of the impairment test indicated that the estimated fair value for the Electronics Group was less than its carrying value as of March 31, 2013. We performed step two of the impairment test and determined that the implied goodwill for the reporting unit was lower than its value as of March 31, 2013. As a result, a non-cash impairment charge of \$6,900,000 was recorded during the three months ended March 31, 2013 to impair the goodwill associated with the Electronics Group reporting unit. The impairment charge has been presented separately in the consolidated statement of operations and fully impairs the carrying amount of goodwill related to the Electronics Group. The fair value of the Electronics Group and the assets and liabilities identified in the step two impairment test were determined using a combination of the income approach and the market approach, which are Level 3 and Level 2 inputs, respectively.

#### **(6) Milestone Revenue Recognition**

The Company periodically enters into research and development contracts with customers related primarily to key encryption products. When the contracts provide for milestone or other interim payments, the Company will recognize revenue under the milestone method in accordance with Accounting Standards Codification (“ASC”) 605-28, *Revenue Recognition – Milestone Method*. The Company had one contract in process as of June 29, 2014 being accounted for under the milestone method. The milestone method requires the Company to deem all milestone payments within each contract as either substantive or non-substantive. That conclusion is determined based upon a thorough review of each contract and the deliverables to which the Company has committed in each contract. For substantive milestones, the Company concludes that upon achievement of each milestone, the amount of the corresponding defined payment is commensurate with the effort required to achieve such milestone or the value of the delivered item. The payment associated with each milestone relates solely to past performance and is deemed reasonable upon consideration of the deliverables and the payment terms within the contract. Milestones may include, for example, the successful completion of design review or technical review, the submission and acceptance of technical drawings, delivery of hardware, software or regulatory agency certifications. All milestones under the contract in process as of June 29, 2014 were deemed substantive. During the three and six months ended June 29, 2014, revenue recognized through the achievement of multiple milestones amounted to \$1,025,000 and \$2,300,000 respectively. There are no performance, cancellation, termination or refund provisions in the arrangement that contain material financial consequences to the Company.

#### **(7) Dana Claim**

On March 3, 2006, Dana and 40 of its U.S. subsidiaries, filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York. On August 7, 2007, the Company entered into a comprehensive settlement agreement with Dana to resolve all outstanding disputes between the parties, terminate previously approved arbitration payments and replace three existing supply agreements with a single, revised contract running through 2014. In addition, Dana provided the Company with an allowed general unsecured non-priority claim in the face amount of \$89,900,000 (the “Claim”).

The Claim provided to the Company was agreed to by the Company and Dana as consideration for the aggregate economic impact of the various elements the two parties were negotiating. After the aggregate Claim value of \$89,900,000 was established, the Company recorded the claim at the estimated fair value of \$76,483,000 and allocated the estimated fair value to each commercial issue negotiated. The revenues and resulting net income associated with each of those issues requiring the Company’s continued involvement was deferred and will be recognized over the applicable period of the involvement. For the six months ended June 29, 2014 and June 30, 2013, the Company recognized into revenue \$4,329,000 and \$4,000,000, respectively, related to the Claim.

#### **(8) Other Expense (Income), Net**



During the three and six months ended June 29, 2014, the Company recognized net gains of \$123,000 and \$714,000, respectively, within the Industrial Group from the receipt of federal grant funds for improvements made under a flood relief program. Additionally, the Company recognized foreign currency translation losses of \$65,000 and \$96,000 for the three and six months ended June 29, 2014, respectively, related to the U.S. dollar denominated monetary asset position of our Mexican subsidiaries for which the Mexican peso is the functional currency. For the three and six months ended June 30, 2013, the Company recognized net gains of \$17,000 and \$1,682,000, respectively, related to the disposition of idle assets and foreign currency translation gains of \$187,000 and losses of \$386,000, respectively. These gains and losses are included in other expense (income), net on the consolidated statements of operations.

#### **(9) Earnings (Loss) Per Common Share**

The Company computes earnings per share using the two-class method, which is an earnings allocation formula that determines earnings per share for common stock and participating securities. Restricted stock granted by the Company is considered a participating security since it contains a non-forfeitable right to dividends.

Our potentially dilutive securities include potential common shares related to our stock options and restricted stock. Diluted earnings per share considers the impact of potentially dilutive securities except in periods in which there is a loss because the inclusion of the potential common shares would have an anti-dilutive effect. Diluted earnings per share excludes the impact of common shares related to our stock options in periods in which the option exercise price is greater than the average market price of our common stock for the period. There were 789,000 and 983,000 potential common shares excluded from diluted earnings per share for the three and six months ended June 29, 2014, respectively. For the three and six months ended June 30, 2013, diluted weighted average common shares does not include the impact of outstanding stock options and unvested compensation-related shares because the effect of these items on diluted net loss would be anti-dilutive.

A reconciliation of the weighted average shares outstanding used in the calculation of basic and diluted earnings (loss) per common share is as follows (in thousands):

|   | <b>Three Months<br/>Ended</b>                |                              | <b>Six Months<br/>Ended</b>                  |                              |
|---|--|------------------------------|--|------------------------------|
|   | <b>June<br/>29,<br/>2014<br/>(Unaudited)</b> | <b>June<br/>30,<br/>2013</b> | <b>June<br/>29,<br/>2014<br/>(Unaudited)</b> | <b>June<br/>30,<br/>2013</b> |
| Income (loss) attributable to stockholders:                                       |  |                              |  |                              |
| Net income (loss) as reported   | \$370  | \$(1,494)                    | \$2,022                                      | \$(7,953)                    |
| Less distributed and undistributed earnings allocable to restricted award holders | 0  | 0                            | (46)   | 0                            |
| Less dividends declared attributable to restricted award holders                  | (15)   | (12)                         | (25)   | (23)                         |
| Net income (loss) allocable to common stockholders                                | \$355  | \$(1,506)                    | \$1,951                                      | \$(7,976)                    |
| Income (loss) per common share attributable to stockholders:                      |  |                              |  |                              |
| Basic   | \$0.02                                       | \$(0.08)                     | \$0.10                                       | \$(0.41)                     |
| Diluted   | \$0.02                                       | \$(0.08)                     | \$0.10                                       | \$(0.41)                     |
| Weighted average shares outstanding – basic                                       | 19,622                                       | 19,347                       | 19,525                                       | 19,255                       |
| Weighted average additional shares assuming conversion of potential common shares | 60   | 0                            | 41   | 0                            |
| Weighted average shares outstanding – diluted                                     | 19,682                                       | 19,347                       | 19,566                                       | 19,255                       |

## **(10) Inventory**

Inventory consisted of the following (in thousands):

|   | <b>June 29,<br/>2014<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2013</b> |
|---|--|----------------------------------|
| Raw materials                             | \$ 20,828                                | \$ 19,372                        |
| Work in process                           | 15,160                                   | 16,436                           |
| Finished goods                            | 5,836                                    | 5,017                            |
| Reserve for excess and obsolete inventory | (6,816 )                                 | (6,403 )                         |
|   | <b>\$ 35,008</b>                         | <b>\$ 34,422</b>                 |

**(11) Property, Plant and Equipment**

Property, plant and equipment consists of the following (in thousands):

|  | <b>June 29,<br/>2014<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2013</b> |
|--|--|----------------------------------|
| Land and land improvements                   | \$ 3,006                                 | \$2,999                          |
| Buildings and building improvements          | 26,294                                   | 26,053                           |
| Machinery, equipment, furniture and fixtures | 162,846                                  | 161,207                          |
| Construction in progress                     | 3,337                                    | 2,133                            |
|  | 195,483                                  | 192,392                          |
| Accumulated depreciation                     | (153,152 )                               | (147,709 )                       |
|  | \$ 42,331                                | \$44,683                         |

The Industrial Group performed an asset recoverability test for its fixed asset group totaling approximately \$37,821,000 as of June 29, 2014. The Company concluded that the undiscounted sum of estimated future cash flows exceeded the carrying value for such asset group, and accordingly, no impairment was recognized. Additionally, the Company received fair market value appraisals for the Industrial Group's personal property from an independent third party, which exceeded the carrying value as of June 29, 2014.

**(12) Segment Data**

The Company is organized into two business groups, the Industrial Group and the Electronics Group. The segments are each managed separately because of the distinctions between products, services, markets, customers, technologies and workforce skills of the segments. The Industrial Group provides manufacturing services for a variety of customers that outsource forged and finished steel components and subassemblies. The Industrial Group also manufactures high-pressure closures and other fabricated products. The Electronics Group provides manufacturing and technical services as an outsourced service provider to and manufactures complex data storage systems for customers in the market for aerospace and defense electronics. There was no intersegment net revenue recognized in any of the periods presented.

The following table presents financial information for the reportable segments of the Company (in thousands):

|  | <b>Three Months<br/>Ended</b> | <b>Six Months Ended</b> |
|--|-------------------------------|-------------------------|
|--|-------------------------------|-------------------------|

|  | <b>June<br/>29,<br/>2014<br/>(Unaudited)</b> | <b>June<br/>30,<br/>2013<br/>(Unaudited)</b> | <b>June 29,<br/>2014<br/>(Unaudited)</b> | <b>June 30,<br/>2013<br/>(Unaudited)</b> |
|--|--|--|--|--|
| Net revenue from unaffiliated customers: |  |  |  |  |
| Industrial Group                         | \$83,710                                     | \$74,432                                     | \$159,549                                | \$145,581                                |
| Electronics Group                        | 9,403  | 7,734  | 17,808                                   | 14,996                                   |
|  | \$93,113                                     | \$82,166                                     | \$177,357                                | \$160,577                                |
| Gross profit (loss):                     |  |  |  |  |
| Industrial Group                         | \$11,383                                     | \$8,858                                      | \$22,537                                 | \$16,968                                 |
| Electronics Group                        | (556 )                                       | (522 )                                       | (1,146 )                                 | (556 )                                   |
|  | \$10,827                                     | \$8,336                                      | \$21,391                                 | \$16,412                                 |
| Operating income (loss):                 |  |  |  |  |
| Industrial Group                         | \$7,040                                      | \$5,976                                      | \$15,153                                 | \$11,361                                 |
| Electronics Group                        | (3,168 )                                     | (4,444 )                                     | (6,245 )                                 | (14,595 )                                |
| General, corporate and other             | (2,196 )                                     | (2,221 )                                     | (4,811 )                                 | (4,336 )                                 |
|  | \$1,676                                      | \$(689 )                                     | \$4,097                                  | \$(7,570 )                               |

|                              | <b>June 29,<br/>2014<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2013</b> |
|------------------------------|--|----------------------------------|
| Total assets:                |  |                                  |
| Industrial Group             | \$ 127,746                               | \$ 100,593                       |
| Electronics Group            | 31,159                                   | 29,689                           |
| General, corporate and other | 10,967                                   | 16,001                           |
|                              | <b>\$ 169,872</b>                        | <b>\$ 146,283</b>                |

### **(13) Commitments and Contingencies**

The provision for estimated warranty costs is recorded at the time of sale and periodically adjusted to reflect actual experience. The Company's warranty liability, which is included in accrued liabilities in the accompanying balance sheets as of June 29, 2014 and December 31, 2013, was \$1,156,000 and \$1,439,000, respectively. The Company's warranty expense for the six months ended June 29, 2014 and June 30, 2013 was \$145,000 and \$136,000, respectively.

Additionally, the Company sells three and five-year extended warranties for one of its link encryption products. The revenue from the extended warranties is deferred and recognized ratably over the contractual term. As of June 29, 2014 and December 31, 2013, the Company had deferred \$1,077,000 and \$1,567,000, respectively, related to extended warranties.

The Company bears insurance risk as a member of a group captive insurance entity for certain general liability, automobile and workers' compensation insurance programs and a self-insured employee health program. The Company records estimated liabilities for its insurance programs based on information provided by the third-party plan administrators, historical claims experience, expected costs of claims incurred but not paid, and expected costs to settle unpaid claims. The Company monitors its estimated insurance-related liabilities on a quarterly basis. As facts change, it may become necessary to make adjustments that could be material to the Company's consolidated results of operations and financial condition. The Company believes that its present insurance coverage and level of accrued liabilities are adequate.

The Company is involved in certain litigation and contract issues arising in the normal course of business. While the outcome of these matters cannot, at this time, be predicted in light of the uncertainties inherent therein, management does not expect that these matters will have a material adverse effect on the consolidated financial position or results of operations of the Company.

As of June 29, 2014, the Company had outstanding purchase commitments of approximately \$6,876,000, primarily for the acquisition of inventory and manufacturing equipment. As of June 29, 2014, the Company also had outstanding letters of credit of \$872,000 primarily under the aforementioned captive insurance program.

#### **(14) Income Taxes**

The provision for income taxes includes federal, state, local and foreign taxes. The Company's effective tax rate varies from period to period due to the proportion of foreign and domestic pre-tax income expected to be generated by the Company. The Company provides for income taxes for its domestic operations at a statutory rate of 35% and for its foreign operations at a statutory rate of 30% in 2014 and 2013. The Company's foreign operations are also subject to minimum income taxes in periods prior to 2014 where positive cash flows exceed taxable income. Reconciling items between the federal statutory rate and the effective tax rate also include the expected usage of federal net operating loss carryforwards, state income taxes, valuation allowances and certain other permanent differences.

The Company recognizes liabilities or assets for the deferred tax consequences of temporary differences between the tax bases of assets or liabilities and their reported amounts in the financial statements in accordance with ASC 740, *Income Taxes*. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of assets or liabilities are recovered or settled. ASC 740 requires that a valuation allowance be established when it is more likely than not that all or a portion of a deferred tax asset will not be realized. The Company evaluates its deferred tax position on a quarterly basis and valuation allowances are provided as necessary. During this evaluation, the Company reviews its forecast of income in conjunction with other positive and negative evidence surrounding the realizability of its deferred tax assets to determine if a valuation allowance is needed. Based on its current forecast, the Company has established a valuation allowance against the domestic net deferred tax asset. Until an appropriate level and characterization of profitability is attained, the Company expects to continue to maintain a valuation allowance on its net deferred tax assets related to future U.S. and certain non-U.S. tax benefits.

The Company expects to repatriate available non-U.S. cash holdings in 2014 and 2015 to support management's strategic objectives and fund ongoing U.S. operational cash flow requirements; therefore current earnings from non-U.S. operations are not treated as permanently reinvested. The U.S. income tax expense recorded in 2014 on these non-U.S. earnings is expected to be offset by the benefit of a partial release of a valuation allowance on U.S. net operating loss carryforwards. Should the U.S. valuation allowance be released at some future date, the U.S. tax expense on foreign earnings not permanently reinvested might have a material effect on our effective tax rate. For the year ending December 31, 2014, the Company expects any additional tax expense from non-U.S. withholding and other taxes expected to be incurred on repatriation of current earnings would not be material.

### (15) Employee Benefit Plans

Pension expense (benefit) consisted of the following (in thousands):

|   | <b>Three Months Ended</b> |                      | <b>Six Months Ended</b> |                      |
|---|---------------------------|----------------------|-------------------------|----------------------|
|   | <b>June 29, 2014</b>      | <b>June 30, 2013</b> | <b>June 29, 2014</b>    | <b>June 30, 2013</b> |
|   | <b>(Unaudited)</b>        |                      | <b>(Unaudited)</b>      |                      |
| Service cost                                  | \$0                       | \$5                  | \$6                     | \$12                 |
| Interest cost on projected benefit obligation | 448                       | 410                  | 895                     | 826                  |
| Net amortizations, deferrals and other costs  | 123                       | 200                  | 265                     | 412                  |
| Expected return on plan assets                | (592)                     | (631)                | (1,199)                 | (1,261)              |
|   | <b>\$(21 )</b>            | <b>\$(16 )</b>       | <b>\$(33 )</b>          | <b>\$(11 )</b>       |

### (16) Accumulated Other Comprehensive Loss

The Company's accumulated other comprehensive loss consists of employee benefit-related adjustments and foreign currency translation adjustments.

Accumulated other comprehensive loss consisted of the following (in thousands):

| <b>June 29,</b> | <b>December</b> |
|-----------------|-----------------|
| <b>2014</b>     | <b>31,</b>      |
|                 | <b>2013</b>     |



**(Unaudited)**

|  |              |              |
|--|--------------|--------------|
| Foreign currency translation adjustments                         | \$ (4,336 )  | \$ (4,435 )  |
| Employee benefit related adjustments, net of tax of \$228 – U.S. | (12,996 )    | (12,996 )    |
| Employee benefit related adjustments – Mexico                    | (303 )       | (303 )       |
| Accumulated other comprehensive loss                             | \$ (17,635 ) | \$ (17,734 ) |

**(17) Fair Value of Financial Instruments**

Cash, accounts receivable, accounts payable and accrued liabilities are reflected in the consolidated financial statements at their carrying amount, which approximates fair value because of the short-term maturity of those instruments. The carrying amount of debt outstanding at June 29, 2014 and December 31, 2013 under the Company's credit facility entered into on May 12, 2011 (the "Credit Facility") approximates fair value because the borrowing interest rates are for terms of less than six months and have rates that reflect currently available terms and conditions for similar debt.

## ITEM 2. **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Overview**

We are a diversified provider of outsourced services and specialty products. We perform a wide range of manufacturing, engineering, design and other technical services, typically under multi-year, sole-source contracts with corporations and government agencies principally in the markets for industrial manufacturing and aerospace and defense electronics.

We are organized into two business groups, the Industrial Group and the Electronics Group. The Industrial Group, which is comprised of Sypris Technologies, Inc. and its subsidiaries, generates revenue primarily from the sale of manufacturing services to customers in the market for truck components and assemblies and from the sale of products to the energy and chemical markets. The Electronics Group, which is comprised of Sypris Electronics, LLC and its subsidiary, generates revenue primarily from the sale of manufacturing services, technical services and products to customers in the market for aerospace and defense electronics.

We focus on those markets where we have the expertise, qualifications and leadership position to sustain a competitive advantage. We target our resources to support the needs of industry leaders that embrace multi-year contractual relationships as a strategic component of their supply chain management. These contracts, many of which are sole-source by part number and, historically, have been renewed for terms of five years or more, enable us to invest in leading-edge processes or technologies to help our customers remain competitive. The productivity, flexibility and economies of scale that can result offer an important opportunity for differentiating ourselves from our competitors when it comes to cost, quality, reliability and customer service.

### *Industrial Group Outlook*

General economic and industry specific conditions have begun to stabilize for our Industrial Group, and improvements in the overall U.S. economy contributed to improved consumer confidence levels in 2014. In North America, production levels for light, medium and heavy duty trucks have steadily increased over the past four years from a low in the depressed economic environment of 2008 and 2009. Subject to the renewal status of our supply contracts with Dana Holding Corporation (“Dana”) and Meritor, Inc. (“Meritor”), we continue to expect modest growth in production levels within our Industrial Group through 2014 and 2015.

Our supply agreement with Dana expires on December 31, 2014 and our supply agreements with Meritor expire on December 31, 2014 and May 2, 2015. For the six months ended June 29, 2014, Dana and Meritor represented approximately 58% and 16%, of our net revenue, respectively.

In July 2013, Sypris and Dana signed an amended and restated supply agreement, the binding effect of which is currently in dispute. Dana has repudiated this agreement and purported to exercise its rights under the parties' prior agreement to begin exploring alternative supply relationships with third parties, including the right to sign new supply agreements, authorize tooling expenditures and engage in certain production part approval processes ("PPAP") with respect to the goods currently supplied by Sypris. Sypris disputes Dana's ability to exercise such rights.

The parties have also asserted various damages claims against each other arising out of their prior supply agreement and have sought the assistance of a mediator and an arbitrator in connection with these disputes. Dana initiated an ancillary action in Ohio state court challenging the arbitrability of the existence and enforceability of the amended and restated supply agreement on January 17, 2014. In addition, Dana has notified us that it intends to terminate its supply relationship with us effective December 31, 2014 and to transition over 2,000 active part numbers, which we currently manufacture for Dana, to alternative suppliers at the expiration date of the original supply agreement. The failure to resolve this dispute with Dana on acceptable terms would have a material adverse effect on our financial condition and financial performance.

In addition, the failure to enter into an agreement with Meritor on acceptable terms, or the entry into agreements for fewer products or reduced volumes or prices would have a material adverse effect on our financial condition and financial performance.

The Company is exploring alternatives to address the various range of potential outcomes for both the Dana and Meritor supply agreements, including the complete or partial renewal of either or both supply agreements, pursuing new business opportunities with existing and potential customers, identifying alternative uses for the related assets and certain other contingency plans. The Company expects to have plans established and initiated prior to December 31, 2014 to mitigate the impact of the potential loss of a significant amount of business and to support the Company's operations and provide sufficient liquidity to finance its operations for the remainder of 2014 and the foreseeable future.

### *Electronics Group Outlook*

We continue to face challenges within the Electronics Group, such as the conclusion of several U.S. Department of Defense programs that the Company supported as a subcontractor, the loss of a key commercial space customer who decided to begin insourcing programs that had been previously outsourced to the Electronics Group, the uncertainty in the worldwide macroeconomic climate and its impact on aerospace and defense spending patterns globally, the emergence of new competitors to our product and service offerings, as well as federal government spending uncertainties in the U.S.

The Electronics Group's revenue has declined year-over-year since 2009 primarily due to our inability to replace the declining demand for certain legacy products and services with competitive new offerings. While we have begun to generate some revenue from the ramp up of new electronic manufacturing service programs, we do not yet have a strong pipeline of programs or other contract awards to replace our legacy programs in the near term. The Company is continuing to develop new products and pursuing new programs to attempt to replenish its revenue stream within the Electronics Group.

The U.S. Government's continued focus on addressing federal budget deficits and the growing national debt exacerbates this challenging environment for the Electronics Group. In addition, the Budget Control Act commits the U.S. Government to reduce the federal deficit by \$1.2 trillion over ten years through a combination of automatic, across-the-board spending cuts and caps on discretionary spending. The deficit-reduction "sequestration" under the Budget Control Act is split equally between defense and non-defense programs and went into effect on March 1, 2013. The Bipartisan Budget Act of 2013 provided some budget relief, reducing the discretionary sequester (and increasing funding) for fiscal year 2014 and fiscal year 2015 for both defense and non-defense programs. However, unless Congress passes a similar law providing budget relief beyond fiscal year 2015, the full sequester cuts will go back into effect for fiscal year 2016. In addition, in February 2014, the Pentagon announced that its budget request for fiscal year 2015 would exceed the sequester caps but would be below the funding in the President's fiscal year 2014 budget request, and in July 2014, the Pentagon's \$58.6 billion budget request for overseas contingency operations funds in 2015 was one third less than it received in 2014. Congress and the Administration continue to debate these long- and short-term funding issues, but reductions in U.S. military spending could materially and adversely affect the results of our Electronics Group, and we expect that certain military and defense programs will experience delays while the receipt of government approvals remain pending.

As a result, the Company expects ongoing uncertainty and the potential for further revenue declines within this segment for at least the next twelve months. For the longer term, we are continuing to make investments and evaluate new investments in products and programs to further improve the attractiveness of our business portfolio, with a specific emphasis on trusted solutions for identity management, cryptographic key distribution and cyber analytics. There can be no assurance that the Company's investment in and efforts to introduce new products and services will result in new business or revenue. In addition, while the Company continues to evaluate and implement cost reduction measures in this segment, the Company's currently contemplated cost reduction measures may not be able to reduce its cost structure to offset the impact of lower revenues. Should revenues decrease further in the coming periods, the Company might be required to implement further cost reductions or other downsizing measures, which could be costly and adversely impact our financial performance.

## Results of Operations

The tables below compare our segment and consolidated results for the three and six month periods of operations of 2014 to the three and six month periods of operations of 2013. The tables present the results for each period, the change in those results from 2013 to 2014 in both dollars and percentage change and the results for each period as a percentage of net revenue.

The first two columns in each table show the absolute results for each period presented.

The columns entitled “Year Over Year Change” and “Year Over Year Percentage Change” show the change in results, both in dollars and percentages. These two columns show favorable changes as positive and unfavorable changes as negative. For example, when our net revenue increases from one period to the next, that change is shown as a positive number in both columns. Conversely, when expenses increase from one period to the next, that change is shown as a negative number in both columns.

The last two columns in each table show the results for each period as a percentage of net revenue. In these two columns, the cost of sales and gross profit for each are given as a percentage of that segment’s net revenue. These amounts are shown in italics.

In addition, as used in the table, “NM” means “not meaningful.”

### Three Months Ended June 29, 2014 Compared to Three Months Ended June 30, 2013

|   | Three Months Ended, |               | Year Over               | Year Over               | Results as   |               |
|---|---------------------|---------------|-------------------------|-------------------------|--|---------------|
|   | June 29, 2014       | June 30, 2013 | Change                  | Change                  | Percentage of Net Revenue for the Three Months Ended |               |
|   |                     |               | Favorable (Unfavorable) | Favorable (Unfavorable) | June 29, 2014  | June 30, 2013 |
| <b>(in thousands, except percentage data)</b> |                     |               |                         |                         |  |               |
| Net revenue:                                  |                     |               |                         |                         |  |               |
| Industrial Group                              | \$83,710            | \$74,432      | \$ 9,278                | 12.5                    | % 89.9   | % 90.6        |
| Electronics Group                             | 9,403               | 7,734         | 1,669                   | 21.6                    | 10.1   | 9.4           |

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|                                     |        |            |          |         |        |           |
|-------------------------------------|--------|------------|----------|---------|--------|-----------|
| Total                               | 93,113 | 82,166     | 10,947   | 13.3    | 100.0  | 100.0     |
| Cost of sales:                      |        |            |          |         |        |           |
| Industrial Group                    | 72,327 | 65,574     | (6,753 ) | (10.3 ) | 86.4   | 88.1      |
| Electronics Group                   | 9,959  | 8,256      | (1,703 ) | (20.6 ) | 105.9  | 106.7     |
| Total                               | 82,286 | 73,830     | (8,456 ) | (11.5 ) | 88.4   | 89.9      |
| Gross profit (loss):                |        |            |          |         |        |           |
| Industrial Group                    | 11,383 | 8,858      | 2,525    | 28.5    | 13.6   | 11.9      |
| Electronics Group                   | (556 ) | (522 )     | (34 )    | (6.5 )  | (5.9 ) | (6.7 )    |
| Total                               | 10,827 | 8,336      | 2,491    | 29.9    | 11.6   | 10.1      |
| Selling, general and administrative | 9,141  | 7,598      | (1,543 ) | (20.3 ) | 9.8    | 9.2       |
| Research and development            | 10     | 1,419      | 1,409    | 99.3    | 0.0    | 1.7       |
| Amortization of intangible assets   | —      | 8          | 8        | NM      | —      | 0.0       |
| Operating income (loss)             | 1,676  | (689 )     | 2,365    | NM      | 1.8    | (0.8 )    |
| Interest expense, net               | 155    | 120        | (35 )    | (29.2 ) | 0.2    | 0.1       |
| Other expense (income), net         | 75     | (259 )     | (334 )   | NM      | 0.1    | (0.3 )    |
| Income (loss) before taxes          | 1,446  | (550 )     | 1,996    | NM      | 1.5    | (0.6 )    |
| Income tax expense                  | 1,076  | 944        | (132 )   | (14.0 ) | 1.1    | 1.2       |
| Net income (loss)                   | \$370  | \$(1,494 ) | \$ 1,864 | NM      | % 0.4  | % (1.8 )% |

## Six Months Ended June 29, 2014 Compared to Six Months Ended June 30, 2013

|                                     | Six Months Ended,                      |            | Year Over     | Year Over     | Results as    |         |
|-------------------------------------|--|------------|---------------|---------------|---------------|---------|
|                                     | June 29,                               | June 30,   | Year          | Year          | Percentage of |         |
|                                     | 2014                                   | 2013       | Change        | Change        | Net Revenue   |         |
|                                     | (in thousands, except percentage data) |            | (Unfavorable) | (Unfavorable) | for the       |         |
|                                     |  |            |               |               | Six Months    |         |
|                                     |  |            |               |               | Ended         |         |
|                                     |  |            |               |               | June          | June    |
|                                     |  |            |               |               | 29,           | 30,     |
|                                     |  |            |               |               | 2014          | 2013    |
| Net revenue:                        |  |            |               |               |               |         |
| Industrial Group                    | \$ 159,549                             | \$ 145,581 | \$ 13,968     | 9.6           | % 90.0        | % 90.7  |
| Electronics Group                   | 17,808                                 | 14,996     | 2,812         | 18.8          | 10.0          | 9.3     |
| Total                               | 177,357                                | 160,577    | 16,780        | 10.4          | 100.0         | 100.0   |
| Cost of sales:                      |  |            |               |               |               |         |
| Industrial Group                    | 137,012                                | 128,613    | (8,399)       | (6.5)         | 85.9          | 88.3    |
| Electronics Group                   | 18,954                                 | 15,552     | (3,402)       | (21.9)        | 106.4         | 103.7   |
| Total                               | 155,966                                | 144,165    | (11,801)      | (8.2)         | 87.9          | 89.8    |
| Gross profit (loss):                |  |            |               |               |               |         |
| Industrial Group                    | 22,537                                 | 16,968     | 5,569         | 32.8          | 14.1          | 11.7    |
| Electronics Group                   | (1,146)                                | (556)      | (590)         | (106.1)       | (6.4)         | (3.7)   |
| Total                               | 21,391                                 | 16,412     | 4,979         | 30.3          | 12.1          | 10.2    |
| Selling, general and administrative | 17,133                                 | 14,756     | (2,377)       | (16.1)        | 9.7           | 9.2     |
| Research and development            | 161                                    | 2,296      | 2,135         | 93.0          | 0.1           | 1.4     |
| Amortization of intangible assets   | —                                      | 30         | 30            | NM            | —             | 0.0     |
| Impairment of goodwill              | —                                      | 6,900      | 6,900         | NM            | —             | 4.3     |
| Operating income (loss)             | 4,097                                  | (7,570)    | 11,667        | NM            | 2.3           | (4.7)   |
| Interest expense, net               | 287                                    | 266        | (21)          | (7.9)         | 0.2           | 0.2     |
| Other (income), net                 | (453)                                  | (1,454)    | (1,001)       | (68.8)        | (0.3)         | (0.9)   |
| Income (loss) before taxes          | 4,263                                  | (6,382)    | 10,645        | NM            | 2.4           | (4.0)   |
| Income tax expense                  | 2,241                                  | 1,571      | (670)         | (42.6)        | 1.3           | 1.0     |
| Net income (loss)                   | \$ 2,022                               | \$ (7,953) | \$ 9,975      | NM            | % 1.1         | % (5.0) |

*Net Revenue.* The Industrial Group derives its revenue from manufacturing services and product sales. Net revenue in the Industrial Group for the three and six month periods ended June 29, 2014 increased \$9.3 million and \$14.0 million from the prior year comparable periods, respectively. Increased volumes accounted for \$9.0 million and \$13.3 million of the increase in revenue for the three and six months ended June 29, 2014, respectively, while pricing accounted for \$0.3 million and \$0.7 million, respectively. The increases in volumes are primarily attributable to the overall improvement in the class 5-8 North American commercial vehicle market and increased demand for components for the trailer, light truck and oil and gas markets.



The Electronics Group derives its revenue from product sales and technical outsourced services. Net revenue in the Electronics Group for the three and six month periods ended June 29, 2014 increased \$1.7 million and \$2.8 million from the prior year comparable periods, respectively, reflecting the ramp up of new electronic manufacturing service programs, partially offset by declines within the space business. Despite the increase over the prior year period, the Electronics Group's outlook continues to be negatively affected by budgetary and funding uncertainty within the U.S. Department of Defense. See "Electronics Group Outlook" above.

*Gross Profit.* The Industrial Group's gross profit increased to \$11.4 million and \$22.5 million in the three and six month periods ended June 29, 2014, respectively, from \$8.9 million and \$17.0 million in the prior year comparable periods. The net increase in sales volumes included a favorable mix of higher margin products, which resulted in an increase in gross profit of approximately \$2.0 million and \$3.6 million for the three and six month periods, respectively. Additionally, productivity improvements and increased pricing contributed to an increase in gross profit of \$0.5 million and \$2.0 million for the three and six month periods, respectively.

The Electronics Group's gross profit decreased to losses of \$0.6 million and \$1.1 million in the three and six month periods ended June 29, 2014, respectively, from losses of \$0.5 million and \$0.6 million in the prior year comparable periods. The decline in gross profit was primarily as a result of an unfavorable mix in sales of lower margin products and services.

*Selling, General and Administrative.* Selling, general and administrative expense increased by \$1.5 million and \$2.4 million for the three and six month periods ended June 29, 2014, respectively, as compared to the same periods in 2013 primarily as a result of an increase in legal expenses regarding contract negotiations (see Note 4 "Customer Contract Negotiations" to the consolidated financial statements in this Quarterly Report on Form 10-Q). Selling, general and administrative expense increased as a percentage of revenue to 9.8% and 9.7% for the three and six month periods ended June 29, 2014, respectively, as compared to 9.2% for each of the three and six months ended June 30, 2013.

*Research and Development.* Research and development costs were negligible in the second quarter and \$0.2 million for the six months ended June 29, 2014 as compared to \$1.4 million and \$2.3 million for the three and six month comparable 2013 periods. As certain projects become customer funded, the Company expects total research and development costs to decrease for the year ending December 31, 2014 in comparison to 2013.

*Impairment of Goodwill.* Goodwill is tested for impairment annually as of December 31 or more frequently if impairment indicators arise. If impairment indicators arise, a step one assessment is performed to identify any possible goodwill impairment in the period in which the indicator is identified. Beginning in March 2013, we noted certain indicators relating to our Electronics Group reporting unit that were significant enough to conclude that an impairment indicator existed as of March 31, 2013. Specifically, the Company experienced emerging uncertainty regarding certain key programs within the Electronics Group's space business beginning in the latter part of the first quarter of 2013, as one key customer communicated its strategic sourcing decision to begin insourcing programs that had been previously outsourced to the Electronics Group. Overall, the Electronics Group has been more impacted by declines in the overall government defense market than originally anticipated as the effects of sequestration became clearer since its initial effective date on March 1, 2013. For example, sales of certain data recording products were significantly reduced due to the impact of sequestration on our customers, and the loss of commercial space business was due in part to our customer's efforts to offset unrelated losses of government business due to sequestration. As a result, the Electronics Group's short term revenue forecasts were materially affected. Further, the Company experienced a decline in the market value of its equity subsequent to March 31, 2013. As a result of the analysis, the Electronics Group's goodwill was deemed to be impaired, resulting in a non-cash impairment charge of \$6.9 million, representing the segment's entire goodwill balance.

*Interest Expense.* Interest expense for the three and six months ended June 29, 2014 increased slightly relative to the comparable 2013 periods. The weighted average interest rate was 2.5% for the three and six month periods of 2014, as compared to 2.6% and 2.5% for the three and six month periods of 2013, respectively. Additionally, our weighted average debt outstanding increased to \$16.4 million and \$15.2 million for the three and six month periods of 2014, respectively, from \$9.9 million and \$13.3 million during the three and six month periods of 2013, respectively.

*Other Expense (Income), Net.* The Company recognized other expense of \$0.1 million and income of \$0.5 million for the three and six months ended June 29, 2014 compared to other income of \$0.3 million and \$1.5 million for the three and six months ended June 30, 2013, respectively. Other expense (income), net for the first six months of 2014 includes gains of \$0.7 million within the Industrial Group from the receipt of federal grant funds for improvements made under a flood relief program, partially offset by foreign currency related losses of \$0.1 million related to the net U.S. dollar denominated monetary asset position of our Mexican subsidiaries for which the Mexican peso is the functional currency. During the six months ended June 30, 2013, the Company recognized net gains of \$1.7 million related to the disposition of idle assets. Additionally, other income, net for the three and six months ended June 30, 2013 includes foreign currency translation gains of \$0.2 million and losses of \$0.4 million, respectively.

*Income Taxes.* Income tax expense for the three and six months ended June 29, 2014 was \$1.1 million and \$2.2 million, respectively, as compared to \$0.9 million and \$1.6 million for the three and six months ended June 30, 2013, respectively. Income tax expense for all periods primarily represents tax on foreign operations at the statutory rate of 30%. In the U.S., our recent history of operating losses does not allow us to satisfy the “more likely than not” criterion for recognition of deferred tax assets. Therefore, there is generally no federal income tax recognized on the pre-tax income or losses in the U.S. as valuation allowance adjustments offset the associated tax effect. However, the Company has provided for certain state taxes expected to be paid in the U.S. As such, our effective income tax for the three and six months ended June 29, 2014 is higher than the U.S. federal statutory rate of 35%.

## Liquidity, Capital Resources

The Company's Credit Facility provides potential total availability of up to \$50.0 million with an option, subject to certain conditions, to increase total potential availability to \$60.0 million in the future. Loans made under the Credit Facility will mature and the commitments thereunder will terminate in May 2016. Actual borrowing availability under the Credit Facility depends upon a monthly borrowing base collateral calculation that is based on specified percentages of the value of eligible accounts receivable, inventory and machinery and equipment, less certain reserves and subject to certain other adjustments. Based on that calculation, at June 29, 2014, we had actual total borrowing availability under the Credit Facility of \$39.7 million, of which we had drawn \$23.0 million, leaving \$15.8 million available for borrowing, after accounting for the letter of credit described below. Along with an unrestricted cash balance of \$18.4 million, we had total cash and available borrowing capacity of \$34.2 million as of June 29, 2014. Approximately \$8.4 million of the unrestricted cash balance relates to our Mexican subsidiaries. Standby letters of credit up to a maximum of \$5.0 million may be issued under the Credit Facility of which \$0.9 million were issued at June 29, 2014. Obligations under the Credit Facility are guaranteed by all of our U.S. subsidiaries and are secured by a first priority lien on substantially all domestic assets of the Company.

The Credit Facility contains a number of covenants that, among other things, limit or restrict our ability to dispose of assets, incur additional indebtedness, incur guarantee obligations, engage in sale and leaseback transactions, prepay other indebtedness, modify organizational documents and certain other agreements, create restrictions affecting subsidiaries, pay dividends and other restricted payments, create liens, make investments, make acquisitions, engage in mergers, change the nature of our business and engage in certain transactions with affiliates. In addition, if the Company's availability under the Credit Facility falls below \$6.0 million (or \$8.0 million for a period of 5 or more consecutive days), the Company must maintain a fixed charge coverage ratio of at least 1.15 to 1.00. As of June 29, 2014, the Company was in compliance with all covenants.

We also had purchase commitments totaling approximately \$6.9 million at June 29, 2014, primarily for inventory and manufacturing equipment.

There are numerous risks and uncertainties relating to the global economy and the commercial vehicle and aerospace and defense industries that could materially affect our financial condition, future results of operations and liquidity. These risks and uncertainties could result in decreased sales, limited access to credit, rising costs, increased competition, customer or supplier bankruptcies, delays in customer payment terms and acceleration of supplier payments, growing inventories and failure to meet debt covenants.

The outcome of the Dana and Meritor contract negotiations could have a significant impact on our liquidity. However, the Company expects to have plans established and executed prior to December 31, 2014 to support its operations and provide sufficient liquidity to finance its operations for the remainder of 2014 and the foreseeable future.

Our ability to service our indebtedness will require a significant amount of cash. Our ability to generate this cash will depend largely on future operations. Based upon our current level of operations and our 2014 business forecast, we believe that cash flow from operations, available cash and available borrowings under our Credit Facility will be adequate to meet our liquidity needs for 2014 and the foreseeable future. However, changing business, regulatory and economic conditions may cause actual results will vary from our forecasts.

## **Financial Condition**

*Operating Activities.* Net cash provided by operating activities was \$4.7 million in the first six months of 2014 as compared to a use of \$1.0 million in the same period of 2013. Cash of \$26.3 million was used to finance increased accounts receivables in the first six months of 2014 resulting from higher revenues and a change in payment terms with one of our largest customers. Similarly, increases in accounts payable provided cash of \$23.6 million. Cash of \$1.0 million was used to finance an increase in inventory during the first six months of 2014, primarily to support higher volumes within our Industrial Group. Accrued liabilities increased and provided \$3.6 million primarily as a result of a \$2.1 million prepayment by a customer within the Electronics Group in addition to the timing of foreign income tax payments within our Industrial Group.

*Investing Activities.* Net cash used by investing activities was \$2.5 million for the first six months of 2014 as compared to net cash provided of \$0.6 million for the first six months of 2013. Net cash used by investing activities for the first six months of 2014 included \$2.5 million of capital expenditures. Net cash used by investing activities for the first six months of 2013 included proceeds of \$2.2 million from the sale of idle assets primarily within the Industrial Group, partially offset by \$1.5 million of capital expenditures.

*Financing Activities.* Net cash used by financing activities was \$2.5 million for the first six months of 2014 as compared to a cash neutral position for the first six months of 2013. Net cash used in financing activities for the first six months of 2014 includes a debt reduction of \$1.0 million on the Credit Facility, dividend payments of \$0.8 million and payments of \$0.7 million for the repurchase of stock and minimum statutory tax withholdings on stock-based compensation. During the first six months of 2013, the Company increased debt by \$1.0 million on the Credit Facility. The Company also paid dividends of \$0.4 million and paid \$0.6 million for minimum statutory tax withholdings on stock-based compensation during the first six months of 2013.

### **Critical Accounting Policies**

See the information concerning our critical accounting policies included under Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operation - Critical Accounting Policies and Estimates” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. There have been no significant changes in our critical accounting policies during the six months ended June 29, 2014.

### **Forward-looking Statements**

This Quarterly Report on Form 10-Q, and our other oral or written communications, may contain “forward-looking” statements. These statements may include our expectations or projections about the future of our industries, business strategies, potential acquisitions or financial results and our views about developments beyond our control, including domestic or global economic conditions, trends and market developments. These statements are based on management’s views and assumptions at the time originally made, and, except as required by law, we undertake no obligation to update these statements, even if, for example, they remain available on our website after those views and assumptions have changed. There can be no assurance that our expectations, projections or views will come to pass, and undue reliance should not be placed on these forward-looking statements.

A number of significant factors could materially affect our specific business operations and cause our performance to differ materially from any future results projected or implied by our prior statements. Many of these factors are identified in connection with the more specific descriptions contained throughout this report. Other factors which could also materially affect such future results currently include: reliance on major customers or suppliers, especially

in the automotive or aerospace and defense electronics sectors, including the risk of potentially adverse outcomes in ongoing contract renewal disputes and negotiations with Dana and Meritor; volatility of our customers' forecasts, scheduling demands and production levels which negatively impact our operational capacity and our effectiveness to integrate new customers; declining revenues and backlog in our aerospace and defense business lines as we attempt to transition from legacy products and services into new market segments and technologies; our ability to successfully develop, launch or sustain new products and programs; dependence on, retention or recruitment of key employees especially in challenging markets; inventory valuation risks including excessive or obsolescent valuations; potential impairments, non-recoverability or write-offs of assets or deferred costs; adverse impacts of new technologies or other competitive pressures which increase our costs or erode our margins; the cost, quality, timeliness, efficiency and yield of our operations and capital investments, including working capital, production schedules, cycle times, scrap rates, injuries, wages, overtime costs, freight or expediting costs; cost and availability of raw materials such as steel, component parts, natural gas or utilities; the costs of compliance with our auditing, regulatory or contractual obligations; the costs and supply of, or access to, debt, equity capital, or insurance; fees, costs or other dilutive effects of refinancing, or compliance with covenants; regulatory actions or sanctions (including FCPA, OSHA and Federal Acquisition Regulations, among others); potential weaknesses in internal controls over financial reporting and enterprise risk management; disputes or litigation involving customer, supplier, employee, lessor, landlord, creditor, stockholder, product liability or environmental claims; U.S. government spending on products and services that our Electronics Group provides, including the timing of budgetary decisions; changes in licenses, security clearances, or other legal rights to operate, manage our work force or import and export as needed; breakdowns, relocations or major repairs of machinery and equipment; pension valuation, health care or other benefit costs; labor relations; strikes; union negotiations; cyber security threats and disruptions; changes or delays in customer budgets, funding or programs; failure to adequately insure or to identify environmental or other insurable risks; revised contract prices or estimates of major contract costs; risks of foreign operations; currency exchange rates; war, terrorism, or political uncertainty; unanticipated or uninsured disasters, losses or business risks; inaccurate data about markets, customers or business conditions; or unknown risks and uncertainties. For more information about our risk factors, see Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are a smaller reporting company as defined in Item 10(f)(1) of Regulation S-K and thus are not required to provide the quantitative and qualitative disclosures about market risk specified in Item 305 of Regulation S-K.

### **ITEM 4. CONTROLS AND PROCEDURES**

(a) *Evaluation of disclosure controls and procedures.* Based on the evaluation of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 Rules 13a-15(e) or 15d-15(e)) required by Securities Exchange Act Rules 13a-15(b) or 15d-15(b), our Chief Executive Officer and our Chief Financial Officer have concluded that as of the end of the period covered by this report, our disclosure controls and procedures were effective.

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

From time to time, the Company is involved in litigation matters arising in the normal course of business. As previously disclosed, Sypris and Dana are engaged in various disputes regarding the existence and enforceability of an amended and restated supply agreement (see Note 4 “Customer Contract Negotiations” to the consolidated financial statements in this Quarterly Report on Form 10-Q.)

### **ITEM 1A. RISK FACTORS**

Information regarding risk factors appears in Part I — Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Forward-Looking Statements,” in this Quarterly Report on Form 10-Q, and in Part I — Item 1A, “Risk Factors,” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. There



have been no material changes from the risk factors disclosed in our Annual Report on Form 10-K.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table summarizes our shares of common stock repurchased during the second quarter ended June 29, 2014 (dollars in thousands except per share data):

| <b>Period</b>         | <b>Total<br/>Number<br/>of Shares<br/>Purchased<br/>(a)</b> | <b>Average<br/>Price<br/>Paid per<br/>Share</b> | <b>Total<br/>Number of<br/>Shares<br/>Purchased<br/>as a Part of<br/>Publicly<br/>Announced<br/>Plans or<br/>Programs</b> | <b>Maximum<br/>Dollar<br/>Value of<br/>Shares<br/>that May<br/>Yet Be<br/>Purchased<br/>Under the<br/>Plans or<br/>Programs<br/>(b)</b> |
|-----------------------|---|---|---|---|
| 3/31/2014 – 4/27/2014 | 94,847  | \$ 2.80   | 2,694   | \$ 4,179  |
| 4/28/2014 – 5/25/2014 | —   | \$ —  | —   | \$ 4,179  |
| 5/26/2014 – 6/29/2014 | 21,428  | \$ 5.25   | 21,428  | \$ 4,067  |

The total number of shares purchased includes shares purchased under the Executive Equity Repurchase (a) Agreement (described below) and shares of stock withheld for the payment of withholding taxes upon the vesting of restricted stock. Common shares withheld to satisfy tax withholding obligations were immediately cancelled.

On December 20, 2011, our Board of Directors approved and we announced an authorization for the repurchase of up to \$5.0 million of our outstanding shares of common stock. The Board also authorized an Executive Equity Repurchase Agreement whereby management, including officers and directors, would grant the Company a first (b)right to purchase shares at current market prices (calculated as the average of several days' closing prices) at any time such a party to the agreement departed the Company or intended to sell more than 1,500 shares of common stock. The agreement has a five-year term, subject to earlier termination by the Company, and participation by each individual is voluntary.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

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**ITEM 6. EXHIBITS**

**Exhibit Number Description**

|         |   |
|---------|---|
| 31(i).1 | CEO certification pursuant to Section 302 of Sarbanes - Oxley Act of 2002.  |
| 31(i).2 | Principal Financial Officer certification pursuant to Section 302 of Sarbanes - Oxley Act of 2002.  |
| 32      | CEO and Principal Financial Officer certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes - Oxley Act of 2002. |
| 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  |

**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.

SYPRIS SOLUTIONS, INC.  
(Registrant)

Date: August 5, 2014 By: /s/ Anthony C. Allen  
(Anthony C. Allen)  
Vice President & Treasurer (Principal  
Financial Officer)

Date: August 5, 2014 By: /s/ Rebecca R. Eckert  
(Rebecca R. Eckert)  
Controller (Principal Accounting Officer)