MOTORCAR PARTS AMERICA INC
Form 10-Q
November 08, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2010

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM TO

Commission File No. 001-33861
MOTORCAR PARTS OF AMERICA, INC.
(Exact name of registrant as specified in its charter)

New York (State or other jurisdiction of incorporation or organization)	11-2153962 (I.R.S. Employer Identification No.)
2929 California Street, Torrance, California (Address of principal executive offices)	90503 (Zip Code)

Registrant s telephone number, including area code: (310) 212-7910

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 o No o

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. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

There were 12,052,271 shares of Common Stock outstanding at November 1, 2010.

MOTORCAR PARTS OF AMERICA, INC.
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MOTORCAR PARTS OF AMERICA, INC.
GLOSSARY

The following terms are frequently used in the text of this report and have the meanings indicated below.

Used Core An alternator or starter which has been used in the operation of a vehicle. Generally, the Used Core is an original equipment (OE) alternator or starter installed by the vehicle manufacturer and subsequently removed for replacement. Used Cores contain salvageable parts which are an important raw material in the remanufacturing process. We obtain most Used Cores by providing credits to our customers for Used Cores returned to us under our core exchange program. Our customers receive these Used Cores from consumers who deliver a Used Core to obtain credit from our customers upon the purchase of a newly remanufactured alternator or starter. When sufficient Used Cores cannot be obtained from our customers, we will purchase Used Cores from core brokers, who are in the business of buying and selling Used Cores. The Used Cores purchased from core brokers or returned to us by our customers under the core exchange program, and which have been physically received by us, are part of our raw material or work in process inventory included in long-term core inventory.

Remanufactured Core The Used Core underlying an alternator or starter that has gone through the remanufacturing process and through that process has become part of a newly remanufactured alternator or starter. The remanufacturing process takes a Used Core, breaks it down into its component parts, replaces those components that cannot be reused and reassembles the salvageable components of the Used Core and additional new components into a remanufactured alternator or starter. Remanufactured Cores are included in our on-hand finished goods inventory and in the remanufactured finished good product held for sale at customer locations. Used Cores returned by consumers to our customers but not yet returned to us continue to be classified as Remanufactured Cores until we physically receive these Used Cores. All Remanufactured Cores are included in our long-term core inventory or in our long-term core inventory deposit.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

		September 30, 2010 (Unaudited)		March 31, 2010
ASSETS				
Current assets:				
Cash	$	5,815,000	$	1,210,000
Short-term investments		265,000		451,000
Accounts receivable net (see Note 4)				5,553,000
Inventory net		27,773,000		31,547,000
Inventory unreturned		4,366,000		3,924,000
Deferred income taxes		8,455,000		8,391,000
Prepaid expenses and other current assets		1,928,000		2,735,000
Total current assets		48,602,000		53,811,000
Plant and equipment net		11,563,000		12,693,000
Long-term core inventory net		76,302,000		67,957,000
Long-term core inventory deposit		25,984,000		25,768,000
Long-term deferred income taxes		722,000		951,000
Long-term note receivable		1,894,000		
Intangible assets net		5,917,000		6,304,000
Other assets		1,660,000		1,549,000
TOTAL ASSETS	$	172,644,000	$	169,033,000
LIABILITIES AND SHAREHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$	30,190,000	$	31,603,000
Accrued liabilities		3,134,000		1,863,000
Accrued salaries and wages		2,574,000		3,590,000
Accrued workers compensation claims		1,350,000		1,574,000
Customer finished goods returns accrual		6,696,000		7,454,000
Income tax payable		535,000		678,000
Other current liabilities		478,000		697,000
Current portion of term loan		2,000,000		2,000,000
Current portion of capital lease obligations		308,000		953,000
Total current liabilities		47,265,000		50,412,000
Term loan, less current portion		6,500,000		7,500,000
Deferred core revenue.		7,738,000		6,061,000
Deferred gain on sale-leaseback		58,000		319,000
Other liabilities		639,000		676,000
Capital lease obligations, less current portion		304,000		445,000
Total liabilities		62,504,000		65,413,000
Commitments and contingencies				

Shareholders equity:				
Preferred stock; par value $.01 per share, 5,000,000 shares authorized; none issued				
Series A junior participating preferred stock; par value $.01 per share, 20,000 shares authorized; none issued				
Common stock; par value $.01 per share, 20,000,000 shares authorized; 12,052,271 and 12,026,021 shares issued and outstanding at September 30, 2010 and March 31, 2010, respectively		121,000		120,000
Treasury stock, at cost, 14,400 shares of common stock at September 30, 2010 and none at March 31, 2010		(89,000)		
Additional paid-in capital		92,934,000		92,792,000
Additional paid-in capital-warrant		1,879,000		1,879,000
Accumulated other comprehensive loss		(981,000)		(1,426,000)
Retained earnings		16,276,000		10,255,000
Total shareholders equity		110,140,000		103,620,000
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	172,644,000	$	169,033,000

The accompanying condensed notes to consolidated financial statements are an integral part hereof.

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MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES
Consolidated Statements of Income
(Unaudited)

	Six Months Ended September 30,		Three Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Net sales	$ 77,211,000	$ 72,127,000	$ 40,977,000	$ 39,437,000
Cost of goods sold	52,984,000	54,140,000	28,295,000	28,621,000
Gross profit	24,227,000	17,987,000	12,682,000	10,816,000
Operating expenses:				
General and administrative	7,595,000	6,165,000	3,571,000	3,653,000
Sales and marketing	2,941,000	2,807,000	1,201,000	1,535,000
Research and development	762,000	668,000	396,000	334,000
Total operating expenses	11,298,000	9,640,000	5,168,000	5,522,000
Operating income	12,929,000	8,347,000	7,514,000	5,294,000
Other expense (income):				
Gain on acquisition		(1,331,000)		(1,331,000)
Interest expense net	3,303,000	1,970,000	1,701,000	974,000
Income before income tax expense	9,626,000	7,708,000	5,813,000	5,651,000
Income tax expense	3,605,000	3,078,000	2,312,000	2,216,000
Net income	$ 6,021,000	$ 4,630,000	$ 3,501,000	$ 3,435,000
Basic net income per share	$ 0.50	$ 0.39	$ 0.29	$ 0.29
Diluted net income per share	$ 0.49	$ 0.38	$ 0.29	$ 0.28
Weighted average number of shares outstanding:				
Basic	12,043,818	11,967,797	12,038,636	11,973,510
Diluted	12,220,257	12,086,298	12,202,507	12,101,997

The accompanying condensed notes to consolidated financial statements are an integral part hereof.

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MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended September 30,	
Cash flows from operating activities:	**2010**	**2009**
Net income	$ 6,021,000	$ 4,630,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,575,000	1,604,000
Amortization of intangible assets	387,000	258,000
Amortization of deferred gain on sale-leaseback	(262,000)	(262,000)
Amortization of deferred financing costs	42,000	
Provision for inventory reserves	699,000	606,000
Provision for customer payment discrepancies	152,000	186,000
Net recovery of doubtful accounts	(98,000)	
Deferred income taxes	173,000	587,000
Share-based compensation expense	29,000	98,000
Gain on acquisition		(1,331,000)
Impact of tax benefit on APIC pool from stock options exercised	3,000	36,000
Gain on redemption of short-term investment	(25,000)	
Loss on disposal of assets	30,000	5,000
Changes in current assets and liabilities:		
Accounts receivable	5,499,000	(1,366,000)
Inventory	3,442,000	(131,000)
Inventory unreturned	(442,000)	439,000
Prepaid expenses and other current assets	785,000	(166,000)
Other assets	(115,000)	116,000
Accounts payable and accrued liabilities	(434,000)	3,436,000
Customer finished goods returns accrual	(758,000)	(1,331,000)
Income tax payable	(179,000)	(297,000)
Deferred core revenue	1,677,000	(425,000)
Long-term core inventory	(8,704,000)	(1,503,000)
Long-term core inventory deposits	(216,000)	(1,317,000)
Other liabilities	(201,000)	(1,147,000)
Net cash provided by operating activities	9,080,000	2,725,000
Cash flows from investing activities:		
Purchase of plant and equipment	(540,000)	(484,000)
Purchase of businesses	(464,000)	(2,489,000)
Long-term note receivable	(1,894,000)	
Change in short term investments	186,000	37,000
Net cash used in investing activities	(2,712,000)	(2,936,000)
Cash flows from financing activities:		
Borrowings under revolving loan	30,700,000	20,000,000
Repayments under revolving loan	(30,700,000)	(17,900,000)
Repayments of term loan	(1,000,000)	

Deferred financing costs	(16,000)	
Payments on capital lease obligations	(786,000)	(814,000)
Exercise of stock options	69,000	123,000
Excess tax benefit from employee stock options exercised	44,000	
Impact of tax benefit on APIC pool from stock options exercised	(3,000)	(36,000)
Repurchase of common stock, including fees	(89,000)	
Proceeds from issuance of common stock	1,000	
Net cash (used in) provided by financing activities	(1,780,000)	1,373,000
Effect of exchange rate changes on cash	17,000	19,000
Net increase in cash	4,605,000	1,181,000
Cash Beginning of period	1,210,000	452,000
Cash End of period	$ 5,815,000	$ 1,633,000
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 3,288,000	$ 1,915,000
Income taxes, net of refunds	3,487,000	2,650,000
Non-cash investing and financing activities:		
Settlement of accounts receivable in connection with the purchase of business.	$	$ 1,123,000

The accompanying condensed notes to consolidated financial statements are an integral part hereof.

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MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES
Condensed Notes to Consolidated Financial Statements
September 30, 2010
(Unaudited)

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six and three months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending March 31, 2011. This report should be read in conjunction with the Company s audited consolidated financial statements and notes thereto for the fiscal year ended March 31, 2010, which are included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on June 14, 2010.

The accompanying consolidated financial statements have been prepared on a consistent basis with, and there have been no material changes to, the accounting policies described in Note 2 to the consolidated financial statements that are presented in the Company s Annual Report on Form 10-K for the fiscal year ended March 31, 2010.

Reclassification

Certain items in the Consolidated Balance Sheet for the fiscal year ended March 31, 2010 have been reclassified to conform to the fiscal 2011 presentation (Refer to Note 4).

1. Company Background and Organization

Motorcar Parts of America, Inc. and its subsidiaries (the Company or MPA) remanufacture and distribute alternators and starters for import and domestic cars and light trucks. These replacement parts are sold for use on vehicles after initial vehicle purchase. These automotive parts are sold to automotive retail chain stores and warehouse distributors throughout the United States and Canada and to major automobile manufacturers.

The Company obtains used alternators and starters, commonly known as Used Cores, primarily from its customers using its core exchange program. The Company also purchases Used Cores from vendors (core brokers). The customers grant a credit to the consumer when the used part is returned to them, and the Company in turn provides a credit to the customers upon return to the Company. These Used Cores are an essential material needed for the remanufacturing operations.

The Company has remanufacturing, warehousing and shipping/receiving operations for alternators and starters in Mexico, California, Singapore and Malaysia. In addition, the Company utilizes third party warehouse distribution centers in Edison, New Jersey and Springfield, Oregon. In June 2010, the Company entered into a two year lease for a warehouse distribution facility in Berlin, Connecticut.

2. Long Term Note Receivable

In August 2010, the Company made a loan in the amount of approximately $1,894,000 (the Loan) to Fenwick Automotive Products Limited (Fenwick), a privately-owned Toronto-based manufacturer, remanufacturer and distributor of new and remanufactured aftermarket auto parts pursuant to a debenture executed by Fenwick in favor of the Company (the Debenture). The Loan was to mature on the later of (i) October 21, 2010 and (ii) July 31, 2012 (provided that the indebtedness subject to the agreement among Fenwick, Royal Bank of Canada (RBC) and certain other parties, dated July 6, 2010, as amended from time to time (RBC Indebtedness), was fully renewed or replaced prior to expiration of the deadline in the agreement). Since the RBC Indebtedness was not renewed or replaced prior to the relevant deadline, the Company is treating the Loan as a demand note in long-term assets due to the subordination noted below. The Loan bears interest at a rate equal to the prime rate plus 8.75% per annum, which is payable in cash quarterly in arrears beginning on September 30, 2010.

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The Loan is secured by a blanket lien on all of Fenwick s assets, FAPL Holdings, Inc. (FAPL), Fenwick s parent company, and each of Fenwick s subsidiaries have also agreed to grant blanket liens of their assets to secure the Loan. The Company s rights to the payment of any amounts due in connection with the Loan and its rights as a secured party under the security agreements are subordinated to the rights of RBC as a lender to, and secured party of, Fenwick. Upon the occurrence of an event of default, as defined in the Debenture, the Company may declare all amounts under the Debenture immediately due and payable.

In connection with the Loan, the Company was granted an option to purchase outstanding shares of FAPL (or at the election of the Company, another Fenwick entity) for an aggregate purchase price of CDN$10,000,000 (the Option). The minimum percentage of shares subject to the Option is 51% and increases, up to a maximum of 80%, for reductions below CDN$10,000,000 in FAPL s adjusted net income for the fiscal year ending March 31, 2011. The Option is exercisable until August 25, 2012.

If the Company exercises the Option, the Company also has a call right, which expires on August 24, 2013, to acquire all the remaining outstanding shares of FAPL (or the applicable Fenwick entity) from its shareholders. If the call right expires without being exercised by the Company, the remaining shareholders are granted a put right to require the Company to acquire all the remaining outstanding shares. The payment for either the call or put shares shall be in cash or the Company s common stock, or a combination thereof, at the Company s option; provided, that the selling shareholders may require that up to 20% of the purchase price be paid in cash.

3. Intangible Assets

The following is a summary of the Company s intangible assets at September 30, 2010 and March 31, 2010.

		September 30, 2010		March 31, 2010	
	Weighted Average Amortization Period	**Gross Carrying Value**	**Accumulated Amortization**	**Gross Carrying Value**	**Accumulated Amortization**
Intangible assets subject to amortization					
Trademarks	9 years	$ 553,000	$ 152,000	$ 553,000	$ 115,000
Customer relationships	12 years	6,464,000	1,123,000	6,464,000	799,000
Non-compete agreements	5 years	257,000	82,000	257,000	56,000
Total	11 years	$ 7,274,000	$ 1,357,000	$ 7,274,000	$ 970,000

Amortization expense related to intangible assets was $387,000 and $258,000 during the six months ended September 30, 2010 and 2009, respectively. Amortization expense related to intangible assets was $193,000 and $151,000 during the three months ended September 30, 2010 and 2009, respectively. The aggregate estimated future amortization expense for intangible assets is as follows:

Year Ending March 31,	
2011 - remaining six months	$ 387,000
2012	774,000
2013	774,000
2014	738,000
2015	670,000
Thereafter	2,574,000
Total	$ 5,917,000

4. Accounts Receivable Net

Included in accounts receivable net are significant offset accounts related to customer allowances earned, customer payment discrepancies, returned goods authorizations (RGA) issued for in-transit unit returns, estimated future credits to be provided for Used Cores returned by the customers and potential bad debts. Due to the forward

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looking nature and the different aging periods of certain estimated offset accounts, they may not, at any point in time, directly relate to the balances in the open trade accounts receivable.

Accounts receivable net is comprised of the following:

	September 30, 2010	March 31, 2010
Accounts receivable trade	$ 23,279,000	$ 30,977,000
Allowance for bad debts	(1,043,000)	(1,141,000)
Customer allowances earned	(7,700,000)	(5,104,000)
Customer payment discrepancies	(525,000)	(553,000)
Customer returns RGA issued (1)	(3,730,000)	(2,582,000)
Customer core returns accruals	(11,883,000)	(16,044,000)
Less: total accounts receivable offset accounts	(24,881,000)	(25,424,000)
Total accounts receivable net	$ (1,602,000) (2)	$ 5,553,000

(1) The portion of customer unit returns for which an RGA was issued at period end for in-transit unit returns (warranty returns) and finished goods returns (stock adjustment returns) is recorded as an offset account to accounts receivable net. The estimated future warranty and stock adjustment returns accrual portion for which an RGA has not been issued is presented as a current liability in the Company s Consolidated Balance Sheets at September 30, 2010 and March 31, 2010, of $6,696,000 and $7,454,000, respectively. The March 31, 2010 customer finished goods returns accrual reclassification from accounts receivable net to current liabilities totaling $7,454,000 did not have any impact on the Company s debt covenant calculations, consolidated financial position or results of operations.

(2) Accounts receivable net has been reclassified and included in accrued liabilities in the Company s Consolidated Balance Sheet at September 30, 2010.

Warranty Returns

The Company allows its customers to return goods to the Company that their end-user customers have returned to them, whether the returned item is or is not defective (warranty returns). The Company accrues an estimate of its exposure to warranty returns based on a historical analysis of the level of this type of return as a percentage of total unit sales. Amounts charged to expense for these warranty returns are considered in arriving at the Company s net sales. At September 30, 2010, the warranty return accrual of $1,658,000 was included under the customer returns RGA issued in the above table and the warranty estimate of $1,317,000 was included in customer finished goods returns accrual in the Consolidated Balance Sheets.

Change in the Company s warranty return accrual is as follows:

	Six Months Ended September 30,		Three Months Ended September 30,	
	2010	2009	2010	2009
Balance at beginning of period	$ (3,445,000)	$ (2,596,000)	$ (3,594,000)	$ (2,604,000)
Charged to expense	19,219,000	18,406,000	10,254,000	10,211,000
Amounts processed	(19,689,000)	(17,863,000)	(10,873,000)	(9,676,000)
Balance at end of period	$ (2,975,000)	$ (3,139,000)	$ (2,975,000)	$ (3,139,000)

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5. Inventory

Inventory includes non-core inventory, inventory unreturned, long-term core inventory, long-term core inventory deposit and is comprised of the following:

	September 30, 2010	March 31, 2010
Non-core inventory		
Raw materials	$ 10,996,000	$ 10,362,000
Work-in-process	170,000	29,000
Finished goods	18,497,000	22,919,000
	29,663,000	33,310,000
Less allowance for excess and obsolete inventory	(1,890,000)	(1,763,000)
Total	$ 27,773,000	$ 31,547,000
Inventory unreturned	$ 4,366,000	$ 3,924,000
Long-term core inventory		
Used cores held at the Company s facilities	$ 20,971,000	$ 14,491,000
Used cores expected to be returned by customers	3,711,000	3,350,000
Remanufactured cores held in finished goods	16,214,000	17,955,000
Remanufactured cores held at customers locations	36,234,000	32,878,000
	77,130,000	68,674,000
Less allowance for excess and obsolete inventory	(828,000)	(717,000)
Total	$ 76,302,000	$ 67,957,000
Long-term core inventory deposit	$ 25,984,000	$ 25,768,000

6. Major Customers

The Company s four largest customers accounted for the following total percentage of net sales and accounts receivable trade:

	Six Months Ended September 30,		Three Months Ended September 30,	
Sales	**2010**	**2009**	**2010**	**2009**
Customer A	48%	44%	48%	42%
Customer B	19%	26%	21%	28%
Customer C	8%	8%	6%	9%
Customer D	8%	8%	7%	7%

Accounts receivable - trade	**September 30, 2010**	**March 31, 2010**
Customer A	40%	24%
Customer B	4%	15%

Customer C	11%	31%
Customer D	9%	4%

For the six months ended September 30, 2010 and 2009, one supplier provided approximately 18% and 30%, respectively, of the raw materials purchased. For the three months ended September 30, 2010 and 2009, one supplier provided approximately 15% and 33%, respectively, of the raw materials purchased. No other supplier accounted for more than 10% of the Company s raw materials purchases for the six and three months ended September 30, 2010 or 2009.

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7. Debt

In October 2009, the Company entered into a revolving credit and term loan agreement (the Credit Agreement), with its bank and one additional lender (the Lenders), which permits the Company to borrow up to $45,000,000 (the Credit Facility). The Credit Facility is comprised of (i) a revolving facility with a $7,000,000 letter of credit sub-facility and (ii) a term loan. The Company may borrow on a revolving basis up to an amount equal to $35,000,000 minus all outstanding letter of credit obligations minus a borrowing reserve of $7,500,000 (the Revolving Loan). The borrowing reserve remains in effect only if the Company is party to a receivable discount program pursuant to which its accounts receivable owed to the Company by its largest customer are being discounted. The term loan is in the principal amount of $10,000,000 (the Term Loan).

The Revolving Loan and the Term Loan bear interest at the bank s reference rate, plus an applicable margin, or a London Interbank Offered Rate (LIBOR) rate, plus an applicable margin, as selected by the Company in accordance with the Credit Agreement. The Credit Agreement, among other things, requires the Company to maintain certain financial covenants, including tangible net worth, fixed charge coverage ratio and leverage ratio covenants. The Company was in compliance with all financial covenants under the Credit Agreement as of September 30, 2010.

The Term Loan matures in October 2014 and requires principal payments of $500,000 on a quarterly basis. The Revolving Loan expires in October 2011 and provides the Company the option to request up to three one-year extensions.

In May 2010, the Company entered into a first amendment to the Credit Agreement with its Lenders. This amendment provides, among other things, that the borrowing reserve against the Company s Revolving Loan commitment amount be increased from $7,500,000 to $10,000,000.

In November 2010, the Company entered into a second amendment to the Credit Agreement with its Lenders. This amendment, among other things, extended the expiration date of the Revolving Loan to October 2012.

The Lenders hold a security interest in substantially all of the Company s assets. There was no outstanding balance on the Revolving Loan at September 30, 2010 and March 31, 2010. The Company had reserved $1,826,000 of the Revolving Loan for standby letters of credit for workers compensation insurance and $1,808,000 for commercial letters of credit as of September 30, 2010. As of September 30, 2010, $31,366,000 was available under the Revolving Loan, and of this, $10,000,000 was reserved for use in the event the Company s largest customer discontinued its current practice of having the Company s receivables discounted.

8. Accounts Receivable Discount Programs

The Company has established receivable discount programs with certain customers and their respective banks. Under these programs, the Company may sell those customers receivables to those banks at a discount to be agreed upon at the time the receivables are sold. These discount arrangements have allowed the Company to accelerate collection of customers receivables aggregating $70,950,000 and $31,113,000 for the six months ended September 30, 2010 and 2009, respectively, by a weighted average of 325 days and 337 days, respectively. On an annualized basis, the weighted average discount rate on the receivables sold to the banks during the six months ended September 30, 2010 and 2009 was 4.5% and 4.7%, respectively. The amount of the discount on these receivables, $2,855,000 and $1,389,000 for the six months ended September 30, 2010 and 2009, respectively, was recorded as interest expense.

9. Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per share includes the effect, if any, from the potential exercise or conversion of securities, such as stock options and warrants, which would result in the issuance of incremental shares of common stock.

The following presents a reconciliation of basic and diluted net income per share.

	Six Months Ended September 30,		Three Months Ended September 30,	
	2010	2009	2010	2009
Net income	$ 6,021,000	$ 4,630,000	$ 3,501,000	$ 3,435,000
Basic shares	12,043,818	11,967,797	12,038,636	11,973,510
Effect of dilutive stock options and warrants	176,439	118,501	163,871	128,487
Diluted shares	12,220,257	12,086,298	12,202,507	12,101,997
Net income per share:				
Basic	$ 0.50	$ 0.39	$ 0.29	$ 0.29
Diluted	$ 0.49	$ 0.38	$ 0.29	$ 0.28

The effect of dilutive options and warrants excludes 1,144,984 shares subject to options and 546,283 shares subject to warrants with exercise prices ranging from $7.27 to $15.00 per share for the six and three months ended September 30, 2010, respectively all of which were anti-dilutive. The effect of dilutive options and warrants excludes 1,256,649 shares subject to options and 546,283 shares subject to warrants with exercise prices ranging from $4.60 to $15.00 per share for the six months ended September 30, 2009 and 1,248,316 shares subject to options and 546,283 shares subject to warrants with exercise prices ranging from $5.00 to $15.00 per share for the three months ended September 30, 2009 all of which were anti-dilutive.

10. Comprehensive Income

Comprehensive income is defined as the change in equity during a period resulting from transactions and other events and circumstances from non-owner sources. The Company s total comprehensive income consists of net income, unrealized (loss) gain on short-term investments and foreign currency translation adjustments.

	Six Months Ended September 30,		Three Months Ended September 30,	
	2010	2009	2010	2009
Net income	$ 6,021,000	$ 4,630,000	$ 3,501,000	$ 3,435,000
Unrealized (loss) gain on short-term investments	(14,000)	55,000	13,000	26,000
Foreign currency translation	459,000	(287,000)	428,000	(280,000)
Comprehensive net income	$ 6,466,000	$ 4,398,000	$ 3,942,000	$ 3,181,000

11. Income Taxes

Income tax expenses for the six and three months ended September 30, 2010 and 2009 reflect income tax rates higher than the federal statutory rates primarily due to state income taxes, which were partially offset by the benefit of lower statutory tax rates in foreign taxing jurisdictions. In addition, during the six months ended September 30, 2010, the rate was further offset to a rate below the federal statutory rate by a reduction in the liability for unrealized tax benefits due to the conclusion of the Internal Revenue Service (IRS) examination noted below.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions with varying statutes of limitations. At March 31, 2010, the IRS had an ongoing tax examination of the federal tax returns for the fiscal year ended March 31, 2007. In November 2009, the IRS expanded its ongoing tax examination of the federal tax returns to include the fiscal year ended March 31, 2008. In May 2010, the IRS concluded its examination of the Company s federal income tax returns for the fiscal 2007 and 2008 tax years. The IRS

required no changes to the Company s tax returns for those fiscal years as filed.

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12. Financial Risk Management and Derivatives

Purchases and expenses denominated in currencies other than the U.S. dollar, which are primarily related to the Company s production facilities overseas, expose the Company to market risk from material movements in foreign exchange rates between the U.S. dollar and the foreign currency. The Company s primary risk exposure is from changes in the rate between the U.S. dollar and the Mexican peso related to the operation of the Company s facility in Mexico. The Company enters into forward foreign currency exchange contracts to exchange U.S. dollars for Mexican pesos in order to mitigate this risk. The extent to which forward foreign currency exchange contracts are used is modified periodically in response to management s estimate of market conditions and the terms and length of specific purchase requirements to fund those overseas facilities.

The Company enters into forward foreign currency exchange contracts in order to reduce the impact of foreign currency fluctuations and not to engage in currency speculation. The use of derivative financial instruments allows the Company to reduce its exposure to the risk that the eventual cash outflow resulting from funding the expenses of the foreign operations will be materially affected by changes in exchange rates. The Company does not hold or issue financial instruments for trading purposes. The forward foreign currency exchange contracts are designated for forecasted expenditure requirements to fund the foreign operations.

The Company had forward foreign currency exchange contracts with a U.S. dollar equivalent notional value of $6,844,000 and $6,159,000 at September 30, 2010 and March 31, 2010, respectively. The forward foreign currency exchange contracts entered into require the Company to exchange Mexican pesos for U.S. dollars. These contracts generally expire in a year or less, at rates agreed at the inception of the contracts. The counterparty to this derivative transaction is a major financial institution with investment grade or better credit rating; however, the Company is exposed to credit risk with this institution. The credit risk is limited to the potential unrealized gains (which offset currency fluctuations adverse to the Company) in any such contract should this counterparty fail to perform as contracted. Any changes in the fair values of forward foreign currency exchange contracts are reflected in current period earnings and accounted for as an increase or offset to general and administrative expenses.

The following tables show the effect of the Company s derivative instruments on its Consolidated Statement of Income:

	Loss (Gain) Recognized within General and Administrative Expenses			
	Six Months Ended September 30,		**Three Months Ended September 30,**	
Derivatives Not Designated as Hedging Instruments	**2010**	**2009**	**2010**	**2009**
Forward foreign currency exchange contracts	$332,000	$(1,103,000)	$(139,000)	$(139,000)

The fair value of the forward foreign currency exchange contracts of $185,000 and $517,000 is included in prepaid expenses and other current assets in the Consolidated Balance Sheets at September 30, 2010 and March 31, 2010, respectively.

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13. Fair Value Measurements

The following table summarizes the Company s financial assets and liabilities measured at fair value, by level within the fair value hierarchy as of September 30, 2010 and March 31, 2010:

	September 30, 2010				March 31, 2010			
		Fair Value Measurements Using Inputs Considered as				Fair Value Measurements Using Inputs Considered as		
	Fair Value	Level 1	Level 2	Level 3	Fair Value	Level 1	Level 2	Level 3
Assets								
Short-term investments								
Cash					$207,000	$207,000		
Mutual funds	$265,000	$265,000			244,000	244,000		
Prepaid expenses and other current assets								
Forward foreign currency exchange contracts	185,000		$185,000		517,000		$517,000	
Liabilities								
Other current liabilities								
Deferred compensation	265,000	265,000			451,000	451,000		

The Company s short-term investments, which fund its deferred compensation liabilities, consist of investments in mutual funds. These investments are classified as Level 1 as the shares of these mutual funds trade with sufficient frequency and volume to enable the Company to obtain pricing information on an ongoing basis.

The forward foreign currency exchange contracts are primarily measured based on the foreign currency spot and forward rates quoted by the banks or foreign currency dealers. During the six months ended September 30, 2010 and 2009, a loss of $332,000 and a gain of $1,103,000, respectively, were recorded in general and administrative expenses due to the change in the value of the forward foreign currency exchange contracts subsequent to entering into the contracts. During the each of the three month periods ended September 30, 2010 and 2009, a gain of $139,000 was recorded in general and administrative expenses due to the change in the value of the forward foreign currency exchange contracts subsequent to entering into the contracts.

During the six and three months ended September 30, 2010, the Company had no significant measurements of assets or liabilities at fair value on a nonrecurring basis subsequent to their initial recognition.

The carrying amounts of cash, short-term investments, accounts receivable, accounts payable and accrued liabilities approximate their fair value due to the short-term nature of these instruments. The carrying amount of the long-term note receivable approximates its fair value based on current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturity. The carrying amounts of the Revolving Loan, Term Loan and other long-term liabilities approximate their fair value based on current rates for instruments with similar characteristics.

14. Treasury Stock

In March 2010, the Company s Board of Directors authorized a share repurchase program of up to $5,000,000 of the Company s outstanding common stock from time to time in the open market and in private transactions at prices deemed appropriate by management. There is no expiration date governing the period over which the Company can

repurchase shares under this program. During July 2010, the Company repurchased 14,400 shares at a total cost of approximately $89,000.

15. New Accounting Pronouncements

Transfers of Financial Assets

In June 2009, the Financial Accounting Standards Board (the FASB) issued new guidance on the treatment of transfers of financial assets which eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures in order to enhance information reported to users of financial statements by providing greater transparency about transfers of financial assets,

including securitization transactions, and an entity s continuing involvement in and exposure to the risks related to transferred financial assets. This new guidance is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2009. The adoption of this guidance on April 1, 2010 did not have any impact on the Company s consolidated financial position and results of operations.

Consolidation of Variable Interest Entities

In June 2009, the FASB issued new guidance which amends the consolidation guidance applicable to variable interest entities and is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2009. The adoption of this guidance on April 1, 2010 did not have any impact on the Company s consolidated financial position and results of operations.

Fair Value Measurements and Disclosures

In January 2010, the FASB issued an update which requires new disclosures for transfers in and out of Level 1 and Level 2 of the fair value hierarchy and expanded disclosures for activity in Level 3 of the fair value hierarchy. The update also clarifies existing disclosures regarding the level of disaggregation for disclosure and disclosures about inputs and valuation techniques. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009. The adoption of this update on January 1, 2010 did not have any impact on the Company s consolidated financial position and results of operations. The disclosures regarding certain Level 3 activity are effective for fiscal years beginning after December 15, 2010. The Company does not expect the adoption of this guidance on April 1, 2011 to have any material impact on its consolidated financial position and results of operations.

Disclosure Requirements Related to Financing Receivables

In July 2010, the FASB issued an update which requires enhanced disclosures about the credit quality of financing receivables and the related allowance for credit losses. Trade accounts receivable with maturities of one year or less are excluded from the disclosure requirements. Disclosures required as of the end of a reporting period are effective for interim and annual periods ending on or after December 15, 2010. The Company does not expect the adoption of this guidance on December 31, 2010 to have any material impact on its consolidated financial position and results of operations. The disclosures required about activity that occurs during a reporting period are effective for interim and annual periods beginning on or after December 15, 2010. The Company does not expect the adoption of this guidance on January 1, 2011 to have any material impact on its consolidated financial position and the results of operations.

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

The following discussion and analysis presents factors that Motorcar Parts of America, Inc. and its subsidiaries (our , we , or us) believe are relevant to an assessment and understanding of our consolidated financial position and results of operations. This financial and business analysis should be read in conjunction with our March 31, 2010 audited consolidated financial statements included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on June 14, 2010.

Disclosure Regarding Private Securities Litigation Reform Act of 1995

This report contains certain forward-looking statements with respect to our future performance that involve risks and uncertainties. Various factors could cause actual results to differ materially from those projected in such statements. These factors include, but are not limited to: concentration of sales to certain customers, changes in our relationship with any of our major customers, the increasing customer pressure for lower prices and more favorable payment and other terms, the increasing demands on our working capital, the significant strain on working capital associated with large Remanufactured Core inventory purchases from customers, our ability to obtain any additional financing we may seek or require, our ability to maintain positive cash flows from operations, potential future changes in our previously reported results as a result of the identification and correction of errors in our accounting policies or procedures or potential material weaknesses in our internal controls over financial reporting, lower revenues than anticipated from new and existing contracts, our failure to meet the financial covenants or the other obligations set forth in our credit agreement and our lenders refusal to waive any such defaults, any meaningful difference between projected production needs and ultimate sales to our customers, increases in interest rates, changes in the financial condition of any of our major customers, the impact of high gasoline prices, the potential for changes in consumer spending, consumer preferences and general economic conditions, increased competition in the automotive parts industry, including increased competition from Chinese and other offshore manufacturers, difficulty in obtaining Used Cores and component parts or increases in the costs of those parts, political, criminal or economic instability in any of the foreign countries where we conduct operations, currency exchange fluctuations, unforeseen increases in operating costs and other factors discussed herein and in our other filings with the SEC.

Management Overview

The after-market for automobile parts is divided into two markets. The first market is the do-it-yourself (DIY) market, which is generally serviced by the large retail chain outlets. Consumers who purchase parts from the DIY channel generally install parts into their vehicles themselves. In most cases, this is a cheaper alternative than having the repair performed by a professional installer. The second market is the professional installer market, commonly known as the do-it-for-me (DIFM) market. This market is serviced by the retail chains, traditional warehouse distributors and the dealer networks. Generally, the consumer in this channel is a professional parts installer.

We remanufacture alternators and starters for import and domestic cars, light trucks, heavy duty, agricultural and industrial applications. These products are distributed to both the DIY and DIFM markets. Our products are distributed predominantly throughout the United States and Canada. Our products are sold to the largest auto parts retail chains in the United States and Canada. In addition, our products are sold to various traditional warehouses for the professional installers, and to major automobile manufacturers for both their after-market programs and their warranty replacement programs (OES). Demand and replacement rates for after-market remanufactured alternators and starters generally increase with increases in miles driven and the age of vehicles.

Historically, our business has focused on the DIY market. In times of recession, we believe consumers are more apt to purchase replacement parts in the DIY market because of lower prices compared to the DIFM market. We believe we have recently increased our market share in the DIY market.

The DIFM market is an attractive opportunity for growth. We are positioned to benefit from this market opportunity in two ways: (1) our auto parts retail customers are expanding their efforts to target the DIFM market and (2) we sell our products under private label and our Quality-Built®, Talon®, Xtreme®, Reliance and other brand names directly to suppliers that focus on professional installers. In addition, we sell our products to original equipment manufacturers for distribution to the professional installer both for warranty replacement and their general after-market channels. We have been successful in growing sales to this market.

In August 2010, we made a $1,894,000 secured loan to Fenwick Automotive Products Limited (Fenwick), a privately-owned Toronto-based manufacturer, remanufacturer and distributor of new and remanufactured aftermarket auto parts. In connection with this loan, we have an option to acquire substantial ownership interest in Fenwick. We believe this transaction provides us potential opportunities to expand beyond our existing product lines of alternators and starters and further enhance our market presence in North America.

Results of Operations for the Three Months Ended September 30, 2010 and 2009

The following discussion and analysis should be read in conjunction with the financial statements and notes thereto appearing elsewhere herein.

The following table summarizes certain key operating data for the periods indicated:

	Three Months Ended September 30,	
	2010	**2009**
Gross profit percentage	30.9%	27.4%
Cash flow provided by (used in) operations	$9,013,000	$(245,000)
Finished goods turnover (annualized) (1)	5.6	5.9
Annualized return on equity (2)	13.5%	14.8%

(1) Annualized finished goods turnover for the fiscal quarter is calculated by multiplying cost of sales for the quarter by 4 and dividing the result by the average between beginning and ending non-core finished goods inventory values for the fiscal quarter. We believe this provides a useful measure of our ability to turn production into revenues.

(2) Annualized return on equity is computed as net income for the fiscal quarter multiplied by 4 and dividing the result by beginning shareholders equity. Annualized return on equity measures our ability to invest shareholders funds profitably.

Following is our unaudited results of operations, reflected as a percentage of net sales:

	Three Months Ended September 30,	
	2010	**2009**
Net sales	100.0%	100.0%
Cost of goods sold	69.1	72.6
Gross profit	30.9	27.4
Operating expenses:		
General and administrative	8.7	9.3
Sales and marketing	2.9	3.9
Research and development	1.0	0.8
Operating income	18.3	13.4
Gain on acquisition		3.4
Interest expense, net	4.2	2.5
Income tax expense	5.6	5.6
Net income	8.5%	8.7%

Net Sales. Net sales for the three months ended September 30, 2010 increased by $1,540,000 to $40,977,000 compared to net sales for the three months ended September 30, 2009 of $39,437,000. The increase in our net sales was primarily due to increased sales to our existing customers and increased sales to several new customers.

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Cost of Goods Sold/Gross Profit. Cost of goods sold as a percentage of net sales decreased during the three months ended September 30, 2010 to 69.1% from 72.6% for the three months ended September 30, 2009, resulting in a corresponding increase in our gross profit of 3.5% to 30.9% for the three months ended September 30, 2010 from 27.4% for the three months ended September 30, 2009. The increase in the gross profit percentage was primarily due to lower per unit manufacturing costs as compared to the three months ended September 30, 2009.

General and Administrative. Our general and administrative expenses for the three months ended September 30, 2010 were $3,571,000, which represents a decrease of $82,000, or 2.2%, from general and administrative expenses for the three months ended September 30, 2009 of $3,653,000. This decrease in general and administrative expenses during the three months ended September 30, 2010 was primarily due to (i) $233,000 of decreased employee-related expenses and (ii) $74,000 of decreased professional services fees. These decreases in general and administrative expenses were partly offset by (i) $183,000 of increased general and administrative expenses at our offshore manufacturing facilities and (ii) $47,000 of increased travel expense.

Sales and Marketing. Our sales and marketing expenses for the three months ended September 30, 2010 decreased $334,000, or 21.8%, to $1,201,000 from $1,535,000 for the three months ended September 30, 2009. This decrease was due primarily to (i) reversal of commission expenses in connection with our prior year acquisition as certain thresholds were not met and (ii) decreased catalog expenses.

Research and Development. Our research and development expenses increased by $62,000, or 18.6%, to $396,000 for the three months ended September 30, 2010 from $334,000 for the three months ended September 30, 2009. The increase in research and development expenses was due primarily to employee-related expenses and an increase in the cost of supplies compared to the three months ended September 30, 2009.

Gain on Acquisition. During the three months ended September 30, 2009, we recorded a gain of $1,331,000 in connection with our August 2009 acquisition as the estimated fair value of the net assets acquired exceeded the fair value of the consideration transferred.

Interest Expense, Net. Our interest expense, net of interest income of $23,000, for the three months ended September 30, 2010 was $1,701,000. This represents an increase of $727,000, or 74.6%, over interest expense of $974,000 for the three months ended September 30, 2009. This increase was primarily attributable to a higher balance of receivables being discounted under the receivable discount programs during the three months ended September 30, 2010 as compared to the three months ended September 30, 2009.

Income Tax. For the three months ended September 30, 2010 and 2009, we recognized income tax expense of $2,312,000 and $2,216,000, respectively. Our effective tax rates for the three months ended September 30, 2010 and 2009 were 39.8% and 39.2%, respectively. This increase was primarily due to a decrease in the benefit of lower statutory rates in foreign taxing jurisdiction during the three months ended September 30, 2010 as compared to the three months ended September 30, 2009.

Results of Operations for the Six Months Ended September 30, 2010 and 2009

The following discussion and analysis should be read in conjunction with the financial statements and notes thereto appearing elsewhere herein.

The following table summarizes certain key operating data for the periods indicated:

	Six Months Ended September 30,	
	2010	**2009**
Gross profit percentage	31.4%	24.9%
Cash flow provided by operations	$9,080,000	$2,725,000
Finished goods turnover (annualized) (1)	5.1	5.6
Annualized return on equity (2)	11.6%	9.9%

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(1) Annualized finished goods turnover for the six months ended September 30, 2010 and 2009 is calculated by multiplying cost of sales for each six month period by 2 and dividing the result by the average between beginning and ending non-core finished goods inventory values for each six month period. We believe this provides a useful measure of our ability to turn production into revenues.

(2) Annualized return on equity is computed as net income for the six months ended September 30, 2010 and 2009 multiplied by 2 and dividing the result by beginning shareholders equity. Annualized return on equity measures our ability to invest shareholders funds profitably.

Following is our unaudited results of operations, reflected as a percentage of net sales:

	Six Months Ended September 30,	
	2010	**2009**
Net sales	100.0%	100.0%
Cost of goods sold	68.6	75.1
Gross profit	31.4	24.9
Operating expenses:		
General and administrative	9.8	8.5
Sales and marketing	3.8	3.9
Research and development	1.0	0.9
Operating income	16.8	11.6
Gain on acquisition		1.8
Interest expense, net	4.3	2.7
Income tax expense	4.7	4.3
Net income	7.8%	6.4%

Net Sales. Net sales for the six months ended September 30, 2010 increased by $5,084,000 to $77,211,000 compared to net sales for the six months ended September 30, 2009 of $72,127,000. The increase in our net sales was primarily due to increased sales to our existing customers and increased sales to several new customers.

Cost of Goods Sold/Gross Profit. Cost of goods sold as a percentage of net sales decreased during the six months ended September 30, 2010 to 68.6% from 75.1% for the six months ended September 30, 2009, resulting in a corresponding increase in our gross profit of 6.5% to 31.4% for the six months ended September 30, 2010 from 24.9% for the six months ended September 30, 2009. The increase in the gross profit percentage was primarily due to lower per unit manufacturing costs during the six months ended September 30, 2010 as compared to the six months ended September 30, 2009.

General and Administrative. Our general and administrative expenses for the six months ended September 30, 2010 were $7,595,000, which represents an increase of $1,430,000, or 23.2%, from general and administrative expenses for the six months ended September 30, 2009 of $6,165,000. This increase in general and administrative expenses during the six months ended September 30, 2010 was primarily due to a loss of $332,000 recorded due to the changes in the fair value of forward foreign currency exchange contracts, compared to a gain of $1,103,000 during the six months ended September 30, 2009.

Sales and Marketing. Our sales and marketing expenses for the six months ended September 30, 2010 increased $134,000, or 4.8%, to $2,941,000 from $2,807,000 for the six months ended September 30, 2009. This increase was due primarily to (i) the addition of employees as a result of our acquisition in the prior year and (ii) increased travel

expenses. These increases were partly offset by (i) reversal of commission expenses in connection with our prior year acquisition as certain thresholds were not met and (ii) decreased catalog expenses.

Research and Development. Our research and development expenses increased by $94,000, or 14.1%, to $762,000 for the six months ended September 30, 2010 from $668,000 for the six months ended September 30, 2009. The

increase in research and development expenses was due primarily to employee-related expenses and an increase in the cost of supplies compared to the six months ended September 30, 2009.

Gain on Acquisition. During the six months ended September 30, 2009, we recorded a gain of $1,331,000 in connection with our August 2009 acquisition as the estimated fair value of the net assets acquired exceeded the fair value of the consideration transferred.

Interest Expense, Net. Our interest expense, net of interest income of $23,000, for the six months ended September 30, 2010 was $3,303,000. This represents an increase of $1,333,000, or 67.7%, over interest expense of $1,970,000 for the six months ended September 30, 2009. This increase was primarily attributable to a higher balance of receivables being discounted under the receivable discount programs during the six months ended September 30, 2010 as compared to the six months ended September 30, 2009. This increase in net interest expense was partly offset by a decrease in interest expense incurred on our Revolving Loan and capital lease obligations.

Income Tax. For the six months ended September 30, 2010, we recognized income tax expense of $3,605,000 compared to an income tax expense of $3,078,000 recognized for the six months ended September 30, 2009. Our effective tax rate for the six months ended September 30, 2010 and 2009 was 37.5% and 39.9%, respectively. The lower effective tax rate for the six months ended September 30, 2010 reflects a reduction in the liability for unrecognized tax benefits due to the conclusion of an IRS examination of the federal tax returns for fiscal years ended March 31, 2007 and March 31, 2008. We were notified during May 2010 that the IRS required no changes to our tax returns for those fiscal years as filed.

Liquidity and Capital Resources

Overview

At September 30, 2010, we had working capital of $1,337,000, a ratio of current assets to current liabilities of 1:1, and cash of $5,815,000, compared to working capital of $3,399,000, a ratio of current assets to current liabilities of 1.1:1, and cash of $1,210,000 at March 31, 2010. The decrease in working capital from March 31, 2010 primarily resulted from a decrease in our non-core inventory levels, which was due primarily to higher sales, and a decrease in our accounts receivable balance due primarily to a higher balance of receivables being discounted under the receivable discount programs, which allowed us to pay down our accounts payable balances.

During the six months ended September 30, 2010, we used cash generated by operations and from our use of receivable discount programs with certain of our major customers as our primary sources of liquidity. These sources were primarily used to make the quarterly principal payment on the Term Loan and pay the purchase price holdback in connection with our May 2008 acquisition. In addition, in August 2010, we made a secured loan of $1,894,000 to Fenwick.

We believe our cash generated by operations, amounts available under our Revolving Loan, and our cash and short term investments on hand are sufficient to satisfy our expected future working capital needs, capital lease commitments, repayment of the current portion of our Term Loan, and capital expenditure obligations over the next twelve months.

Cash Flows

Net cash provided by operating activities was $9,080,000 and $2,725,000 for the six months ended September 30, 2010 and 2009, respectively. The most significant changes in operating activities for the six months ended September 30, 2010 compared to the six months ended September 30, 2009 were (i) a higher balance of receivables being discounted under the receivable discount programs we have with certain of our major customers and (ii) a decrease in our non-core inventory levels due primarily to higher sales. These changes in operating activities were partly offset by (i) an increase in our long-term core inventory levels and (ii) a decrease in our accounts payable balances. During the six months ended September 30, 2010, the increase in long-term core inventory was primarily due to increase in our Used Cores held in our facilities and increase in Remanufactured Cores held for sale at our customers locations.

Net cash used in investing activities was $2,712,000 and $2,936,000 during the six months ended September 30, 2010 and 2009, respectively. The decrease in net cash used in investing activities primarily resulted from the payment of the purchase price holdback of $464,000 in connection with our May 2008 acquisition compared to the payment of $2,489,000 during the six months ended September 30, 2009 for our acquisitions. This decrease in net cash used in investing activities was partly offset by the secured loan made to Fenwick in August 2010. Capital expenditures for the six months ended September 30, 2010 primarily related to the purchase of equipment for our manufacturing facilities and improvements to our California facility compared to purchases in the same period of the prior year primarily related to purchases of equipment for our manufacturing facilities.

Net cash used in financing activities was $1,780,000 during the six months ended September 30, 2010 compared to net cash provided by financing activities of $1,373,000 during the six months ended September 30, 2009. This change was primarily due to repayments of our Term Loan during the six months ended September 30, 2010 compared to borrowings under our previous revolving loan during the six months ended September 30, 2009. Additionally, during the six months ended September 30, 2010, we repurchased 14,400 shares at a total cost of $89,000 pursuant to a share repurchase program authorized by our Board of Directors in March 2010.

Capital Resources

Debt

In October 2009, we entered into a revolving credit and term loan agreement (the Credit Agreement) with our bank and one additional lender (the Lenders), which permits us to borrow up to $45,000,000 (the Credit Facility). The Credit Facility is comprised of (i) a revolving facility with a $7,000,000 letter of credit sub-facility and (ii) a term loan. We may borrow on a revolving basis up to an amount equal to $35,000,000 minus all outstanding letter of credit obligations minus a borrowing reserve of $7,500,000 (the Revolving Loan). The borrowing reserve remains in effect only if we are party to a receivable discount program pursuant to which our accounts receivable owed to us by our largest customer are being discounted. The term loan is in the principal amount of $10,000,000 (the Term Loan).

The Credit Agreement, among other things, requires us to maintain certain financial covenants, including tangible net worth, fixed charge coverage ratio and leverage ratio covenants. We were in compliance with all financial covenants under the Credit Agreement as of September 30, 2010.

The Term Loan matures in October 2014 and requires principal payments of $500,000 on a quarterly basis. The Revolving Loan expires in October 2011 and provides us the option to request up to three one-year extensions.

In May 2010, we entered into a first amendment to the Credit Agreement with our Lenders. This amendment provides, among other things, that the borrowing reserve against our Revolving Loan commitment amount be increased from $7,500,000 to $10,000,000.

In November 2010, we entered into a second amendment to the Credit Agreement with our Lenders. This amendment, among other things, (i) extended the expiration date of the Revolving Loan to October 2012 and (ii) lowered the applicable margins on our borrowings to the levels described below.

The Lenders hold a security interest in substantially all of our assets. There was no outstanding balance on the Revolving Loan at September 30, 2010 and March 31, 2010. Additionally, we had reserved $1,826,000 of the Revolving Loan for standby letters of credit for workers compensation insurance and $1,808,000 for commercial letters of credit as of September 30, 2010. As of September 30, 2010, $31,366,000 was available under the Revolving Loan, and of this, $10,000,000 was reserved for use in the event our largest customer discontinued its current practice of having our receivables discounted.

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The Revolving Loan and the Term Loan bear interest at either our bank s reference rate plus an applicable margin or a London Interbank Offered Rate (LIBOR) rate (which in the case of the Term Loan shall not be lower than 3.75%) plus an applicable margin, as selected by us in accordance with the Credit Agreement. The reference rate is, as further described in the Credit Agreement, the higher of our bank s announced base rate and the Federal funds rate plus 1/2 percent. The applicable margins are determined quarterly on a prospective basis as set forth below:

Leverage Ratio	Applicable LIBOR Margin	Applicable Reference Rate Margin
Less than 1.0:1.0	250 basis points	125 basis points
Greater than or equal to 1.0:1.0, but less than 1.5:1.0	275 basis points	150 basis points
Greater than or equal to 1.5:1.0	300 basis points	175 basis points

Our ability to comply in future periods with the financial covenants in the Credit Agreement, will depend on our ongoing financial and operating performance, which, in turn, will be subject to economic conditions and to financial, business and other factors, many of which are beyond our control and will be substantially dependent on the selling prices and demand for our products, customer demands for marketing allowances and other concessions, raw material costs, and our ability to successfully implement our overall business strategy, including acquisitions. If a violation of any of the covenants occurs in the future, we would attempt to obtain a waiver or an amendment from our Lenders. No assurance can be given that we would be successful in this regard.

Receivable Discount Programs

Our liquidity has been positively impacted by receivable discount programs we have established with certain customers and their respective banks. Under these programs, we have the option to sell those customers receivables to those banks at a discount to be agreed upon at the time the receivables are sold. The weighted average discount under this program was 4.5% during the six months ended September 30, 2010 and has allowed us to accelerate collection of receivables aggregating $70,950,000 by a weighted average of 325 days. While these arrangements have reduced our working capital needs, there can be no assurance that these programs will continue in the future. These programs resulted in interest expense of $2,855,000 during the six months ended September 30, 2010. Interest expense resulting from these programs would increase if interest rates rise, if utilization of these discounting arrangements expands or if the discount period is extended to reflect more favorable payment terms to customers.

Off-Balance Sheet Arrangements

At September 30, 2010, we had no off-balance sheet financing or other arrangements with unconsolidated entities or financial partnerships (such as entities often referred to as structured finance or special purpose entities) established for purposes of facilitating off-balance sheet financing or other debt arrangements or for other contractually narrow or limited purposes.

Capital Expenditures and Commitments

Capital Expenditures

Our capital expenditures were $540,000 for the six months ended September 30, 2010 and primarily related to the purchase of equipment for our manufacturing facilities and improvements for our California facility. We expect our fiscal year 2011 capital expenditures to be approximately $2.0 million. We expect to use our working capital and incur additional capital lease obligations to finance these capital expenditures.

Related Party Transactions

Our related party transactions primarily consist of employment and director agreements and stock option agreements. Our related party transactions have not changed since March 31, 2010.

Critical Accounting Policies

There have been no material changes to our critical accounting policies and estimates that are presented in the

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Company s Annual Report on Form 10-K for the year ended March 31, 2010, which was filed on June 14, 2010, except as discussed below.

New Accounting Pronouncements

Transfers of Financial Assets

In June 2009, the Financial Accounting Standards Board (the FASB) issued new guidance on the treatment of transfers of financial assets which eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures in order to enhance information reported to users of financial statements by providing greater transparency about transfers of financial assets, including securitization transactions, and an entity s continuing involvement in and exposure to the risks related to transferred financial assets. This new guidance is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2009. The adoption of this guidance on April 1, 2010 did not have any impact on our consolidated financial position and results of operations.

Consolidation of Variable Interest Entities

In June 2009, the FASB issued new guidance which amends the consolidation guidance applicable to variable interest entities and is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2009. The adoption of this guidance on April 1, 2010 did not have any impact on our consolidated financial position and results of operations.

Fair Value Measurements and Disclosures

In January 2010, the FASB issued an update which requires new disclosures for transfers in and out of Level 1 and Level 2 of the fair value hierarchy and expanded disclosures for activity in Level 3 of the fair value hierarchy. The update also clarifies existing disclosures regarding the level of disaggregation for disclosure and disclosures about inputs and valuation techniques. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009. The adoption of this update on January 1, 2010 did not have any impact on our consolidated financial position and results of operations. The disclosures regarding certain Level 3 activity are effective for fiscal years beginning after December 15, 2010. We do not expect the adoption of this guidance on April 1, 2011 to have any material impact on our consolidated financial position and results of operations.

Disclosure Requirements Related to Financing Receivables

In July 2010, the FASB issued an update which requires enhanced disclosures about the credit quality of financing receivables and the related allowance for credit losses. Trade accounts receivable with maturities of one year or less are excluded from the disclosure requirements. Disclosures required as of the end of a reporting period are effective for interim and annual periods ending on or after December 15, 2010. We do not expect the adoption of this guidance on December 31, 2010 to have any material impact on our consolidated financial position and results of operations. The disclosures required about activity that occurs during a reporting period are effective for interim and annual periods beginning on or after December 15, 2010. We do not expect the adoption of this guidance on January 1, 2011 to have any material impact on our consolidated financial position and the results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in market risk from the information provided in Item 7A. Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K as of March 31, 2010, which was filed on June 14, 2010.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of management, including our Chief Executive Officer, Chief Financial Officer, and Chief Accounting Officer, we have conducted an evaluation of the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based on this evaluation, our Chief Executive Officer, Chief Financial Officer, and Chief Accounting Officer concluded that the Company s disclosure controls and procedures were effective as of September 30, 2010.

Changes in Internal Control over Financial Reporting

There were no changes in the Company s internal control over financial reporting during the second quarter ended September 30, 2010, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes to the risk factors set forth in Item 1A to Part I of our Annual Report on Form 10-K for the fiscal year ended March 31, 2010, filed on June 14, 2010.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Limitation on Payment of Dividends The Credit Agreement prohibits the declaration or payment of any dividends by us other than dividends payable in our capital stock.

Issuer Purchases of Equity Securities

The following table presents information about our purchases of shares of our common stock during the fiscal quarter ended September 30, 2010:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1)	Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs(1)(2)
July 1 - July 31, 2010	14,400	$ 6.16	14,400	$ 4,911,339
August 1 - August 31, 2010				
September 1 - September 30, 2010				

(1) On March 16, 2010, we announced that our Board of Directors had authorized a share repurchase program of up to $5,000,000 of our outstanding common stock from time to time in the open market and in private transactions at prices deemed appropriate by management. There is no expiration date governing the period over which we can repurchase shares under this program.

(2) Excludes brokerage commissions paid by us.

Item 5. Other Information

On August 18, 2010, our Board of Directors adopted and approved, effective immediately, our Amended and Restated By-Laws (the Amended and Restated By-Laws) that, among other things, (i) added advance notice

provisions, (ii) conformed the language of the by-laws to certain aspects of New York law and (iii) clarified and modernized certain other by-law provisions.

The advance notice provisions in the Amended and Restated By-Laws, among other things:

- require shareholders to provide advance notice of shareholder proposals or nominations (other than Rule 14a-8 proposals or nominations) sought to be made at an annual meeting not less than 90 days nor more than 120 days prior to first anniversary of the preceding year s annual meeting, subject to specified conditions;

- require disclosure of material interests of shareholders making proposals or nominations or acting by written consent including, among other things, ownership interests, derivative positions, voting arrangements, hedged positions and other economic and voting interests, as well as any other agreements and arrangements between the shareholder making the proposal or nomination and any other persons regarding the proposal or nomination;

- require disclosure of certain information regarding any proposed director nominees including, among other things, all material interests of the proposed director nominees and any material relationships between the shareholder proponents and their affiliates on the one hand, and the proposed director nominees and their affiliates, on the other hand;

- require a reasonably detailed description of all agreements, arrangements and understandings between any shareholder proponents or between any shareholder proponent and any other person or entity in connection with any proposed business;

- require these disclosures to be updated and supplemented so as to be accurate as of the record date for a meeting and as of 10 business days prior to the meeting, or, for actions by written consent 5 business days prior to the date that the consent solicitation is commenced; and

- clarify that the requirements in the Amended and Restated By-Laws do not apply to shareholder proposals made pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, as amended (which provides certain different procedural requirements).

The foregoing summary of the Amended and Restated By-Laws does not purport to be complete and is qualified in its entirety by reference to the full text of the Amended and Restated By-Laws, a copy of which is attached as Exhibit 3.6 hereto and incorporated herein by reference.

On November 3, 2010, we entered into a Second Amendment to our Credit Agreement (the Second Amendment) with Union Bank, N.A. and Branch Banking & Trust Company. The Second Amendment, among other things, (i) extended the term of the Credit Agreement from October 28, 2011 to October 29, 2012 and (ii) lowered the applicable margins used to determine the interest rates under our Revolving Loan and Term Loan so that they are determined as set forth below:

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Leverage Ratio	Applicable LIBOR Margin	Applicable Reference Rate Margin
Less than 1.0:1.0	250 basis points	125 basis points
Greater than or equal to 1.0:1.0, but less than 1.5:1.0	275 basis points	150 basis points
Greater than or equal to 1.5:1.0	300 basis points	175 basis points

The foregoing summary of the Second Amendment does not purport to be complete and is qualified in its entirety by the terms of the Second Amendment, which is attached as Exhibit 10.4 hereto and incorporated herein by reference.

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Item 6. Exhibits

(a) Exhibits:

Number	Description of Exhibit	Method of Filing
3.1	Certificate of Incorporation of the Company	Incorporated by reference to Exhibit 3.1 to the Company s Registration Statement on Form SB-2 declared effective on March 22, 1994 (the 1994 Registration Statement).
3.2	Amendment to Certificate of Incorporation of the Company	Incorporated by reference to Exhibit 3.2 to the Company s Registration Statement on Form S-1 (No. 33-97498) declared effective on November 14, 1995.

		71,901	(748)	105,451	
Common stock issued for conversion of stock options net of 477 shares returned as payment	4,722	133	--	--	133
Dividends paid, $0.16 per share	--	--	(616)	--	(616)
Stock-based compensation	--	990	--	--	990
Foreign currency translation	--	--	--	(49)	(49)
Net income	--	--	994	--	994
September 30, 2018	3,852,747	35,421	72,279	(797)	106,903
Common stock issued to employees	6,580	412	--	--	412

under compensation plans, net of 485 shares returned as payment					
Dividends paid, $0.16 per share	--	--	(617)	--	(617)
Stock-based compensation	--	695	--	--	695
Foreign currency translation	--	--	--	(658)	(658)
Net income	--	--	858	--	858
December 31, 2018	3,859,327	$36,528	$72,520	$(1,455)	$107,593

*Accumulated Other Comprehensive Income (Loss).

See accompanying notes to condensed consolidated financial statements.

Mesa Laboratories, Inc.

Condensed Consolidated Statements of Stockholders’ Equity

(unaudited)

(in thousands, except per share data)

	Common Stock Number of Shares	**Amount**	**Retained Earnings**	**AOCI***	**Total**
March 31, 2017	3,734,704	$25,925	$73,656	$(1,760)	$97,821
Common stock issued for conversion of stock options net of 3,795 shares returned as payment	23,471	963	--	--	963
Dividends paid, $0.16 per share	--	--	(601)	--	(601)
Stock-based compensation	--	540	--	--	540
Foreign Currency Translation	--	--	--	751	751
Net income	--	--	1,517	--	1,517
June 30, 2017	3,758,175	27,428	74,572	(1,009)	100,991
Common stock issued for conversion of stock options net of 1,541 shares returned as payment	21,542	1,101	--	--	1,101
Dividends paid, $0.16 per share	--	--	(600)	--	(600)
Stock-based compensation	--	445	--	--	445
Foreign Currency Translation	--	--	--	948	948
Net income	--	--	2,353	--	2,353
September 30, 2017	3,779,717	28,974	76,325	(61)	105,238
Common stock issued to employees under compensation plans, net of 304 shares returned as payment	2,089	282	--	--	282
Dividends paid, $0.16 per share	--	--	(606)	--	(606)
Stock-based compensation	--	438	--	--	438
Foreign Currency Translation	--	--	--	181	181
Net income	--	--	(11,086)	--	(11,086)
December 31, 2017	3,781,806	$29,694	$64,633	$120	$94,447

*Accumulated Other Comprehensive Income (Loss).

See accompanying notes to condensed consolidated financial statements.

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Mesa Laboratories, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

(dollar amounts in thousands, unless otherwise specified)

Note 1. Description of Business and Summary of Significant Accounting Policies

Description of Business

In this quarterly report on Form 10-Q, Mesa Laboratories, Inc., a Colorado corporation, together with its subsidiaries is collectively referred to as "we," "us," "our," the "Company" or "Mesa."

We pursue a strategy of focusing primarily on quality control products and services which are sold into niche markets that are driven by regulatory requirements. We prefer markets in which we can establish a strong presence and achieve high gross margins. We are organized into four divisions across nine physical locations. Our Sterilization and Disinfection Control Division manufactures and sells biological, cleaning, and chemical indicators. Biological, cleaning, and chemical indicators are used to assess the effectiveness of sterilization and disinfection processes in the hospital, dental, medical device, and pharmaceutical industries. The division also provides testing and laboratory services, mainly to the dental industry. Our Instruments Division designs, manufactures, and markets quality control instruments and disposable products utilized in the healthcare, pharmaceutical, food and beverage, medical device, industrial hygiene, and environmental air sampling industries. Our Cold Chain Monitoring Division designs, develops, and markets systems which are used to monitor various environmental parameters such as temperature, humidity, and differential pressure to ensure that critical storage and processing conditions are maintained in hospitals, pharmaceutical and medical device manufacturers, blood banks, pharmacies, and laboratory environments. Our Cold Chain Packaging Division provides packaging development consulting services and thermal packaging products such as coolers, boxes, insulation materials, and phase-change products to control temperature during the customer's transport of their own products.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, such unaudited information includes all adjustments, consisting of normal recurring adjustments necessary for a fair presentation of our financial position and results of operations. The results of operations for the interim periods are not necessarily indicative of results that may be achieved for the entire year. The financial statements and related notes do not include all information and footnotes required by U.S. GAAP for annual reports. This quarterly report should be read in conjunction with the consolidated financial statements included in our annual report on Form 10-K for the year ended March 31, 2018.

Fair Value Measurements

As of December 31, 2018 and March 31, 2018, our financial instruments were categorized as Level 1 (inputs are quoted prices in active markets) and include cash, accounts receivable, accounts payable, accrued liabilities and short-term and long-term debt. With the exception of long-term debt, the carrying value of these financial instruments is considered to be representative of their fair value due to the short maturity of these instruments. Our debt has a variable interest rate, so the carrying amount approximates fair value because interest rates on these instruments approximate the interest rate on debt with similar terms available to us.

Acquisitions

During the three months ended December 31, 2018, we completed the purchase of Point Six Wireless, LLC. We made an initial allocation of the purchase price at the date of acquisition based on our understanding of the fair value of acquired assets and assumed liabilities. We obtained the information to make the allocation during due diligence and through the use of other information available to us. In the months after closing, we will obtain additional information about the assets and liabilities acquired, including asset appraisals, and we will refine the estimates of the fair value to more accurately allocate the purchase price.

Recently Issued Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-02, *Leases (Topic 842)*. The pronouncement requires lessees to recognize a liability for lease obligations, which represents the discounted obligation to make future minimum lease payments, and a corresponding right-of-use asset on the balance sheet for all leases with terms greater than 12 months. The guidance also requires qualitative and quantitative disclosures designed to present financial statement users with the ability to assess the amount, timing, and uncertainty of cash flows arising from leases. We have initiated our plan for the adoption and implementation of this new accounting standard, including assessing our lease arrangements, evaluating practical expedients, and making necessary changes to our accounting policies, processes, and internal controls over financial reporting. We expect to adopt the standard using the optional transition method, which will allow us to apply the standard as of the effective date, therefore we will not apply changes to comparative periods presented in our financial statements. We are still assessing the expected impact of the standard on our consolidated balance sheets, but it will not significantly impact our consolidated statements of operations and cash flows.

Recently Adopted Accounting Pronouncements

In August 2018, the Securities and Exchange Commission issued Release No. 33-10532 that amends and clarifies certain financial reporting requirements. The principal change to our financial reporting is the inclusion of the annual disclosure requirement of changes in stockholders' equity in Rule 3-04 of Regulation S-X to interim periods. We adopted this new rule beginning the quarter ended December 31, 2018 and have included our Consolidated Statements of Stockholders' Equity with this quarterly filing on Form 10-Q.

During the nine months ended December 31, 2018, we elected to early-adopt ASU 2018-15 *Intangibles – Goodwill and Other Internal-Use Software: Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* ("ASU 2018-15") on a prospective basis. ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs of other internal-use software arrangements. Accordingly, we capitalized $206 of costs incurred during the nine months ended December 31, 2018 to implement a hosted enterprise resource planning system to our European subsidiaries. The related asset is held in prepaid expenses and other on the condensed consolidated balance sheets, and we began amortizing the expense to general and administrative costs on our condensed consolidated statements of operations on a straight-line basis over the contractual term of the arrangement.

Effective April 1, 2018, we adopted ASU 2014-09 *Revenue from Contracts with Customers (Topic 606)* and all related amendments (referred to collectively hereinafter as "ASU 606") to all contracts on a modified retrospective basis. ASU 606 requires an entity to recognize revenue for the transfer of goods or services equal to the amount it expects to be entitled to receive for the goods and services. The adoption did not have a material impact on our condensed

consolidated balance sheets, statements of operations, or cash flows. The primary impact of adoption was the enhancement of disclosures to provide additional clarity regarding how revenue is earned and recognized, and to show revenues at a more disaggregated level, included in Note 2. “Revenue Recognition.”

In March 2018, the FASB issued ASU 2018-05, Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118. We adopted the ASU immediately upon release. The amendments in the update provide guidance on when to record and disclose provisional amounts for certain income tax effects of the Tax Cuts and Jobs Act ("TCJA"). The amendments also require any provisional amounts or subsequent adjustments to be included in net income from continuing operations. Additionally, this ASU discusses required disclosures that an entity must make with regard to the TCJA. As of the three months ended December 31, 2018, we have completed our analysis of the TCJA’s income tax effects. the Refer to Note 8. “Income Taxes” for additional information on the TCJA.

The TCJA created a new requirement that global intangible low taxed income earned by controlled foreign corporations (“CFCs”) must be included currently in the gross income of the CFC’s U.S. shareholder. Under U.S. GAAP, we are allowed to make an accounting policy choice of how GILTI taxes are treated. We have elected to treat taxes due on future U.S. inclusions in taxable income related to GILTI as current period expenses when incurred (“the period cost method”).

Note 2. Revenue Recognition

We design, manufacture, market, sell, and maintain quality control instruments and software, consumables, and services driven primarily by the regulatory requirements of niche markets. Our consumables, such as biological indicator test strips and packaging materials, are typically used on a standalone basis; however, some, such as calibration solutions, are also critical to the ongoing use of our instruments. Hardware and software sales, such as medical meters, wireless sensor systems, and data loggers are generally driven by our acquisition of new customers, growth of existing customers, or customer replacement of existing equipment. Hardware sales may be offered with perpetual or annual software licenses, which in some cases are required for the hardware to function. We generally generate service revenues from three categories: 1) discrete installation of our hardware and software, 2) discrete but recurring calibration and maintenance of our hardware or 3) contracted and recurring testing and maintenance services and software license subscriptions. We evaluate our revenues internally both by product line as well as by timing of revenue generation and nature of goods and services provided. Typically, discrete revenue is recognized at the shipping point or upon completion of the service, while contracted revenue is recognized over a period of time reflective of the performance obligation period in the applicable contract.

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Substantially all of our revenues and related receivables are generated from contracts with customers that are 12 months or less in duration. For both discrete and contracted revenue, evidence of an arrangement is typically in the form of a formal contract and/or purchase order. Prices are fixed at the time of the order and no price protections or variables are offered. Collectability is reasonably assured through our customer credit and review process, and payment is typically due within 60 days or less. Revenue is recognized when performance obligations under the terms of the contracts with our customers are satisfied. We elected to adopt the practical expedient that allows us to expense commission costs as incurred.

Our performance obligations related to the sale of instruments and consumables generally consist of the promise to sell tangible goods to distributors or end users. Ownership of these goods is typically transferred at time of shipment, at which point we have satisfied our performance obligation and we recognize revenue.

Our performance obligations related to services may include testing, installation, and/or maintenance of our products, either on-site at our customers' facilities or in our own calibration laboratories. Performance obligations arise from service contracts when discrete services are contracted in advance and performed at a future time, often at the time of the customer's choosing. In this case, the performance obligation is satisfied, and revenue is recognized, upon the customer's acceptance of the completion of the specified work. Alternatively, service revenue may be recognized for contracted services or maintenance provided continually over a period of time, and our performance obligations are satisfied by completing any service that is contractually required, if applicable, or simply by the passage of time if no services are required or requested. For contracted services, revenue is recognized on a straight-line basis over the life of the service contract, which is a faithful depiction of these annual service contracts, which may or may not be invoked.

The following tables present disaggregated revenues for the three and nine months ended December 31, 2018 and December 31, 2017, respectively:

	Three Months Ended December 31, 2018				
	Sterilization and Disinfection Control	**Instruments**	**Cold Chain Monitoring**	**Cold Chain Packaging**	**Total**
Discrete Revenues					
Consumables	$9,853	$ 834	$ 151	$ 1,868	$12,706
Hardware and Software	110	6,417	1,980	49	8,556
Services	372	2,090	534	135	3,131
Contracted Revenues					
Services	1,210	--	1,079	--	2,289

Total Revenues	$11,545	$ 9,341	$ 3,744	$ 2,052	$26,682

	Three Months Ended December 31, 2017				
	Sterilization and Disinfection Control	Instruments	Cold Chain Monitoring	Cold Chain Packaging	Total
Discrete Revenues					
Consumables	$8,872	$ 754	$ 36	$ 1,345	$11,007
Hardware and Software	280	5,724	1,332	3	7,339
Services	244	1,704	489	244	2,681
Contracted Revenues					
Services	1,234	--	1,410	--	2,644
Total Revenues	$10,630	$ 8,182	$ 3,267	$ 1,592	$23,671

	Nine Months Ended December 31, 2018				
	Sterilization and Disinfection Control	**Instruments**	**Cold Chain Monitoring**	**Cold Chain Packaging**	**Total**
Discrete Revenues					
Consumables	$29,478	$ 2,272	$ 351	$ 5,139	$37,240
Hardware and Software	487	18,039	4,951	105	23,582
Services	884	6,465	1,507	277	9,133
Contracted Revenues					
Services	3,626	--	3,108	--	6,734
Total Revenues	$34,475	$ 26,776	$ 9,917	$ 5,521	$76,689

	Nine Months Ended December 31, 2017				
	Sterilization and Disinfection Control	**Instruments**	**Cold Chain Monitoring**	**Cold Chain Packaging**	**Total**
Discrete Revenues					
Consumables	$25,810	$ 2,314	$ 107	$ 3,861	$32,092
Hardware and Software	647	16,811	3,800	72	21,330
Services	772	5,643	1,283	464	8,162
Contracted Revenues					
Services	3,569	--	4,145	--	7,714
Total Revenues	$30,798	$ 24,768	$ 9,335	$ 4,397	$69,298

Contract Balances

Our contracts have varying payment terms and conditions. Some customers prepay for services, resulting in unearned revenues or customer deposits, called contract liabilities, which are included within other accrued expenses and unearned revenues in the accompanying condensed consolidated balance sheets. Contract assets would exist when sales are recorded (i.e. the control of the goods or services has been transferred to the customer), but customer payment is contingent on a future event besides the passage of time (such as satisfaction of additional performance obligations). We do not have any contract assets. Unbilled receivables, which are not classified as contract assets, represent arrangements in which sales have been recorded prior to billing and right to payment is unconditional.

A summary of contract liabilities is as follows:

Contract liabilities balance as of March 31, 2018	$4,147
Prior year liabilities recognized in revenues during the nine months ended December 31, 2018	(3,504)
Contract liabilities added during the nine months ended December 31, 2018, net of revenues recognized	3,631
Contract liabilities balance as of December 31, 2018	$4,274

Note 3. Impairment Loss on Goodwill and Long-Lived Assets

During the nine months ended December 31, 2018, we performed an impairment analysis on our Cold Chain Packaging reporting segment as the segment's financial results continued to fall short of expectations. Specifically, rising commodity costs used in the segment's principal product have increased over the past nine months, eroding the gross profit margin of the segment. We determined that the long-lived assets and goodwill associated with our Cold Chain Packaging reporting segment were impaired and we recognized non-cash impairment charge of $1,028 on goodwill and $2,641 on long-lived assets, in impairment loss on goodwill and long-lived assets on the accompanying condensed consolidated statements of operations. The remaining goodwill and intangible assets associated with this segment are $300 and $809, respectively as of December 31, 2018. The fair value of the impaired assets was determined using Level 3 inputs (unobservable inputs) based on a discounted cash flow method.

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Note 4. Inventories

Inventories consist of the following:

	December 31, 2018	March 31, 2018
Raw materials	$ 7,485	$ 9,059
Work-in-process	379	380
Finished goods	3,154	3,152
Less: reserve	(3,412)	(3,363)
Inventories, net	$ 7,606	$ 9,228

Note 5. Facility Relocation

In August 2016, we announced that we planned to shut down both our Omaha and Traverse City manufacturing facilities and relocate those operations to the new Bozeman building. The move of those two facilities, along with the current Bozeman operations, began in March 2017 and was completed as of June 30, 2018. The total cost of the relocation was $1,584 (which is comprised primarily of facility moving expenses, retention bonuses for existing personnel and payroll costs for duplicative personnel during the transition period) and these costs pertain to the Sterilization and Disinfection Control Division.

Facility relocation amounts accrued and paid for the nine months ended December 30, 2018 are as follows:

Balance at March 31, 2018	408
Facility Relocation Expense	17
Cash payments	(425)
Balance at December 31, 2018	-

We completed the sale of our old Bozeman facility during the nine months ended December 31, 2018, for $2,222 (net of commissions) resulting in a gain of $288, which is recorded in other (income) expense, net on our condensed consolidated statements of operations.

Note 6. Long-Term Debt

Long-term debt consists of the following:

	December 31, 2018	March 31, 2018
Line of credit (3.813%, as of December 31, 2018)	$ 12,000	$ 28,000
Term loan (3.875% as of December 31, 2018)	17,500	18,625
Less: discount	(287)	(365)
Less: current portion	(2,000)	(1,625)
Long-term portion	$ 27,213	$ 44,635

On March 1, 2017, we entered into a five-year agreement (the “Credit Facility”) for an $80,000 revolving line of credit (“Line of Credit”), a $20,000 term loan (“Term Loan”) and up to $2,500 of letters of credit with a banking syndicate of four banks. In addition, the Credit Facility provides a post-closing accordion feature which allows for the Company to request to increase the Line of Credit or Term Loan up to an additional $100,000.

Line of Credit and Term Loan indebtedness bears interest at either: (1) LIBOR, as defined in the agreement, plus an applicable margin ranging from 1.50% to 2.50%; or (2) the alternate base rate (“ABR”), which is the greater of JPMorgan’s prime rate or the federal funds effective rate or the overnight bank funding rate plus 0.5%. We elect the interest rate with each borrowing under the line of credit. In addition, there is an unused line fee of 0.15% to 0.35%. Letter of credit fees are based on the applicable LIBOR rate.

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The Credit Facility is secured by all of our assets and requires us to maintain a ratio of funded debt to our trailing four quarters of EBIDTA (the "Leverage Ratio"), as defined in the agreement, of less than 3.0 to 1.0, provided that, we may once during the term of the Credit Facility, in connection with a Permitted Acquisition for which the aggregate consideration paid or to be paid in respect thereof equals or exceeds $20,000, elect to increase the maximum Leverage Ratio permitted hereunder to (i) 3.50 to 1.00 for a period of four consecutive fiscal quarters commencing with the fiscal quarter in which such Permitted Acquisition occurs (the "Initial Holiday Period") and (ii) 3.25 to 1.00 for the period of four consecutive fiscal quarters immediately following the Initial Holiday Period. The Credit Facility also requires us to maintain a minimum fixed charge coverage ratio of less than 1.25 to 1.0. We were in compliance with all debt covenants as of December 31, 2018.

As of December 31, 2018, future contractual maturities of debt are as follows:

For the year ending March 31,	
2019	$500
2020	2,125
2021	2,625
2022	24,250
Total	$29,500

Subsequent to December 2018, we made a $3,000 payment under our line of credit.

Note 7. Stock-Based Compensation

During the nine months ended December 31, 2018, we granted restricted stock units ("RSUs") on 17,458 shares of our common stock to eligible employees. The weighted average grant date fair value of the RSUs was $154.91 per share. The RSUs generally vest in equal installments on the anniversary of the grant date over a period of five years. During the nine months ended December 31, 2018, 2,000 RSUs vested, and 1,445 RSUs were forfeited or cancelled.

During the nine months ended December 31, 2018, we awarded 11,385 performance share units ("PSUs") that are subject to both service and performance conditions to eligible employees. The PSUs had a grant date fair value of $192.99 per share and vest both based on our achievement of specific performance criteria for the three-year period from April 1, 2018 through March 31, 2021, as well as continued service through June 15, 2021. The quantity of shares that will be issued upon vesting will range from 0 percent to 400 percent of the targeted number of shares; if the defined minimum targets are not met, then no shares will vest. During the nine months ended December 31, 2018, 1,050 PSUs were forfeited.

During the nine months ended December 31, 2018, we granted non-qualified stock options ("NQSOs") on 25,544 shares of common stock to eligible employees. The weighted-average grant date fair value of the NQSOs was $53.93 per share with a weighted average exercise price of $144.65 per share based on the closing price of the common stock on the date of grant. The NQSOs generally vest in equal installments on the anniversary of the grant date over a period of five years.

Amounts recognized in the condensed consolidated financial statements related to stock-based compensation are as follows:

	Three Months Ended December 31,		**Nine Months Ended December 31,**	
	2018	**2017**	**2018**	**2017**
Stock-based compensation expense	$695	$438	$2,424	$1,423
Amount of income tax (benefit) expense recognized in earnings	(160)	99	(1,018)	(893)
Stock-based compensation, net of tax	$535	$537	$1,406	$530
Benefit to earnings per share				
Basic	$0.14	$0.14	$0.37	$0.14
Diluted	0.13	0.14	0.35	0.14

Stock-based compensation expense is included in cost of revenues, selling, general and administrative, and research and development expense in the accompanying condensed consolidated statements of operations.

The following is a summary of stock option and non-vested stock award activity for the nine months ended December 31, 2018 (shares in thousands):

	Stock Options		Non-Vested Stock Awards	
	Number of Shares	Weighted-Average Exercise Price per Share	Number of Shares	Weighted-Average Grant Date Fair Value
Outstanding at March 31, 2018	458	$ 86.38	9	$ 125.68
Awards granted	26	144.65	29	169.94
Awards forfeited or expired	(36)	98.91	(3)	171.51
Awards exercised or vested	(58)	69.75	(2)	163.47
Outstanding as of December 31, 2018	390	$ 91.58	33	$ 128.04
Exercisable at December 31, 2018	151			

We issue shares in connection with stock-based compensation pursuant to the Mesa Laboratories, Inc. 2014 Equity Plan (the “2014 Equity Plan”). For the purposes of counting the shares remaining as available under the 2014 Incentive Plan, each share issuable pursuant to outstanding full value awards, such as RSUs and PSUs, counts as five shares issued, whereas each share underlying a stock option counts as one share issued. Under the 2014 Equity Plan, 1,100,000 shares of common stock have been authorized and reserved for eligible participants, of which 611,504 shares were available for future grants as of December 31, 2018.

Note 8. Income Taxes

For interim income tax reporting, we estimate our annual effective tax rate and apply this effective tax rate to our year-to-date pre-tax income. Each quarter, our estimate of the annual effective tax rate is updated, and if the estimated effective tax rate changes, a cumulative adjustment is made. Additionally, the tax effects of significant unusual or infrequently occurring items are recognized as discrete items in the interim period in which the events occur. The impact of changes in tax laws or rates on deferred tax amounts, impairments of non-deductible goodwill, excess benefits from stock-based compensation, and changes in tax reserves resulting from the finalization of tax audits or reviews are examples of significant unusual or infrequently occurring items that are recognized as discrete items in the interim period in which the event occurs. There is a potential for volatility of the effective tax rate due to several factors, including changes in the mix of the pre-tax income and the jurisdictions to which it relates, changes in tax

laws and foreign tax holidays, settlement with taxing authorities, and foreign currency fluctuations.

On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was enacted in the U.S., making significant changes to U.S. tax law. The TCJA reduces the U.S. federal corporate income tax rate from 34 percent to 21 percent, requires companies to pay a one-time transition tax on certain un-remitted earnings of foreign subsidiaries that were previously tax deferred, generally eliminates U.S. federal income tax on dividends from foreign subsidiaries, creates new taxes on certain foreign-sourced earnings, repeals the Section 199 deduction, and imposes limitations on executive compensation under Section 162(m).

We have completed our analysis of the TCJA's income tax effects. In total, the TCJA resulted in a net tax expense of $43. The final effect of the TCJA's one-time transition tax was a tax liability of $322. During the nine months ended December 31, 2018, we re-measured the applicable deferred tax assets and liabilities based on the rates at which they are expected to reverse. The amount recorded related to the re-measurement of our deferred tax balance was a benefit of $279.

Our effective income tax rate was 9.5 percent and (5.3) percent for the three months ended December 31, 2018 and December 31, 2017, respectively; and 8.6 percent and (18.0) percent for the nine months ended December 31, 2018 and December 31, 2017, respectively. The effective tax rate for the three and nine months ended December 31, 2018 differed from the statutory federal rate of 21 percent primarily due to the impact of the state income taxes, share-based payment awards for employees, and the foreign rate differential.

Since we are subject to audit by various taxing authorities, it is reasonably possible that the amount of unrecognized tax benefits will change during the next 12 months. However, we do not expect the change, if any, to have a material effect on our financial condition or results of operations within the next 12 months.

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Note 9. Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding during the reporting period. Diluted earnings per share (“diluted EPS”) is computed similarly to basic earnings per share, except that it includes the potential dilution that could occur if dilutive securities were exercised. Potentially dilutive securities include common shares related to stock options and non-vested stock awards (collectively “stock awards”). Stock awards are excluded from the calculation of diluted EPS in the event that they are subject to performance conditions or are antidilutive.

The following table presents a reconciliation of the denominators used in the computation of basic and diluted earnings per share (shares in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2018	**2017**	**2018**	**2017**
Net income (loss) available for shareholders	$858	$(11,086)	$6,082	$(7,216)
Weighted average outstanding shares of common stock	3,855	3,781	3,840	3,765
Dilutive effect of stock options	180	--	182	--
Dilutive effect of non-vested shares	10	--	15	--
Fully diluted shares	4,045	3,781	4,037	3,765
Basic	$0.22	$(2.93)	$1.58	$(1.92)
Diluted	$0.21	$(2.93)	$1.51	$(1.92)

The following stock awards were excluded from the calculation of diluted EPS:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2018	**2017**	**2018**	**2017**
Stock awards that were anti-dilutive	1	501	23	501
Stock awards subject to performance conditions	10	-	9	-
Total stock awards excluded from diluted EPS	11	501	32	501

Note 10. Commitments and Contingencies

In February 2018, Dr. James L. Orrington II filed a purported civil class action in the United States District Court for the Northern District of Illinois, Eastern Division, alleging that we sent unsolicited advertisements to telephone facsimile machines. The complaint includes counts alleging violations of the Telephone Consumer Protection Act (“TCPA”), the Illinois Consumer Fraud Act, Conversion, Nuisance, and Trespass to ChattelsThe plaintiff seeks monetary damages, injunctive relief, and attorneys’ fees. Additionally, in June 2018, Rowan Family Dentistry, Inc. filed a purported class action complaint in the United States District Court for the District of Colorado making substantially the same claims as Dr. James L. Orrington II and seeking substantially the same relief. During the nine months ended December 31, 2018, we recorded an expense of $3,300 as an estimate of our potential loss associated with the matter. The expense is recorded as estimated legal settlement on our condensed consolidated statements of operations and a corresponding liability is included as estimated legal liability on our condensed consolidated balance sheets. In January 2019, we received preliminary court approval of a class action settlement with Dr. James L. Orrington II in the amount of $3,300. We will continue to vigorously defend the aforementioned cases and while we believe that the liability recorded as of December 31, 2018 approximates the amount that we will ultimately pay, it is possible that we will be subject to liabilities greater or less than the current amount accrued.

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Note 11. Segment Information

We have four reporting segments: Sterilization and Disinfection Control, Instruments, Cold Chain Monitoring, and Cold Chain Packaging. The following tables set forth our segment information:

	Three Months Ended December 31, 2018				
	Sterilization and Disinfection Control	Instruments	Cold Chain Monitoring	Cold Chain Packaging	Total
Revenues [1]	$11,545	$ 9,341	$ 3,744	$ 2,052	$26,682
Gross profit	$7,876	$ 5,922	$ 1,575	$ 261	$15,634
Reconciling items [2]					(14,686)
Earnings before income taxes					$948

	Three Months Ended December 31, 2017				
	Sterilization and Disinfection Control	Instruments	Cold Chain Monitoring	Cold Chain Packaging	Total
Revenues [1]	$10,630	$ 8,182	$ 3,267	$ 1,592	$23,671
Gross profit	$7,134	$ 5,150	$ (43)	$ 440	$12,681
Reconciling items [2]					(23,207)
Earnings before income taxes					$(10,526)

	Nine Months Ended December 31, 2018				
	Sterilization and Disinfection Control	Instruments	Cold Chain Monitoring	Cold Chain Packaging	Total

Revenues [1]	$34,475	$ 26,776	$ 9,917	$ 5,521	$76,689
Gross profit	$23,660	$ 16,909	$ 4,203	$ 530	$45,302
Reconciling items [2]					(38,648)
Earnings before income taxes					$6,654

	Nine Months Ended December 31, 2017				
	Sterilization and Disinfection Control	Instruments	Cold Chain Monitoring	Cold Chain Packaging	Total
Revenues [1]	$30,798	$ 24,768	$ 9,335	$ 4,397	$69,298
Gross profit	$20,676	$ 15,021	$ 2,044	$ 844	$38,585
Reconciling items [2]					(44,702)
Earnings before income taxes					$(6,117)

(1) Intersegment revenues are not significant and are eliminated to arrive at consolidated totals.
(2) Reconciling items include selling, general and administrative, research and development, impairment loss on goodwill and long-lived assets, estimated legal settlement, and other expenses

	December 31, 2018	March 31, 2018
Total assets		
Sterilization and Disinfection Control	$76,983	$83,452
Instruments	29,332	33,479
Cold Chain Monitoring	34,749	30,796
Cold Chain Packaging	2,722	7,091
Corporate and administrative	14,374	9,283
Total	$158,160	$164,101

As of December 31, 2018, all long-lived assets are located in the United States except for $5,952, $2,471 and $15,130 which are associated with our French, Canadian, and German subsidiaries, respectively.

Revenues from external customers are attributed to individual countries based upon locations to which the product is shipped or exported, as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2018	2017	2018	2017
United States	$17,003	$14,221	$49,167	$41,664
Foreign	9,679	9,450	27,522	27,634
Total	$26,682	$23,671	$76,689	$69,298

No foreign country exceeds 10 percent of total revenues.

Note 12. Subsequent Event

In January 2018, we announced that our Board of Directors declared a quarterly cash dividend of $0.16 per share of common stock, payable on March 15, 2019, to shareholders of record at the close of business on February 28, 2019.

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

Forward Looking Statements

This report contains information that may constitute "forward-looking statements." Generally, the words "will," "estimate," "believe," "expect," "anticipate," "intend," "project," and similar expressions identify forward-looking statements, which generally are not historical in nature. However, the absence of these words or similar expressions does not mean that a statement is not forward-looking. All statements that address operating performance, events, or developments that we expect or anticipate will occur in the future — including statements relating to revenues growth and statements expressing general views about future operating results — are forward-looking statements. Management believes that these forward-looking statements are reasonable as and when made. However, caution should be taken not to place undue reliance on any such forward-looking statements because such statements speak only as of the date when made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise, except as required by law. In addition, forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and our present expectations or projections. These risks and uncertainties include, but are not limited to those described in Part II, "Item 1A. Risk Factors" and elsewhere in this report and in our Annual Report on Form 10-K for the year ended March 31, 2018, and those described from time to time in our subsequent reports filed with the Securities and Exchange Commission.

General Discussion

We pursue a strategy of focusing primarily on quality control products and services, which are sold into niche markets that are driven by regulatory requirements. We prefer markets in which we can establish a strong presence and achieve high gross margins. We are organized into four divisions across nine physical locations. Our Sterilization and Disinfection Control Division ("SDC" Division) manufactures and sells biological, cleaning, and chemical indicators. Biological, cleaning, and chemical indicators are used to assess the effectiveness of sterilization and disinfection processes in the hospital, dental, medical device, and pharmaceutical industries. The division also provides testing and laboratory services, mainly to the dental industry. Our Instruments Division designs, manufactures, and markets quality control instruments and disposable products utilized in the healthcare, pharmaceutical, food and beverage, medical device, industrial hygiene, and environmental air sampling industries. Our Cold Chain Monitoring Division designs, develops, and markets systems which are used to monitor various environmental parameters such as temperature, humidity, and differential pressure to ensure that critical storage and processing conditions are maintained in hospitals, pharmaceutical and medical device manufacturers, blood banks, pharmacies, and laboratory environments. Our Cold Chain Packaging Division provides packaging development consulting services and thermal packaging products such as coolers, boxes, insulation materials, and phase-change products to control temperature during the customer's transport of their own products.

Our revenues come from three main sources – hardware and software, consumables, and services. Product sales (hardware, software, and consumables) are dependent on several factors, including general economic conditions, both domestic and international, customer capital spending trends, competition, introduction of new products and acquisitions. Sterilization and disinfection control products and most products in our Cold Chain Packaging Division are disposable and are used on a routine basis, thus product sales are less sensitive to general economic conditions. Instrument products and cold chain monitoring products and systems have a longer life, and their purchase by our customers is somewhat discretionary, so sales are more sensitive to general economic conditions. Cold chain monitoring and instruments products may be sold in conjunction with a perpetual or subscription-based software license, which may be required for the related hardware to function. Service demand is driven by our customers' quality control and regulatory environments, which require periodic repair and recalibration or certification of our instrument products and cold chain monitoring systems. We typically evaluate costs and pricing annually. Our policy is to price our products competitively and, where possible, we pass along cost increases in order to maintain our margins.

Gross profit is affected by our product mix, manufacturing efficiencies, and price competition. Historically, as we have integrated our acquisitions and taken advantage of manufacturing efficiencies, our gross margin percentages for some products have improved. There are, however, differences in gross margin percentages between product lines, and ultimately the mix of sales will continue to impact our overall gross margin.

During the nine months ended December 31, 2018, we completed a business combination (the "Point Six Wireless Acquisition") whereby we acquired substantially all of the assets (other than current assets) and certain liabilities of Point Six Wireless, LLC's continuous monitoring business.

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General Trends

Our strategic objectives include growth both organically and through further acquisitions. During the nine months ended December 31, 2018, we continued to build our infrastructure to prepare for future growth, including completing the relocation and sale of the old Bozeman manufacturing facility, moving those operations into the new Bozeman building, the addition of key personnel to our operations, sales and marketing, and research and development teams, and the continued rollout of phase three of our ERP implementation project (European operations), which was completed as of December 31, 2018.

The markets for sterilization and disinfection control products remain strong, as the disposable nature of these products makes them less sensitive to general economic conditions. The worldwide market for sterilization and disinfection control products is growing as more countries focus on verifying the effectiveness of sterilization and disinfection processes.

Demand for our instruments products and cold chain services and monitoring systems remains solid and we strive to continue to grow revenues going forward. In general, our instruments products and cold chain monitoring systems are more impacted by general economic conditions than our sterilization and disinfection control and cold chain packaging products. As a result, uncertainty about global economic conditions may cause businesses to postpone spending in response to tighter credit, unemployment, negative financial news and/or declines in income or asset values. Worldwide and regional economic conditions could also reduce the demand for our products and services, as our customers reduce or delay capital equipment and other types of purchases.

We are working on several research and development projects that, if completed, may result in enhanced or new products for both existing customers and new markets. We are hopeful that we will have enhanced or new products and services available for sale in the coming year.

Overall revenues increased 13 percent and 11 percent for the three and nine months ended December 31, 2018. Organic revenues growth by reporting segment was as follows:

	Three Months Ended December 31, 2018		**Nine Months Ended December 31, 2018**	
Sterilization and Disinfection Control	6	%	1	%
Instruments	14	%	8	%

Cold Chain Monitoring	14	%	6	%
Cold Chain Packaging	29	%	26	%
Total Company	11	%	6	%

During the three months ended December 31, 2018, we performed a financial analysis of the Cold Chain Packaging Division, which revealed that gross profits for the segment continue to decline, primarily due to rising commodity costs. As a result, we performed an impairment test on the reporting segment, and recognized non-cash impairment charges of $1,028 on goodwill and $2,641 on long-lived assets, in impairment loss on goodwill and long-lived assets on the accompanying condensed consolidated statements of operations.

Results of Operations

(Dollars in thousands)

The following table sets forth, for the periods indicated, condensed consolidated statements of operations data. The table and the discussion below should be read in conjunction with the accompanying condensed consolidated financial statements and the notes thereto appearing elsewhere in this report:

	Three Months Ended December 31,			**Percent**
	2018	**2017**	**Change**	**Change**
Revenues	$26,682	$23,671	$3,011	13 %
Cost of revenues	11,048	10,990	58	1 %
Gross profit	$15,634	$12,681	$2,953	23 %
Gross profit margin	59 %	54 %	5 %	
Operating expenses:				
Selling	$2,054	$1,942	$112	6 %
General and administrative	7,731	6,256	1,475	24 %
Research and development	860	752	108	14 %
Impairment loss on goodwill and long-lived assets	3,669	13,819	(10,150)	(73 %)
	$14,314	$22,769	$(8,455)	(37 %)
Operating income (loss)	$1,320	$(10,088)	$11,408	113 %
Net income (loss)	$858	$(11,086)	$11,944	108 %
Net income (loss) margin	3 %	(47 %)	50 %	

	Nine Months Ended December 31,			**Percent**
	2018	**2017**	**Change**	**Change**
Revenues	$76,689	$69,298	$7,391	11 %
Cost of revenues	31,387	30,713	674	2 %
Gross profit	$45,302	$38,585	$6,717	17 %
Gross profit margin	59 %	56 %	3 %	

Operating expenses:				
Selling	$5,748	$6,909	$(1,161)	(17 %)
General and administrative	22,824	19,525	3,299	17 %
Research and development	2,539	2,790	(251)	(9 %)
Impairment loss on goodwill and long-lived assets	3,669	13,819	(10,150)	(73 %)
Estimated legal settlement	3,300	--	3,300	N/A
	$38,080	$43,043	$(4,963)	(12 %)
Operating income (loss)	$7,222	$(4,458)	$11,680	262 %
Net income (loss)	$6,082	$(7,216)	$13,298	184 %
Net income (loss) margin	8 %	(10 %)	18 %	

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Revenues

The following tables summarize our revenues by source:

	Three Months Ended December 31,			Percent	
	2018	2017	Change	Change	
Sterilization and Disinfection Control	$11,545	$10,630	$915	9	%
Instruments	9,341	8,182	1,159	14	%
Cold Chain Monitoring	3,744	3,267	477	15	%
Cold Chain Packaging	2,052	1,592	460	29	%
Total	$26,682	$23,671	$3,011	13	%

	Nine Months Ended December 31,			Percent	
	2018	2017	Change	Change	
Sterilization and Disinfection Control	$34,475	$30,798	$3,677	12	%
Instruments	26,776	24,768	2,008	8	%
Cold Chain Monitoring	9,917	9,335	582	6	%
Cold Chain Packaging	5,521	4,397	1,124	26	%
Total	$76,689	$69,298	$7,391	11	%

Three and nine months ended December 31, 2018 versus December 31, 2017

Sterilization and Disinfection Control revenues for the three months ended December 31, 2018 increased nine percent, primarily as a result of six percent organic revenues growth, and to a lesser extent, the acquisition of BAG Health Care GmbH Hygiene Monitoring (“BAG”) during fiscal year 2018. Sterilization and Disinfection Control revenues increased 12 percent for the nine months ended December 31, 2018, primarily as a result of the acquisitions of BAG, SIMICON GmbH, and Hucker & Hucker GmbH during fiscal year 2018.

Instruments revenues for the three and nine months ended December 31, 2018 increased 14 percent and eight percent, respectively, primarily due to the timing of orders and modest price increases. Instrument revenues for the three months ended December 31, 2017 were impacted by a slower than expected adoption of an updated medical product and the discontinuation of its predecessor product. However, the adoption rate of the product has increased over the

past calendar year.

Cold Chain Monitoring revenues increased 15 percent and six percent for the three and nine months ended December 31, 2018, respectively, primarily as a result of organic revenues growth. Revenues in this division fluctuate quarter over quarter due to the timing of performance obligations and the nature and timing of orders and installations within any given quarter.

Cold Chain Packaging revenues increased 29 percent and 26 percent for the three and nine months ended December 31, 2018, respectively, as a result of the normalization in the order rate of the division’s largest customer.

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Gross Profit

The following summarizes our gross profit by segment:

	Three Months Ended December 31,			Percent
	2018	2017	Change	Change
Sterilization and Disinfection Control	$7,876	$7,134	$742	10 %
Gross profit margin	68 %	67 %	1 %	
Instruments	5,922	5,150	772	15 %
Gross profit margin	63 %	63 %	-- %	
Cold Chain Monitoring	1,575	(43)	1,618	3,763 %
Gross profit margin	42 %	(1 %)	43 %	
Cold Chain Packaging	261	440	(179)	(41 %)
Gross profit margin	13 %	28 %	(15 %)	
Total gross profit	$15,634	$12,681	$2,953	23 %
Gross profit margin	59 %	54 %	5 %	

	Nine Months Ended December 31,			Percent
	2018	2017	Change	Change
Sterilization and Disinfection Control	$23,660	$20,676	$2,984	14 %
Gross profit margin	69 %	67 %	2 %	
Instruments	16,909	15,021	1,888	13 %
Gross profit margin	63 %	61 %	2 %	
Cold Chain Monitoring	4,203	2,044	2,159	106 %
Gross profit margin	42 %	22 %	20 %	
Cold Chain Packaging	530	844	(314)	(37 %)
Gross profit margin	10 %	19 %	(9 %)	
Total gross profit	$45,302	$38,585	$6,717	17 %
Gross profit margin	59 %	56 %	3 %	

Three and nine months ended December 31, 2018 versus December 31, 2017

Sterilization and Disinfection Control gross profit margin percentage increased for both the three and nine months ended December 31, 2018 primarily as a result of $150 and $503 of moving expenses related to the Bozeman facility that were incurred during the three and nine months ended December 31, 2017, respectively. Excluding the impact of the moving expenses, gross margin percentage for both periods was essentially flat as compared to the prior year.

Instruments gross margin percentage was flat during the three months ended December 31, 2018, primarily due to product and service mix, offset by volume-based efficiencies associated with an increase in revenues. Instruments gross margin percentage increased during the nine months ended December 31, 2018 due primarily to favorable product and service mix, as well as a $163 increase in inventory reserve recorded in the nine months ended December 31, 2017 as a result of the decision to discontinue the sale of certain instruments products.

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Cold Chain Monitoring gross profit margin percentage increased during the three months ended December 31, 2018 primarily due to $1,700 of inventory reserve expense recorded in the three months ended December 31, 2017; excluding the impact of the reserve in the comparable period, gross margin percentage decreased as a result of timing of orders and unfavorable product mix variations. Cold Chain Monitoring gross profit margin percentage increased during the nine months ended December 31, 2018, primarily due to $1,916 of inventory reserve expense recorded in the nine months ended December 31, 2017. Excluding the impact of the inventory reserve charge in the comparable period, gross profit margin percentage was flat as compared to the nine months ended December 31, 2017.

Cold Chain Packaging gross profit margin decreased during the three and nine months ended December 31, 2018 primarily as a result of significantly higher commodities costs than in previous periods, and to a lesser extent, sales volumes related to a large customer contract containing lower-than-standard contractual pricing. We are currently implementing a commercial initiative to pass some of our increasing commodities costs on to our customers. Even if we are successful with this initiative, we expect that our Cold Chain Packaging gross profit margin percentage will continue to be substantially lower than the historical results of our other segments due to the nature of these products. See *General Trends* for additional discussion.

Operating Expenses

Operating expenses for the three and nine months ended December 31, 2018 decreased in total as compared to the prior year as follows:

Selling

Three and nine months ended December 31, 2018 versus December 31, 2017

Selling expense is driven primarily by labor costs, including salaries and commissions; accordingly, it may vary with sales levels. Selling expense increased six percent for the three months ended December 31, 2018 and decreased 17 percent for the nine months ended December 31, 2018, primarily due to timing of the reduction and replacement of selling personnel. As a percentage of revenues, selling expense was eight percent and seven percent for the three and nine months ended December 31, 2018, respectively, as compared to eight percent and ten percent for the three and nine months ended December 31, 2017, respectively. We plan to continue to strategically reinvest in sales and marketing resources in an effort to further increase organic revenues growth.

General and Administrative

Three and nine months ended December 31, 2018 versus December 31, 2017

Labor costs, including non-cash stock-based compensation, and amortization of intangible assets drive the substantial majority of general and administrative expense. General and administrative expenses increased $1,475 during the three months ended December 31, 2018, due primarily to increased incentive-based compensation as a result of the Company’s financial performance and higher salary expense. General and administrative costs increased $3,299 during the nine months ended December 31, 2018, due primarily to increased incentive-based compensation as a result of the Company’s financial performance and increases in non-cash stock-based compensation expense. We expect to incrementally increase our headcount in the future as we continue to invest in future organic revenues growth.

Research and Development

Three and nine months ended December 31, 2018 versus December 31, 2017

Research and development expense is predominantly comprised of labor costs and third-party consultants. Research and development expenses for the three months ended December 31, 2018 increased 14 percent and for the nine months ended December 31, 2018, decreased nine percent, due to streamlining the necessary engineers, materials, and supplies required to support existing businesses in the prior year. During the three months ended December 31, 2018, we began to make incremental investments in research and development to enhance existing products.

Impairment Loss on Goodwill and Long-Lived Assets

Three and nine months ended December 31, 2018 versus December 31, 2017

During the three and nine months ended December 31, 2018, we recorded impairment expense of $3,669 related to goodwill and long-lived assets associated with our Cold Chain Packaging Division. During the three and nine months ended December 31, 2017, we recorded impairment expense of $13,819 related to goodwill associated with our Cold Chain Packaging Division. See *General Trends* above for additional discussion.

Estimated Legal Settlement

Three and nine months ended December 31, 2018 versus December 31, 2017

During the nine months ended December 31, 2018, we recorded a $3,300 estimated legal settlement expense; see Note 10. “Commitments and Contingencies” within Item 1. *Financial Statements.*

Other Expense

Other expense for the three months ended December 31, 2018 is composed primarily of interest expense associated with our Credit Facility. During the nine months ended December 31, 2018, other expense is composed of interest expense associated with our credit facility, offset by a $288 gain recorded on the sale of our Bozeman facility; see Note 5. “Facility Relocation” within Item 1. *Financial Statements* for more information.

Net Income

Our income tax rate varies based upon many factors but in general, we anticipate that on a go-forward basis, our effective tax rate will be approximately 26 percent, plus or minus the impact of excess tax benefits and deficiencies associated with share-based payment awards to employees; see Note 8. “Income Taxes” within Item 1. *Financial Statements* for additional discussion. The excess tax benefits and deficiencies associated with share-based payment awards to our employees have caused and, in the future, may cause large fluctuations in our realized effective tax rate based on timing, volume, and nature of stock options exercised under our share-based payment program. Net income for the nine months ended December 31, 2018 varied with the changes in revenues, gross profit, and operating expenses (which includes $5,418 and $2,424 of non-cash amortization of intangible assets and stock-based compensation, respectively). Net income for the nine months ended December 31, 2018 was also significantly impacted by a $3,669 impairment loss on goodwill and long-lived assets (see Note 3. “Impairment Loss on Goodwill and Long-Lived Assets” within Item 1. *Financial Statements.*

Liquidity and Capital Resources

Our sources of liquidity include cash generated from operations, working capital, capacity under our Credit Facility, and potential equity and debt offerings. We believe that cash generated from these sources will be sufficient to meet

our short-term and long-term needs. Our more significant uses of resources have historically included long-term capital equipment expenditures, payment of debt obligations, quarterly dividends to shareholders, and acquisitions. Working capital is the amount by which current assets exceed current liabilities. We had working capital of $11,778 and $14,698 at December 31, 2018 and March 31, 2018, respectively.

Given our cash flow projections and unused capacity on our line of credit that is available until March 1, 2022, our liquidity is strong and is expected to meet our ongoing cash and debt service requirements for our general business needs. Interest-bearing debt of $29,500 and $46,625 was outstanding at December 31, 2018 and March 31, 2018, respectively. The Term Loan requires 20 quarterly principal payments, which began on March 31, 2017, in the amount of $250,000 (increasing by $125,000 each year up to $750,000 in the fifth year). The remaining balance of principal and accrued interest are due on March 1, 2022. We were in compliance with all loan agreements at December 31, 2018 and for all prior years presented and have met all debt payment obligations.

Subsequent to December 2018, we made a $3,000 payment under our line of credit.

As of June 30, 2018, our previously-announced move of our Omaha, Traverse City, and old Bozeman manufacturing facilities to our new facility in Bozeman, Montana was complete. We also completed the sale of our old Bozeman facility during the nine months ended December 31, 2018, which resulted in a gain of $288.

We have recorded an estimated litigation accrual of $3,300, which we expect to pay over the next twelve months; see Note 10. “Commitments and Contingencies” within Item 1. *Financial Statements*.

We routinely evaluate opportunities for strategic acquisitions. Future material acquisitions may require that we obtain additional capital, assume third party debt or incur other long-term obligations. We believe that we have the option to utilize both equity and debt instruments as vehicles for the long-term financing of our investment activities and acquisitions. At December 31, 2018, we had $68,000 on unused capacity under our line of credit, subject to covenant restrictions. In addition, in June 2018, the SEC declared effective our Universal Shelf Registration Statement which allows us to sell, in one or more public offerings, common stock or warrants, or any combination of such securities for proceeds in an aggregate amount of up to $300,000. The terms of any offering, including the type of securities involved, would be established at the time of sale.

Dividends

We have paid regular quarterly dividends since 2003. We declared and paid dividends of $0.16 per share for the three months ended June 30, 2018, September 30, 2018, and December 31, 2018 as well as each quarter for the year ending March 31, 2018.

In January 2019, we announced that our Board of Directors declared a quarterly cash dividend of $0.16 per share of common stock, payable on March 15, 2019, to shareholders of record at the close of business on February 28, 2019.

Cash Flows

Our cash flows from operating, investing, and financing activities were as follows (in thousands):

	Nine Months Ended December 31,	
	2018	**2017**
Net cash provided by operating activities	$20,292	$16,078
Net cash used in investing activities	(3,825)	(16,840)
Net cash (used in) provided by financing activities	(16,057)	884

At December 31, 2018, we had contractual obligations for open purchase orders of approximately $3,823 for routine purchases of supplies and inventory, which are payable in less than one year.

Critical Accounting Estimates

Critical accounting estimates are those that we believe are both significant and require us to make difficult, subjective, or complex judgments, often because we need to estimate the effect of inherently uncertain matters. These estimates are based on historical experience and various other factors that we believe to be appropriate under the circumstance. Actual amounts and results could differ from these estimates made by management. Certain accounting policies that require significant management estimates and are deemed critical to our results of operations or financial position are discussed in our Annual Report on Form 10-K for the year ended March 31, 2018 in the Critical Accounting Policies and Estimates section of “Item 7. Management's Discussion and Analysis of Financial Condition and Results of

Operations."

Item 3. ***Quantitative and Qualitative Disclosures about Market Risk***

We have no derivative instruments and minimal exposure to commodity market risks. A portion of our operations consist of activities outside of the U.S. and we have currency risk on the transactions in other currencies and translation adjustments resulting from the conversion of our international financial results into the U.S. dollar. However, a substantial majority of our operations and investment activities are transacted in U.S. dollars and therefore our foreign currency risk is not material at this date.

Item 4. ***Controls and Procedures***

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act") that are designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our internal control over financial reporting as of December 31, 2018 based on the framework in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2013. Based on that evaluation, our management concluded that our internal control over financial reporting was effective at December 31, 2018.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the three months ended December 31, 2018 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

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Part II. Other Information

Item 1. ***Legal Proceedings***

See Note 10. "Commitments and Contingencies" within Item 1. "*Financial Statements.*" for information regarding any legal proceedings in which we may be involved.

Item 1A. ***Risk factors***

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are described in our Annual Report on Form 10-K for the year ended March 31, 2018, under the heading "Part I – Item 1A. Risk Factors." There have been no material changes to those risk factors.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

On November 7, 2005, our Board of Directors adopted a share repurchase plan which allows for the repurchase of up to 300,000 of our common shares, of which 162,486 have been purchased to date. This plan will continue until the maximum is reached or the plan is terminated by further action of the Board of Directors. We have made no repurchases of our common stock in the current or any of the last three fiscal years.

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Item 6. ***Exhibits***

Exhibit No.	Description of Exhibit
3.1	Articles of Incorporation and Amendments to Articles of Incorporation (incorporated by reference from exhibit 3.1 to Mesa Laboratories, Inc.'s report on Form 10-Q filed on July 31, 2018 (Commission File Number: 000-11740))
10.1	Credit agreement dated as of March 1, 2017 between Mesa Laboratories, Inc., JPMorgan Chase Bank, N.A., as administrative agent, and the other lenders referred to therein (incorporated by reference from Exhibit 10.1 to Mesa Laboratories, Inc.'s report on Form 8-K filed on March 2, 2017 (Commission File Number: 000-11740)).
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following financial information from the quarterly report on Form 10-Q of Mesa Laboratories, Inc. for the quarter ended December 31, 2018, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Statements of Operations, (ii) Condensed Consolidated Balance Sheets, (iii) Condensed Consolidated Statements of Comprehensive Income (Loss), (iv) Condensed Consolidated Statements of Cash Flows, (iv) Condensed Consolidated Statements of Stockholders' Equity, and (vi) Notes to the Condensed Consolidated Financial Statements.

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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.

MESA LABORATORIES, INC.

(Registrant)

		/s/ Gary M. Owens.
DATED: February 4, 2019	BY:	Gary M. Owens
		Chief Executive Officer
		/s/ John V. Sakys
DATED: February 4, 2019	BY:	John V. Sakys
		Chief Financial Officer

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