

UNIVERSAL CORP /VA/
Form 10-Q
February 07, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
☒ QUARTERLY REPORT
PURSUANT TO SECTION 13 OR 15
(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD
ENDED DECEMBER 31, 2016

OR

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

_____ TO _____

Commission File Number: 001-00652

UNIVERSAL CORPORATION

(Exact name of registrant as specified in its charter)

Virginia	54-0414210
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

9201 Forest Hill Avenue, Richmond, Virginia	23235
(Address of principal executive offices)	(Zip Code)

804-359-9311
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐

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

As of February 3, 2017, the total number of shares of common stock outstanding was 25,273,449.

UNIVERSAL CORPORATION
FORM 10-Q
TABLE OF CONTENTS

Item No.		Page
	<u>PART I</u> - FINANCIAL INFORMATION	
1.	<u>Financial Statements</u>	<u>3</u>
2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>25</u>
3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>30</u>
4.	<u>Controls and Procedures</u>	<u>31</u>
	<u>PART II</u> - OTHER INFORMATION	
1.	<u>Legal Proceedings</u>	<u>32</u>
<u>1A.</u>	<u>Risk Factors</u>	<u>32</u>
2.	Unregistered Sales <u>of Equity Securities</u> and Use of Proceeds	<u>32</u>
<u>6.</u>	<u>Exhibits</u>	<u>33</u>
	<u>Signatures</u>	<u>34</u>

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

UNIVERSAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(in thousands, except share and per share data)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
	(Unaudited)		(Unaudited)	
Sales and other operating revenues	\$668,771	\$584,592	\$1,421,188	\$1,316,393
Costs and expenses				
Cost of goods sold	533,318	464,686	1,145,694	1,050,004
Selling, general and administrative expenses	52,068	54,081	153,101	166,187
Other income	—	(3,390)	—	(3,390)
Restructuring and impairment costs	178	—	3,860	2,389
Operating income	83,207	69,215	118,533	101,203
Equity in pretax earnings of unconsolidated affiliates	4,495	2,326	5,625	2,556
Interest income	482	452	1,116	896
Interest expense	4,051	3,937	12,440	11,733
Income before income taxes	84,133	68,056	112,834	92,922
Income tax expense	27,071	21,441	36,778	27,368
Net income	57,062	46,615	76,056	65,554
Less: net income attributable to noncontrolling interests in subsidiaries	(3,415)	(2,081)	(2,621)	(4,502)
Net income attributable to Universal Corporation	53,647	44,534	73,435	61,052
Dividends on Universal Corporation convertible perpetual preferred stock	(3,687)	(3,687)	(11,061)	(11,061)
Earnings available to Universal Corporation common shareholders	\$49,960	\$40,847	\$62,374	\$49,991
Earnings per share attributable to Universal Corporation common shareholders:				
Basic	\$2.17	\$1.80	\$2.73	\$2.20
Diluted	\$1.92	\$1.60	\$2.63	\$2.18
Weighted average common shares outstanding:				
Basic	22,982,473	22,717,043	22,831,717	22,671,943
Diluted	27,996,583	27,854,908	27,967,215	22,957,050
Total comprehensive income, net of income taxes	\$58,717	\$47,794	\$76,038	\$69,644
Less: comprehensive income attributable to noncontrolling interests, net of income taxes	(3,214)	(2,042)	(1,976)	(4,037)
Comprehensive income attributable to Universal Corporation, net of income taxes	\$55,503	\$45,752	\$74,062	\$65,607
Dividends declared per common share	\$0.54	\$0.53	\$1.60	\$1.57

See accompanying notes.

UNIVERSAL CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands of dollars)

	December 31, 2016 (Unaudited)	December 31, 2015 (Unaudited)	March 31, 2016
ASSETS			
Current assets			
Cash and cash equivalents	\$ 411,507	\$ 167,625	\$ 319,447
Accounts receivable, net	280,978	267,632	428,659
Advances to suppliers, net	93,175	84,905	101,890
Accounts receivable—unconsolidated affiliate	2,073	762	2,316
Inventories—at lower of cost or market:			
Tobacco	736,368	965,917	637,132
Other	67,638	65,123	60,888
Prepaid income taxes	11,419	16,359	17,814
Other current assets	61,856	67,456	70,400
Total current assets	1,665,014	1,635,779	1,638,546
Property, plant and equipment			
Land	22,760	22,870	22,987
Buildings	264,485	256,970	264,838
Machinery and equipment	603,860	591,292	591,327
	891,105	871,132	879,152
Less: accumulated depreciation	(569,697)	(545,518)	(553,265)
	321,408	325,614	325,887
Other assets			
Goodwill and other intangibles	98,869	99,035	99,071
Investments in unconsolidated affiliates	75,574	75,351	82,441
Deferred income taxes	24,266	38,750	23,853
Other noncurrent assets	41,798	52,245	61,379
	240,507	265,381	266,744
Total assets	\$ 2,226,929	\$ 2,226,774	\$ 2,231,177

See accompanying notes.

UNIVERSAL CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands of dollars)

	December 31, 2016 (Unaudited)	December 31, 2015 (Unaudited)	March 31, 2016
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities			
Notes payable and overdrafts	\$ 52,052	\$ 65,894	\$ 66,179
Accounts payable and accrued expenses	131,925	132,572	120,527
Accounts payable—unconsolidated affiliates	10,522	21,768	8,343
Customer advances and deposits	14,201	41,209	16,438
Accrued compensation	22,800	20,681	27,593
Income taxes payable	7,239	5,893	7,190
Current portion of long-term debt	—	—	—
Total current liabilities	238,739	288,017	246,270
Long-term debt	368,645	368,292	368,380
Pensions and other postretirement benefits	78,930	90,643	92,177
Other long-term liabilities	30,038	33,179	41,794
Deferred income taxes	29,075	27,447	29,494
Total liabilities	745,427	807,578	778,115
Shareholders' equity			
Universal Corporation:			
Preferred stock:			
Series A Junior Participating Preferred Stock, no par value, 500,000 shares authorized, none issued or outstanding	—	—	—
Series B 6.75% Convertible Perpetual Preferred Stock, no par value, 220,000 shares authorized, 107,418 shares issued and outstanding (218,490 at December 31, 2015 and March 31, 2016)	104,012	211,562	211,562
Common stock, no par value, 100,000,000 shares authorized, 25,270,976 shares issued and outstanding (22,717,448 at December 31, 2015, and 22,717,735 at March 31, 2016)	319,509	206,941	208,946
Retained earnings	1,090,148	1,033,986	1,066,064
Accumulated other comprehensive loss	(71,723)	(70,439)	(72,350)
Total Universal Corporation shareholders' equity	1,441,946	1,382,050	1,414,222
Noncontrolling interests in subsidiaries	39,556	37,146	38,840
Total shareholders' equity	1,481,502	1,419,196	1,453,062
Total liabilities and shareholders' equity	\$ 2,226,929	\$ 2,226,774	\$ 2,231,177

See accompanying notes.

UNIVERSAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands of dollars)

	Nine Months Ended December 31,	
	2016	2015
	(Unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$76,056	\$65,554
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	26,107	27,221
Net provision for losses (recoveries) on advances and guaranteed loans to suppliers	414	(1,026)
Foreign currency remeasurement loss (gain), net	12,493	21,492
Fair value gain upon acquisition of partner's interest in joint venture	—	(3,390)
Restructuring and impairment costs	3,860	2,389
Other, net	7,290	18,004
Changes in operating assets and liabilities, net	56,533	(120,045)
Net cash provided by operating activities	182,753	10,199
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(28,544)	(38,504)
Purchase of partner's interest in joint venture, net of cash held by the business	—	(5,964)
Proceeds from sale of property, plant and equipment	665	1,380
Other	—	(398)
Net cash used by investing activities	(27,879)	(43,486)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance (repayment) of short-term debt, net	(11,299)	4,168
Dividends paid to noncontrolling interests	(1,260)	(1,260)
Dividends paid on convertible perpetual preferred stock	(11,061)	(11,061)
Dividends paid on common stock	(36,181)	(35,349)
Other	(2,256)	(3,736)
Net cash used by financing activities	(62,057)	(47,238)
Effect of exchange rate changes on cash	(757)	(633)
Net increase (decrease) in cash and cash equivalents	92,060	(81,158)
Cash and cash equivalents at beginning of year	319,447	248,783
Cash and cash equivalents at end of period	\$411,507	\$167,625

Non-cash Financing Transaction - The consolidated financial statements for the nine months ended December 31, 2016 include a non-cash reclassification of \$107.6 million from preferred stock to common stock to reflect the conversion of 111,072 shares of the Company's outstanding Series B 6.75% Convertible Perpetual Preferred Stock into common stock. See Note 3 for additional information.

See accompanying notes.

UNIVERSAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

Universal Corporation, which together with its subsidiaries is referred to herein as “Universal” or the “Company,” is the leading global leaf tobacco supplier. Because of the seasonal nature of the Company’s business, the results of operations for any fiscal quarter will not necessarily be indicative of results to be expected for other quarters or a full fiscal year. All adjustments necessary to state fairly the results for the period have been included and were of a normal recurring nature. Certain amounts in prior year statements have been reclassified to conform to the current year presentation. This Form 10-Q should be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended March 31, 2016.

NOTE 2. ACCOUNTING PRONOUNCEMENTS

Pronouncements Adopted in Fiscal Year 2017

In April 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2015-03, “Simplifying the Presentation of Debt Issuance Costs” (“ASU 2015-03”). ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-03 is effective for fiscal years beginning after December 31, 2015. The Company adopted ASU 2015-03 effective as of April 1, 2016, the beginning of fiscal year 2017. The implementation of ASU 2015-03, which requires retrospective application, resulted in a \$1.8 million and \$1.6 million reclassification of unamortized debt issuance costs from other noncurrent assets to long-term debt for the comparative prior periods ended December 31, 2015 and March 31, 2016, respectively.

In May 2015, the FASB issued Accounting Standards Update No. 2015-07, “Fair Value Measurement, Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share or its Equivalent” (“ASU 2015-07”). ASU 2015-07 removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient and eliminates certain disclosures for investments that are eligible to be measured at fair value using the net asset value per share practical expedient. The Company adopted ASU 2015-07 effective as of April 1, 2016, the beginning of fiscal year 2017. Disclosures for all periods presented in Note 8 - Fair Value Measurements were adjusted accordingly.

In March 2016, the FASB issued Accounting Standards Update No. 2016-09, “Compensation - Stock Compensation” (“ASU 2016-09”). ASU 2016-09 provides simplification for the accounting for employee stock-based payment transactions, including the related income tax consequences, treatment of excess tax benefits in determining income tax expense, the classification of awards as either equity or liabilities, and the classification of transactions in the statement of cash flows. ASU 2016-09 is effective for fiscal years beginning after December 15, 2017, with early adoption permitted. The Company early adopted ASU 2016-09 effective as of April 1, 2016. Effective with the adoption of ASU 2016-09, employees that the Company has a statutory requirement to withhold taxes on behalf of can now elect to withhold income taxes upon settlement of stock-based compensation awards up to the maximum statutory tax rate without requiring classification of the awards as a liability. As required by ASU 2016-09, employee tax withholding payments and excess tax benefits resulting from stock-based compensation have been classified as financing activities and operating activities, respectively, in the consolidated statements of cash flows for all periods presented.

Pronouncements to be Adopted in Future Periods

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which supersedes substantially all of the current revenue recognition guidance under U.S. generally accepted accounting principles ("U.S. GAAP"). ASU 2014-09 was developed under a joint project with the International Accounting Standards Board ("IASB") to improve and converge the existing revenue recognition accounting guidance in U.S. GAAP and International Accounting Standards. Under ASU 2014-09, the central underlying principle is to recognize revenues when promised goods or services are transferred to customers at an amount determined by the consideration a company expects to receive for those goods or services. The guidance outlines a five-step process for determining the amount and timing of revenue to be recognized from those arrangements. It is more principles-based than the existing guidance under U.S. GAAP, and therefore is expected to require more management judgment and involve more estimates than the current guidance. ASU 2014-09 is effective for annual periods beginning after December 15, 2017, including all interim periods within the year of adoption. Companies are allowed to select between two transition methods: (1) a full retrospective transition method with the application of the new guidance to each prior reporting period presented, or (2) a retrospective transition method that recognizes the cumulative effect on prior periods at the date of adoption together with additional footnote disclosures. Since the issuance of ASU 2014-09, the FASB has issued several amendments to provide additional supplemental guidance on certain aspects of the original pronouncement. Universal expects to adopt ASU 2014-09 and the related

supplemental amendments effective April 1, 2018, which is the beginning of the fiscal year ending March 31, 2019. The Company is currently evaluating the impact that the adoption of ASU 2014-09 and the related amendments will have on its consolidated financial statements and has not made a decision on the method of adoption.

In July 2015, the FASB issued Accounting Standards Update No. 2015-11, "Simplifying the Measurement of Inventory" ("ASU 2015-11"). ASU 2015-11 requires that most inventory be measured at the lower of cost or net realizable value. ASU 2015-11 defines net realizable value as the "estimated selling price in the ordinary course of business, less reasonable predictable costs of completion, disposal, and transportation." ASU 2015-11 is effective for fiscal years beginning after December 31, 2016. The Company is currently evaluating the impact that the adoption of ASU 2015-11 will have on its consolidated financial statements. ASU 2015-11 will be applied prospectively after the date of adoption, as required by the guidance.

In January 2016, the FASB issued Accounting Standards Update No. 2016-01, "Financial Instruments-Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). ASU 2016-01 requires all equity investments to be measured at fair value with changes in the fair value recognized through net income (other than those accounted for under the equity method of accounting or those that result in consolidation of the investee). This guidance is effective for fiscal years beginning after December 15, 2017. The Company is currently evaluating the impact that the adoption of ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, "Leases" ("ASU 2016-02"). ASU 2016-02 requires a lessee to recognize lease payment obligations as a lease liability and the corresponding right-of-use asset as a leased asset in the balance sheet for the term of the lease. This guidance supersedes Topic 840 "Leases" and is effective for fiscal years beginning after December 15, 2018. The Company will be required to adopt ASU 2016-02 effective April 1, 2019, which is the beginning of its fiscal year ending March 31, 2020, and is currently evaluating the impact that the updated guidance will have on its consolidated financial statements.

In August 2016, the FASB issued Accounting Standards Update No. 2016-15, "Statement of Cash Flows" ("ASU 2016-15"). ASU 2016-15 is intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. This guidance is effective for fiscal years beginning after December 15, 2017, with early adoption permitted. The Company is currently evaluating the impact that the adoption of ASU 2016-15 will have on its consolidated financial statements.

NOTE 3. GUARANTEES, OTHER CONTINGENT LIABILITIES, AND OTHER MATTERS

Guarantees and Other Contingent Liabilities

Guarantees of Bank Loans and Other Contingent Liabilities

Guarantees of bank loans to tobacco growers for crop financing have long been industry practice in Brazil and support the farmers' production of tobacco there. The Company's operating subsidiary in Brazil had guarantees outstanding at December 31, 2016, all of which expire within one year. The subsidiary withholds payments due to the farmers on delivery of tobacco and forwards those payments to the third-party banks. Failure of farmers to deliver sufficient quantities of tobacco to the subsidiary to cover its obligations to the third-party banks could result in a liability for the subsidiary under the related guarantees; however, in that case, the subsidiary would have recourse against the farmers. The maximum potential amount of future payments that the Company's subsidiary could be required to make at December 31, 2016, was the face amount, \$35 million including unpaid accrued interest (\$27 million at December 31, 2015, and \$13 million at March 31, 2016). The fair value of the guarantees was a liability of approximately \$2 million at December 31, 2016 (\$1 million at December 31, 2015, and \$2 million at March 31, 2016). In addition to these guarantees, the Company has other contingent liabilities, primarily related to outstanding letters of credit, totaling approximately \$2 million at December 31, 2016.

Value-Added Tax Assessments in Brazil

As further discussed below, the Company's local operating subsidiaries pay significant amounts of value-added tax ("VAT") in connection with their normal operations. In Brazil, VAT is assessed at the state level when green tobacco is transferred between states. The Company's operating subsidiary there pays VAT when tobaccos grown in the states of Santa Catarina and Parana are transferred to its factory in the state of Rio Grande do Sul for processing. The subsidiary has received assessments for additional VAT plus interest and penalties from tax authorities for the states of Santa Catarina and Parana based on audits of the subsidiary's VAT filings for specified periods. In June 2011, tax authorities for the state of Santa Catarina issued assessments for tax, interest, and penalties for periods from 2006 through 2009 totaling approximately \$15 million. In September 2014, tax authorities for the state of Parana issued an assessment for tax, interest, and penalties for periods from 2009 through 2014 totaling approximately \$17 million. Those amounts are based on the exchange rate for the Brazilian currency at December 31, 2016. Management of the

operating subsidiary and outside counsel believe that errors were made by the tax authorities for both states in determining all or significant portions of these assessments and that various defenses support the subsidiary's positions.

With respect to the Santa Catarina assessments, the subsidiary took appropriate steps to contest the full amount of the claims. As of December 31, 2016, a portion of the subsidiary's arguments had been accepted, and the outstanding assessment had been reduced. The reduced assessment, together with the related accumulated interest through the end of the current reporting period, totaled approximately \$14 million (at the December 31, 2016 exchange rate). The subsidiary is continuing to contest the full remaining amount of the assessment. While the range of reasonably possible loss is zero up to the full \$14 million remaining assessment, based on the strength of the subsidiary's defenses, no loss within that range is considered probable at this time and no liability has been recorded at December 31, 2016. With respect to the Parana assessment, management of the subsidiary and outside counsel challenged the full amount of the claim. A significant portion of the Parana assessment was based on positions taken by the tax authorities that management and outside counsel believe deviate significantly from the underlying statutes and relevant case law. In addition, under the law, the subsidiary's tax filings for certain periods covered in the assessment were no longer open to any challenge by the tax authorities. In December 2015, the Parana tax authorities withdrew the initial claim, and subsequently issued a new assessment covering the same tax periods. The new assessment totaled approximately \$5 million at the December 31, 2016 exchange rate, reflecting a substantial reduction from the original \$17 million assessment. Notwithstanding the reduction, management and outside counsel continue to believe that the new assessment is not supported by the underlying statutes and relevant case law and have challenged the full amount of the claim. The range of reasonably possible loss is considered to be zero up to the full \$5 million assessment. However, based on the strength of the subsidiary's defenses, no loss within that range is considered probable at this time and no liability has been recorded at December 31, 2016.

In both states, the process for reaching a final resolution to the assessments is expected to be lengthy, and management is not currently able to predict when either case will be concluded. Should the subsidiary ultimately be required to pay any tax, interest, or penalties in either case, the portion paid for tax would generate value-added tax credits that the subsidiary may be able to recover.

Other Legal and Tax Matters

Various subsidiaries of the Company are involved in litigation and tax examinations incidental to their business activities. While the outcome of these matters cannot be predicted with certainty, management is vigorously defending the matters and does not currently expect that any of them will have a material adverse effect on the Company's business or financial position. However, should one or more of these matters be resolved in a manner adverse to management's current expectation, the effect on the Company's results of operations for a particular fiscal reporting period could be material.

Advances to Suppliers

In many sourcing origins where the Company operates, it provides agronomy services and seasonal advances of seed, fertilizer, and other supplies to tobacco farmers for crop production, or makes seasonal cash advances to farmers for the procurement of those inputs. These advances are short term, are repaid upon delivery of tobacco to the Company, and are reported in advances to suppliers in the consolidated balance sheets. In several origins, the Company has made long-term advances to tobacco farmers to finance curing barns and other farm infrastructure. In some years, due to low crop yields and other factors, individual farmers may not deliver sufficient volumes of tobacco to fully repay their seasonal advances, and the Company may extend repayment of those advances into future crop years. The long-term portion of advances is included in other noncurrent assets in the consolidated balance sheets. Both the current and the long-term portions of advances to suppliers are reported net of allowances recorded when the Company determines that amounts outstanding are not likely to be collected. Short-term and long-term advances to suppliers totaled \$125 million at December 31, 2016, \$116 million at December 31, 2015, and \$134 million at March 31, 2016. The related

valuation allowances totaled \$30 million at December 31, 2016, \$28 million at December 31, 2015, and \$29 million at March 31, 2016, and were estimated based on the Company's historical loss information and crop projections. The allowances were increased by net provisions of approximately \$0.4 million and reduced by net recoveries of \$1 million in the nine-month periods ended December 31, 2016 and 2015, respectively. These net provisions and recoveries are included in selling, general, and administrative expenses in the consolidated statements of income. Interest on advances is recognized in earnings upon the farmers' delivery of tobacco in payment of principal and interest.

Recoverable Value-Added Tax Credits

In many foreign countries, the Company's local operating subsidiaries pay significant amounts of value-added tax ("VAT") on purchases of unprocessed and processed tobacco, crop inputs, packing materials, and various other goods and services. In some countries, VAT is a national tax, and in other countries it is assessed at the state level. Items subject to VAT vary from jurisdiction to jurisdiction, as do the rates at which the tax is assessed. When tobacco is sold to customers in the country of origin, the operating

subsidiaries generally collect VAT on those sales. The subsidiaries are normally permitted to offset their VAT payments against the collections and remit only the incremental VAT collections to the tax authorities. When tobacco is sold for export, VAT is normally not assessed. In countries where tobacco sales are predominately for export markets, VAT collections generated on downstream sales are often not sufficient to fully offset the subsidiaries' VAT payments. In those situations, unused VAT credits can accumulate. Some jurisdictions have procedures that allow companies to apply for refunds of unused VAT credits from the tax authorities, but the refund process often takes an extended period of time and it is not uncommon for refund applications to be challenged or rejected in part on technical grounds. Other jurisdictions may permit companies to sell or transfer unused VAT credits to third parties in private transactions, although approval for such transactions must normally be obtained from the tax authorities, limits on the amounts that can be transferred may be imposed, and the proceeds realized may be heavily discounted from the face value of the credits. Due to these factors, local operating subsidiaries in some countries can accumulate significant balances of VAT credits over time. The Company reviews these balances on a regular basis and records valuation allowances on the credits to reflect amounts that are not expected to be recovered, as well as discounts anticipated on credits that are expected to be sold or transferred. At December 31, 2016, the aggregate balance of recoverable tax credits held by the Company's subsidiaries totaled approximately \$41 million (\$51 million at December 31, 2015, and \$52 million at March 31, 2016), and the related valuation allowances totaled approximately \$11 million (\$19 million at December 31, 2015, and \$19 million at March 31, 2016). The net balances are reported in other current assets and other noncurrent assets in the consolidated balance sheets.

Conversion of Series B 6.75% Convertible Perpetual Preferred Stock

In December 2016, holders of 111,072 shares of the Company's Series B 6.75% Convertible Perpetual Preferred Stock (approximately 50.8% of the outstanding shares) voluntarily exercised their conversion rights under the original issuance terms of the preferred shares. The Company chose to satisfy the full conversion obligation for those preferred shares with shares of its common stock, issuing 2,487,118 common shares at the applicable conversion rate in exchange for the preferred shares tendered. The consolidated balance sheet at December 31, 2016 reflects a non-cash reclassification of \$107.6 million from preferred stock to common stock to reflect the conversion of those preferred shares.

On January 9, 2017, the Company announced a mandatory conversion of all 107,418 remaining outstanding shares of the preferred stock after meeting the requirements to initiate the mandatory conversion under the original terms of the preferred shares. The Company chose to satisfy the full conversion obligation for the mandatory conversion in cash, paying approximately \$178.4 million for those preferred shares on January 31, 2017 to complete the conversion. With the completion of the mandatory conversion in January 2017, the Company's outstanding equity securities consist only of its common stock. Dividend payments on the preferred shares, which previously totaled approximately \$15 million annually, have been discontinued. Although the conversions of the preferred stock into common stock or for cash do not impact the Company's net income, the shares converted for cash under the mandatory conversion in January 2017 will result in a one-time reduction of retained earnings of approximately \$74.4 million during the quarter ending March 31, 2017, representing the excess of the conversion cost over the carrying value of those shares. The reduction in retained earnings will also result in a corresponding one-time reduction of earnings available to common shareholders for the quarter and fiscal year ending March 31, 2017 for purposes of determining the amounts reported for basic and diluted earnings per share for those periods.

NOTE 4. RESTRUCTURING AND IMPAIRMENT COSTS

Universal continually reviews its business for opportunities to realize efficiencies, reduce costs, and realign its operations in response to business changes. Restructuring and impairment costs are periodically incurred in connection with those activities. For the reporting periods ended December 31, 2016 and 2015, the majority of restructuring costs incurred related to operations that are part of the Other Regions reportable segment of the Company's Flue-Cured and Burley Tobacco Operations.

Quarter and Nine Months Ended December 31, 2016

For the quarter and nine months ended December 31, 2016, the Company recorded restructuring and impairment costs totaling \$0.2 million and \$3.9 million, respectively, primarily related to the Company's decision to close its tobacco processing facility in Hungary. The Company is now processing tobaccos sourced from Hungary in the Company's facilities in Italy. The restructuring and impairment costs incurred for the change in operations in Hungary included statutory employee termination benefits and impairment charges related to certain property and equipment. Substantially all of the termination benefits were paid before December 31, 2016.

Nine Months Ended December 31, 2015

In the first quarter of fiscal year 2016, the Company recorded restructuring and impairment costs totaling \$2.4 million related to the scale back of its operations in Zambia. Those costs included statutory employee termination benefits, impairment charges related to outstanding balances on loans to farmers whose contracts were terminated as a result of the decision, and impairment charges on certain property and equipment. The majority of the termination benefits were paid during fiscal year 2016.

NOTE 5. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

(in thousands, except share and per share data)	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Basic Earnings Per Share				
Numerator for basic earnings per share				
Net income attributable to Universal Corporation	\$53,647	\$44,534	\$73,435	\$61,052
Less: Dividends on convertible perpetual preferred stock	(3,687)	(3,687)	(11,061)	(11,061)
Earnings available to Universal Corporation common shareholders for calculation of basic earnings per share	49,960	40,847	62,374	49,991
Denominator for basic earnings per share				
Weighted average shares outstanding	22,982,473	22,717,043	22,831,717	22,671,943
Basic earnings per share	\$2.17	\$1.80	\$2.73	\$2.20
Diluted Earnings Per Share				
Numerator for diluted earnings per share				
Earnings available to Universal Corporation common shareholders	\$49,960	\$40,847	\$62,374	\$49,991
Add: Dividends on convertible perpetual preferred stock (if conversion assumed)	3,687	3,687	11,061	—
Earnings available to Universal Corporation common shareholders for calculation of diluted earnings per share	53,647	44,534	73,435	49,991
Denominator for diluted earnings per share				
Weighted average shares outstanding	22,982,473	22,717,043	22,831,717	22,671,943
Effect of dilutive securities (if conversion or exercise assumed)				
Convertible perpetual preferred stock	4,693,155	4,857,262	4,816,904	—
Employee share-based awards	320,955	280,603	318,594	285,107
Denominator for diluted earnings per share	27,996,583	27,854,908	27,967,215	22,957,050
Diluted earnings per share	\$1.92	\$1.60	\$2.63	\$2.18

In December 2016, 111,072 shares of the Company's Series B 6.75% Convertible Perpetual Preferred Stock were converted into approximately 2.5 million of the Company's common stock. The effect from the conversion on the computation of basic and diluted earnings per share for the three and nine months ended December 31, 2016, is included in the table above. See Note 3 for additional information.

The Company had the following potentially dilutive securities (stock appreciation rights) outstanding for the nine months ended December 31, 2016 and 2015 that were not included in the computation of diluted earnings per share because their exercise price exceeded the market price of the Company's common stock, and thus their effect would have been antidilutive:

	Nine Months Ended December 31, 2016	2015
Potentially dilutive securities	122,200	133,600

Weighted-average exercise price \$62.66 \$62.66

NOTE 6. INCOME TAXES

The Company is subject to the tax laws of many jurisdictions. Changes in tax laws or the interpretation of tax laws can affect the Company's earnings, as can the resolution of pending and contested tax issues. The Company's consolidated effective income tax rate on pretax earnings is affected by a number of factors, including the mix of domestic and foreign earnings, the effect of exchange rate changes on deferred taxes, and the Company's ability to utilize foreign tax credits.

The Company's consolidated effective income tax rates were approximately 32% and 33% for the quarter and nine months ended December 31, 2016, respectively, compared to approximately 32% and 29% for the quarter and nine months ended December 31, 2015, respectively. The effective rate for the prior year nine-month period was lower primarily due to the effects of changes in currency exchange rates on deferred income tax assets and liabilities of foreign subsidiaries. The effective tax rate for the current year period more closely approximates the 35% U.S. federal statutory rate because the effects of currency exchange rate changes have not been significant.

NOTE 7. DERIVATIVES AND HEDGING ACTIVITIES

Universal is exposed to various risks in its worldwide operations and uses derivative financial instruments to manage two specific types of risks – interest rate risk and foreign currency exchange rate risk. Interest rate risk has been managed by entering into interest rate swap agreements, and foreign currency exchange rate risk has been managed by entering into forward foreign currency exchange contracts. However, the Company's policy also permits other types of derivative instruments. In addition, foreign currency exchange rate risk is also managed through strategies that do not involve derivative instruments, such as using local borrowings and other approaches to minimize net monetary positions in non-functional currencies. The disclosures below provide additional information about the Company's hedging strategies, the derivative instruments used, and the effects of these activities on the consolidated statements of income and comprehensive income and the consolidated balance sheets. In the consolidated statements of cash flows, the cash flows associated with all of these activities are reported in net cash provided by operating activities.

Hedging Strategy for Interest Rate Risk

In January 2015, the Company entered into receive-floating/pay-fixed interest rate swap agreements that were designated and qualified as hedges of the exposure to changes in interest payment cash flows created by fluctuations in variable interest rates on two outstanding non-amortizing bank term loans. Although no significant ineffectiveness is expected with this hedging strategy, the effectiveness of the interest rate swaps is evaluated on a quarterly basis. At December 31, 2016, the total notional amount of the interest rate swaps was \$370 million, which corresponded with the aggregate outstanding balance of the term loans.

Cash Flow Hedging Strategy for Foreign Currency Exchange Rate Risk Related to Forecast Purchases of Tobacco and Related Processing Costs

The majority of the tobacco production in most countries outside the United States where Universal operates is sold in export markets at prices denominated in U.S. dollars. However, purchases of tobacco from farmers and most processing costs (such as labor and energy) in those countries are usually denominated in the local currency. Changes in exchange rates between the U.S. dollar and the local currencies where tobacco is grown and processed affect the ultimate U.S. dollar cost of the processed tobacco. From time to time, the Company enters into forward contracts to sell U.S. dollars and buy the local currency at future dates that coincide with the expected timing of a portion of the tobacco purchases and processing costs. This strategy offsets the variability of future U.S. dollar cash flows for tobacco purchases and processing costs for the foreign currency notional amount hedged. This hedging strategy has been used mainly for tobacco purchases and processing costs in Brazil. The aggregate U.S. dollar notional amount of forward contracts entered for these purposes during the first nine months of fiscal years 2017 and 2016 was as follows:

	Nine Months Ended December 31,	
(in millions of dollars)	2016	2015
Tobacco purchases	\$9.7	\$19.8
Processing costs	2.7	5.6
Total	\$12.4	\$25.4

The reduced U.S. dollar notional amounts for tobacco purchases and processing costs hedged during the nine months ended December 31, 2016 reflect the reduced size of the 2016 Brazilian crop and a variation in the timing of fixed-price orders from

customers for their purchases from the respective crop years. All contracts related to tobacco purchases were designated and qualify as hedges of the future cash flows associated with the forecast purchases of tobacco. As a result, except for amounts related to any ineffective portion of the hedging strategy or any early de-designation of the hedge arrangement, changes in fair values of the forward contracts have been recognized in comprehensive income as they occurred, but only recognized in earnings upon sale of the related tobacco to third-party customers. Forward contracts related to processing costs have not been designated as hedges, and gains and losses on those contracts have been recognized in earnings on a mark-to-market basis.

All forward contracts to hedge purchases of the 2016 crop in Brazil matured and settled by December 31, 2016. For substantially all hedge gains and losses recorded in accumulated other comprehensive loss at December 31, 2016, the Company expects to complete the sale of the tobacco and recognize the amounts in earnings during fiscal year 2017.

Hedging Strategy for Foreign Currency Exchange Rate Risk Related to Net Local Currency Monetary Assets and Liabilities of Foreign Subsidiaries

Most of the Company's foreign subsidiaries transact the majority of their sales in U.S. dollars and finance the majority of their operating requirements with U.S. dollar borrowings, and therefore use the U.S. dollar as their functional currency. These subsidiaries normally have certain monetary assets and liabilities on their balance sheets that are denominated in the local currency. Those assets and liabilities can include cash and cash equivalents, accounts receivable and accounts payable, advances to farmers and suppliers, deferred income tax assets and liabilities, recoverable value-added taxes, and other items. Net monetary assets and liabilities denominated in the local currency are remeasured into U.S. dollars each reporting period, generating gains and losses that the Company records in earnings as a component of selling, general, and administrative expenses. The level of net monetary assets or liabilities denominated in the local currency normally fluctuates throughout the year based on the operating cycle, but it is most common for monetary assets to exceed monetary liabilities, sometimes by a significant amount. When this situation exists and the local currency weakens against the U.S. dollar, remeasurement losses are generated. Conversely, remeasurement gains are generated on a net monetary asset position when the local currency strengthens against the U.S. dollar. To manage a portion of its exposure to currency remeasurement gains and losses, the Company enters into forward contracts to buy or sell the local currency at future dates coinciding with expected changes in the overall net local currency monetary asset position of the subsidiary. Gains and losses on the forward contracts are recorded in earnings as a component of selling, general, and administrative expenses for each reporting period as they occur, and thus directly offset the related remeasurement losses or gains in the consolidated statements of income for the notional amount hedged. The Company does not designate these contracts as hedges for accounting purposes. The contracts are generally arranged to hedge the subsidiary's projected exposure to currency remeasurement risk for specified periods of time, and new contracts are entered as necessary throughout the year to replace previous contracts as they mature. The Company is currently using forward currency contracts to manage its exposure to currency remeasurement risk in Brazil. The total notional amounts of contracts outstanding at December 31, 2016 and 2015 were approximately \$23.4 million and \$56.8 million, respectively. At March 31, 2016, the net local monetary asset position in Brazil was not significant, and there were no foreign currency contracts outstanding at that time to manage currency remeasurement risk. To further mitigate currency remeasurement exposure, the Company's foreign subsidiaries may utilize short-term local currency financing during certain periods. This strategy, while not involving the use of derivative instruments, is intended to minimize the subsidiary's net monetary position by financing a portion of the local currency monetary assets with local currency monetary liabilities, thus hedging a portion of the overall position.

Several of the Company's foreign subsidiaries transact the majority of their sales and finance the majority of their operating requirements in their local currency, and therefore use their respective local currencies as the functional currency for reporting purposes. From time to time, these subsidiaries sell tobacco to customers in transactions that are not denominated in the functional currency. In those situations, the subsidiaries routinely enter into forward exchange contracts to offset currency risk for the period of time that a fixed-price order and the related trade account receivable

are outstanding with the customer. The contracts are not designated as hedges for accounting purposes.

Effect of Derivative Financial Instruments on the Consolidated Statements of Income

The table below outlines the effects of the Company's use of derivative financial instruments on the consolidated statements of income for the three- and nine-month periods ended December 31, 2016 and 2015:

	Three Months Ended December 31,		Nine Months Ended December 31,	
(in thousands of dollars)	2016	2015	2016	2015
Cash Flow Hedges - Interest Rate Swap Agreements				
Derivative				
Effective Portion of Hedge				
Gain (loss) recorded in accumulated other comprehensive loss	\$10,876	\$3,529	\$8,484	\$(2,527)
Gain (loss) reclassified from accumulated other comprehensive loss into earnings	\$(987)	\$(1,328)	\$(3,135)	\$(4,004)
Location of gain (loss) reclassified from accumulated other comprehensive loss into earnings	Interest expense			
Ineffective Portion of Hedge				
Gain (loss) recognized in earnings	\$—	\$—	\$—	\$—
Location of gain (loss) recognized in earnings	Selling, general and administrative expenses			
Hedged Item				
Description of hedged item	Floating rate interest payments on term loan			

Cash Flow Hedges - Forward Foreign Currency Exchange Contracts