

GREATBATCH, INC.
Form 10-Q
August 12, 2014
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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 July 4, 2014
Commission File Number 1-16137

GREATBATCH, INC.
(Exact name of Registrant as specified in its charter)

Delaware
(State of
Incorporation)
2595 Dallas Parkway
Suite 310
Frisco, Texas 75034
(Address of principal executive offices)
(716) 759-5600
(Registrant’s telephone number, including area code)

16-1531026
(I.R.S. Employer
Identification No.)

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 checkmark 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

The number of shares outstanding of the Company’s common stock, \$0.001 par value per share, as of August 12, 2014 was: 24,910,395 shares.

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Greatbatch, Inc.

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PART I—FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

GREATBATCH, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS—Unaudited

(in thousands except share and per share data)

	As of July 4, 2014	January 3, 2014
Assets		
Current assets:		
Cash and cash equivalents	\$51,193	\$35,465
Accounts receivable, net of allowance for doubtful accounts of \$1.7 million in 2014 and \$2.0 million in 2013	124,562	113,679
Inventories	120,612	118,358
Refundable income taxes	—	2,306
Deferred income taxes	5,871	6,008
Prepaid expenses and other current assets	8,898	6,717
Total current assets	311,136	282,533
Property, plant and equipment, net	143,457	145,773
Amortizing intangible assets, net	69,397	76,122
Indefinite-lived intangible assets	20,288	20,288
Goodwill	347,126	346,656
Deferred income taxes	3,136	2,933
Other assets	17,227	16,398
Total assets	\$911,767	\$890,703
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$43,899	\$46,508
Income taxes payable	495	—
Deferred income taxes	618	613
Accrued expenses	33,530	44,681
Total current liabilities	78,542	91,802
Long-term debt	192,500	197,500
Deferred income taxes	50,526	52,012
Other long-term liabilities	6,737	7,334
Total liabilities	328,305	348,648
Stockholders' equity:		
Preferred stock, \$0.001 par value, authorized 100,000,000 shares; no shares issued or outstanding in 2014 or 2013	—	—
Common stock, \$0.001 par value, authorized 100,000,000 shares; 24,921,009 shares issued and 24,904,704 shares outstanding in 2014; 24,459,153 shares issued and 24,422,555 shares outstanding in 2013	25	24
Additional paid-in capital	357,587	344,915
Treasury stock, at cost, 16,305 shares in 2014 and 36,598 shares in 2013	(720)	(1,232)
Retained earnings	211,260	183,990
Accumulated other comprehensive income	15,310	14,358
Total stockholders' equity	583,462	542,055
Total liabilities and stockholders' equity	\$911,767	\$890,703

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

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GREATBATCH, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 AND COMPREHENSIVE INCOME — Unaudited
 (in thousands except per share data)

	Three Months Ended		Six Months Ended		
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	
Sales	\$172,081	\$171,331	\$346,362	\$319,596	
Cost of sales	113,611	114,029	230,296	213,545	
Gross profit	58,470	57,302	116,066	106,051	
Operating expenses:					
Selling, general and administrative expenses	21,877	22,248	43,632	42,340	
Research, development and engineering costs, net	12,793	14,097	26,324	25,177	
Other operating expenses, net	4,261	3,822	4,047	7,060	
Total operating expenses	38,931	40,167	74,003	74,577	
Operating income	19,539	17,135	42,063	31,474	
Interest expense	1,073	1,445	2,157	8,433	
Other (income) expense, net	334	679	(287	) 964
Income before provision for income taxes	18,132	15,011	40,193	22,077	
Provision for income taxes	5,784	5,259	12,923	6,662	
Net income	\$12,348	\$9,752	\$27,270	\$15,415	
Earnings per share:					
Basic	\$0.50	\$0.41	\$1.10	\$0.65	
Diluted	\$0.48	\$0.39	\$1.06	\$0.62	
Weighted average shares outstanding:					
Basic	24,838	23,914	24,726	23,832	
Diluted	25,901	24,922	25,823	24,818	
Comprehensive Income					
Net income	\$12,348	\$9,752	\$27,270	\$15,415	
Other comprehensive income (loss):					
Foreign currency translation gain (loss)	(393) 631	789	(2,432)
Net change in cash flow hedges, net of tax	86	(231	) 163	38
Defined benefit plan liability adjustment, net of tax	—	—	—	597	
Other comprehensive income (loss)	(307) 400	952	(1,797)
Comprehensive income	\$12,041	\$10,152	\$28,222	\$13,618	

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

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GREATBATCH, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS—Unaudited

(in thousands)

	Six Months Ended	
	July 4, 2014	June 28, 2013
Cash flows from operating activities:		
Net income	\$27,270	\$15,415
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	18,561	17,853
Debt related amortization included in interest expense	387	5,887
Stock-based compensation	6,729	7,347
Other non-cash gains	(3,896)	(276)
Deferred income taxes	(1,655)	(30,910)
Changes in operating assets and liabilities:		
Accounts receivable	(10,741)	(18,030)
Inventories	(2,049)	(15,966)
Prepaid expenses and other current assets	(69)	(161)
Accounts payable	(2,106)	(699)
Accrued expenses	(8,967)	(7,853)
Income taxes payable	3,052	18,760
Net cash provided by (used in) operating activities	26,516	(8,633)
Cash flows from investing activities:		
Acquisition of property, plant and equipment	(11,972)	(11,557)
Proceeds from sale of orthopaedic product lines (Note 8)	2,655	3,228
Purchase of cost and equity method investments	(450)	(1,287)
Other investing activities	—	30
Net cash used in investing activities	(9,767)	(9,586)
Cash flows from financing activities:		
Principal payments of long-term debt	(5,000)	(208,782)
Proceeds from issuance of long-term debt	—	215,000
Issuance of common stock	5,353	2,579
Other financing activities	(1,129)	(688)
Net cash provided by (used in) financing activities	(776)	8,109
Effect of foreign currency exchange rates on cash and cash equivalents	(245)	10
Net increase (decrease) in cash and cash equivalents	15,728	(10,100)
Cash and cash equivalents, beginning of period	35,465	20,284
Cash and cash equivalents, end of period	\$51,193	\$10,184

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

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GREATBATCH, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY — Unaudited

(in thousands)

	Common Stock		Additional	Treasury		Retained	Accumulated	Total
	Shares	Amount	Paid-In	Shares	Amount	Earnings	Other	Stockholders'
			Capital				Comprehensive	Equity
At January 3, 2014	24,459	\$24	\$344,915	(37)	\$(1,232)	\$183,990	\$ 14,358	\$ 542,055
Stock-based compensation	—	—	4,374	—	—	—	—	4,374
Net shares issued under stock incentive plans	462	1	8,172	(74)	(3,703)	—	—	4,470
Shares contributed to 401(k) Plan	—	—	126	95	4,215	—	—	4,341
Net income	—	—	—	—	—	27,270	—	27,270
Total other comprehensive income	—	—	—	—	—	—	952	952
At July 4, 2014	24,921	\$25	\$357,587	(16)	\$(720)	\$211,260	\$ 15,310	\$ 583,462

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

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GREATBATCH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – Unaudited

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information (Accounting Standards Codification (“ASC”) 270, Interim Reporting) and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information necessary for a full presentation of financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America (“GAAP”). Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole. In the opinion of management, the condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the results of Greatbatch, Inc. and its wholly-owned subsidiary, Greatbatch Ltd. (collectively “Greatbatch” or the “Company”), for the periods presented. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, sales, expenses, and related disclosures at the date of the financial statements and during the reporting period. Actual results could differ materially from these estimates. The January 3, 2014 condensed consolidated balance sheet data was derived from audited consolidated financial statements but does not include all disclosures required by GAAP. For further information, refer to the consolidated financial statements and notes included in the Company’s Annual Report on Form 10-K for the year ended January 3, 2014. The Company utilizes a fifty-two, fifty-three week fiscal year ending on the Friday nearest December 31st. The second quarter and year-to-date periods of 2014 and 2013 each contained 13 weeks and 26 weeks, respectively, and ended on July 4, and June 28, respectively.

2. SUPPLEMENTAL CASH FLOW INFORMATION

(in thousands)	Six Months Ended	
	July 4, 2014	June 28, 2013
Noncash investing and financing activities:		
Common stock contributed to 401(k) Plan	\$4,341	\$2,477
Property, plant and equipment purchases included in accounts payable	1,486	825
Cash paid during the period for:		
Interest	\$1,845	\$2,926
Income taxes	7,939	18,895

3. INVENTORIES

Inventories are comprised of the following (in thousands):

	As of	
	July 4, 2014	January 3, 2014
Raw materials	\$70,082	\$67,939
Work-in-process	38,995	36,670
Finished goods	11,535	13,749
Total	\$120,612	\$118,358

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GREATBATCH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – Unaudited

4. INTANGIBLE ASSETS

Amortizing intangible assets are comprised of the following (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net Carrying Amount
At July 4, 2014				
Technology and patents	\$97,376	\$(72,555)	) \$2,062	\$26,883
Customer lists	68,257	(28,004)	) 1,524	41,777
Other	4,434	(4,501)	) 804	737
Total amortizing intangible assets	\$170,067	\$(105,060)	) \$4,390	\$69,397
At January 3, 2014				
Technology and patents	\$97,376	\$(69,026)	) \$1,980	\$30,330
Customer lists	68,257	(24,671)	) 1,367	44,953
Other	4,434	(4,399)	) 804	839
Total amortizing intangible assets	\$170,067	\$(98,096)	) \$4,151	\$76,122

Aggregate intangible asset amortization expense is comprised of the following (in thousands):

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Cost of sales	\$1,566	\$1,759	\$3,129	\$3,539
Selling, general and administrative expenses	1,717	1,445	3,434	2,897
Research, development and engineering costs, net	200	136	401	272
Total intangible asset amortization expense	\$3,483	\$3,340	\$6,964	\$6,708

Estimated future intangible asset amortization expense based on the current carrying value is as follows (in thousands):

	Estimated Amortization Expense
Remainder of 2014	\$6,842
2015	12,752
2016	10,457
2017	9,334
2018	7,046
Thereafter	22,966
Total estimated amortization expense	\$69,397

Indefinite-lived intangible assets are comprised of the following (in thousands):

	Trademarks and Tradenames
At January 3, 2014	\$20,288
At July 4, 2014	\$20,288

The change in goodwill is as follows (in thousands):

	Greatbatch Medical	QiG	Total
At January 3, 2014	\$304,856	\$41,800	\$346,656
Foreign currency translation	470	—	470
At July 4, 2014	\$305,326	\$41,800	\$347,126

5. DEBT

Long-term debt is comprised of the following (in thousands):

	As of	
	July 4, 2014	January 3, 2014
Revolving line of credit	\$—	\$—
Variable rate term loan	192,500	197,500
Total long-term debt	\$192,500	\$197,500

Credit Facility – In September 2013, the Company amended and extended its credit facility (the “Credit Facility”). The new Credit Facility provides a \$300 million revolving credit facility (the “Revolving Credit Facility”), a \$200 million term loan (the “Term Loan”), a \$15 million letter of credit subfacility, and a \$15 million swingline subfacility. The Revolving Credit Facility can be increased by \$200 million upon the Company’s request and approval by the lenders. The Revolving Credit Facility has a maturity date of September 20, 2018, which may be extended to September 20, 2019 upon notice by the Company and subject to certain conditions. The principal of the Term Loan is payable in quarterly installments as specified in the Credit Facility until its maturity date of September 20, 2019, when the unpaid balance is due in full.

The Credit Facility is secured by the Company’s non-realty assets including cash, accounts receivable and inventories. Interest rates on the Revolving Credit Facility and Term Loan are, at the Company’s option either at: (i) the prime rate plus the applicable margin, which ranges between 0.0% and 0.75%, based on the Company’s total leverage ratio or (ii) the applicable LIBOR rate plus the applicable margin, which ranges between 1.375% and 2.75%, based on the Company’s total leverage ratio. Loans under the swingline subfacility will bear interest at the prime rate plus the applicable margin, which ranges between 0.0% and 0.75%, based on the Company’s total leverage ratio. The Company is also required to pay a commitment fee, which varies between 0.175% and 0.25% depending on the Company’s total leverage ratio.

The Credit Facility contains limitations on the incurrence of indebtedness, liens and licensing of intellectual property, investments and certain payments. The Credit Facility permits the Company to engage in the following activities up to an aggregate amount of \$300 million: 1) permitted acquisitions in the aggregate not to exceed \$250 million; 2) other investments in the aggregate not to exceed \$100 million; 3) stock repurchases and dividends not to exceed \$150 million in the aggregate; and 4) investments in foreign subsidiaries not to exceed \$20 million in the aggregate. At any time that the total leverage ratio of the Company for the two most recently ended fiscal quarters is less than 2.75 to 1.0, the Company may make an election to reset each of the amounts specified above. Additionally, these limitations can be waived upon the Company’s request and approval of a majority of the lenders. As of July 4, 2014, the Company had available to it 100% of the above limits except for the aggregate limit and other investments limit which are now \$297 million and \$97 million, respectively.

The Credit Facility requires the Company to maintain a rolling four quarter ratio of adjusted EBITDA to interest expense of at least 3.0 to 1.0, and a total leverage ratio of not greater than 4.5 to 1.0 decreasing to not greater than 4.25 to 1.0 after January 2, 2016. The calculation of adjusted EBITDA and total leverage ratio excludes non-cash charges, extraordinary, unusual, or non-recurring expenses or losses, non-cash stock-based compensation, and non-recurring expenses or charges incurred in connection with permitted acquisitions. As of July 4, 2014, the Company was in compliance with all covenants under the Credit Facility.

The Credit Facility contains customary events of default. Upon the occurrence and during the continuance of an event of default, a majority of the lenders may declare the outstanding advances and all other obligations under the Credit Facility immediately due and payable.

As of July 4, 2014, the weighted average interest rate on borrowings under the Credit Facility, which does not take into account the impact of the Company’s interest rate swap, was 1.57%. As of July 4, 2014, the Company had \$300 million of borrowing capacity available under the Revolving Credit Facility. This borrowing capacity may vary from period to period based upon the debt and EBITDA levels of the Company, which impacts the covenant calculations described above.

Interest Rate Swap – From time to time, the Company enters into interest rate swap agreements in order to hedge against potential changes in cash flows on the outstanding borrowings on the Credit Facility. The variable rate

received on the interest rate swaps and the variable rate paid on the debt have the same rate of interest, excluding the credit spread, and resets and pays interest on the same date. During 2012, the Company entered into a three-year \$150

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million interest rate swap, which amortizes \$50 million per year. This swap was entered into in order to hedge against potential changes in cash flows on the outstanding Credit Facility borrowings, which are also indexed to the one-month LIBOR rate. This swap is being accounted for as a cash flow hedge. Information regarding the Company's outstanding interest rate swap as of July 4, 2014 is as follows (dollars in thousands):

Instrument	Type of Hedge	Notional Amount	Start Date	End Date	Pay Fixed Rate	Current Receive Floating Rate	Fair Value July 4, 2014	Balance Sheet Location
Interest rate swap	Cash flow	\$100,000	Feb-13	Feb-16	0.573 %	0.153 %	\$(272)	Other Long-Term Liabilities

The estimated fair value of the interest rate swap agreement represents the amount the Company expects to receive (pay) to terminate the contract. No portion of the change in fair value of the Company's interest rate swap during the six months ended July 4, 2014 was considered ineffective. The amount recorded as Interest Expense during the six months ended July 4, 2014 and June 28, 2013 related to the Company's interest rate swap was \$0.2 million and \$0.1 million, respectively.

Convertible Subordinated Notes – In March 2007, the Company issued \$197.8 million of convertible subordinated notes ("CSN") at a 5% discount. CSN accrued interest at 2.25% per annum. The effective interest rate of CSN, which took into consideration the amortization of the discount and deferred fees related to the issuance of these notes, was 8.5%. On February 20, 2013, the Company redeemed all outstanding CSN.

The contractual interest and discount amortization for CSN were as follows (in thousands):

	Three Months ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Contractual interest	\$—	\$—	\$—	\$634
Discount amortization	—	—	—	5,368

The expected future minimum principal payments under the Term Loan as of July 4, 2014 are as follows (in thousands):

Remainder of 2014	\$5,000
2015	11,250
2016	16,250
2017	20,000
2018	20,000
Thereafter	120,000
Total	\$192,500

The Company has the ability and intent to use availability under the Revolving Credit Facility to fund principal payments on the Term Loan. As such, the entire balance of the Term Loan is classified as a non-current liability in the condensed consolidated balance sheets.

Deferred Financing Fees - The change in deferred financing fees is as follows (in thousands):

At January 3, 2014	\$3,860
Amortization during the period	(387)
At July 4, 2014	\$3,473

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GREATBATCH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – Unaudited

6. DEFINED BENEFIT PLANS

The Company is required to provide its employees located in Switzerland, Mexico and France certain statutorily mandated defined benefits. Under these plans, benefits accrue to employees based upon years of service, position, age and compensation. The defined benefit plan provided to employees located in Switzerland is a funded contributory plan while the plans that provide benefits to employees located in Mexico and France are unfunded and noncontributory. The liability and corresponding expense related to these benefit plans is based on actuarial computations of current and future benefits for employees.

During 2012, the Company transferred most major functions performed at its facilities in Switzerland into other existing facilities. As a result, the Company curtailed its defined benefit plan provided to employees at those Swiss facilities and recognized a curtailment gain during 2013. In accordance with ASC 715, this gain was recognized in Other Operating Expenses, Net as the related employees were terminated. Refer to Note 8 "Other Operating Expenses, Net" for further information.

The change in net defined benefit plan liability is as follows (in thousands):

At January 3, 2014	\$1,691
Net defined benefit cost	154
Benefit payments	(115)
Foreign currency translation	4
At July 4, 2014	\$1,734

Net defined benefit cost (income) is comprised of the following (in thousands):

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Service cost	\$52	\$69	\$104	\$151
Interest cost	20	40	39	103
Curtailed gain (Other Operating Expenses, Net)	—	—	—	(1,150)
Amortization of net loss	5	—	11	—
Net defined benefit (income) cost	\$77	\$109	\$154	\$(896)

7. STOCK-BASED COMPENSATION

The components and classification of stock-based compensation expense were as follows (in thousands):

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Stock options	\$612	\$705	\$1,216	\$1,410
Restricted stock and units	1,601	1,482	3,158	2,945
401(k) Plan stock contribution	1,339	2,729	2,355	2,992
Total stock-based compensation expense	\$3,552	\$4,916	\$6,729	\$7,347
Cost of sales	\$1,147	\$1,707	\$2,058	\$2,129
Selling, general and administrative expenses	1,998	2,587	3,921	4,454
Research, development and engineering costs, net	407	622	750	764
Total stock-based compensation expense	\$3,552	\$4,916	\$6,729	\$7,347

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The weighted average fair value and assumptions used to value options granted are as follows:

	Six Months Ended			
	July 4, 2014	June 28, 2013		
Weighted average fair value	\$16.43	\$8.38		
Risk-free interest rate	1.73	% 0.73		%
Expected volatility	39	% 39		%
Expected life (in years)	5	5		
Expected dividend yield	—	% —		%

The following table summarizes time-vested stock option activity:

	Number of Time-Vested Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value (In Millions)
Outstanding at January 3, 2014	1,616,409	\$22.92		
Granted	183,571	43.84		
Exercised	(179,032)	) 22.83		
Forfeited or expired	(29,792)	) 27.32		
Outstanding at July 4, 2014	1,591,156	25.26	6.5	\$38.7
Exercisable at July 4, 2014	1,168,372	23.05	5.7	\$31.0

The following table summarizes performance-vested stock option activity:

	Number of Performance- Vested Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value (In Millions)
Outstanding at January 3, 2014	177,261	\$23.27		
Exercised	(54,271)	) 23.32		
Outstanding at July 4, 2014	122,990	23.26	3.4	\$3.2
Exercisable at July 4, 2014	122,990	23.26	3.4	\$3.2

The following table summarizes time-vested restricted stock and restricted stock unit activity:

	Time-Vested Activity	Weighted Average Fair Value
Nonvested at January 3, 2014	67,575	\$26.37
Granted	39,191	44.08
Vested	(10,270)	) 43.80
Forfeited	(5,812)	) 32.89
Nonvested at July 4, 2014	90,684	31.63

The following table summarizes performance-vested restricted stock and restricted stock unit activity:

	Performance- Vested Activity	Weighted Average Fair Value
Nonvested at January 3, 2014	779,678	\$16.41
Granted	186,825	31.33
Vested	(221,470)	) 18.51
Forfeited	(24,022)	) 17.86
Nonvested at July 4, 2014	721,011	19.58

8. OTHER OPERATING EXPENSES, NET

Other Operating Expenses, Net is comprised of the following (in thousands):

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
2014 investments in capacity and capabilities	\$2,166	\$—	\$2,218	\$—
2013 operating unit realignment	32	852	1,035	852
Orthopaedic facility optimization costs	1,187	2,667	36	5,303
Medical device facility optimization	—	125	11	230
ERP system upgrade (income) costs	(10	) 64	(82	) 385
Acquisition and integration (income) costs	47	71	(381	) 182
Asset dispositions, severance and other	839	43	1,210	108
	\$4,261	\$3,822	\$4,047	\$7,060

2014 investments in capacity and capabilities. In 2014, the Company announced several initiatives to invest in capacity and capabilities and to better align its resources to meet its customers' needs and drive organic growth and profitability. This included the following:

• Functions currently performed at the Company's facility in Plymouth, MN to manufacture catheters and introducers will transfer into the Company's existing facility in Tijuana, Mexico by the first half of 2016.

• Functions currently performed at the Company's facilities in Beaverton, OR and Raynham, MA to manufacture products for the portable medical market will transfer to a new facility in Tijuana, Mexico by the end of 2015.

• Products currently manufactured at the Beaverton facility, which do not serve the portable medical market, are planned to transfer to the Company's Raynham facility.

• Establishing a R&D hub in the Minneapolis/St. Paul, MN area for the Company's Global R&D QiG - Medical Device Systems team, which will serve as the technical center of expertise for active implantable medical device development, implantable leads design, system level design verification testing, and continuation engineering. As part of this initiative, the design engineering responsibilities currently performed at our Cleveland, OH facility will be transferred to the new R&D hub by the end of 2014.

• Establishing a commercial operations hub at its global headquarters in Frisco, Texas. This initiative will build upon the investment the Company has made to its global sales and marketing function and is expected to be completed during the first half of 2015.

The total capital investment expected for these initiatives is between \$18.0 million and \$20.0 million, of which \$0.3 million has been expended to date. Total restructuring charges expected to be incurred in connection with this realignment are between \$22.0 million and \$27.0 million, of which \$2.2 million has been incurred to date. Expenses related to this initiative are recorded within the applicable segment and corporate cost centers that the expenditures relate to and include the following:

- Severance and retention: \$7.0 million - \$9.0 million;
- Accelerated depreciation and asset write-offs: \$2.0 million - \$3.0 million; and
- Other: \$13.0 million - \$15.0 million

Other costs primarily consist of costs to relocate certain equipment and other personnel, duplicate personnel costs, disposal and travel expenditures. All expenses are cash expenditures, except accelerated depreciation and asset write-offs.

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The change in accrued liabilities related to the 2014 investments in capacity and capabilities is as follows (in thousands):

	Severance and Retention	Accelerated Depreciation/Asset Write-offs	Other	Total
At January 3, 2014	\$ —	\$ —	\$—	\$—
Restructuring charges	531	33	1,654	2,218
Write-offs	—	(33	) —	(33)
Cash payments	—	—	(1,234	) (1,234)
At July 4, 2014	\$ 531	\$ —	\$ 420	\$ 951

2013 operating unit realignment. In June 2013, the Company initiated a plan to realign its operating structure in order to optimize its continued focus on profitable growth. As part of this initiative, the sales and marketing and operations groups of its former Implantable Medical and Electrochem Solutions (“Electrochem”) reportable segments were combined into one sales and marketing and one operations group serving the entire Company. This initiative is expected to be completed during 2014. Total restructuring charges expected to be incurred in connection with this realignment are between \$6.7 million and \$7.1 million, of which \$6.7 million has been incurred to date. Expenses related to this initiative are recorded within the applicable segment and corporate cost centers that the expenditures relate to and include the following:

Severance and retention: \$5.0 million – \$5.2 million; and

Other: \$1.7 million – \$1.9 million.

Other costs primarily consist of relocation, recruitment and travel expenditures.

The change in accrued liabilities related to the 2013 operating unit realignment is as follows (in thousands):

	Severance and Retention	Other	Total
At January 3, 2014	\$465	\$746	\$ 1,211
Restructuring charges	852	183	1,035
Cash payments	(1,205	) (774	) (1,979)
At July 4, 2014	\$ 112	\$ 155	\$ 267

Orthopaedic facility optimization costs. In 2010, the Company began updating its Indianapolis, IN facility to streamline operations, consolidate two buildings, increase capacity, further expand capabilities and reduce dependence on outside suppliers. This initiative was completed in 2011.

In 2011, the Company began construction on an orthopaedic manufacturing facility in Fort Wayne, IN and transferred manufacturing operations being performed at its Columbia City, IN location into this new facility. This initiative was completed in 2012.

During 2012, the Company transferred manufacturing and development operations performed at its facilities in Orvin and Corgemont, Switzerland into existing facilities in Fort Wayne, IN and Tijuana, Mexico. In connection with this consolidation, in 2012, the Company entered into an agreement to sell assets related to certain non-core Swiss orthopaedic product lines to an independent third party including inventory, machinery, equipment, customer lists and technology related to these product lines. This transaction closed during the first quarter of 2013 and the Company received payments totaling \$4.7 million in 2013 in connection with this transaction and the third party assumed \$2.4 million of severance liabilities. During the first half of 2014, the Company recognized a gain and received an additional contingent payment of \$2.7 million from the third party in connection with the achievement of certain milestones defined in the sales agreement. In addition, during the first quarter of 2013, the Company recognized a pension curtailment gain in connection with this consolidation. Refer to Note 6 "Defined Benefit Plans" for further

information. These gains were recognized in Other Operating Expenses, Net in the Condensed Consolidated Statements of Operations.

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During 2013, the Company initiated a project to expand its Chaumont, France facility in order to enhance its capabilities and fulfill larger volume customer supply agreements. This initiative is expected to be completed over the next three years.

The total capital investment expected for these initiatives is between \$30 million and \$35 million, of which \$23.6 million has been expended to date. Total expense expected to be incurred for these initiatives is between \$43 million and \$48 million, of which \$41.2 million has been incurred to date. All expenses are recorded within the Greatbatch Medical segment and are expected to include the following:

Severance and retention: approximately \$11 million;

Accelerated depreciation and asset write-offs: approximately \$13 million; and

Other: \$19 million – \$24 million.

Other costs include production inefficiencies, moving, revalidation, personnel, training and travel costs associated with these consolidation projects.

All expenses are cash expenditures, except accelerated depreciation and asset write-offs. The change in accrued liabilities related to the orthopaedic facility optimization is as follows (in thousands):

	Severance and Retention	Accelerated Depreciation/Asset Write-offs	Other	Total
At January 3, 2014	\$—	\$—	\$857	\$857
Restructuring charges (income)	—	(2,655	) 2,691	36
Cash (payments) receipts	—	2,655	(2,952	) (297
At July 4, 2014	\$—	\$—	\$596	\$596

Medical device facility optimization. Near the end of 2011, the Company initiated plans to upgrade and expand its manufacturing infrastructure in order to support its medical device strategy. This includes the transfer of certain product lines to create additional capacity for the manufacture of medical devices, expansion of two existing facilities, as well as the purchase of equipment to enable the production of medical devices. These initiatives are expected to be completed over the next year. Total capital investment under these initiatives is expected to be between \$15 million and \$20 million, of which approximately \$12.5 million has been expended to date. Total expenses expected to be incurred on these projects is between \$2.0 million and \$3.0 million, of which \$1.8 million has been incurred to date. All expenses are recorded within the Greatbatch Medical segment and are expected to include the following:

Production inefficiencies, moving and revalidation: \$0.5 million – \$1.0 million;

Personnel: \$1.0 million – \$1.5 million; and

Other: approximately \$1.0 million.

The change in accrued liabilities related to the medical device facility optimization is as follows (in thousands):

	Production Inefficiencies, Moving and Revalidation	Personnel	Other	Total
At January 3, 2014	\$—	\$—	\$—	\$—
Restructuring charges	—	1	10	11
Cash payments	—	(1	) (10	) (11
At July 4, 2014	\$—	\$—	\$—	\$—

ERP system upgrade (income) costs. In 2011, the Company initiated plans to upgrade its existing global ERP system. This initiative was completed during the first half of 2014. Total capital investment expended under this initiative was

\$4.0 million. Total expenses incurred on this initiative were \$5.8 million. Expenses related to this initiative were recorded within the applicable segment and corporate cost centers that the expenditures related to and included the following:

- Training and consulting costs: \$3.3 million; and
- Accelerated depreciation and asset write-offs: \$2.5 million.

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The change in accrued liabilities related to the ERP system upgrade is as follows (in thousands):

	Training & Consulting Costs	Accelerated Depreciation/Asset Write-offs	Total
At January 3, 2014	\$—	\$—	\$—
Restructuring income	(82	) —	(82
Cash receipts	82	—	82
At July 4, 2014	\$—	\$—	\$—

Acquisition and integration (income) costs. During 2014 and 2013, the Company incurred (income) cost related to the integration of Micro Power Electronics, Inc. and NeuroNexus Technologies, Inc., which were acquired in December 2011 and February 2012, respectively. These expenses were primarily for retention bonuses, travel costs in connection with integration efforts, training, severance, and the change in fair value of the contingent consideration recorded in connection with these acquisitions. Refer to Note 13 "Fair Value Measurements" for discussion on changes in fair value of the contingent consideration, which resulted in net gains being recognized in Other Operating Expenses, Net in the Condensed Consolidated Statements of Operations for the first two quarters of 2014.

Asset dispositions, severance and other. During 2014 and 2013, the Company recorded charges in connection with various asset disposals and write downs. Additionally, during 2014 the Company recorded charges as a result of various tax planning initiatives in connection with its business reorganization to align its contract manufacturing operations, which is expected to produce tax savings over the long-term. Costs incurred primarily relate to consulting and IT development, which are expected to be completed during the second half of 2014.

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9. INCOME TAXES

The income tax provision for interim periods is determined using an estimate of the annual effective tax rate, adjusted for discrete items, if any, that are taken into account in the relevant period. Each quarter, the estimate of the annual effective tax rate is updated, and if the estimated effective tax rate changes, a cumulative adjustment is made. 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, business reorganizations, implementation of tax planning strategies, settlements with taxing authorities and foreign currency fluctuations. As of July 4, 2014, the balance of unrecognized tax benefits is approximately \$1.9 million. It is reasonably possible that a reduction of up to \$0.1 million of the balance of unrecognized tax benefits may occur within the next twelve months as a result of potential audit settlements. Approximately \$1.7 million of the balance of unrecognized tax benefits would favorably impact the effective tax rate, net of federal benefit on state issues, if recognized.

10. COMMITMENTS AND CONTINGENCIES

Litigation – On December 21, 2012, the Company and several other unaffiliated parties were named as defendants in a personal injury and wrongful death action filed in the 113th Judicial District Court of Harris County, Texas. The complaint seeks damages alleging marketing and product defects and failure to warn, negligence and gross negligence relating to a product the Company manufactured and sold to a customer, one of the other named defendants. The Company's customer, in turn, incorporated the Greatbatch product into its own product which it sold to its customer, another named defendant. This matter is currently scheduled for trial in the second half of 2014.

The Company is indemnified by its customer against any loss in this matter, including costs of defense, which obligation is supported by the customer's product liability insurance coverage in the amount of \$5 million. The Company also has its own product liability insurance coverage, which has a \$10 million retention. The Company has meritorious defenses and is vigorously defending the matter. In the event of an adverse judgment, however, the Company could have liability to the extent of the amount of any award its customer is unable to satisfy. To date, the Company has not recorded a reserve in connection with this matter since any potential loss is not currently probable and the range of loss is not reasonably estimable at this time.

The Company is a party to various other legal actions arising in the normal course of business. While the Company does not expect that the ultimate resolution of any of these pending actions will have a material effect on its consolidated results of operations, financial position, or cash flows, litigation is subject to inherent uncertainties and there can be no assurance that any pending legal action, which the Company currently believes to be immaterial, does not become material in the future.

Product Warranties– The Company generally warrants that its products will meet customer specifications and will be free from defects in materials and workmanship. The change in aggregate product warranty liability is as follows (in thousands):

At January 3, 2014	\$1,819	
Reduction to warranty reserve	(274)
Warranty claims paid	(355)
At July 4, 2014	\$1,190	

Purchase Commitments – Contractual obligations for purchase of goods or services are defined as agreements that are enforceable and legally binding on the Company and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum, or variable price provisions; and the approximate timing of the transaction. The Company's purchase orders are normally based on its current manufacturing needs and are fulfilled by its vendors within short time horizons. The Company also enters into blanket orders with vendors that have preferred pricing and terms, however these orders are normally cancelable without penalty. As of July 4, 2014, the total contractual obligation related to such expenditures is approximately \$29.2 million and will primarily be funded by existing cash and cash equivalents, cash flow from operations, or borrowings under the Credit Facility. The Company also enters into contracts for outsourced services; however, the obligations under these contracts were not significant and the contracts generally contain clauses allowing for cancellation without significant penalty.

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Workers' Compensation Trust - The Company was a member of a group self-insurance trust that provided workers' compensation benefits to its Western New York employees (the "Trust"). Under the Trust agreement, each participating organization has joint and several liability for Trust obligations if the assets of the Trust are not sufficient to cover those obligations. During 2011, the Company was notified by the Trust of its intention to cease operations at the end of 2011, and was assessed a pro-rata share of future costs related to the Trust. Based on actual experience, the Company could receive a refund or be assessed additional contributions for workers' compensation claims insured by the Trust. Since 2011, the Company utilized a traditional insurance provider for workers' compensation coverage.

Operating Leases – The Company is a party to various operating lease agreements for buildings, equipment and software. Estimated future operating lease expense is as follows (in thousands):

Remainder of 2014	\$2,557
2015	4,642
2016	4,001
2017	1,471
2018	1,002
Thereafter	936
Total estimated operating lease expense	\$14,609

Foreign Currency Contracts – The Company enters into forward contracts to purchase Mexican pesos in order to hedge the risk of peso-denominated payments associated with the operations at its Tijuana, Mexico facility. The impact to the Company's results of operations from these forward contracts was as follows (in thousands):

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Increase(reduction) in cost of sales	\$8	\$(390	)\$ (156	)\$ (562
Ineffective portion of change in fair value	—	—	—	—

Instrument	Type of Hedge	Aggregate Notional Amount	Start Date	End Date	\$/Peso	Fair Value	Balance Sheet Location
FX Contract	Cash flow	\$3,854	Jan-14	Dec-14	0.0767	\$(3	Other Current Assets
FX Contract	Cash flow	\$3,160	Jan-14	Dec-14	0.0752	\$58	Other Current Assets

Self-Insured Medical Plan – The Company self-funds the medical insurance coverage provided to its U.S. based employees. The risk to the Company is being limited through the use of stop loss insurance, which has specific stop loss coverage per associate for claims in the year exceeding \$225 thousand per associate with no annual maximum aggregate stop loss coverage. As of July 4, 2014, the Company has \$1.5 million accrued related to the self-insurance portion of its medical plan, which is recorded in Accrued Expenses in the Condensed Consolidated Balance Sheet, and is primarily based upon claim history.

Subsequent Event – On August 12, 2014, the Company purchased all of the outstanding common stock of Centro de Construcción de Cardioestimuladores del Uruguay ("CCC"), headquartered in Montevideo, Uruguay. CCC is an active implantable medical device systems developer and manufacturer that produces a range of devices for global medical device companies, including implantable pulse generators, programmer systems, battery chargers, patient wands and leads. This acquisition allows the Company to more broadly partner with medical device companies, complements the Company's core discrete technology offerings and enhances the Company's medical device innovation efforts. This transaction will be accounted for under the acquisition method of accounting. Accordingly, the operating results of CCC will be included in the Company's QiG segment from the date of acquisition. The aggregate purchase price of

\$18.0 million, plus a working capital adjustment, was funded with cash on hand.

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11. EARNINGS PER SHARE (“EPS”)

The following table illustrates the calculation of Basic and Diluted EPS (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Numerator for basic and diluted EPS:				
Net income	\$12,348	\$9,752	\$27,270	\$15,415
Denominator for basic EPS:				
Weighted average shares outstanding	24,838	23,914	24,726	23,832
Effect of dilutive securities:				
Stock options, restricted stock and restricted stock units	1,063	1,008	1,097	986
Denominator for diluted EPS	25,901	24,922	25,823	24,818
Basic EPS	\$0.50	\$0.41	\$1.10	\$0.65
Diluted EPS	\$0.48	\$0.39	\$1.06	\$0.62

The diluted weighted average share calculations do not include the following securities, which are not dilutive to the EPS calculations or the performance criteria have not been met:

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Time-vested stock options, restricted stock and restricted stock units	179,000	72,000	179,000	395,000
Performance-vested restricted stock units	—	—	—	—

For the 2013 period, no shares related to CSN were included in the diluted EPS calculations as the average share price of the Company’s common stock for that period did not exceed CSN’s conversion price per share.

12. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated Other Comprehensive Income is comprised of the following (in thousands):

	Defined Benefit Plan Liability	Cash Flow Hedges	Foreign Currency Translation Adjustment	Total Pre-Tax Amount	Tax	Net-of-Tax Amount
At April 4, 2014	\$(672)	\$(350)	\$16,134	\$15,112	\$505	\$15,617
Unrealized gain on cash flow hedges	—	18	—	18	(6)	12
Realized loss on foreign currency hedges	—	8	—	8	(3)	5
Realized loss on interest rate swap hedges	—	106	—	106	(37)	69
Foreign currency translation loss	—	—	(393)	(393)	—	(393)
At July 4, 2014	\$(672)	\$(218)	\$15,741	\$14,851	\$459	\$15,310

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	Defined Benefit Plan Liability	Cash Flow Hedges	Foreign Currency Translation Adjustment	Total Pre-Tax Amount	Tax	Net-of-Tax Amount
At January 3, 2014	\$(672)	\$(468)	\$14,952	\$13,812	\$546	\$14,358
Unrealized gain on cash flow hedges	—	168	—	168	(59)	109
Realized gain on foreign currency hedges	—	(156)	—	(156)	55	(101)
Realized loss on interest rate swap hedges	—	238	—	238	(83)	155
Foreign currency translation gain	—	—	789	789	—	789
At July 4, 2014	\$(672)	\$(218)	\$15,741	\$14,851	\$459	\$15,310

	Defined Benefit Plan Liability	Cash Flow Hedges	Foreign Currency Translation Adjustment	Total Pre-Tax Amount	Tax	Net-of-Tax Amount
At March 29, 2013	\$(365)	\$533	\$10,368	\$10,536	\$214	\$10,750
Unrealized loss on cash flow hedges	—	(107)	—	(107)	37	(70)
Realized gain on foreign currency hedges	—	(390)	—	(390)	137	(253)
Realized loss on interest rate swap hedges	—	142	—	142	(50)	92
Foreign currency translation gain	—	—	631	631	—	631
At June 28, 2013	\$(365)	\$178	\$10,999	\$10,812	\$338	\$11,150

	Defined Benefit Plan Liability	Cash Flow Hedges	Foreign Currency Translation Adjustment	Total Pre-Tax Amount	Tax	Net-of-Tax Amount
At December 28, 2012	\$(962)	\$120	\$13,431	\$12,589	\$358	\$12,947
Unrealized gain on cash flow hedges	—	421	—	421	(147)	274
Realized gain on foreign currency hedges	—	(562)	—	(562)	197	(365)
Realized loss on interest rate swap hedges	—	199	—	199	(70)	129
Net defined benefit plan gain (Note 6)	597	—	—	597	—	597
Foreign currency translation loss	—	—	(2,432)	(2,432)	—	(2,432)
At June 28, 2013	\$(365)	\$178	\$10,999	\$10,812	\$338	\$11,150

The realized (gains) losses relating to the Company's foreign currency and interest rate swap hedges were recognized in Cost of Sales and Interest Expense, respectively, in the Condensed Consolidated Statements of Operations.

The net defined benefit plan reclassifications from Accumulated Other Comprehensive Income are as follows (in thousands):

	Six Months Ended June 28, 2013
Net gain occurring during the period	\$(171)
Amortization of losses	(581)
Prior service cost	155
Pre-tax adjustment	(597)
Taxes	—
Net gain	\$(597)

13. FAIR VALUE MEASUREMENTS

Assets and Liabilities Measured at Fair Value on a Recurring Basis

Fair value measurement standards apply to certain financial assets and liabilities that are measured at fair value on a recurring basis (each reporting period). For the Company, these financial assets and liabilities include its derivative instruments and accrued contingent consideration. The Company does not have any nonfinancial assets or liabilities that are measured at fair value on a recurring basis.

Foreign currency contracts – The fair value of foreign currency contracts are determined through the use of cash flow models that utilize observable market data inputs to estimate fair value. These observable market data inputs include foreign exchange rate and credit spread curves. In addition, the Company received fair value estimates from the foreign currency contract counterparty to verify the reasonableness of the Company's estimates. The Company's foreign currency contracts are categorized in Level 2 of the fair value hierarchy. The fair value of the Company's foreign currency contracts will be realized as Cost of Sales as the inventory, which the contracts are hedging the cash flows to produce, is sold, of which approximately \$0.06 million is expected to be realized within the next six months as a reduction to Cost of Sales.

Interest rate swap – The fair value of the Company's interest rate swap outstanding at July 4, 2014 was determined through the use of a cash flow model that utilizes observable market data inputs. These observable market data inputs include LIBOR, swap rates, and credit spread curves. In addition, the Company received a fair value estimate from the interest rate swap counterparty to verify the reasonableness of the Company's estimate. This fair value calculation was categorized in Level 2 of the fair value hierarchy. The fair value of the Company's interest rate swap will be realized as Interest Expense as interest on the Credit Facility is accrued.

Accrued contingent consideration – In circumstances where an acquisition involves a contingent consideration arrangement, the Company recognizes a liability equal to the fair value of the contingent payments it expects to make as of the acquisition date. The Company re-measures this liability each reporting period and records changes in the fair value through Other Operating Expenses, Net. Increases or decreases in the fair value of the contingent consideration liability can result from changes in discount periods and rates, as well as changes in the timing, amount, or the likelihood of achieving the applicable milestones.

The fair value of accrued contingent consideration recorded by the Company represents the estimated fair value of the contingent consideration the Company expects to pay to the former shareholders of NeuroNexus Technologies, Inc. acquired in 2012 based upon the achievement of certain financial and development-based milestones. The fair value of the contingent consideration liability was estimated by discounting to present value, the probability weighted contingent payments expected to be made utilizing a risk adjusted discount rate. During the first quarter of 2014, the financial milestone expired unachieved and as a result, was determined to have a fair value of zero. The maximum amount of future contingent consideration (undiscounted) that the Company could be required to pay for the development milestone is \$1.0 million. The Company's accrued contingent consideration is categorized in Level 3 of the fair value hierarchy.

Changes in accrued contingent consideration were as follows (in thousands):

At January 3, 2014	\$840	
Fair value adjustments	(620)
At July 4, 2014	\$220	

The recurring Level 3 fair value measurements of the Company's contingent consideration liability include the following significant unobservable inputs (dollars in thousands):

Contingent Consideration Liability	Fair Value at July 4, 2014	Valuation Technique	Unobservable Inputs		
Development milestone	\$220	Discounted cash flow	Discount rate	20	%
			Projected year of payment	2015	
			Probability weighted payment amount	\$250	

The following table provides information regarding assets and liabilities recorded at fair value on a recurring basis in the Condensed Consolidated Balance Sheet (in thousands):

Description	Fair Value Measurements Using			
	At July 4, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Foreign currency contracts (Note 10)	\$55	\$—	\$55	\$—
Liabilities				
Interest rate swap (Note 5)	\$272	\$—	\$272	\$—
Accrued contingent consideration	220	—	—	220

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Fair value standards also apply to certain nonfinancial assets and liabilities that are measured at fair value on a nonrecurring basis. The carrying amounts of cash, accounts receivable, accounts payable and accrued expenses approximate fair value because of the short-term nature of these items. As of July 4, 2014, the fair value of the Company's variable rate Long-Term Debt approximates its carrying value and is categorized in Level 2 of the fair value hierarchy. A summary of the valuation methodologies for the Company's assets and liabilities measured on a nonrecurring basis is as follows:

Long-lived assets – The Company reviews the carrying amount of its long-lived assets to be held and used, other than goodwill and indefinite-lived intangible assets, for potential impairment whenever certain indicators are present such as: a significant decrease in the market price of the asset or asset group; a significant change in the extent or manner in which the long-lived asset or asset group is being used or in its physical condition; a significant change in legal factors or in the business climate that could affect the value of the long-lived asset or asset group, including an action or assessment by a regulator; an accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of the asset; a current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of the long-lived asset or asset group; or a current expectation that it is more likely than not the long-lived asset or asset group will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term more likely than not refers to a level of likelihood that is more than 50 percent.

If an indicator is present, potential recoverability is measured by comparing the carrying amount of the long-lived asset or asset group to its related total future undiscounted cash flows. If the carrying value is not recoverable, the asset or asset group is considered to be impaired. Impairment is measured by comparing the asset or asset group's carrying amount to its fair value, which is determined by using independent appraisals or discounted cash flow models. The discounted cash flow model requires inputs such as a risk-adjusted discount rate, terminal values, cash flow projections, and remaining useful lives of the asset or asset group. If the carrying value of the long-lived asset or asset group exceeds the fair value, the carrying value is written down to the fair value in the period identified. During the second quarter of 2014, the Company transferred \$2.1 million of assets relating to the Company's Orvin, Switzerland property to held for sale. The Company did not record any impairment charges related to any of its long-lived assets during the first six months of 2014 and 2013.

Goodwill and indefinite-lived intangible assets – The Company assesses the impairment of goodwill and other indefinite-lived intangible assets on the last day of each fiscal year, or more frequently if certain indicators are present as described above under long-lived assets. The Company assesses goodwill for impairment by comparing the fair value of its reporting units to their carrying amounts. If the fair value of a reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the implied fair value of the goodwill within the reporting unit is less than its carrying value. Fair values for reporting units are determined based on discounted cash flow models and market multiples. The discounted cash flow model requires inputs such as a risk-adjusted discount rate, terminal

values, probability of success factor, and cash flow projections. The fair value from the discounted cash flow model is then combined, based on certain weightings, with market multiples in order to determine the fair value of the reporting unit. These market multiples include revenue multiples and multiples of earnings before interest, taxes, depreciation and amortization.

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Indefinite-lived intangible assets are assessed for impairment by comparing the fair value of the intangible asset to its carrying value. If the carrying value of the indefinite-lived intangible asset exceeds the fair value, the carrying value is written down to the fair value in the period identified. The fair value of indefinite-lived intangible assets is determined by using a discounted cash flow model. The discounted cash flow model requires inputs such as a risk-adjusted discount rate, royalty rates, and cash flow projections.

The Company did not record any impairment charges related to its indefinite-lived intangible assets, including goodwill, during the first six months of 2014 and 2013, respectively. See Note 4 “Intangible Assets” for additional information on the Company’s intangible assets.

Cost and equity method investments – The Company holds investments in equity and other securities that are accounted for as either cost or equity method investments and are classified as Other Assets. The total carrying value of these investments is reviewed quarterly for changes in circumstance or the occurrence of events that suggest the Company’s investment may not be recoverable. The fair value of cost or equity method investments is not adjusted if there are no identified events or changes in circumstances that may have a material effect on the fair value of the investments.

Gains and losses realized on cost and equity method investments are recorded in Other (Income) Expense, Net, unless separately stated. The aggregate recorded amount of cost and equity method investments at July 4, 2014 and January 3, 2014 was \$13.6 million and \$12.3 million, respectively. The Company recorded income (loss) related to its cost and equity method investments of \$0.8 million and (\$0.6) million during the first six months of 2014 and 2013, respectively.

14. BUSINESS SEGMENT, GEOGRAPHIC AND CONCENTRATION RISK INFORMATION

In connection with the realignment of the Company's operating structure in 2013 to optimize profitable growth, which included changing the Company's management and reporting structure, the Company reevaluated its operating and reporting segments. Beginning in the fourth quarter of 2013, the Company determined that it has two reportable segments: Greatbatch Medical and QiG Group (“QiG”). As required, the Company reclassified certain prior year amounts to conform them to the current year presentation, including goodwill, segment operating income (loss), and segment sales categorizations.

Greatbatch Medical designs and manufactures medical devices and components where Greatbatch either owns the intellectual property or has unique manufacturing and assembly expertise and includes the financial results of the former Implantable Medical and Electrochem segments, excluding QiG. Greatbatch Medical provides medical devices and components to the following markets:

• **Cardiac/Neuromodulation:** Products include batteries, capacitors, filtered and unfiltered feed-throughs, engineered components, implantable stimulation leads, and enclosures used in implantable medical devices.

• **Orthopaedic:** Products include hip and shoulder joint reconstruction implants, bone plates and spinal devices, and instruments and delivery systems used in hip and knee replacement, trauma fixation, and spinal surgeries.

• **Portable Medical:** Products include batteries, chargers and power supplies for a wide range of medical devices including automated external defibrillators, portable oxygen concentrators, ventilators, and powered surgical tools.

• **Vascular:** Products include introducers, medical coatings, steerable sheaths, and catheters that deliver therapies for various markets such as coronary and neurovascular disease, peripheral vascular disease, interventional radiology, vascular access, atrial fibrillation, and interventional cardiology, plus products for medical imaging and pharmaceutical delivery.

• **Energy, Military, and Environmental (“EME”):** Products include primary and rechargeable batteries and battery packs for demanding applications such as down hole drilling tools.

Greatbatch Medical also offers value-added assembly and design engineering services for medical devices that utilize its component products.

QiG focuses on developing medical device systems for some of healthcare’s most pressing challenges and reflects Greatbatch’s strategic evolution of its product offerings in order to raise the growth and profitability profile of the Company. QiG utilizes a disciplined and diversified portfolio approach with three investment modes: new medical device systems commercialization, collaborative programs with original equipment manufacturers (“OEM”), and strategic equity positions in start-up companies. The development of new medical device systems are facilitated through the establishment of newly formed business entities, usually limited liability companies (“LLC”). These entities

do not own, but have the exclusive right to use the technology of Greatbatch Medical in certain specifically

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GREATBATCH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – Unaudited

	Three Months Ended		Six Months Ended	
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013
Sales by geographic area:				
United States	\$ 77,761	\$ 89,234	\$ 158,873	\$ 160,568
Non-Domestic locations:				
Puerto Rico	31,885	27,158	66,483	55,656
Belgium	17,650	17,277	33,629	34,948
Rest of world	44,785	37,662	87,377	68,424
Total sales	\$ 172,081	\$ 171,331	\$ 346,362	\$ 319,596

Three customers accounted for a significant portion of the Company's sales as follows:

	Three Months Ended		Six Months Ended		
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	
Customer A	17	% 19	% 19	% 19	%
Customer B	17	% 16	% 16	% 17	%
Customer C	12	% 12	% 12	% 14	%
Total	46	% 47	% 47	% 50	%

Long-lived tangible assets by geographic area are as follows (in thousands):

	As of	
	July 4, 2014	January 3, 2014
United States	\$ 114,535	\$ 116,484
Rest of world	28,922	29,289
Total	\$ 143,457	\$ 145,773

15. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In the normal course of business, management evaluates all new accounting pronouncements issued by the Financial Accounting Standards Board ("FASB"), Securities and Exchange Commission, Emerging Issues Task Force, American Institute of Certified Public Accountants or other authoritative accounting bodies to determine the potential impact they may have on the Company's Condensed Consolidated Financial Statements. Based upon this review except as noted below, management does not expect any of the recently issued accounting pronouncements, which have not already been adopted, to have a material impact on the Company's Condensed Consolidated Financial Statements. In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers." The core principle behind ASU 2014-09 is that an entity should recognize revenue in an amount that reflects the consideration to which the entity expects to be entitled in exchange for delivering goods and services. This model involves a five-step process that includes identifying the contract with the customer, identifying the performance obligations in the contract, determining the transaction price, allocating the transaction price to the performance obligations in the contract and recognizing revenue when the entity satisfies the performance obligations. This ASU supersedes existing revenue recognition guidance and is effective for annual reporting periods beginning after December 15, 2016 with early application not permitted. This ASU allows two methods of adoption; a full retrospective approach where three years of financial information are presented in accordance with the new standard, and a modified retrospective approach where this ASU is applied to the most current period presented in the financial statements. The Company is currently assessing the financial impact of adopting the new standard and the methods of adoption; however, given the scope of the new standard, the company is currently unable to provide a reasonable estimate regarding the financial impact or which method of adoption will be elected.

In April 2014, the FASB issued ASU No. 2014-08, "Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity," which amends the definition of a discontinued operation and requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued operations criteria. The revised

guidance changes how entities identify and disclose information about disposal transactions under U.S. GAAP. This ASU is effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) or components initially classified as held for sale in periods beginning on or after December 15, 2014, with early

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GREATBATCH, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – Unaudited

adoption permitted. This ASU will be applicable for disposal transactions, if any, that the Company enters into after the adoption date.

In July 2013, the FASB issued ASU No. 2013-11, “Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.” This ASU requires that entities present an unrecognized tax benefit, or portion of an unrecognized tax benefit, as a reduction to a deferred tax asset in the financial statements for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, with certain exceptions. This ASU was adopted during the first quarter of 2014 and did not impact the Company's Condensed Consolidated Financial Statements as the Company does not have any net operating loss carryforward deferred tax assets that are eligible to be reduced by an unrecognized tax benefit as required by the ASU.

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

Our Business

In connection with the realignment of our operating structure in 2013 to optimize profitable growth, which included changing our management and reporting structure, we reevaluated our operating and reporting segments. Beginning in the fourth quarter of 2013, we have two reportable segments: Greatbatch Medical and QiG Group ("QiG"). As required, prior year amounts have been reclassified in order to conform them to the current year presentation. Greatbatch Medical designs and manufactures products where Greatbatch either owns the intellectual property or has unique manufacturing and assembly expertise. The financial results of Greatbatch Medical include the former Implantable Medical and Electrochem Solutions ("Electrochem") segments, excluding QiG. These products include medical devices and components for the cardiac, neuromodulation, orthopaedic, portable medical, vascular, and energy, military and environmental ("EME") markets. The Greatbatch Medical segment also offers value-added assembly and design engineering services for medical devices that utilize its component products.

QiG focuses on developing medical device systems for some of healthcare's most pressing challenges and reflects Greatbatch's strategic evolution of its product offerings in order to raise the growth and profitability profile of the Company. Through the research and development professionals in QiG, the Company is now investing in three areas — new medical device systems commercialization, collaborative programs with original equipment manufacturers ("OEM") customers, and strategic equity positions in start-up companies — to grow a diversified and distinctive portfolio. The medical device systems developed by QiG will be manufactured by Greatbatch Medical. Currently, no revenue earned by QiG is manufactured by Greatbatch Medical.

Our Customers

The nature and extent of our selling relationships with each of our customers is different in terms of breadth of products purchased, product volumes, length of contractual commitment, ordering patterns, inventory management and selling prices. Our Greatbatch Medical customers include large multi-national OEMs, such as Biotronik, Boston Scientific, Halliburton, Johnson & Johnson, Medtronic, Philips Healthcare, Smith & Nephew, Sorin Group, St. Jude Medical, Stryker, and Zimmer. For the six months ended July 4, 2014, Johnson & Johnson, Medtronic and St. Jude Medical collectively accounted for 47% of our total sales.

Current QiG customers include numerous scientists, hospitals and universities throughout the world who perform research for the neuroscience and clinical markets.

Financial Overview

On an organic constant currency basis, second quarter 2014 sales were consistent with the prior year period. However, for the first six months of 2014, sales increased 8% on an organic constant currency basis, which is ahead of our strategic goal of 5% organic constant currency growth. In comparison to the prior year second quarter and year-to-date periods, foreign currency exchange rate fluctuations increased sales by approximately \$1.5 million and \$2.5 million, respectively. During the second quarter and for the first half of 2014, we experienced double digit growth in sales from our orthopaedic and vascular product lines as we continue to realize the benefits of our increased sales force productivity, marketing efforts and market growth. For the second quarter of 2014, our cardiac and neuromodulation sales decreased 4% due to the timing of shipments of customer orders, as well as the initial end of life impact for two legacy products. However, for the first six months of 2014, cardiac and neuromodulation sales increased 9% due to the timing of customer product launches and inventory replenishments. As expected, our portable medical sales decreased 24% and 12% for the 2014 second quarter and year-to-date periods, respectively, as we are refocusing our product line offerings in the portable medical space to products that have higher profitability and correspondingly have discontinued or reduced volumes in certain of our lower margin products.

We prepare our condensed consolidated financial statements in accordance with generally accepted accounting principles in the United States of America ("GAAP"). Additionally, we consistently report and discuss in our quarterly earnings releases and investor presentations adjusted operating income and margin, adjusted net income, adjusted earnings per diluted share and organic constant currency growth rates. These adjusted amounts, other than organic constant currency growth rates, consist of GAAP amounts excluding the following adjustments to the extent they occur during the period: (i) acquisition-related charges, (ii) facility consolidation, optimization, manufacturing transfer

and system integration charges, (iii) asset write-down and disposition charges, (iv) severance charges in connection with corporate realignments or a reduction in force, (v) litigation charges and gains, (vi) the impact of certain non-cash charges to interest expense, (vii) unusual or infrequently occurring items, (viii) for 2013, certain R&D expenditures (such as medical device design verification (“DVT”) expenses in connection with developing our neuromodulation platform), (ix) gain/loss on the sale of investments, (x) the income tax (benefit) related to these adjustments and (xi) certain tax items related to the Federal R&D Tax Credit which are outside the normal benefit received. To calculate organic constant currency growth rates, which excludes the impact of changes in foreign currency

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exchange rates, as well as the impact of any acquisitions or divestitures of product lines on sales growth rates, we convert current period sales from local currency to U.S. dollars using the previous periods' foreign currency exchange rates and exclude the amount of sales acquired/divested during the period from the current/previous period amounts, respectively.

We believe that reporting these amounts provides important supplemental information to our investors and creditors seeking to understand the financial and business trends impacting our financial condition and results of operations. Additionally, certain performance-based compensation incentives provided to our executives are determined utilizing these adjusted amounts.

A reconciliation of GAAP operating income (loss) to adjusted amounts is as follows (dollars in thousands):

	Three Months Ended								
	Greatbatch Medical		QiG		Unallocated		Total		
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	
Sales	\$171,216	\$170,494	\$865	\$837	\$—	\$—	\$172,081	\$171,331	
Operating income (loss) as reported	\$32,439	\$29,845	\$(6,173)	\$(7,377)	\$(6,727)	\$(5,333)	\$19,539	\$17,135	
Adjustments:									
Medical device DVT expenses (RD&E) ^(a)	—	—	—	1,235	—	—	—	1,235	
Consolidation and optimization (income) costs	3,342	3,191	38	—	(5)	517	3,375	3,708	
Acquisition and integration (income) expenses	30	31	(173)	40	190	—	47	71	
Asset dispositions, severance and other	3	43	—	—	836	—	839	43	
Adjusted operating income (loss)	\$35,814	\$33,110	\$(6,308)	\$(6,102)	\$(5,706)	\$(4,816)	\$23,800	\$22,192	
Adjusted operating margin	20.9	% 19.4	% N/A	N/A	N/A	N/A	13.8	% 13.0	%
	Six Months Ended								
	Greatbatch Medical		QiG		Unallocated		Total		
	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	July 4, 2014	June 28, 2013	
Sales	\$344,811	\$318,116	\$1,551	\$1,480	\$—	\$—	\$346,362	\$319,596	
Operating income (loss) as reported	\$67,567	\$56,360	\$(12,086)	\$(14,733)	\$(13,418)	\$(10,153)	\$42,063	\$31,474	
Adjustments:									
Medical device DVT expenses (RD&E) ^(a)	—	—	—	2,969	—	—	—	2,969	
Consolidation and optimization costs	2,920	5,951	66	—	232	819	3,218	6,770	

Acquisition and integration (income) 30 expenses	71	(603)	110	192	1	(381)	182		
Asset dispositions, severance and other (7)	108	—	—	1,217	—	1,210	108		
Adjusted operating income (loss)	\$70,510	\$62,490	\$(12,623)	\$(11,654)	\$(11,777)	\$(9,333)	\$46,110	\$41,503	
Adjusted operating margin	20.4 %	19.6 %	N/A	N/A	N/A	N/A	13.3 %	13.0 %	%

(a) As a result of our premarket approval (“PMA”) submission to the United States Food & Drug Administration (“FDA”) for our Spinal Cord Stimulation (“SCS”) system to treat chronic pain of the trunk and limbs in December 2013, we no longer exclude design verification testing (“DVT”) costs associated with this system from adjusted operating income and adjusted diluted EPS. DVT costs incurred in connection with the development of this system during the three and six month periods ended July 4, 2014 were \$455 thousand and \$1.2 million, respectively.

GAAP operating income for the second quarter and first six months of 2014 increased 14% and 34%, respectively, in comparison to the prior year. Adjusted operating income, which excludes net other operating expenses and DVT costs (for the 2013 period only), increased 7% and 11%, respectively, for the second quarter and first six months of 2014. These GAAP and adjusted operating income variances are primarily due to the following:

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Second Quarter 2014

A 2% increase in gross profit driven primarily by higher sales volumes. Additionally, in comparison to the prior year second quarter, gross profit as a percentage of sales increased 60 basis points due to production efficiencies and lower performance-based compensation in comparison to the prior year quarter, which more than offset the impact of contractual price concessions granted in exchange for long-term agreements with our customers;

A 2% decrease in selling, general, and administrative (“SG&A”) expenses primarily attributable to our operating unit realignment in the second half of 2013 and lower performance-based compensation, partially offset by our continued investments in sales and marketing and increased legal fees, which includes higher patent filing costs;

- A 9% decrease in our net research, development and engineering (“RD&E”) costs primarily due to a lower level of DVT costs incurred in connection with the development of our SCS system, an increase in customer cost reimbursements due to the timing of achievement of milestones on various projects, and lower performance-based compensation; and

The increase in GAAP operating income for the second quarter of 2014 in comparison to 2013 also included a higher level of net other operating expenses incurred in connection with our 2014 investments in capacity and capabilities, offset by lower costs incurred in connection with our orthopaedic facility optimization initiative and 2013 operating unit realignment. See Cost Savings and Consolidation Initiatives section for further description of these projects.

First Six Months 2014

A 9% increase in gross profit driven primarily by higher sales volumes. Additionally, in comparison to the prior year first half, gross profit as a percentage of sales increased 30 basis points due to production efficiencies and an increased sales mix of higher margin products, which more than offset the impact of price concessions granted in exchange for long-term agreements with our customers;

A 3% increase in SG&A expenses primarily attributable to our increased investments in sales and marketing and increased legal fees, which includes higher patent filing costs, partially offset by cost savings realized in connection with our operating unit realignment in the second half of 2013;

A 5% increase in our net RD&E costs primarily attributable to lower customer cost reimbursements due to the timing of achievement of milestones on various projects. Additionally, lower DVT costs were offset by higher costs incurred in connection with the development of our next generation cardiac products (i.e. batteries, capacitors, filtered feedthroughs); and

The increase in GAAP operating income for the first six months of 2014 in comparison to 2013 also included a lower level of net other operating expenses incurred in connection with our orthopaedic facility optimization initiative. Additionally, in the first quarter of 2014, we recognized a \$2.5 million gain in connection with the achievement of contingent earnouts related to the sale of certain Swiss orthopaedic product lines in 2013.

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A reconciliation of GAAP net income and diluted EPS to adjusted amounts is as follows (in thousands, except per share amounts):

	Three Months Ended				Six Months Ended			
	July 4, 2014		June 28, 2013		July 4, 2014		June 28, 2013	
	Net Income	Per Diluted Share	Net Income	Per Diluted Share	Net Income	Per Diluted Share	Net Income	Per Diluted Share
Net income as reported	\$12,348	\$0.48	\$9,752	\$0.39	\$27,270	\$1.06	\$15,415	\$0.62
Adjustments:								
Medical device DVT expenses (RD&E) ^(a)	—	—	803	0.03	—	—	1,930	0.08
Consolidation and optimization costs ^(a)	2,181	0.08	2,956	0.12	1,255	0.05	5,296	0.21
Acquisition and integration (income) expenses ^(a)	31	—	46	—	(248)	(0.01)	118	—
Asset dispositions, severance and other ^(a)	545	0.02	26	—	787	0.03	91	—
Loss (gain) on cost and equity method investments, net ^{(a)(b)}	27	—	352	0.01	(507)	(0.02)	398	0.02
CSN conversion option discount and deferred fee accelerated amortization ^{(a)(c)}	—	—	—	—	—	—	2,906	0.12
R&D Tax Credit ^(d)	400	0.02	—	—	800	0.03	(1,500)	(0.06)
Adjusted net income and diluted EPS ^(e)	\$15,532	\$0.60	\$13,935	\$0.56	\$29,357	\$1.14	\$24,654	\$0.99
Adjusted diluted weighted average shares	25,901		24,922		25,823		24,818	

(a) Net of tax amounts computed using a 35% tax rate for all non-Swiss items and a 0% tax rate for Swiss items for both the 2014 and 2013 periods.

Pre-tax amount is a loss of \$42 thousand and a gain of \$780 thousand for the 2014 quarter and year-to-date periods, respectively, and a loss of \$542 thousand and \$612 thousand for the 2013 quarter and year-to-date periods, respectively.

(c) Pre-tax amount is \$4.5 million for the 2013 year-to-date period.

The Federal R&D tax credit has not yet been extended for 2014. The 2014 amount assumes that the tax credit will be enacted for the full year 2014. The 2013 amount relates to the 2012 portion of the R&D tax credit which was reinstated in the first quarter of 2013 retroactive to the beginning of 2012. As required, the impact of the R&D tax credit relating to 2012 was recognized in the first quarter of 2013.

(e) The per share data in this table has been rounded to the nearest \$0.01 and therefore may not sum to the total. GAAP and adjusted diluted EPS for the second quarter of 2014 were \$0.48 and \$0.60, respectively, compared to \$0.39 and \$0.56, respectively, for the second quarter 2013. For the first six months of 2014, GAAP and adjusted diluted EPS were \$1.06 and \$1.14, respectively, compared to \$0.62 and \$0.99 per share, respectively, for the same period of 2013. These variances were primarily due to the same factors impacting GAAP and adjusted operating income discussed above, as well as the following:

• Lower interest expense as a result of lower interest rates paid on our long-term debt due to the repayment of our convertible subordinated debt with availability under our Credit Facility in 2013;

• The changes in the GAAP effective tax rate between the 2014 second quarter and year-to-date periods in comparison to the same periods of 2013 were primarily due to the timing of the Federal R&D tax credit, as well as the 2014

periods having higher income in lower tax rate jurisdictions. The Federal R&D tax credit expired at the end of 2013 and has not yet been extended for 2014. Additionally, we recognized the full year 2012 R&D tax credit in the first quarter of 2013 as the credit was reinstated, retroactive to the beginning of 2012, in that period.

An increase in weighted average diluted shares outstanding for the second quarter and first six months of 2014 versus the same periods of 2013 as a result of the increase in our stock price during those respective periods. This increase reduced the 2014 second quarter and year to date diluted EPS by \$0.02 and \$0.04 per share, respectively, on both a GAAP and adjusted basis.

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Financial Guidance

Based upon our results for the first two quarters of 2014, as well as our expectations for the remainder of the year, we believe that our revenue and adjusted diluted EPS for 2014 will be in-line with our guidance provided at the beginning of the year as follows:

Sales	\$685 - \$705 million
GAAP Operating Income as a % of Sales	11.0% - 11.5%
Adjusted Operating Income as a % of Sales	13.0% - 13.3%
GAAP Diluted EPS	\$1.94 - \$1.99
Adjusted Diluted EPS	\$2.25 - \$2.35

Adjusted operating income for 2014 is expected to consist of GAAP operating income excluding items such as acquisition, consolidation, integration and asset disposition/write-down charges totaling approximately \$12 million to \$15 million. The after tax impact of these adjustments is estimated to be \$7.5 million to \$10 million or \$0.31 to \$0.35 per share.

Our CEO's View

As we continue to invest and execute our global strategy, we are seeing results in line with our expectations. We currently expect our vascular and orthopaedic product lines to continue to deliver double digit growth, which will be balanced by our large, slower growth markets, such as cardiac rhythm management and portable medical. We remain focused on delivering 5% year over year revenue growth and returning two times that amount to the bottom line leveraging our deep customer relationships, the strength of our intellectual property and our culture of continuous improvement. During the quarter, we announced several capacity realignments, including investment of up to \$45 million to complete these projects. Additionally, we received CE Mark for our spinal cord stimulator - Algovita, and we remain on track with our active implantable medical device strategy.

Product Development

Greatbatch Medical

Our core business is well positioned because our OEM customers leverage our portfolio of intellectual property, and we continue to build a healthy pipeline of diverse medical technology opportunities. We continue to deepen our relationships with our OEM customers and continue to see an increased pace of product development opportunities. These product development opportunities, when combined with our increased sales and marketing resources, are expected to allow us to continue to grow faster than our underlying markets. Some of the product development opportunities Greatbatch Medical is pursuing are as follows:

Product Line	Product Development Opportunities
Cardiac/ Neuromodulation	Developing next generation technology programs including Gen 2 Q _{HR} battery, next generation filtered feedthroughs, and high voltage capacitors.

Orthopaedic	Developing single use instruments and a suite of reusable bone preparation instruments with an emphasis on increased efficacy and longer life.
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Portable Medical	Developing wireless power solutions for the surgical tool marketplace.
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Vascular	Developing introducer technologies to expand into new clinical markets, as well as line extensions for current introducer platforms to better serve existing clinical markets and customers.
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EME QiG	Developing wide range temperature battery packs.
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Through QiG, we provide our Greatbatch Medical customers with complete medical device systems. This medical device strategy includes strategic equity investments and medical devices developed independently, as well as in conjunction with our OEM partners. While we do not intend to discuss each of these projects individually, we will discuss significant milestones as they occur.

Algovita (formerly known as Algostim), our spinal cord stimulator to treat chronic intractable pain of the trunk and/or limbs, was designed to target unmet clinical needs with a focus on safety and product differentiation for all user groups. This product was submitted for PMA to the FDA in December 2013, and in January 2014 documentation for European CE Mark was submitted to the notified body, TÜV SÜD America. CE Mark approval was received in June 2014. We continue to move through the regulatory approval process and we believe we will be in a position to receive PMA approval in early 2015.

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CardiomoniX is an implantable loop recorder for cardiac arrhythmia diagnostics that is being designed to address the unmet needs of remote patient monitoring and data quality.

QiG is in the early stages of development of two additional medical device systems, which are targeting approved and emerging indications. Additionally, based upon the technology acquired from NeuroNexus Technologies, Inc. (“NeuroNexus”), QiG is developing a platform of thin-film electrodes for neuromodulation leads, sub-systems and components.

Cost Savings and Consolidation Initiatives

In 2014 and 2013, we recorded charges in Other Operating Expenses, Net related to various cost savings and consolidation initiatives. These initiatives were undertaken to improve our operational efficiencies and profitability and consist of our 2013 operating unit realignment, optimizing our orthopaedic facilities, and upgrading and expanding our manufacturing infrastructure to support our medical device strategy. When fully implemented, the operating unit realignment is expected to result in annual savings of approximately \$7.0 to \$7.7 million and the orthopaedic and medical device initiatives are expected to generate approximately \$10 million to \$15 million of annual cost savings and to increase our capacity in order to support our growth and the manufacturing of complete medical devices.

In the second quarter of 2014, we announced several initiatives to invest in capacity and capabilities and to better align our resources to meet our customers' needs and drive organic growth and profitability. This included transferring certain functions currently performed at our Plymouth, MN and Beaverton, OR facilities into new and existing facilities in Tijuana, Mexico. Additionally, we announced the establishment a R&D hub in the Minneapolis/St. Paul, MN area for the Company's Global R&D QiG - Medical Device Systems team and a commercial operations hub at our global headquarters in Frisco, Texas. We believe these initiatives will generate up to \$17 million of annualized savings beginning in 2016.

Additional information regarding the timing, cash flow impact and amount of future expenditures for these initiatives is set forth in Note 8 “Other Operating Expenses, Net” of the Notes to the Condensed Consolidated Financial Statements contained in Item 1 of this report. We continually evaluate our operating structure in order to maximize efficiencies and drive margin expansion. Future charges could be incurred if new consolidation and optimization initiatives are undertaken.

Our Financial Results

We utilize a fifty-two, fifty-three week fiscal year ending on the Friday nearest December 31st. For 52-week years, each quarter contains 13 weeks. The second quarter and year-to-date periods of 2014 and 2013 ended on July 4, and June 28, respectively, and each contained 13 weeks and 26 weeks, respectively. The commentary that follows should be read in conjunction with our Condensed Consolidated Financial Statements and related notes and with the Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the fiscal year ended January 3, 2014.

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The following table presents certain selected financial information derived from our Condensed Consolidated Financial Statements for the periods presented (dollars in thousands, except per share data):

	Three Months Ended				Six Months Ended			
	July 4, 2014	June 28, 2013	Change \$	%	July 4, 2014	June 28, 2013	Change \$	%
Sales:								
Greatbatch Medical								
Cardiac/Neuromodulation	\$80,005	\$83,177	\$(3,172)	(4)%	\$166,785	\$153,701	\$13,084	9%
Orthopaedic	37,865	32,341	5,524	17%	74,296	61,964	12,332	20%
Portable Medical	16,737	22,167	(5,430)	(24)%	35,940	41,056	(5,116)	(12)%
Vascular	15,257	12,249	3,008	25%	28,307	22,873	5,434	24%
Energy, Military, Environmental	21,352	20,560	792	4%	39,483	38,522	961	2%
Total Greatbatch Medical	171,216	170,494	722	—%	344,811	318,116	26,695	8%
QiG	865	837	28	3%	1,551	1,480	71	5%
Total sales	172,081	171,331	750	—%	346,362	319,596	26,766	8%
Cost of sales	113,611	114,029	(418)	—%	230,296	213,545	16,751	8%
Gross profit	58,470	57,302	1,168	2%	116,066	106,051	10,015	9%
Gross profit as a % of sales	34.0%	33.4%			33.5%	33.2%		
Selling, general and administrative expenses (SG&A)	21,877	22,248	(371)	(2)%	43,632	42,340	1,292	3%
SG&A as a % of sales	12.7%	13.0%			12.6%	13.2%		
Research, development and engineering costs, net (RD&E)	12,793	14,097						