HEXCEL CORP /DE/
Form 10-Q
October 19, 2016

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 Quarter Ended September 30, 2016

or

Transition Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934
For the transition period from to

Commission File Number 1-8472

Hexcel Corporation

(Exact name of registrant as specified in its charter)

Delaware	94-1109521
(State of Incorporation)	(I.R.S. Employer Identification No.)

Two Stamford Plaza

281 Tresser Boulevard

Stamford, Connecticut 06901-3238

(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (203) 969-0666

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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.

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

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Class	Outstanding at October 14, 2016
COMMON STOCK	91,760,952

HEXCEL CORPORATION AND SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements (Unaudited)

Hexcel Corporation and Subsidiaries
Condensed Consolidated Balance Sheets

(In millions)	(Unaudited) September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$45.7	$ 51.8
Accounts receivable, net	254.4	234.0
Inventories	315.1	307.2
Prepaid expenses and other current assets	25.9	40.8
Total current assets	641.1	633.8
Property, plant and equipment	2,341.2	2,099.4
Less accumulated depreciation	(751.5)	(673.8)
Property, plant and equipment, net	1,589.7	1,425.6
Goodwill and other intangible assets	73.9	58.9
Investments in affiliated companies	48.3	30.4
Other assets	37.6	38.7
Total assets	$2,390.6	$ 2,187.4
Liabilities and Stockholders' Equity		
Current liabilities:		
Current portions of capital lease and term loan	$4.7	$ —
Accounts payable	149.3	148.9
Accrued liabilities	122.6	143.7
Total current liabilities	276.6	292.6
Commitments and contingencies (see Note 11)		
Long-term debt	670.2	576.5
Other non-current liabilities	184.4	138.7
Total liabilities	1,131.2	1,007.8
Stockholders' equity:		
Common stock, $0.01 par value, 200.0 shares authorized, 106.6 shares and 106.0 shares issued at September 30, 2016 and December 31, 2015	1.1	1.1
Additional paid-in capital	735.0	715.8
Retained earnings	1,205.2	1,044.4

Accumulated other comprehensive loss	(132.8)	(123.9)
	1,808.5	1,637.4
Less – Treasury stock, at cost, 14.7 shares at September 30, 2016, and 12.5 shares at December 31, 2015	(549.1)	(457.8)
Total stockholders' equity	1,259.4	1,179.6
Total liabilities and stockholders' equity	$ 2,390.6	$ 2,187.4

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

Hexcel Corporation and Subsidiaries

Condensed Consolidated Statements of Operations

(In millions, except per share data)	(Unaudited) Quarter Ended September 30, 2016	2015	Nine Months Ended September 30, 2016	2015
Net sales	$500.5	$448.8	$1,520.8	$1,396.3
Cost of sales	364.8	324.7	1,091.8	991.3
Gross margin	135.7	124.1	429.0	405.0
Selling, general and administrative expenses	35.1	35.5	121.1	120.3
Research and technology expenses	11.5	10.6	34.8	33.5
Operating income	89.1	78.0	273.1	251.2
Interest expense, net	5.5	4.6	16.8	9.0
Non-operating expense	—	—	0.4	—
Income before income taxes, and equity in earnings from affiliated companies	83.6	73.4	255.9	242.2
Provision for income taxes	16.1	20.7	67.5	60.6
Income before equity in earnings from affiliated companies	67.5	52.7	188.4	181.6
Equity in earnings from affiliated companies	0.7	0.8	1.9	1.7
Net income	$68.2	$53.5	$190.3	$183.3
Basic net income per common share:	$0.74	$0.56	$2.04	$1.91
Diluted net income per common share:	$0.72	$0.55	$2.01	$1.88
Weighted-average common shares:				
Basic	92.7	95.8	93.1	96.2
Diluted	94.1	97.3	94.6	97.7

Hexcel Corporation and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income

(In millions)	(Unaudited) Quarter Ended September 30, 2016	2015	Nine Months Ended September 30, 2016	2015
Net Income	$68.2	$53.5	$190.3	$183.3
Currency translation adjustments	(0.4)	(2.9)	(11.0)	(35.7)

Net unrealized pension and other benefit actuarial gains and prior service credits	0.4	0.8	1.9	0.8
Net unrealized gains (losses) on financial instruments (net of tax)	1.7	3.6	0.2	(2.4)
Total other comprehensive income (loss)	1.7	1.5	(8.9)	(37.3)
Comprehensive income	$69.9	$55.0	$181.4	$146.0

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

Hexcel Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(In millions)	(Unaudited) Nine Months Ended September 30, 2016	2015
Cash flows from operating activities		
Net income	$190.3	$183.3
Reconciliation to net cash provided by operating activities:		
Depreciation and amortization	69.0	56.5
Amortization of deferred financing costs and debt discount	1.4	0.8
Deferred income taxes	50.5	39.3
Equity in earnings from affiliated companies	(1.9)	(1.7)
Stock-based compensation	13.6	15.2
Excess tax benefits on stock-based compensation	—	(9.2)
Changes in assets and liabilities:		
Increase in accounts receivable	(16.8)	(38.9)
Increase in inventories	(5.0)	(46.2)
Increase in prepaid expenses and other current assets	(7.3)	(6.0)
Decrease in accounts payable/accrued liabilities	(9.1)	(26.0)
Other – net	2.1	(2.8)
Net cash provided by operating activities	286.8	164.3
Cash flows from investing activities		
Capital expenditures	(231.8)	(249.3)
Acquisition of business and investments and advances to affiliates	(33.6)	—
Net cash used for investing activities	(265.4)	(249.3)
Cash flows from financing activities		
Proceeds from senior unsecured credit facility	63.0	—
Proceeds from Euro term loan	27.4	—
Proceeds from issuance of senior notes	—	300.0
Repayment of senior unsecured credit facility	—	(115.0)
Other debt, net	(0.4)	(1.2)
Issuance costs related to credit facilities	(1.7)	—
Deferred financing costs and discount related to long-term debt	—	(3.6)
Dividends paid	(29.7)	(28.9)
Repurchase of stock	(84.9)	(100.0)
Activity under stock plans	(1.0)	13.2
Net cash (used for) provided by financing activities	(27.3)	64.5
Effect of exchange rate changes on cash and cash equivalents	(0.2)	(7.2)
Net decrease in cash and cash equivalents	(6.1)	(27.7)
Cash and cash equivalents at beginning of period	51.8	70.9

Cash and cash equivalents at end of period	$45.7	$43.2
Supplemental data:		
Accrual basis additions to property, plant and equipment	$232.6	$227.8

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

HEXCEL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 — Significant Accounting Policies

In these notes, the terms "Hexcel," "the Company," "we," "us," or "our" mean Hexcel Corporation and subsidiary companies. The accompanying condensed consolidated financial statements are those of Hexcel Corporation. Refer to Note 1 to the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2015 for a discussion of our significant accounting policies.

Basis of Presentation

The accompanying Condensed Consolidated Financial Statements have been prepared from the unaudited accounting records of Hexcel pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") and in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information. Certain information and footnote disclosures normally included in financial statements have been omitted pursuant to rules and regulations of the SEC.

In the opinion of management, the Condensed Consolidated Financial Statements include all normal recurring adjustments as well as any non-recurring adjustments necessary to present a fair statement of financial position, results of operations and cash flows for the interim periods presented. The Condensed Consolidated Balance Sheet as of December 31, 2015 was derived from the audited 2015 consolidated balance sheet. Interim results are not necessarily indicative of results expected for any other interim period or for the full year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our 2015 Annual Report on Form 10-K filed with the SEC on February 4, 2016.

Investments in Affiliated Companies

We have a 50% equity ownership investment in a joint venture Aerospace Composites Malaysia Sdn. Bhd. ("ACM"). This investment is accounted for using the equity method of accounting. In the second quarter of 2016, the Company invested a total of $25.0 million in two new affiliates. The investments are each below a 20% ownership level and the Company accounts for these investments using the cost method.

Recent Accounting Pronouncements

In August 2015, the Financial Accounting Standards Board ("FASB") postponed Accounting Standard Update ("ASU") No. 2014-09, Revenue from Contracts with Customers until 2018. The update clarifies the principles for recognizing revenue and develops a common revenue standard for all industries. Early application is permitted in 2017 for calendar year entities. We are currently evaluating the impact of adopting this prospective guidance on our consolidated results of operations and financial condition.

In March of 2016, the FASB issued Accounting Standards Update No. 2016-09 (ASU 2016-09) "Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting" intended to simplify the accounting for employee share-based payments. Under this guidance all excess tax benefits (“windfalls”) and deficiencies (“shortfalls”) related to employee stock compensation are recognized within income tax expense. Under prior guidance windfalls were recognized to Additional paid-in capital (“APIC”) and shortfalls were only recognized to the extent they exceed the pool of windfall tax benefits.

The Company early adopted ASU 2016-09 effective for the quarter ended March 31, 2016. As a result of the adoption, tax benefits of $1.2 million and $2.4 million were recorded in the quarter and first nine months of 2016 reflecting the excess tax benefits. The adoption was on a prospective basis and therefore had no impact on prior years. The Company also recorded an adjustment to opening retained earnings of $0.4 million to recognize U.S. net operating loss carryforwards attributable to excess tax benefits on stock compensation that had not been previously recognized to APIC because they did not reduce income taxes payable.

Note 2 — Net Income per Common Share

(In millions, except per share data)	Quarter Ended September 30, 2016	2015	Nine Months Ended September 30, 2016	2015
Basic net income per common share:				
Net income	$68.2	$53.5	$190.3	$183.3
Weighted average common shares outstanding	92.7	95.8	93.1	96.2
Basic net income per common share	$0.74	$0.56	$2.04	$1.91
Diluted net income per common share:				
Net income	$68.2	$53.5	$190.3	$183.3
Weighted average common shares outstanding — Basic	92.7	95.8	93.1	96.2
Plus incremental shares from assumed conversions:				
Restricted stock units	0.4	0.5	0.5	0.5
Stock options	1.0	1.0	1.0	1.0
Weighted average common shares outstanding — Dilutive	94.1	97.3	94.6	97.7
Dilutive net income per common share	$0.72	$0.55	$2.01	$1.88

Total shares underlying stock options of 0.4 million and 0.5 million were excluded from the computation of diluted net income per share for the quarter and nine months ended September 30, 2016, respectively, as they were anti-dilutive. Total shares underlying stock options of 0.1 million were excluded from the computation of diluted net income per share for the quarter and nine months ended September 30, 2015 as they were anti-dilutive.

Note 3 — Inventories

(In millions)	September 30, 2016	December 31, 2015
Raw materials	$ 129.2	$ 120.7
Work in progress	49.3	54.7
Finished goods	136.6	131.8
Total inventory	$ 315.1	$ 307.2

Note 4 — Retirement and Other Postretirement Benefit Plans

We maintain qualified and nonqualified defined benefit retirement plans covering certain current and former U.S. and European employees, retirement savings plans covering eligible U.S. and U.K. employees and certain postretirement health care and life insurance benefit plans covering eligible U.S. retirees. We also participate in a union sponsored multi-employer pension plan covering certain U.S. employees with union affiliations.

Defined Benefit Retirement Plans

Net Periodic Benefit Costs

Net periodic benefit costs of our defined benefit retirement plans for the quarters and nine months ended September 30, 2016 and 2015 were as follows:

	Quarter Ended September 30,		Nine Months Ended September 30,	
(In millions)	2016	2015	2016	2015
U.S. Nonqualified Defined Benefit Retirement Plans				
Service cost	$ 0.3	$ 0.2	$0.9	$ 0.8
Interest cost	0.2	0.1	0.5	0.4
Net amortization and deferral	—	0.1	0.2	1.6
Net periodic benefit cost	$ 0.5	$ 0.4	$1.6	$ 2.8

	September 30, 2016	December 31, 2015
Amounts recognized on the balance sheet:		
Accrued liabilities	$ 0.7	$ 0.7
Other non-current liabilities	18.2	17.0
Total accrued benefit	$ 18.9	$ 17.7

	Quarter Ended September 30,		Nine Months Ended September 30,	
(In millions)	2016	2015	2016	2015
European Defined Benefit Retirement Plans				
Service cost	$ 0.2	$ 0.2	$0.6	$0.6
Interest cost	1.5	1.6	4.4	4.9
Expected return on plan assets	(2.1)	(2.3)	(6.2)	(6.8)
Net amortization and deferral	0.2	0.3	0.5	0.7
Net periodic benefit credit	$ (0.2)	$ (0.2)	$(0.7)	$(0.6)

	September 30, 2016	December 31, 2015
Amounts recognized on the balance sheet:		
Noncurrent asset	$ 17.6	$ 13.6
Accrued liabilities	0.9	0.4
Other non-current liabilities	17.8	15.6
Total accrued benefit	$ 18.7	$ 16.0

Contributions

We generally fund our U.S. non-qualified defined benefit retirement plans when benefit payments are incurred. Under the provisions of these non-qualified plans, we have contributed approximately $0.1 million for the first nine months of 2016 to cover unfunded benefits and expect to contribute a total of $0.2 million in 2016. We contributed $4.9 million to our U.S. non-qualified defined benefit retirement plans during 2015.

We contributed $1.2 million and $1.3 million to our European defined benefit retirement plans in the third quarters of 2016 and 2015, respectively. Contributions to the defined benefit retirement plans were $4.9 million and $4.0 million for the nine months ended September 30, 2016 and 2015, respectively. We plan to contribute approximately $6.0 million during 2016 to these European plans. We contributed $4.3 million to our European plans during 2015.

Postretirement Health Care and Life Insurance Benefit Plans

Net periodic benefit costs of our postretirement health care and life insurance benefit plans for the quarters and nine months ended September 30, 2016 and 2015 were immaterial.

	September 30, 2016	December 31, 2015
Amounts recognized on the balance sheet:		
Accrued liabilities	$ 0.5	$ 0.6
Other non-current liabilities	4.7	4.7
Total accrued benefit	$ 5.2	$ 5.3

In connection with our postretirement plans, we contributed about $0.1 million during each of the nine-month periods ended September 30, 2016 and 2015. We periodically fund our postretirement plans to pay covered expenses as they are incurred. Based upon nine months of activity, we expect to contribute approximately $0.2 million in 2016 to cover unfunded benefits. We contributed $0.2 million to our postretirement plans during 2015.

Note 5 — Debt

(In millions)	September 30, 2016	December 31, 2015
Current portion of capital lease	$ 0.8	$ —
Current portion of Euro term loan	3.9	—
Current portion of debt	4.7	$ —
Senior unsecured credit facility- revolving loan due 2021	350.0	—
Non-current portion of Euro term loan	23.5	
Senior unsecured credit facility - revolving loan due 2019	—	280.0
4.7% senior notes due 2025	300.0	300.0
Senior notes - original issue discount and deferred financing costs	(3.3)	(3.5)
Long-term debt	670.2	576.5
Total debt	$ 674.9	$ 576.5

In June 2016, the Company amended and extended its $700 million senior unsecured credit facility ("the Facility"). The maturity of the Facility was extended from September 2019 to June 2021. The amendment provided for a modest reduction in interest costs, as well as less restrictive covenants. The interest rate for the revolver is LIBOR + 1.25%. The interest rate ranges from LIBOR + 0.875% to a maximum of LIBOR + 1.875%, depending upon the Company's leverage ratio. At September 30, 2016 total borrowings under the Facility were $350 million, which approximates fair value. The Facility permits us to issue letters of credit up to an aggregate amount of $40 million. Outstanding letters of credit reduce the amount available for borrowing under our revolving loan. As of September 30, 2016 we had issued letters of credit under the Facility totaling $2.1 million, resulting in undrawn availability under the Facility as of September 30, 2016 of $347.9 million.

The Facility contains financial and other covenants, including, but not limited to, restrictions on the incurrence of debt and the granting of liens, as well as the maintenance of an interest coverage ratio and a leverage ratio. In accordance with the terms of the Facility, we are required to maintain a minimum interest coverage ratio of 3.50 (based on the ratio of EBITDA, as defined in the credit agreement, to interest expense) and may not exceed a maximum leverage ratio of 3.50 (based on the ratio of total debt to EBITDA) throughout the term of the Facility. In addition, the Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. The average interest rate on the Facility was 1.8% for the nine months of 2016. The average interest rate was 1.8% for 2015.

In June 2016 we also entered into a €60 million ($67.4 million) term loan. The loan has two tranches of which the first tranche for €25 million has a six month availability period at a rate of Euribor +1.2% and a final maturity date of June 30, 2023. The second tranche for €35 million has a one year availability period at a rate of Euribor +1.25% and a final maturity date of June 30, 2024. There is a zero percent floor on the Euribor. The loans are payable in annual installments, beginning on June 30, 2017 and June 30, 2019, respectively. We had $27.4 million outstanding under this loan at September 30, 2016, which approximates fair value.

In August 2015, the Company issued $300 million aggregate principal amount of 4.7% Senior Unsecured Notes due in 2025. The interest rate on these senior notes may be increased by 0.25% each time a credit rating applicable to the notes is downgraded. The maximum rate is 6.7%. The net proceeds of approximately $296.4 million were initially used to repay, in part, the Facility. The conditions and covenants related to the senior notes are less restrictive than those of our Facility. The effective interest rate for the outstanding nine-month period of 2016 was 4.8%. The fair value of the senior notes based on quoted prices utilizing level 2 inputs was $319.3 million at September 30, 2016.

Note 6 — Derivative Financial Instruments

Interest Rate Swap and Interest Lock Agreements

During the third quarter, the Company entered into interest rate swaps with a notional value of $50 million. These new swaps replaced $50 million which matured in September 2016. As of September 30, 2016 the Company had two agreements to swap $50 million each of floating rate obligations for fixed rate obligations at an average of 1.09% and 0.89% against LIBOR in U.S. dollars. Of the total of $100 million of swaps outstanding at September 30, 2016, $50 million matures on each of March 2017 and September 2019. The swaps were accounted for as cash flow hedges of our floating rate bank loans. To ensure the swaps were highly effective, all of the principal terms of the swaps matched the terms of the bank loans. The fair value of the interest rate swaps was a liability of $0.1 million at both September 30, 2016 and December 31, 2015.

The Company also uses treasury locks to protect against unfavorable movements in the benchmark treasury rate related to forecasted debt issuances. On September 22, 2016, the Company entered into an interest rate treasury lock agreement with a notional value of $150 million for a forecasted 2017 debt issuance. We account for this interest rate treasury lock as a cash flow hedge so any change in fair value is recorded into other comprehensive income and then amortized into interest expense over the life of the bonds upon issuance. As of September 30, 2016, the fair value of this the treasury lock was $0.9 million and is recorded in current liabilities and other comprehensive income, net of tax. The interest rate lock had no impact on net income or cash flows from operations for the nine months ended September 30, 2016.

Foreign Currency Forward Exchange Contracts

A number of our European subsidiaries are exposed to the impact of exchange rate volatility between the U.S. dollar and the subsidiaries' functional currencies, being either the Euro or the British Pound sterling. We entered into contracts to exchange U.S. dollars for Euros and British Pound sterling through March 2019, which we account for as cash flow hedges. The aggregate notional amount of these contracts was $389.1 million and $417.5 million at September 30, 2016 and December 31, 2015, respectively. The purpose of these contracts is to hedge a portion of the forecasted transactions of European subsidiaries under long-term sales contracts with certain customers. These contracts are expected to provide us with a more balanced matching of future cash receipts and expenditures by currency, thereby reducing our exposure to fluctuations in currency exchange rates.The effective portion of the hedges, losses of $1.4 million and $10.7 million, respectively, were recorded in other comprehensive income ("OCI") for the three and nine months ended September 30, 2016, and losses of $0.3 million and $16.3 million for the three and nine months ended September 30, 2015. We classified the carrying amount of these contracts of $1.8 million in other assets and $20.0 million in other liabilities on the Condensed Consolidated Balance Sheets at September 30, 2016 and $0.9 million in other assets and $22.1 million classified in other liabilities at December 31, 2015. During the three and nine months ended September 30, 2016, we recognized net losses of $5.0 million and $13.5 million in gross margin, respectively. During the three and nine months ended September 30, 2015, we recognized net losses of $4.2 million and of $13.0 million in gross margin, respectively. For the quarters ended September 30, 2016 and 2015, hedge ineffectiveness was immaterial.

In addition, we enter into foreign exchange forward contracts which are not designated as hedges. These are used to provide an offset to transactional gains or losses arising from the remeasurement of non-functional monetary assets and liabilities such as accounts receivable. The change in the fair value of the derivatives is recorded in the statement of operations. There are no credit contingency features in these derivatives. During the quarters ended September 30, 2016 and 2015, we recognized net foreign exchange gains of $0.8 million and $1.5 million, respectively, in the Condensed Consolidated Statements of Operations. During the nine months ended September 30, 2016 and 2015, we recognized net foreign exchange gains of $3.4 million andnet foreign exchange losses of $12.5 million, respectively, in the Condensed Consolidated Statements of Operations. The net foreign exchange impact recognized from these hedges offset the translation exposure of these transactions. The carrying amount of the contracts for asset and liability derivatives not designated as hedging instruments was $0.2 million classified in other assets and $0.1 million in other liabilities and $0.4 million classified in other assets and $0.4 million in other liabilities on the September 30, 2016 and December 31, 2015 Condensed Consolidated Balance Sheets, respectively.

The change in fair value of our foreign currency forward exchange contracts under hedge designations recorded net of tax within accumulated other comprehensive income for the quarters and nine months ended September 30, 2016 and 2015 was as follows:

(In millions)	Quarter Ended September 30, 2016	2015	Nine Months Ended September 30, 2016	2015
Unrealized losses at beginning of period, net of tax	$(16.5)	$(15.3)	$(15.0)	$(9.2)
Losses reclassified to net sales	4.0	3.8	10.1	11.2
Decrease in fair value	(1.7)	(0.2)	(9.3)	(13.7)
Unrealized losses at end of period, net of tax	$(14.2)	$(11.7)	$(14.2)	$(11.7)

We expect to reclassify $9.8 million of unrealized losses into earnings over the next twelve months as the hedged sales are recorded.

Note 7 — Income Taxes

The income tax provision for the quarter ended September 30, 2016 was $16.1 million, including a net benefit of $6.6 million from the release of reserves for uncertain tax positions. The effective tax rate, excluding this benefit, for the third quarter was 27.2% as compared to 28.2% in 2015, as both periods primarily benefitted from favorable tax return to provision adjustments. The 2015 nine-month period income tax provision of $60.6 million included $11.6 million of benefits primarily related to the release of reserves for uncertain tax positions. Excluding these discrete benefits, our effective tax rate was 30.5% for the nine-month period of 2016, as compared to 30.6% for the nine-month period of 2015.

Effective for the quarter ended March 31, 2016, the Company early adopted Accounting Standards Update No. 2016-09 (ASU 2016-09) "Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting". Under this guidance all excess tax benefits (“windfalls”) and deficiencies (“shortfalls”) related to employee stock compensation are recognized within income tax expense. Under prior guidance, windfalls were recognized to APIC and shortfalls were only recognized to the extent they exceed the pool of windfall tax benefits.

As a result of the adoption, tax benefits of $1.2 million and $2.4 million were recorded in the quarter and first nine months of 2016, respectively, reflecting the excess tax benefits. The adoption was on a prospective basis and therefore had no impact on prior years. The Company also recorded an adjustment to opening retained earnings of $0.4 million to recognize U.S. net operating loss carryforwards attributable to excess tax benefits on stock compensation that had not been previously recognized to APIC because they did not reduce income taxes payable, see Note 1.

Note 8 — Fair Value Measurements

The authoritative guidance for fair value measurements establishes a hierarchy for observable and unobservable inputs used to measure fair value, into three broad levels, which are described below:

- Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.
- Level 2: Observable prices that are based on inputs not quoted on active markets, but corroborated by market data.
- Level 3: Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

In determining fair value, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible as well as consider counterparty credit risk in our assessment of fair value.

We do not have any significant assets or liabilities that utilize Level 3 inputs. In addition, we have no assets or liabilities that utilize Level 1 inputs. For derivative assets and liabilities that utilize Level 2 inputs, we prepare estimates of future cash flows of our derivatives, which are discounted to a net present value. The estimated cash flows and the discount factors used in the valuation model are based on observable inputs, and incorporate non-performance risk (the credit standing of the counterparty when the derivative is in a net asset position, and the credit standing of Hexcel when the derivative is in a net liability position). The fair value of these assets and liabilities was approximately $1.9 million and $21.1 million, respectively, at September 30, 2016. In addition, the fair value of these derivative contracts, which are subject to a master netting arrangement under certain circumstances, is presented on a gross basis in the consolidated balance sheet.

Below is a summary of valuation techniques for all Level 2 financial assets and liabilities:

- Interest rate swaps — valued using LIBOR yield curves at the reporting date. Fair value was a liability of $0.1 million at September 30, 2016.
- Treasury Locks — valued using 10 Yr. US Treasury prices at the reporting date. Fair value was a liability of $0.9 million at September 30, 2016.
- Foreign exchange derivative assets and liabilities — valued using quoted forward prices at the reporting date. Fair value of assets and liabilities at September 30, 2016 was $1.9 million and $20.1 million, respectively.

Counterparties to the above contracts are highly rated financial institutions, none of which experienced any significant downgrades in the nine months ended September 30, 2016 that would reduce the receivable amount owed, if any, to the Company.

Note 9 — Segment Information

The financial results for our operating segments are prepared using a management approach, which is consistent with the basis and manner in which we internally segregate financial information for the purpose of assisting in making internal operating decisions. We evaluate the performance of our operating segments based on operating income, and generally account for intersegment sales based on arm’s length prices. Corporate and certain other expenses are not allocated to the operating segments, except to the extent that the expense can be directly attributable to the business segment.

Financial information for our operating segments for the quarters and nine months ended September 30, 2016 and 2015 is as follows:

(In millions	(Unaudited) Composite Materials	Engineered Products	Corporate & Other (a)	Total
Third Quarter 2016				
Net sales to external customers	$398.2	$ 102.3	$ —	$500.5
Intersegment sales	16.2	—	(16.2)	—
Total sales	414.4	102.3	(16.2)	500.5
Operating income	88.8	12.9	(12.6)	89.1
Depreciation and amortization	21.7	1.8	—	23.5
Stock-based compensation	0.7	—	0.1	0.8
Accrual basis additions to capital expenditures	84.4	5.9	0.1	90.4
Third Quarter 2015				
Net sales to external customers	$347.4	$ 101.4	$ —	$448.8
Intersegment sales	15.9	—	(15.9)	—
Total sales	363.3	101.4	(15.9)	448.8
Operating income	74.1	14.2	(10.3)	78.0
Depreciation and amortization	17.7	1.5	0.1	19.3
Stock-based compensation	0.7	0.1	—	0.8
Accrual basis additions to capital expenditures	83.1	3.2	—	86.3
Nine Months Ended September 30, 2016				
Net sales to external customers	$1,219.3	$ 301.5	$ —	$1,520.8
Intersegment sales	53.2	—	(53.2)	—
Total sales	1,272.5	301.5	(53.2)	1,520.8
Operating income	281.2	36.8	(44.9)	273.1
Depreciation and amortization	63.5	5.4	0.1	69.0
Stock-based compensation	4.9	0.9	7.8	13.6
Accrual basis additions to capital expenditures	221.6	10.9	0.1	232.6
Nine Months Ended September 30, 2015				
Net sales to external customers	$1,088.3	$ 308.0	$ —	$1,396.3
Intersegment sales	56.2	0.1	(56.3)	—
Total sales	1,144.5	308.1	(56.3)	1,396.3
Operating income	254.5	43.3	(46.6)	251.2
Depreciation and amortization	51.7	4.5	0.3	56.5
Stock-based compensation	5.4	0.8	9.0	15.2
Accrual basis additions to capital expenditures	216.8	11.0	—	227.8

(a) We do not allocate Corporate expenses to the operating segments

Goodwill and Intangible Assets

The carrying amount of gross goodwill and intangible assets by segment is as follows:

(In millions)	September 30, 2016	December 31, 2015
Composite Materials	$ 57.9	$ 42.8
Engineered Products	16.0	16.1
Goodwill and intangible assets	$ 73.9	$ 58.9

Goodwill and intangible assets increased by $16.0 million in 2016 primarily due to the Formax acquisition (see Note 10). No impairments have been recorded against these amounts.

Note 10 — Business Acquisition and Investments in Affiliates

In the second quarter of 2016, we acquired a 10.3% interest in Oxford Performance Materials ("OPM") for $15.0 million. OPM produces thermoplastic, carbon fiber reinforced 3D printed parts primarily for Commercial Aerospace and Space and Defense applications. In addition, if OPM achieves certain milestones within an 18 month period or at Hexcel's discretion, the Company will invest an additional $10 million, increasing its investment in OPM to 16.1%. We account for this investment using the cost method. We also issued an 8% convertible secured promissory note to Luminati Aerospace LLC ("Luminati"), in the amount of $10 million. Luminati is an aerospace technology company focusing on research, development, testing, and manufacturing of next generation solar-electric unmanned aerial vehicles, or UAVs. The note matures in 2023 and the principal and interest are convertible to a 17.2% interest in Luminati. The note will convert upon Luminati achieving certain milestones or at Hexcel's discretion.

On January 5, 2016 the Company acquired the remaining 50% of Formax (UK) Limited ("Formax") for $12 million of which $8.6 million was paid on closing and the remaining will be paid in installments over the next four years. The Company previously acquired a 50% interest in the privately-owned company in December 2014.

Located in Leicester, U.K., Formax is a leading manufacturer of composite reinforcements, specializing in the production of lightweight carbon multi-axials and highly engineered glass fiber and aramid fiber fabrics. The total purchase price, net of cash acquired and including the 50% interest acquired in December 2014, was $22 million and the assumption of long-term debt of $8.2 million.

The step acquisition was accounted for under the acquisition method of accounting with the Company treated as the acquiring entity. Accordingly, the consideration paid by the Company to complete the acquisition has been recorded to the assets acquired and liabilities assumed based upon their estimated fair values as of the date of acquisition. The Company engaged a third party to assist with the valuation of assets including property plant and equipment and intangible assets. The fair value of the property, plant and equipment was based upon the assessed value of the land, which was determined to approximate fair value, as well as the income approach in determining the fair value of building improvements and equipment. The carrying values for current assets and liabilities were deemed to approximate their fair values due to the short-term nature of these assets and liabilities. The excess of the purchase price over the estimated fair value of the net assets acquired, including identifiable intangible assets, of $10.2 million was allocated to goodwill. The goodwill recognized is attributable to expected revenue synergies generated by the integration of our products and technologies with those of Formax, costs synergies resulting from the consolidation or elimination of certain functions, and intangible assets that do not qualify for separate recognition, such as the assembled workforce of Formax.

Note 11 — Commitments and Contingencies

We are involved in litigation, investigations and claims arising out of the normal conduct of our business, including those relating to commercial transactions, environmental, employment, and health and safety matters. We estimate and accrue our liabilities when a loss becomes probable and estimable. These judgments take into consideration a variety of factors, including the stage of the proceeding; potential settlement value; assessments by internal and external counsel; and assessments by environmental engineers and consultants of potential environmental liabilities and remediation costs. Such estimates are not discounted to reflect the time value of money due to the uncertainty in estimating the timing of the expenditures, which may extend over several years.

While it is impossible to ascertain the ultimate legal and financial liability with respect to certain contingent liabilities and claims, we believe, based upon our examination of currently available information, our experience to date, and advice from legal counsel, that the individual and aggregate liabilities resulting from the ultimate resolution of these contingent matters, after taking into consideration our existing insurance coverage and amounts already provided for, will not have a material adverse impact on our consolidated results of operations, financial position or cash flows.

Environmental Matters

We are subject to various international, U.S., state and local environmental, and health and safety laws and regulations. We are also subject to liabilities arising under the Federal Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" or "Superfund"), the Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act, and similar state and international laws and regulations that impose responsibility for the control, remediation and abatement of air, water and soil pollutants and the manufacturing, storage, handling and disposal of hazardous substances and waste.

We have been named as a potentially responsible party ("PRP") with respect to several hazardous waste disposal sites that we do not own or possess, which are included on, or proposed to be included on, the Superfund National Priority List of the U.S. Environmental Protection Agency ("EPA") or on equivalent lists of various state governments. Because CERCLA allows for joint and several liability in certain circumstances, we could be responsible for all remediation costs at such sites, even if we are one of many PRPs. We believe, based on the amount and nature of our waste, our existing insurance coverage, the amounts already provided for and the number of other financially viable PRPs, that our liability in connection with such matters will not be material.

Lodi, New Jersey Site

Pursuant to the New Jersey Industrial Site Recovery Act, Hexcel entered into an Administrative Consent Order for the environmental remediation of a manufacturing facility we own and formerly operated in Lodi, New Jersey. As of September 2016, Hexcel has completed all active investigation and remediation activities in accordance with a State-approved plan and has received a Response Actions Outcome from the New Jersey Licensed Site Remediation Professional. Hexcel is in the process of monitoring contaminant levels to support a Monitored Natural Attenuation program and therefore we believe the spending is largely complete.

Lower Passaic River Study Area

Hexcel and a group of approximately 52 other PRPs comprise the Lower Passaic Cooperating Parties Group (the "CPG"). Hexcel and the CPG are subject to a May 2007 Administrative Order on Consent ("AOC") to perform a Remedial Investigation/Feasibility Study ("RI/FS") of environmental conditions in the Lower Passaic River watershed. We were included in the CPG based on our operations at our former manufacturing site in Lodi, New Jersey.

In March 2016, the EPA issued a Record of Decision ("ROD") setting forth the EPA's selected remedy for the lower eight miles of the river. The ROD calls for capping and dredging of the lower eight miles of the Passaic River, with the placement of an engineered cap over the entire eight miles, at an expected cost ranging from $0.97 billion to $2.07 billion, according to the EPA. Because the EPA has not yet selected a remedy for the upper nine miles of the Lower Passaic River, this estimate range does not include any costs related to a future remedy for the upper portion of the river. Now that it has issued the final ROD, the EPA will seek to hold some combination of the PRPs liable to perform the work selected through the ROD. At this point, we have not yet determined our allocable share of performing the selected remedy. However, based on a review of the Company's position, and as no point within the range is a more probable outcome than any other point, the Company has determined that its accrual is sufficient at this time. The accrual balance was $2.1 million and $1.9 million as of September 30, 2016 and December 31, 2015, respectively. Despite the issuance of the final ROD, there continue to be many uncertainties associated with the selected remedy and the Company's allocable share of the remediation. Given those uncertainties, the amounts accrued may not be indicative of the amounts for which the Company is ultimately responsible and will be refined as events in the remediation process develop.

Kent, Washington Site

We were party to a cost-sharing agreement regarding the operation of certain environmental remediation systems necessary to satisfy a post-closure care permit issued to a previous owner of our Kent, Washington site by the EPA. Under the terms of the cost-sharing agreement, we were obligated to reimburse the previous owner for a portion of the cost of the required remediation activities. The previous owner, who also continues to own an adjacent site, has installed certain remediation and isolation technologies on its upgradient site and is operating those pursuant to an order agreed with the State of Washington. We and the Washington Department of Ecology have reached an agreed order to perform certain cleanup activities on our site by certain deadlines, and we are in full compliance with the order. The Department of Ecology has recently approved a reduced number of wells and a reduced pumping volume for Hexcel's wells on its property and agreed with a plan for more active remediation going forward. The total accrued liability related to this matter was $0.3 million and $0.5 million at September 30, 2016 and December 31, 2015, respectively.

Omega Chemical Corporation Superfund Site, Whittier, California

We are a PRP at a former chemical waste site in Whittier, California. The PRPs at Omega have established a PRP Group, (the "Omega PRP Group"), and are currently investigating and remediating soil and groundwater at the site pursuant to a Consent Decree with the EPA. The Omega PRP Group has attributed approximately 1.07% of the waste tonnage sent to the site to Hexcel. In addition to the Omega site specifically, the EPA is investigating the scope of regional groundwater contamination in the vicinity of the Omega site and issued a Record of Decision; the Omega PRP Group members have been served notice by the EPA as PRPs who will be required to be involved in the remediation of the regional groundwater contamination in that vicinity as well. As a member of the Omega PRP Group, Hexcel will incur costs associated with the investigation and remediation of the Omega site and the regional groundwater remedy, although our ultimate liability, if any, in connection with this matter cannot be determined at this time. The total accrued liability relating to potential liability for both the Omega site and regional groundwater remedies was $0.7 million and $0.3 million at September 30, 2016 and at December 31, 2015, respectively.

Summary of Environmental Reserves

Our estimate of liability as a PRP and our remaining costs associated with our responsibility to monitor the Lodi, New Jersey site and to remediate the Lower Passaic River; Kent, Washington; and other sites are accrued in the consolidated balance sheets. As of September 30, 2016, our aggregate environmental related accruals were $3.4 million, of which $1.7 million was included in accrued liabilities with the remainder included in non-current liabilities. As of December 31, 2015, our aggregate environmental related accruals were $2.9 million, of which $1.1 million was included in accrued liabilities with the remainder included in non-current liabilities. As related to certain environmental matters the accrual was estimated at the low end of a range of possible outcomes since no amount within the range is a better estimate than any other amount. If we had accrued at the high end of the range of possible outcomes for those sites where we are able to estimate our liability, our accrual would have been $16 million higher. These accruals can change significantly from period to period due to such factors as additional information on the nature or extent of contamination, the methods of remediation required, changes in the apportionment of costs among responsible parties, amount of insurance coverage, and other actions by governmental agencies or private parties, or the impact, if any, of being named in a new matter.

Environmental remediation spending charged to our reserve balance for the quarters ended September 30, 2016 and 2015 was $0.2 million and $0.5 million, respectively, and $0.7 million and $2.8 million for the nine months ended September 30, 2016 and 2015. In addition, our operating costs relating to environmental compliance charged to expense were $2.6 million and $3.1 million for the quarters ended September 30, 2016 and 2015, respectively, and $7.5 million and $9.5 million for the nine-month periods ended September 30, 2016 and 2015, respectively. Capital expenditures for environmental matters were $4.8 million and $1.8 million for the quarters ended September 30, 2016 and 2015, respectively, and $9.6 million and $4.2 million for the nine-month periods ended September 30, 2016 and 2015, respectively.

Product Warranty

We provide for an estimated amount of product warranty expense at the time revenue is recognized. This estimated amount is provided by product and based on historical warranty experience. In addition, we periodically review our warranty accrual and record any adjustments as deemed appropriate. Warranty expense for the quarter ended September 30, 2016, and accrued warranty cost, included in "accrued liabilities" in the condensed consolidated balance sheets at September 30, 2016 and December 31, 2015, were as follows:

(In millions)	Product Warranties
Balance as of December 31, 2015	$ 6.1
Warranty expense	2.8
Deductions and other	(1.9)
Balance as of June 30, 2016	$ 7.0
Warranty expense	0.3
Deductions and other	(0.6)
Balance as of September 30, 2016	$ 6.7

Note 12 — Stock Repurchase Plan

In October 2015, our Board authorized the repurchase of $250 million of the Company’s stock (“2015 Repurchase Plan”). During the first nine months of 2016 the Company spent $84.9 million to repurchase our common stock under the 2015 Repurchase Plan. As of September 30, 2016, the Company has $119 million remaining under the 2015 Repurchase Plan.

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

Business Overview

We develop, manufacture, and market lightweight, high-performance structural materials, including carbon fibers, specialty reinforcements, prepregs and other fiber-reinforced matrix materials, honeycomb, adhesives, engineered honeycomb and composite structures, for use in Commercial Aerospace, Space & Defense and Industrial markets. Our products are used in a wide variety of end applications, such as commercial and military aircraft, space launch vehicles and satellites, wind turbine blades, automotive, recreational products and a variety of other industrial applications.

We serve international markets through manufacturing facilities, sales offices and representatives located in the Americas, Asia Pacific, Europe and Russia. We are also a 50% partner in a joint venture in Malaysia, which manufactures composite structures for Commercial Aerospace applications. During 2016, the Company invested a total of $25 million in two new affiliates. The investments are each below a 20% ownership level.

Hexcel has two segments, Composite Materials and Engineered Products. The Composite Materials segment is comprised of our carbon fiber, specialty reinforcements, resins, prepregs and other fiber-reinforced matrix materials, and honeycomb core product lines. The Engineered Products segment is comprised of lightweight high strength composite structures, molded components and specialty machined honeycomb product lines.

Net sales for the third quarter were $500.5 million, 11.5% higher (11.9% in constant currency) than the $448.8 million reported for the third quarter of 2015. Year to date net sales were 8.9% higher (9.0% in constant currency. The growth was led by the commercial aerospace market, which accounts for over 70% of our year to date sales.

Commercial aerospace sales of $360.6 million increased 14.7% (15.1% in constant currency) for the quarter as compared to the third quarter of 2015 and increased 12.5% (12.6% in constant currency) for the nine-month period as compared to 2015. Combined revenues attributed to new aircraft programs (B787, A350 XWB, A320neo, and B737 MAX) increased about 40% versus the third quarter and just under 50% for the first nine months as compared to last year, with A350 XWB shipments leading the growth. Sales for Airbus and Boeing legacy aircraft were down modestly compared to the third quarter of 2015.

Sales to other commercial aerospace, which includes regional and business aircraft customers, were about 20% higher compared to the low third quarter of 2015. Sales for the first nine months of 2016 were just under the comparable period of 2015.

Space & Defense sales of $81.5 million increased 5.4% (same in constant currency) for the third quarter as compared to the third quarter of 2015. Rotorcraft sales comprise just over half of Space & Defense sales and were modestly higher than the third quarter of 2015. Sales for the first nine months were down 4.6% (4.7% in constant currency) compared to the prior year, due to an approximate 10% decline in rotorcraft.

Total Industrial sales of $58.4 million for the third quarter of 2016 were 2.5% (3.2% in constant currency) higher than the third quarter of 2015. Wind energy sales (which account for more than half of the total Industrial sales) were just above last year for both the quarter and first nine months. Total Industrial sales for the first nine months of 2016 were 8.9% (9.6% in constant currency) higher than the comparable 2015 period with the growth coming from the Formax acquisition partially offset by weakness in recreation and other industrial submarkets.

Gross margin for the third quarter was 27.1% compared to 27.7% in the third quarter of 2015 as both periods reflected strong operating performance. Selling, general and administrative expenses were slightly lower than the third quarter of 2015. Research and technology expenses in the third quarter of 2016 of $11.5 million were 8.5% higher than the comparable 2015 period and expenses for the first nine months of 2016 are higher by 4% than the comparable period in 2015.

Free cash flow (defined as cash provided by operating activities less capital expenditures) for the first nine months of 2016 was a source of $55 million versus a use of $85 million in 2015. Working capital was a use of $38 million as compared to a $117 million use in the first nine months of 2015. Cash used for capital expenditures was $232 million in the first nine months of 2016 compared to $249 million in the 2015 period. Accrual basis additions to capital expenditures were $233 million for the first nine months of 2016 and $288 million in the comparable 2015 period. We expect to be at the higher end of our 2016 guidance for both free cash flow of $20 million to $60 million, and accrual basis capital expenditures of $280 million to $320 million, as we continue to expand capacity to meet the planned needs of our customers. The largest driver of our capital expenditures is capacity additions for the planned ramp-up of the A350 XWB as we supply the primary structure prepreg under a contract extending through 2030.

Financial Overview

Results of Operations

(In millions, except per share data)	Quarter Ended September 30, 2016	2015	% Change	Nine Months Ended September 30, 2016	2015	% Change
Net sales	$500.5	$448.8	11.5 %	$1,520.8	$1,396.3	8.9 %
Net sales change in constant currency			11.9 %			9.0 %
Operating income	89.1	78.0	14.2 %	273.1	251.2	8.7 %
As a percentage of net sales	17.8 %	17.4 %		18.0 %	18.0 %	
Net income	68.2	53.5	27.5 %	190.3	183.3	3.8 %
Diluted net income per common share	$0.72	$0.55	30.9 %	$2.01	$1.88	6.9 %
Non-GAAP measures:						
Adjusted net income	$61.6	$53.5	15.1 %	$184.0	$171.7	7.2 %
Adjusted diluted earnings per share	$0.65	$0.55	18.2 %	$1.94	$1.76	10.2 %

The Company's performance measurements include sales measured in constant dollars, net income adjusted for special items and free cash flow, all of which are non-GAAP measures. Management believes these non-GAAP measurements are meaningful to investors because they provide a view of Hexcel with respect to ongoing operating results. Special items represent significant charges or credits that are important to understanding Hexcel's overall operating results in the periods presented. Such non-GAAP measurements are not recognized in accordance with generally accepted accounting principles and should not be viewed as an alternative to GAAP measures of performance. The following is a reconciliation from GAAP to non-GAAP amounts.

(In millions, except per share data)	Quarter Ended September 30, 2016	2015	Nine Months Ended September 30, 2016	2015
Net income	$68.2	$53.5	$190.3	$183.3
Accelerated amortization of deferred financing costs (a)	—	—	0.3	—
Discrete tax items (b)	(6.6)	—	(6.6)	(11.6)
Adjusted net income (Non-GAAP)	$61.6	$53.5	$184.0	$171.7

(a) Accelerated amortization of deferred financing costs related to our previous senior unsecured credit facility (net of taxes), which was refinanced in the second quarter of 2016.

(b) The quarter and nine months ended September 30, 2016 and the nine months ended 2015 included benefits of $6.6 million and $11.6 million, respectively, primarily related to the release of reserves for uncertain tax positions.

	Nine Months Ended September 30,	
(In millions)	2016	2015
Net cash provided by operating activities	$286.8	$164.3
Less: Capital expenditures	(231.8)	(249.3)
Free cash flow (Non-GAAP)	$55.0	$(85.0)

17

Net Sales

The following table summarizes net sales to third-party customers by segment and end market for the quarters and nine months ended September 30, 2016 and 2015:

(In millions)	Quarter Ended September 30, 2016	2015	% Change		Nine Months Ended September 30, 2016	2015	% Change	
Consolidated Net Sales	$500.5	$448.8	11.5	%	$1,520.8	$1,396.3	8.9	%
Commercial Aerospace	360.6	314.5	14.7	%	1,079.4	959.5	12.5	%
Space & Defense	81.5	77.3	5.4	%	242.6	254.2	(4.6	)%
Industrial	58.4	57.0	2.5	%	198.8	182.6	8.9	%
Composite Materials	$398.2	$347.4	14.6	%	$1,219.3	$1,088.3	12.0	%
Commercial Aerospace	276.0	230.7	19.6	%	828.3	712.5	16.3	%
Space & Defense	63.8	59.7	6.9	%	192.2	196.8	(2.3	)%
Industrial	58.4	57.0	2.5	%	198.8	179.0	11.1	%
Engineered Products	$102.3	$101.4	0.9	%	$301.5	$308.0	(2.1	)%
Commercial Aerospace	84.6	83.8	1.0	%	251.1	247.0	1.7	%
Space & Defense	17.7	17.6	0.6	%	50.4	57.4	(12.2	)%
Industrial	—	—	N/A	%	—	3.6	N/A	%

Sales by Segment

Composite Materials: Net sales of $398.2 million in the third quarter of 2016 increased $50.8 million over the $347.4 million in the prior year driven by an almost 20% increase in Commercial Aerospace sales, led by the A350 XWB. Space & Defense sales increased almost 7% compared to the low third quarter of 2015, primarily due to higher rotorcraft sales. Industrial sales increased 2.5% primarily from the Formax acquisition. The increase of 12.0% in net sales to $1,219.3 million for the first nine months of 2016 was also driven by Commercial Aerospace and Industrial, partially offset by a modest decline in Space & Defense sales.

Engineered Products: Net sales of $102.3 million in the third quarter of 2016 increased $0.9 million from the $101.4 million for 2015 as both Commercial Aerospace and Space & Defense sales had slight increases. The decrease of 2.1% in net sales to $301.5 million for the first nine months of 2016 was driven by a decline in Space & Defense sales as rotorcraft sales were lower. There were no significant sales to the Industrial market from this segment.

Sales by Market

Commercial Aerospace: Net sales increased $46.1 million, or 14.7% (15.1% in constant currency), to $360.6 million for the third quarter of 2016. Net sales for the nine months ended September 30, 2016 increased $129.9 million or 12.5% (12.6% in constant currency) to $1,079.4 million. Revenues attributed to new aircraft programs (B787, A350 XWB, A320neo, and B737 MAX) increased about 40% versus the third quarter of 2015 and just under 50% for the first nine months compared to last year, with A350 XWB shipments leading the growth. Sales for Airbus and Boeing legacy aircraft were down modestly compared to the third quarter and first nine months of 2015.

Sales to other commercial aerospace, which includes regional and business aircraft customers, were about 20% higher compared to the low third quarter of 2015. Sales for the first nine months of 2016 were just under the comparable period in 2015.

Space & Defense: Net sales of $81.5 million increased 5.4% (no foreign exchange effect) for the quarter as compared to the third quarter of 2015. Rotorcraft sales comprise just over half of Space & Defense sales and were modestly higher than the third quarter of 2015. Sales for the first nine months were down 4.6% (4.7% in constant currency) compared to the prior year, due to an approximate 10% decline in rotorcraft.

Industrial: Net sales of $58.4 million for the third quarter of 2016 were 2.5% higher (3.2% in constant currency) than the third quarter of 2015. Wind energy sales (which account for more than half of the total Industrial sales) were just above last year for both the quarter and the first nine months. Total Industrial sales for the first nine months of 2016 were 8.9% (9.6% in constant currency) higher than 2015 with the growth coming from the Formax acquisition, partially offset by weakness in recreation and other industrial submarkets.

Gross Margin

(In millions)	Quarter Ended September 30, 2016		2015		% Change		Nine Months Ended September 30, 2016		2015		% Change	
Gross margin	$	135.7	$	124.1	9.3	%	$	429.0	$	405.0	5.9	%
Percentage of sales	27.1	%	27.7	%			28.2	%	29.0	%		

We achieved a gross margin percentage of 27.1% compared to 27.7% in the third quarter of 2015, as both periods reflected strong operating performance. Gross margin of 28.2% in the first nine months of 2016, as compared to the comparable period last year at 29.0%, reflects the start-up of several new production lines in the first nine months of the year for additional capacity to support our forecasted growth.

Operating Expenses

(In millions)	Quarter Ended September 30, 2016		2015		% Change		Nine Months Ended September 30, 2016		2015		% Change	
SG&A expense	$	35.1	$	35.5	(1.1	)%	$	121.1	$	120.3	0.7	%
Percentage of sales	7.0	%	7.9	%			8.0	%	8.6	%		
R&T expense	$	11.5	$	10.6	8.5	%	$	34.8	$	33.5	3.9	%
Percentage of sales	2.3	%	2.4	%			2.3	%	2.4	%		

Selling, general and administrative expenses were slightly lower for the third quarter and slightly higher in the first nine months of 2016 as compared to the comparable periods in 2015. Research and technology expenses in the third quarter of 2016 of $11.5 million were $0.9 million higher than the comparable 2015 period and expenses for the first nine months of 2016 were 3.9% higher than the comparable period in 2015.

Operating Income

Quarter Ended September 30,

				Nine Months Ended September 30,		
(In millions)	2016	2015	% Change	2016	2015	% Change
Consolidated operating income	$ 89.1	$ 78.0	14.2 %	$ 273.1	$ 251.2	8.7 %
Operating margin	17.8 %	17.4 %		18.0 %	18.0 %	