FARMER BROTHERS CO
Form 10-Q
February 06, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 31, 2012

OR

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number: 001-34249

FARMER BROS. CO.
(exact name of registrant as specified in its charter)

Delaware	95-0725980
(State of Incorporation)	(I.R.S. Employer Identification No.)

20333 South Normandie Avenue, Torrance, California 90502
(address of principal executive offices, Zip code)

Registrant’s telephone number, including area code: 310-787-5200

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 ý 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 ý NO £

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES £ NO ý

On February 5, 2013, the registrant had 16,342,008 shares outstanding of its common stock, par value $1.00 per share, which is the registrant’s only class of common stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FARMER BROS. CO.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	December 31, 2012	June 30, 2012
ASSETS	(Unaudited)	
Current assets:		
Cash and cash equivalents	$5,218	$3,906
Short-term investments	20,570	21,021
Accounts and notes receivable, net	43,752	40,736
Inventories	68,385	65,981
Income tax receivable	478	762
Prepaid expenses	2,740	3,445
Total current assets	141,143	135,851
Property, plant and equipment, net	98,159	108,135
Intangible assets, net	6,929	7,615
Other assets	3,052	2,904
Deferred income taxes	854	854
Total assets	$250,137	$255,359
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$31,594	$27,676
Accrued payroll expenses	18,372	20,494
Short-term borrowings under revolving credit facility	15,074	29,126
Short-term obligations under capital leases	3,527	3,737
Deferred income taxes	1,479	1,480
Other current liabilities	11,691	10,176
Total current liabilities	81,737	92,689
Long-term borrowings under revolving credit facility	10,000	—
Accrued postretirement benefits	35,158	34,557
Other long-term liabilities—capital leases	10,617	12,130
Accrued pension liabilities	41,778	42,513
Accrued workers' compensation liabilities	4,022	4,131
Deferred income taxes	607	607
Total liabilities	$183,919	$186,627
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, $1.00 par value, 500,000 shares authorized and none issued	$—	$—
Common stock, $1.00 par value, 25,000,000 shares authorized; 16,341,662 and 16,308,859 issued and outstanding at December 31, 2012 and June 30, 2012, respectively	16,342	16,309
Additional paid-in capital	31,906	34,834
Retained earnings	96,035	100,455
Unearned ESOP shares	(20,836)	(25,637)
Less accumulated other comprehensive loss	(57,229)	(57,229)
Total stockholders' equity	$66,218	$68,732

Total liabilities and stockholders’ equity	$250,137	$255,359

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

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share data)
(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
Net sales	$135,705	$131,770	$254,858	$252,967
Cost of goods sold	85,352	87,229	159,884	168,741
Gross profit	50,353	44,541	94,974	84,226
Selling expenses	40,765	36,771	78,036	72,452
General and administrative expenses	9,165	9,071	18,058	17,705
Pension withdrawal expense	—	4,348	—	4,348
Operating expenses	49,930	50,190	96,094	94,505
Income (loss) from operations	423	(5,649)	(1,120)	(10,279)
Other (expense) income:				
Dividend income	284	304	543	663
Interest income	99	21	191	36
Interest expense	(463)	(506)	(920)	(1,081)
Other, net	(7,656)	1,780	(2,711)	(627)
Total other (expense) income	(7,736)	1,599	(2,897)	(1,009)
Loss before taxes	(7,313)	(4,050)	(4,017)	(11,288)
Income tax (benefit) expense	(19)	60	403	406
Net loss	$(7,294)	$(4,110)	$(4,420)	$(11,694)
Net loss per common share—basic and diluted	$(0.47)	$(0.27)	$(0.28)	$(0.77)
Weighted average common shares outstanding—basic and diluted	15,548,094	15,247,215	15,519,980	15,214,712

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

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)
(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
Net income (loss)	$(7,294)	$(4,110)	(4,420)	(11,694)
Other comprehensive income (loss)	—	—	—	—
Total comprehensive income (loss)	$(7,294)	$(4,110)	$(4,420)	$(11,694)

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

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended December 31,			
	2012		2011	
Cash flows from operating activities:				
Net loss	$(4,420	)	$(11,694	)
Adjustments to reconcile net loss to net cash provided by operating activities:				
Depreciation and amortization	16,640		15,821	
(Recovery) provision for doubtful accounts	(963	)	737	
Net gains on sales of assets	(3,202	)	(662	)
ESOP and share-based compensation expense	1,906		1,476	
Net loss on derivatives and investments	7,038		2,250	
Change in operating assets and liabilities:				
Short-term investments	(6,587	)	3,743	
Accounts and notes receivable	(2,053	)	(2,000	)
Inventories	(2,404	)	1,110	
Income tax receivable	284		277	
Prepaid expenses and other assets	558		(361	)
Accounts payable	4,615		(1,712	)
Accrued payroll, expenses and other liabilities	(605	)	(165	)
Accrued postretirement benefits	600		767	
Other long-term liabilities	(1,302	)	112	
Net cash provided by operating activities	$10,105		$9,699	
Cash flows from investing activities:				
Purchases of property, plant and equipment	(6,396	)	(5,808	)
Proceeds from sales of property, plant and equipment	3,911		1,227	
Net cash used in investing activities	$(2,485	)	$(4,581	)
Cash flows from financing activities:				
Proceeds from revolving credit facility	15,000		9,400	
Repayments on revolving credit facility	(19,750	)	(15,700	)
Payments of capital lease obligations	(1,558	)	(778	)
Net cash used in financing activities	$(6,308	)	$(7,078	)
Net increase (decrease) in cash and cash equivalents	$1,312		$(1,960	)
Cash and cash equivalents at beginning of period	3,906		6,081	
Cash and cash equivalents at end of period	$5,218		$4,121	

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

FARMER BROS. CO.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Farmer Bros. Co. and Summary of Significant Accounting Policies

The Company

Farmer Bros. Co., a Delaware corporation (including its consolidated subsidiaries, unless the context otherwise requires, herein referred to as the “Company,” “we,” “our” or “Farmer Bros.”), is a manufacturer, wholesaler and distributor of coffee, tea and culinary products. The Company is a direct distributor of coffee to restaurants, hotels, casinos, hospitals and other foodservice providers, and is a provider of private brand coffee programs to Quick Service Restaurants, grocery retailers, national drugstore chains, restaurant chains, convenience stores, and independent coffee houses, nationwide. The Company was founded in 1912, was incorporated in California in 1923, and reincorporated in Delaware in 2004. The Company operates in one business segment.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States (“GAAP”) for complete consolidated financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals, unless otherwise indicated) considered necessary for a fair presentation of the interim financial data have been included. Operating results for the three and six months ended December 31, 2012 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2013. Events occurring subsequent to December 31, 2012 have been evaluated for potential recognition or disclosure in the unaudited consolidated financial statements for the three and six months ended December 31, 2012.

The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012, filed with the Securities and Exchange Commission (the “SEC”) on September 10, 2012.

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company reviews its estimates on an ongoing basis using currently available information. Changes in facts and circumstances may result in revised estimates and actual results may differ from those estimates.

Fair Value Measurements

Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants. The Company maximizes the use of observable market inputs, minimizes the use of unobservable market inputs and discloses in the form of an outlined hierarchy the details of such fair value measurements. See Note 2 for additional information.

Coffee Brewing Equipment and Service

The Company classifies certain expenses related to coffee brewing equipment provided to customers as cost of goods sold. These costs include the cost of equipment as well as the cost of servicing that equipment (including service employees' salaries, cost of transportation and the cost of supplies and parts) and are considered directly attributable to the generation of revenues from the Company's customers. Accordingly, such costs included in cost of goods sold in the accompanying unaudited consolidated financial statements for the three months ended December 31, 2012 and 2011 are $6.3 million and $6.4 million, respectively. Coffee brewing equipment costs included in cost of goods sold for the six months ended December 31, 2012 and 2011 are $12.1 million and $12.4 million, respectively. The Company capitalized coffee brewing equipment in the amounts of $4.9 million and $5.2 million in the six months ended December 31, 2012 and 2011, respectively. Depreciation expense related to capitalized coffee brewing equipment reported as cost of goods sold was $3.3 million and $2.9 million in the three months ended December 31, 2012 and 2011, respectively. Depreciation expense related to capitalized coffee brewing equipment reported as cost of goods sold was $6.6 million and $5.8 million in the six months ended December 31, 2012 and 2011, respectively.

Revenue Recognition

Most product sales are made “off-truck” to the Company's customers at their places of business by the Company's sales representatives. Revenue is recognized at the time the Company's sales representatives physically deliver products to customers and title passes or upon acceptance by the customer when shipped by third party delivery.

The Company sells roast and ground coffee and tea to The J.M. Smucker Company ("J.M. Smucker") pursuant to a co-packing agreement. The co-packing agreement was assigned by Sara Lee Corporation ("Sara Lee") to J.M. Smucker on February 17, 2012, as part of J.M. Smucker's acquisition of Sara Lee's coffee business. The Company recognizes revenue from the co-packing arrangement for sale of tea on a net basis, net of direct costs of revenue, since the Company acts as an agent of J.M. Smucker in such transactions. As of December 31, 2012 and June 30, 2012, the Company had $0.4 million and $0.8 million, respectively, of receivables related to this arrangement, which are included in “Other receivables” in the consolidated balance sheets (see Note 3).

Earnings (Loss) Per Common Share

Basic earnings (loss) per share ("EPS") represents net earnings attributable to common stockholders divided by the weighted average number of common shares outstanding for the period, excluding unallocated shares held by the Company's Employee Stock Ownership Plan ("ESOP"). Diluted EPS represents net earnings attributable to common stockholders divided by the weighted average number of common shares outstanding, inclusive of the dilutive impact of common equivalent shares outstanding during the period. However, nonvested restricted stock awards (referred to as participating securities) are excluded from the dilutive impact of common equivalent shares outstanding in accordance with authoritative guidance under the two-class method. The nonvested restricted stockholders are entitled to participate in dividends declared on common stock as if the shares were fully vested and hence are deemed to be participating securities. Under the two-class method, earnings (loss) attributable to nonvested restricted stockholders are excluded from net earnings (loss) attributable to common stockholders for purposes of calculating basic and diluted EPS.

Computation of EPS for the three and six months ended December 31, 2012 does not include the dilutive effect of 699,317 shares issuable under stock options since their inclusion would be anti-dilutive. Computation of EPS for the three and six months ended December 31, 2011 does not include the dilutive effect of 495,670 shares issuable under stock options since their inclusion would be anti-dilutive. Accordingly, the unaudited consolidated financial statements present only basic net loss per common share for all periods presented (see Note 9).

Dividends Declared

Although historically the Company has paid a dividend to stockholders, in light of the Company's current financial position, the Company's Board of Directors has omitted the payment of a quarterly dividend since the third quarter of fiscal 2011. The amount, if any, of dividends to be paid in the future will depend upon the Company's then available cash, anticipated cash needs, overall financial condition, loan agreement restrictions, future prospects for earnings and cash flows, as well as other relevant factors.

Impairment of Indefinite-lived Intangible Assets

The Company performs its annual indefinite-lived intangible assets impairment test as of June 30 of each fiscal year. Indefinite-lived intangible assets are not amortized but instead are reviewed for impairment annually by comparing their fair values to their carrying values.

In addition to an annual test, indefinite-lived intangible assets must also be tested on an interim basis if events or circumstances indicate that the estimated fair value of such assets has decreased below their carrying value. There were no such events or circumstances during the six months ended December 31, 2012.

Long-lived Assets, Excluding Indefinite-lived Intangible Assets

The Company reviews the recoverability of its long-lived assets whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Long-lived assets evaluated for impairment are grouped with other assets to the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The estimated future cash flows are based upon, among other things, assumptions about expected future operating performance, and may differ from actual cash flows. If the sum of the projected undiscounted cash flows (excluding interest) is less than the carrying value of the assets, the assets will be written down to the estimated fair value in the period in which the determination is made. There were no such events or circumstances during the six months ended December 31, 2012.

Recently Adopted Accounting Standards

In September 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-08, “Goodwill and Other (Topic 350), Testing Goodwill for Impairment” (“ASU 2011-08”). Pursuant to ASU 2011-08 companies have the option to first assess qualitative factors to determine whether it is more likely than not (a likelihood of more than 50%) that the fair value of a reporting unit is less than its carrying amount. If, after considering the totality of events and circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, performing the two-step impairment test is unnecessary. The amendments include examples of events and circumstances that an entity should consider. ASU 2011-08 is effective for annual and interim impairment tests performed for fiscal years beginning after June 15, 2012 and is effective for the Company for fiscal 2013 beginning July 1, 2012. Adoption of ASU 2011-08 did not have a material effect on the results of operations, financial position or cash flows of the Company.

On July 1, 2012, the Company adopted ASU No. 2011-05, "Comprehensive Income (Topic 220): Presentation of Comprehensive Income" ("ASU 2011-05"), except for the provisions of ASU 2011-05 which were deferred by ASU No. 2011-12, "Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income" in ASU No. 2011-05 ("ASU 2011-12"). The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. Instead, the Company presents other comprehensive income in a separate statement following the consolidated statements of operations. The new guidance also requires entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the consolidated statement of operations and the consolidated statement of comprehensive income. ASU 2011-12 indefinitely defers the guidance related to the presentation of reclassification adjustments. ASU 2011-05 only relates to disclosure requirements and its adoption did not have a material effect on the results of operations, financial position or cash flows of the Company.

In May 2011, the FASB issued ASU No. 2011-04, “Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs” (“ASU 2011-04”). ASU 2011-04 amends the fair value measurement and disclosure guidance in Accounting Standards Codification (“ASC”) 820, “Fair Value Measurements and Disclosures” (“ASC 820”), of the FASB for financial assets and liabilities to converge GAAP and International Financial Reporting Standards requirements for measuring amounts at fair value as well as disclosures about these measurements. Many of the amendments clarify existing concepts and are generally not expected to result in significant changes to how many companies currently apply the fair value principles. In certain instances, however, the FASB changed a principle to achieve convergence, and while limited, these amendments have the potential to significantly change practice for some companies. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. The Company adopted the amendments beginning July 1, 2012. The adoption of ASU 2011-04 did not have a material effect on the results of operations, financial position or cash flows of the Company.

New Accounting Pronouncements

As of December 31, 2012, there were no new accounting pronouncements anticipated to be adopted by the Company.

Note 2. Investments and Derivative Instruments

The Company purchases various derivative instruments as investments or to create economic hedges of its interest rate risk and commodity price risk. At December 31, 2012 and 2011, derivative instruments were not designated as accounting hedges as defined by ASC 815, “Accounting for Derivative Instruments and Hedging Activities.” The fair value of derivative instruments is based upon broker quotes. The Company records unrealized gains and losses on trading securities and changes in the market value of certain coffee contracts meeting the definition of derivatives in "Other, net" in the consolidated statements of operations.

The Company groups its assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1—Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2—Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3—Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Assets and liabilities measured and recorded at fair value on a recurring basis were as follows (in thousands):

As of December 31, 2012 (Unaudited)	Total	Level 1	Level 2	Level 3
Preferred stock(1)	$20,507	$15,408	$5,099	$—
Futures, options and other derivative assets(1)	$63	$—	$63	$—
Derivative liabilities(2)	$2,710	$—	$2,710	$—
Derivative liabilities—interest rate swap	$40	—	40	—

As of June 30, 2012	Total	Level 1	Level 2	Level 3
Preferred stock(1)	$19,395	$14,078	$5,317	$—
Futures, options and other derivative assets(1)	$1,626	$—	$1,626	$—
Derivative liabilities(2)	$410	$—	$410	$—

(1) Included in "Short-term investments" on the consolidated balance sheets.

(2) Included in "Accounts payable" on the consolidated balance sheets.

There were no significant transfers of securities between Level 1 and Level 2 in each of the periods presented.

Effective December 1, 2012, the Company entered into an interest rate swap transaction utilizing a notional amount of $10.0 million and a maturity date of March 1, 2015. The Company entered into the swap transaction to effectively fix the future interest rate during the applicable period on a portion of its borrowings under the revolving credit facility. The swap transaction is intended to manage the Company's interest rate risk related to its revolving credit facility and requires the Company to pay a fixed rate of 0.48% per annum in exchange for a variable interest rate based on 1-month USD LIBOR-BBA.

The Company values its interest rate swap using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of the interest rate swap. This analysis reflects the contractual terms of the interest rate swap, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

Valuation of the interest rate swap transaction is based on proprietary curves that take into account both Level 1 and Level 2 inputs. The fair value of the interest rate swap is determined using the market standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on an expectation of future interest rates (forward curves). These forward curves are market-based, utilizing observable market data. Discount curves for present value purposes are constructed using rates representing estimated costs of funding swap positions for early terminations based on an appropriate observable discount rate.

Gains and losses, both realized and unrealized, on derivatives and investments, are included in "Other, net" in the consolidated statements of operations and in "Net loss on derivatives and investments" in the consolidated statements of cash flows. Net realized and unrealized gains and losses on derivatives and investments are as follows:

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2012	2011	2012	2011
(In thousands)	(Unaudited)		(Unaudited)	
Coffee-related derivatives:				
Unrealized gains	$—	$1,721	$—	$1,405
Unrealized losses	(6,658)	—	(5,512)	(2,424)
Realized gains	—	22	—	81
Realized losses	(1,201)	(2,208)	(1,644)	(3,220)
Net realized and unrealized coffee-related derivative losses	(7,859)	(465)	(7,156)	(4,158)
Net realized and unrealized gains from investments	59	837	158	1,908
Net unrealized losses from interest rate swap	(40)	—	(40)	—
Net (losses) gains on derivatives and investments	(7,840)	372	(7,038)	(2,250)
Net (losses) gains on sales of assets	(11)	564	3,202	662
Other gains, net	195	844	1,125	961
Other, net	$(7,656)	$1,780	$(2,711)	$(627)

Preferred stock investments as of December 31, 2012 consisted of securities with a fair value of $16.5 million in an unrealized gain position and securities with a fair value of $4.0 million in an unrealized loss position. Preferred stock investments as of June 30, 2012 consisted of securities with a fair value of $16.5 million in an unrealized gain position and securities with a fair value of $2.9 million in an unrealized loss position.

The following tables show gross unrealized losses (although such losses have been recognized in the consolidated statements of operations) and fair values for those investments that were in an unrealized loss position as of December 31, 2012 and June 30, 2012, aggregated by the length of time those investments have been in a continuous loss position:

	December 31, 2012 (Unaudited)					
	Less than 12 Months		12 Months and Greater		Total	
(In thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Preferred stock	$2,615	$(20)	$1,348	$(57)	$3,963	$(77)

	June 30, 2012					
	Less than 12 Months		12 Months and Greater		Total	
(In thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Preferred stock	$1,750	$(16)	$1,141	$(24)	$2,891	$(40)

Note 3. Accounts and Notes Receivable, Net

(In thousands)	As of December 31, 2012 (Unaudited)	June 30, 2012
Trade receivables	$43,401	$40,687
Other receivables	1,260	1,921
Allowance for doubtful accounts	(909)	(1,872)
Accounts and notes receivable, net	$43,752	$40,736

Allowance for doubtful accounts decreased in the six months ended December 31, 2012, primarily due to $0.8 million in recovery of an account previously deemed uncollectible.

Note 4. Inventories

The Company's inventories consisted of the following:

	Processed	Unprocessed	Total
December 31, 2012 (Unaudited)	(In thousands)		
Coffee	$13,514	$15,768	$29,282
Tea and culinary products	22,860	5,081	27,941
Coffee brewing equipment	6,154	5,008	11,162
	$42,528	$25,857	$68,385

	Processed	Unprocessed	Total
June 30, 2012	(In thousands)		
Coffee	$15,485	$11,836	$27,321
Tea and culinary products	24,502	4,817	29,319
Coffee brewing equipment	3,977	5,364	9,341
	$43,964	$22,017	$65,981

Inventories are valued at the lower of cost or market. The Company accounts for coffee, tea and culinary products on the last in, first out ("LIFO") basis and coffee brewing equipment manufactured on the first in, first out ("FIFO") basis. The Company regularly evaluates these inventories to determine whether market conditions are correctly reflected in the recorded carrying value. At the end of each quarter, the Company records the expected beneficial effect of the liquidation of LIFO inventory quantities, if any, and records the actual impact at fiscal year-end. An actual valuation of inventory under the LIFO method is made only at the end of each fiscal year based on the inventory levels and costs at that time. If inventory quantities decline at the end of the fiscal year compared to the beginning of the fiscal year, the reduction results in the liquidation of LIFO inventory quantities carried at the cost prevailing in prior years. This LIFO inventory liquidation may result in a decrease or increase in cost of goods sold depending on whether the cost prevailing in prior years was lower or higher, respectively, than the current year cost. Accordingly, interim LIFO calculations must necessarily be based on management's estimates of expected fiscal year-end inventory levels and costs. Because these estimates are subject to many forces beyond management's control, interim results are subject to the final fiscal year-end LIFO inventory valuation. The Company anticipates its inventory levels at June 30, 2013 will decrease from June 30, 2012 levels, and, therefore, recorded $0.5 million in expected beneficial effect of LIFO inventory liquidation in cost of goods sold in the three months ended December 31, 2012 which reduced net loss for the three and six months ended December 31, 2012 by $0.5 million. In the three and six months ended December 31, 2011, the Company recorded $3.8 million and $5.5 million, respectively, in expected beneficial effect of LIFO inventory liquidation in cost of goods sold which reduced net loss for the three and six months ended December 31, 2011 by $3.8 million and $5.5 million, respectively.

The Company routinely enters into specialized hedging transactions to purchase future coffee contracts to enable it to lock in green coffee prices within a pre-established range, and holds a mix of futures contracts and options to help hedge against volatility in green coffee prices. None of these hedging transactions, futures contracts or options is designated as an accounting hedge. The Company values its futures contracts by marking them to market price and recognizes immediately in “Other, net” in the consolidated statements of operations the unrealized and realized gains or losses based on whether the market price is higher or lower than the price that was locked-in. During the three months ended December 31, 2012, green coffee commodity prices declined below the Company's locked-in price, and the Company recognized the resulting losses in its results. Such losses are expected to either be offset by future derivative gains as the coffee market changes, or recovered through operating income as a result of the lower cost of goods assigned to the related coffee.

For the three and six months ended December 31, 2012, the Company recorded $(7.9) million and $(7.2) million, respectively, in net realized and unrealized coffee-related derivative losses. For the three and six months ended December 31, 2011, the Company recorded $(0.5) million and $(4.2) million, respectively, in net realized and unrealized coffee-related derivative losses (see Note 2).

Note 5. Employee Benefit Plans

The Company provides pension plans for most full time employees. Generally the plans provide benefits based on years of service and/or a combination of years of service and earnings. Certain retirees are also eligible for medical, dental and vision benefits.

The Company is required to recognize the funded status of a benefit plan in its consolidated balance sheet. The Company is also required to recognize in other comprehensive income certain gains and losses that arise during the period but are deferred under pension accounting rules. The Company measures its plan assets and benefit obligations annually as of June 30.

Single Employer Pension Plans

The Company has a defined benefit pension plan, the Farmer Bros. Salaried Employees Pension Plan (the “Farmer Bros. Plan”), for the majority of its employees who are not covered under a collective bargaining agreement. The Company amended the Farmer Bros. Plan, freezing the benefit for all participants effective June 30, 2011. After the plan freeze, participants do not accrue any benefits under the plan, and new hires are not eligible to participate in the plan. As all plan participants became inactive following this curtailment, net gain or loss is now amortized based on the remaining life expectancy of these participants instead of the remaining service period of these participants.

The Company also has two defined benefit pension plans for certain hourly employees covered under a collective bargaining agreement (the “Brewmatic Plan” and the “Hourly Employees’ Plan”).

The net periodic benefit cost for the defined benefit pension plans is as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
(In thousands)	(Unaudited)		(Unaudited)	
Service cost	$119	$124	$238	$248
Interest cost	1,449	1,525	2,898	3,050
Expected return on plan assets	(1,660)	(1,703)	(3,320)	(3,406)
Amortization of net loss(1)	387	342	774	685
Amortization of net prior service cost(1)	5	5	10	10
Net periodic benefit cost	$300	$293	$600	$587

(1) These amounts represent the estimated portion of the net loss and net prior service cost remaining in accumulated other comprehensive income that is expected to be recognized as a component of net periodic benefit cost over the current fiscal year.

Weighted average assumptions used to determine net periodic benefit cost

	Fiscal	
	2013	2012
Discount rate	4.55%	5.60%
Expected long-term rate of return	8.00%	8.25%
Rate of compensation increase(1)	—%	3.00%

(1) For Hourly Employees' Plan only.

Basis used to determine expected long-term return on plan assets

Historical and future projected returns of multiple asset classes were analyzed to develop a risk-free real rate of return and risk premiums for each asset class. The overall rate for each asset class was developed by combining a long-term inflation component, the risk-free real rate of return, and the associated risk premium. A weighted average rate of return was developed based on those overall rates and the target asset allocation of the plans.

Multiemployer Pension Plans

The Company participates in the Western Conference of Teamsters Pension Plan ("WCTPP"), a defined benefit pension plan that is union sponsored and collectively bargained, for the benefit of certain employees subject to collective bargaining agreements. The Company makes contributions to WCTPP generally based on the number of hours worked by the participants in accordance with the provisions of negotiated labor contracts.

Effective October 2011, the Company withdrew from the United Teamsters Pension Fund, a defined benefit pension plan, and replaced it with the United Teamsters Annuity Fund (the "Annuity Fund"), a defined contribution pension plan, for certain employees covered by a collective bargaining agreement expiring in 2014. The Company incurred no withdrawal liability related to the withdrawal from the United Teamsters Pension Fund. The Company's contributions to the Annuity Fund are based on the number of compensable hours worked by the Company's employees who participate in the Annuity Fund.

In the second quarter of fiscal 2012, the Company withdrew from the Labor Management Pension Fund, a defined benefit pension plan, and recorded a charge of $4.3 million associated with withdrawal from this plan, representing the present value of the estimated withdrawal liability expected to be paid in quarterly installments of $0.1 million over 80 quarters. Installment payments will commence once the final determination of the amount of withdrawal liability is established, which determination may take up to 24 months from the date of withdrawal from the pension plan. Upon withdrawal, the employees covered under this multiemployer pension plan were included in the Company's 401(k) plan (the "401(k) Plan").

Future collective bargaining negotiations may result in the Company withdrawing from the remaining multiemployer pension plans in which it participates and, if successful, the Company may incur a withdrawal liability, the amount of which could be material to the Company's results of operations and cash flows.

Multiemployer Plans Other Than Pension Plans

The Company participates in nine multiemployer defined contribution plans other than pension plans that provide medical, vision, dental and disability benefits to certain retirees subject to collective bargaining agreements who meet the eligibility rules in effect when they retire and/or qualified members of their families.

401(k) Plan

The Company's 401(k) Plan is available to all eligible employees who have worked more than 1,000 hours during a calendar year and were employed at the end of the calendar year. Participants in the 401(k) Plan may choose to contribute 1% to 100% of their annual pay subject to the maximum contribution allowed by the Internal Revenue Service. The Company's matching contribution is discretionary based on approval by the Company's Board of Directors. For the calendar years 2012 and 2013, the Company's Board of Directors approved a Company matching contribution of 50.0% of an employee's annual contribution to the 401(k) Plan, up to 6.0% of the employee's eligible income. The matching contributions (and any earnings thereon) vest at the rate of 20.0% for each of the participant's first 5 years of vesting service, so that a participant is fully vested in his or her matching contribution account after 5 years of vesting service. A participant is automatically vested in the event of death, disability or attainment of age 65 while employed by the Company. Employees are 100% vested in their contributions. For employees subject to a collective bargaining agreement, the match is only available if so provided in the labor agreement.

The Company recorded matching contributions of $0.5 million and $0.6 million in operating expenses for the six months ended December 31, 2012 and 2011, respectively.

Postretirement Benefits

The Company sponsors an unfunded postretirement medical, dental and vision plan that covers qualified non-union retirees and certain qualified union retirees. Under this postretirement plan, the Company's contributions toward premiums for retiree medical, dental and vision coverage for participants and dependents are scaled based on length of service, with greater Company contributions for retirees with greater length of service, but subject to a maximum monthly Company contribution.

The net periodic postretirement benefit cost is as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
(In thousands)	(Unaudited)		(Unaudited)	
Service cost	$860	$409	$1,269	$818
Interest cost	26	330	356	660
Expected return on plan assets	—	—	—	—
Amortization of net gain	(236)	(199)	(435)	(398)
Amortization of unrecognized transition (asset) obligation	—	—	—	—
Amortization of prior service credit	(422)	(58)	(480)	(116)
Net periodic postretirement benefit cost	$228	$482	$710	$964

Weighted average assumptions used to determine net periodic postretirement benefit cost

	Fiscal	
	2013	2012
Discount rate	4.40%	5.46%

The fiscal 2013 estimate of net periodic postretirement benefit cost is based on July 1, 2012 census data.

Note 6. Bank Loan

On September 12, 2011, the Company entered into an Amended and Restated Loan and Security Agreement (the "Loan Agreement") among the Company and Coffee Bean International, Inc. ("CBI"), as Borrowers, certain of the Company's other subsidiaries, as Guarantors, the Lenders party thereto, and Wells Fargo Bank, National Association ("Wells Fargo"), as Agent.

The Loan Agreement provides for a senior secured revolving credit facility of up to $85.0 million, with a letter of credit sublimit of $20.0 million. The revolving credit facility provides for advances of 85% of eligible accounts receivable and 75% of eligible inventory (subject to a $60.0 million inventory loan limit), as defined. The Loan Agreement provides for interest rates based on modified Monthly Average Excess Availability levels with a range of PRIME + 0.25% to PRIME + 0.75% or Adjusted Eurodollar Rate + 2.0% to Adjusted Eurodollar Rate + 2.5%. The Loan Agreement has an amendment fee of 0.375% and an unused line fee of 0.25%. Outstanding obligations under the Loan Agreement are collateralized by all of the Borrowers' assets, including the Company's preferred stock portfolio. The Loan Agreement expires on March 2, 2015.

The Loan Agreement contains a variety of affirmative and negative covenants of types customary in an asset-based lending facility, including those relating to reporting requirements, maintenance of records, properties and corporate existence, compliance with laws, incurrence of other indebtedness and liens, limitations on certain payments, including the payment of dividends and capital expenditures, and transactions and extraordinary corporate events. The Loan Agreement allows the Company to pay dividends, subject to certain liquidity requirements. The Loan Agreement also contains financial covenants requiring the Borrowers to maintain minimum Excess Availability and Total Liquidity levels. The Loan Agreement allows the Lender to establish reserve requirements, which may reduce the amount of credit otherwise available to the Company, to reflect events, conditions, or risks that would have a reasonable likelihood of adversely affecting the Lender’s collateral or the Company’s assets, including the Company’s green coffee inventory.

On January 9, 2012, the Loan Agreement was amended (“Amendment No. 1”) in connection with JPMorgan Chase Bank, N.A. (“JPMorgan Chase”), becoming an additional Lender thereunder. Pursuant to Amendment No. 1, Wells Fargo will provide a commitment of $60.0 million and JPMorgan Chase will provide a commitment of $25.0 million.

On December 31, 2012, the Company was eligible to borrow up to a total of $70.3 million under the credit facility. As of December 31, 2012, the Company had outstanding borrowings of $25.1 million, excluding loan extension fees of $0.2 million, utilized $10.2 million of its letters of credit sublimit, and had excess availability under the credit facility of $34.8 million. In connection with entering into the interest rate swap agreement, the Company reclassified $10.0 million of its borrowings under the revolving credit facility as long-term because the Company intends to repay the borrowings in accordance with the termination date of the swap agreement which extends beyond one year. At December 31, 2012, the weighted average interest rate on the Company’s outstanding borrowings under the credit facility was 1.59%. As of December 31, 2012, the Company was in compliance with all restrictive covenants under the credit facility. There can be no assurance that the Lender will issue a waiver or grant an amendment to the covenants in future periods, if the Company required one.

Effective December 1, 2012, the Company entered into an interest rate swap transaction utilizing a notional amount of $10.0 million and a maturity date of March 1, 2015. The Company entered into the swap transaction to effectively fix the future interest rate during the applicable period on a portion of its borrowings under the revolving credit facility. The swap transaction is intended to manage the Company's interest rate risk related to its revolving credit facility and requires the Company to pay a fixed rate of 0.48% per annum in exchange for a variable interest rate based on 1-month USD LIBOR-BBA. As of December 31, 2012, the variable interest rate based on 1-month USD LIBOR-BBA was 0.2%.

The Company has not designated its interest rate swap as a hedge. The Company records the interest rate swap on its consolidated balance sheet at fair market value with the changes in fair value recorded as gain or loss in "Other, net" in its consolidated statements of operations. In each of the three and six months ended December 31, 2012 and 2011, the Company recorded a loss of $40,000 and $0, respectively, for the change in fair value of its interest rate swap (see Note 2).

Note 7. Share-based Compensation

On August 23, 2007, the Company’s Board of Directors approved the Farmer Bros. Co. 2007 Omnibus Plan (the “Omnibus Plan”), which was approved by stockholders on December 6, 2007. On December 6, 2012, the stockholders approved an amendment to increase the maximum number of shares of common stock available for issuance under the Omnibus Plan to 1,125,000 from 1,000,000, subject to adjustment as provided in the Omnibus Plan.

The Company measures and recognizes compensation expense for all share-based payment awards made under the Omnibus Plan based on estimated fair values.

Stock Options

On December 7, 2012, the Company granted 158,006 shares issuable upon the exercise of non-qualified stock options with an exercise price of $11.81 per share to eligible employees and officers under the Omnibus Plan. Shares issuable under the options vest ratably over a three-year period. Following are the weighted average assumptions used in the Black-Scholes valuation model for the grants issued during the six months ended December 31, 2012 and 2011:

	Six Months Ended December 31,			
	2012		2011	
Weighted average fair value of options	$5.54		$3.64	
Risk-free interest rate	0.8	%	1.1	%

Dividend yield	—		—	
Average expected life	6	years	6	years
Expected stock price volatility	49.5	%	52.5	%

The Company estimates the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in the Company's consolidated statements of operations. Compensation expense recognized for all stock option awards is recognized using the straight-line method over the vesting period. The options generally vest ratably over a three-year period, however, fiscal 2012 grants included nonqualified stock option awards to executive officers with different vesting periods, in each case, subject to certain events of acceleration as provided in the applicable employment agreement or award agreement with the executive officer.

The share-based compensation expense recognized in the Company's consolidated statements of operations for the three and six months ended December 31, 2012 and 2011 is based on awards ultimately expected to vest. Currently, management estimates an annual forfeiture rate of 6.5% based on actual forfeiture experience from the inception of the Omnibus Plan. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company uses the Black-Scholes option valuation model, which requires management to make certain assumptions for estimating the fair value of stock options at the date of the grant. The Company's assumption regarding expected stock price volatility is based on the historical volatility of the Company's stock price. The risk-free interest rate is based on U.S. Treasury zero-coupon issues at the date of grant with a remaining term equal to the expected life of the stock options. The average expected life is based on the midpoint between the vesting date and the end of the contractual term of the award.

The following table summarizes stock option activity for the six months ended December 31, 2012 (unaudited):

Outstanding Stock Options	Number of Stock Options	Weighted Average Exercise Price ($)	Weighted Average Grant Date Fair Value ($)	Weighted Average Remaining Life (Years)	Aggregate Intrinsic Value ($ in thousands)
Outstanding at June 30, 2012	667,235	12.84	4.78	4.8	143
Granted	158,006	11.81	5.54	6.9	414
Cancelled/forfeited	(125,924)	12.79	4.16	—	—
Outstanding at December 31, 2012	699,317	12.62	5.06	5.4	2,281
Vested and exercisable, December 31, 2012	329,499	15.00	5.18	4.7	—
Vested and expected to vest, December 31, 2012	664,388	15.00	5.07	5.5	2,135

The aggregate intrinsic values in the table above represent the total pretax intrinsic value, based on the Company's closing stock price of $14.43 at December 31, 2012, representing the last trading day of the fiscal quarter ended December 31, 2012, which would have been received by award holders had all award holders exercised their awards that were in-the-money as of that date. Total fair value of options vested during the six months ended December 31, 2012 was $0.4 million.

As of December 31, 2012 and 2011, there was approximately $1.6 million and $1.4 million, respectively, of unrecognized compensation cost related to stock options. Compensation expense recognized in general and administrative expenses was $0.3 million in each of the three months ended December 31, 2012 and 2011. Compensation expense recognized in general and administrative expenses was $0.5 million and $0.6 million for the six months ended December 31, 2012 and 2011, respectively.

Restricted Stock

On December 7, 2012, the Company granted a total of 37,544 shares of restricted stock, with a grant date fair value of $11.81 per share. In the prior fiscal year, 78,756 shares of restricted stock were granted during the three months ended

December 31, 2011, with a grant date fair value of $7.32 per share. Shares of restricted stock generally vest on the third anniversary of the date of grant for employees including officers. Shares of restricted stock generally vest ratably over a three-year period for directors and officers who are not employees. Fiscal 2012 grants included certain awards to executive officers with different vesting periods, in each case, subject to accelerated vesting as provided in the applicable employment agreement or award agreement with the executive officer.

Compensation expense is recognized on a straight-line basis over the service period based on the estimated fair value of the restricted stock. Compensation expense recognized in general and administrative expenses was $0.3 million and $0.2 million, for the three months ended December 31, 2012 and 2011, respectively. Compensation expense recognized in general and administrative expenses was $0.5 million and $0.3 million, for the six months ended December 31, 2012 and 2011, respectively. As of December 31, 2012 and 2011, there was approximately $1.2 million and $1.3 million, respectively, of unrecognized compensation cost related to restricted stock.

The following table summarizes restricted stock activity for the six months ended December 31, 2012 (unaudited):

Outstanding and Nonvested Restricted Stock Awards	Shares Awarded	Weighted Average Grant Date Fair Value ($)	Weighted Average Remaining Life (Years)	Aggregate Intrinsic Value ($ in thousands)
Outstanding June 30, 2012	175,947	10.16	1.9	1,401
Granted	44,374	11.39	—	505
Vested	(43,513)	12.58	—	—
Cancelled/forfeited	(18,143)	10.35	—	—
Outstanding at December 31, 2012	158,665	9.82	2.1	1,192
Expected to vest, December 31, 2012	134,218	9.78	2.1	1,053

Note 8. Income Taxes

The Company adjusts its effective tax rate each quarter based on its current estimated annual effective tax rate. The Company also records the tax impact of certain discrete items, unusual or infrequently occurring tax events and the effects of changes in tax laws or rates, in the interim period in which they occur. In addition, the Company evaluates its deferred tax assets quarterly to determine if a valuation allowance is required.

The Company considered whether a valuation allowance should be recorded against deferred tax assets based on the likelihood that the benefits of the deferred tax assets would or would not ultimately be realized in future periods. In making this assessment, significant weight was given to evidence that could be objectively verified such as recent operating results and less consideration was given to less objective indicators such as future earnings projections. After consideration of positive and negative evidence, including the recent history of losses, the Company cannot conclude that it is more likely than not to generate future earnings sufficient to realize the Company's deferred tax assets. Accordingly, the Company increased its valuation allowance by $2.9 million in the three months ended December 31, 2012 to $86.6 million. The valuation allowance at June 30, 2012 was $85.0 million.

A summary of the income tax expense recorded for the three and six months ended December 30, 2012 and 2011 is as follows:

	Three Months Ended		Six Months Ended	
	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011
(In thousands)	(Unaudited)		(Unaudited)	
Loss before taxes	$(7,313)	$(4,050)	$(4,017)	$(11,288)
Income tax benefit at statutory rate	(2,487)	(1,377)	(1,366)	(3,838)
State income tax (benefit) expense (net of federal tax benefit)	(320)	(168)	109	(448)
Dividend income exclusion	—	(9)	—	(58)
Valuation allowance	2,852	1,601	1,617	4,683
Other permanent items	(64)	13	43	67

Income tax (benefit) expense	$(19)	$60	$403	$406

As of December 31, 2012 and June 30, 2012 the Company had not recognized the following tax benefits in its consolidated financial statements:

(In thousands)	As of December 31, 2012 (Unaudited)	June 30, 2012
Total unrecognized tax benefits(1)	$3,211	$3,211
Unrecognized tax benefits that, if recognized, would affect the Company's effective tax rate, subject to the valuation allowance(1)	$3,064	$3,064

(1) Excluding interest and penalties.

The Company believes it is reasonably possible that approximately $43,000 of its total unrecognized tax benefits could be released in the next 12 months.

The Company is currently appealing a decision reached by the Internal Revenue Service regarding its June 30, 2003 through June 30, 2008 tax returns. In January 2012, the appeals officer gave a preliminary indication that the audit results will be upheld.

Note 9. Earnings (Loss) Per Common Share

The following table sets forth the calculation of basic and diluted net loss per common share:

	Three Months Ended December 31,		Six Months Ended December 31	
	2012	2011	2012	2011
(In thousands, except share and per share amounts)	(Unaudited)		(Unaudited)	
Net loss attributable to common stockholders—basic	(7,225)	(4,094)	(4,378)	(11,638)
Net loss attributable to nonvested restricted stockholders	(69)	(16)	(42)	(56)
Total net loss	$(7,294)	$(4,110)	(4,420)	(11,694)
Weighted average shares outstanding—basic	15,548,094	15,247,215	15,519,980	15,214,712
Effect of dilutive securities:				
Shares issuable under stock options	—	—	—	—
Weighted average shares outstanding—diluted	15,548,094	15,247,215	15,519,980	15,214,712
Net loss per common share—basic and diluted	$(0.47)	$(0.27)	$(0.28)	$(0.77)

Note 10. Commitments and Contingencies

Contractual obligations for the remainder of fiscal 2013 and future fiscal years are as follows:

	Contractual Obligations (Unaudited)				
(In thousands)	Capital Lease Obligations	Operating Lease Obligations	Pension Plan Obligations	Postretirement Benefits Other Than Pension Plans	Revolving Credit Facility
Six months ending June 30, 2013	$2,263	$2,002	$3,182	$682	$15,074
Fiscal year ending June 30, 2014	3,841	3,562	6,508	1,450	—
Fiscal year ending June 30, 2015	3,760	2,927	6,692	1,846	10,000
Fiscal year ending June 30, 2016	3,444	1,998	6,898	2,106	—
Fiscal year ending June 30, 2017	1,519	1,367	7,165	2,362	—
Thereafter	980	2,047	40,943	15,559	—
		$13,903	$71,388	$24,005	$25,074
Total minimum lease payments	$15,807				
Less: imputed interest (0.82% to 10.7%)	(1,663)				
Present value of future minimum lease payments	14,144				
Less: current portion	3,527				
Long-term capital lease obligations	$10,617				

The Company is a party to various pending legal and administrative proceedings. It is management's opinion that the outcome of such proceedings will not have a material impact on the Company's financial position, results of operations or cash flows.

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

Forward-Looking Statements

The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of many factors. The results of operations for the three and six months ended December 31, 2012 and 2011 are not necessarily indicative of the results that may be expected for any future period. The following discussion should be read in combination with the consolidated financial statements and the notes thereto included in Part I, Item 1 of this report and with the “Risk Factors” described in Part II, Item 1A of this report.

Liquidity and Capital Resources

Credit Facility

On September 12, 2011, we entered into an Amended and Restated Loan and Security Agreement (the “Loan Agreement”) among the Company and CBI, as Borrowers, certain of the Company’s other subsidiaries, as Guarantors, the Lenders party thereto, and Wells Fargo Bank, National Association ("Wells Fargo"), as Agent

The Loan Agreement provides for a senior secured revolving credit facility of up to $85.0 million, with a letter of credit sublimit of $20.0 million. The revolving credit facility provides for advances of 85% of eligible accounts receivable and 75% of eligible inventory (subject to a $60.0 million inventory loan limit), as defined. The Loan Agreement provides for interest rates based on modified Monthly Average Excess Availability levels with a range of PRIME + 0.25% to PRIME + 0.75% or Adjusted Eurodollar Rate + 2.0% to Adjusted Eurodollar Rate + 2.5%. The Loan Agreement has an amendment fee of 0.375% and an unused line fee of 0.25%. Outstanding obligations under the Loan Agreement are collateralized by all of the Borrowers’ assets, including the Company’s preferred stock portfolio. The term of the Loan Agreement expires on March 2, 2015.

The Loan Agreement contains a variety of affirmative and negative covenants of types customary in an asset-based lending facility, including those relating to reporting requirements, maintenance of records, properties and corporate existence, compliance with laws, incurrence of other indebtedness and liens, limitations on certain payments, including the payment of dividends and capital expenditures, and transactions and extraordinary corporate events. The Loan Agreement allows us to pay dividends, subject to certain liquidity requirements. The Loan Agreement also contains financial covenants requiring the Borrowers to maintain minimum Excess Availability and Total Liquidity levels. The Loan Agreement allows the Lender to establish reserve requirements, which may reduce the amount of credit otherwise available to us, to reflect events, conditions, or risks that would have a reasonable likelihood of adversely affecting the Lender’s collateral or our assets, including our green coffee inventory.

The Loan Agreement provides that an event of default includes, among other things, subject to certain grace periods: (i) payment defaults; (ii) failure by any guarantor to perform any guarantee in favor of Lender; (iii) failure to abide by loan covenants; (iv) default with respect to other material indebtedness; (v) final judgment in a material amount not discharged or stayed; (vi) any change of control; (vii) bankruptcy or insolvency; and (viii) the failure of the Farmer Bros. Co. Employee Stock Ownership Benefit Trust, created by the Company to implement the Farmer Bros. Co. Employee Stock Ownership Plan ("ESOP"), to be duly qualified under Section 401(a) of the Internal Revenue Code of 1986, as amended, or exempt from federal income taxation, or if the ESOP engages in a material non-exempt prohibited transaction.

On January 9, 2012, the Loan Agreement was amended (“Amendment No. 1”) in connection with JPMorgan Chase Bank, N.A. (“JPMorgan Chase”), becoming an additional Lender thereunder. Pursuant to Amendment No. 1, Wells Fargo will provide a commitment of $60.0 million and JPMorgan Chase will provide a commitment of $25.0 million.

As of December 31, 2012, we had outstanding borrowings of $25.1 million, excluding loan extension fees of $0.2 million, utilized $10.2 million of the letters of credit sublimit, and had excess availability under the credit facility of $34.8 million. In connection with entering into the interest rate swap agreement, we reclassified $10.0 million of our borrowings under the revolving credit facility as long-term because we intend to repay the borrowings in accordance with the termination date of the swap agreement which extends beyond one year. The weighted average interest rate on our outstanding borrowings under the credit facility was 1.59% at December 31, 2012. We believe that the carrying value of our outstanding borrowings under the revolving credit facility approximates fair value at December 31, 2012 as the revolving credit facility bears interest at a variable interest rate based on prevailing market conditions.

As of December 31, 2012, we were in compliance with all restrictive covenants under the Loan Agreement. There can be no assurance that the Lender will issue a waiver or grant an amendment to the covenants in future periods, if we required one. As of January 31, 2013, we had estimated outstanding borrowings of $25.1 million, excluding loan extension fees of $0.2 million, utilized $10.2 million of the letters of credit sublimit, and had excess availability under the credit facility of $40.0 million. As of January 31, 2013, the weighted average interest rate on our outstanding borrowings under the credit facility was 1.59%.

Effective December 1, 2012, we entered into an interest rate swap transaction utilizing a notional amount of $10.0 million and a maturity date of March 1, 2015. We entered into the swap to effectively fix the future interest rate during the applicable period on a portion of our borrowings under the revolving credit facility. The swap transaction is intended to manage our interest rate risk related to the revolving credit facility and requires us to pay a fixed rate of 0.48% per annum in exchange for a variable interest rate based on 1-month USD LIBOR-BBA.

We have not designated our interest rate swap as a hedge. We record the interest rate swap on our consolidated balance sheet at fair market value with the changes in fair value recorded as gain or loss in "Other, net" in our consolidated statements of operations. In each of the three and six months ended December 31, 2012 and 2011, we recorded a loss of $40,000 and $0, respectively, for the change in fair value of our interest rate swap (see Note 2 to the consolidated financial statements).

Liquidity

We generally finance our operations through cash flow from operations and borrowings under our revolving credit facility described above. As of December 31, 2012, we had $5.2 million in cash and cash equivalents and $20.6 million in short-term investments. We believe our revolving credit facility, to the extent available, in addition to our cash flows from operations and other liquid assets, are sufficient to fund our working capital and capital expenditure requirements for the next 12 months.

We generate cash from operating activities primarily from cash collections related to the sale of our products. Net cash provided by operating activities was $10.1 million in the six months ended December 31, 2012, compared with $9.7 million in the six months ended December 31, 2011. Net cash provided by operating activities in the first half of fiscal 2013 was primarily due to lower net loss and increase in accounts payable offset, in part, by increase in accounts receivable and inventories. Net cash provided by operating activities in the first half of fiscal 2012 was primarily due to proceeds from short-term investments and decrease in inventory levels.

Net cash used in investing activities was $2.5 million in the first half of fiscal 2013, compared to $4.6 million in the first half of fiscal 2012. In the first half of fiscal 2013, cash inflow from the sale of fixed assets was $3.9 million and cash outflow for capital expenditures was $6.4 million. In the first half of the prior fiscal year, cash inflow from the sale of real estate was $1.2 million and cash outflow for capital expenditures was $5.8 million.

Net cash used in financing activities was $6.3 million in the first half of fiscal 2013, compared to $7.1 million in the first half of fiscal 2012. Cash flows related to financing activities included net repayments on our revolving credit facility of $4.8 million in the first half of fiscal 2013 compared to net borrowings of $6.3 million in the first half of fiscal 2012.

In the first half of fiscal 2013, we capitalized $6.4 million in property, plant and equipment purchases which included $4.9 million in expenditures to replace normal wear and tear of coffee brewing equipment, and $1.8 million in expenditures for vehicles, and machinery and equipment.

Our expected capital expenditures for fiscal 2013 include expenditures to replace normal wear and tear of coffee brewing equipment, vehicles, and machinery and equipment and are expected not to deviate significantly from fiscal 2012 levels.

Our working capital is composed of the following:

	December 31, 2012	June 30, 2012
(In thousands)	(Unaudited)	
Current assets	$141,143	$135,851
Current liabilities(1)	81,737	92,689
Working capital	$59,406	$43,162

(1) Includes $10.0 million in borrowings under revolving credit facility as of June 30, 2012, which was reclassified into long-term liabilities as of December 31, 2012.

Liquidity information:

	Six Months Ended December 31,	
	2012	2011
(In thousands)	(Unaudited)	
Capital expenditures	$6,396	$5,808

Results of Operations

Net sales in the fiscal quarter ended December 31, 2012 increased $3.9 million, or 3%, to $135.7 million as compared to $131.8 million in the fiscal quarter ended December 31, 2011. The increase was primarily due to increases in sales of our coffee and tea products. Net sales in the first half of fiscal 2013 increased $1.9 million, or 1%, to $254.9 million as compared to $253.0 million in the first half of fiscal 2011, primarily due to increase in sales of our coffee and tea products.

Gross profit in the three months ended December 31, 2012 increased $5.8 million, or 13%, to $50.4 million, as compared to $44.5 million during the three months ended December 31, 2011. Gross margin increased to 37% in the three months ended December 31, 2012 from 34% in the comparable period in the prior fiscal year. Gross profit during the six months ended December 31, 2012 increased $10.7 million, or 13%, to $94.9 million, as compared to $84.2 million during the six months ended December 31, 2011. Gross margin increased to 37% in the six months ended December 31, 2012 from 33% in the comparable period of the prior fiscal year. Gross profit in each of the three and six months ended December 31, 2012 includes the expected beneficial effect of the liquidation of LIFO inventory quantities in the amount of $0.5 million. Gross profit in the three and six months ended December 31, 2011 included the expected beneficial effect of the liquidation of LIFO inventory quantities in the amount of $3.8 million and $5.5 million, respectively (see Note 4 to the consolidated financial statements). The increase in gross margin during the three and six months ended December 31, 2012 is primarily due to a 31% and 32% decline, respectively, in average cost of green coffee beans purchased compared to the same periods in the prior fiscal year.

Operating expenses in the three months ended December 31, 2012 decreased $0.3 million, or 0.5%, to $49.9 million, or 37% of sales, from $50.2 million, or 38% of sales, in the second quarter of the prior fiscal year. Operating expenses in the six months ended December 31, 2012 increased $1.6 million, or 2%, to $96.1 million, or 38% of sales, from $94.5 million, or 37% of sales, in the six months ended December 31, 2011. Operating expenses in the three and six months ended December 31, 2012 benefited from the absence of pension withdrawal expense but included higher payroll and related expenses resulting from our investments in additional sales and marketing personnel, higher startup costs related to the increase in national customers, higher expenses related to sales training and losses in one of our distribution centers affected by hurricane Sandy. Operating expenses in the three and six months ended December 31, 2011 included $4.3 million in pension withdrawal expense related to a multiemployer pension plan.

Total other expense in the three months ended December 31, 2012 was $7.7 million compared to total other income of $1.6 million in the three months ended December 31, 2011. Total other expense in the six months ended December 31, 2012 was $2.9 million compared to $1.0 million in the six months ended December 31, 2011.

Total other expense in the three and six months ended December 31, 2012 included $7.9 million and $7.2 million, respectively, in net realized and unrealized losses on coffee-related derivatives, compared to $0.5 million and $4.2 million, respectively, in the three and six months ended December 31, 2011. The increase in net realized and unrealized losses from coffee-related derivatives in the three and six months ended December 31, 2012 compared to the same periods in the prior fiscal year is due in large part to the increase in the number of futures contracts combined with a decline of approximately 17% per pound and 15% per pound, respectively, in coffee commodity costs during the three and six months ended December 31, 2012. There was a four-fold increase in the number of our coffee-related derivative contracts as of December 31, 2012 covering 28.2 million pounds of green coffee compared to 6.6 million pounds of green coffee covered as of December 31, 2011. The increase in the number of such contracts is primarily due to the increase in the number of our national customers since a majority of the contracts are purchased for their accounts.

We have adopted a hedging strategy intended to establish predictable prices for future supply of green coffee with futures contracts that we purchase for certain of our national customer accounts and for our own account for a longer period of time than was done previously because the cost of coffee significantly declined during the last 12 to 18 months, making these long-term futures contracts relatively less expensive than they had been previously. Since the coffee-related derivatives are not designated as accounting hedges, in accordance with GAAP, we recognized the net unrealized and realized losses immediately in our consolidated statements of operations as the derivative contracts were re-valued to their market prices. These losses are expected to either be offset by future derivative gains as the coffee market changes or recovered through operating income as a result of the lower cost of goods assigned to the related coffee.

Total other expense in the three months ended December 31, 2012 and 2011 included $(11,000) in net losses on sales of assets and $0.6 million in net gains on sales of assets, respectively. Total other expense in the six months ended December 31, 2012 included $3.2 million in net gains on sales of assets, primarily real estate, and $0.8 million in recovery of an account previously deemed uncollectible. Total other expense in the six months ended December 31, 2011 included $1.9 million in net gains on sales of investments and $0.7 million in net gains on sales of assets, primarily real estate.

Income tax benefit in the three months ended December 31, 2012 was $19,000 compared to income tax expense of $60,000 in the three months ended December 31, 2011. Income tax expense in each of the six months ended December 31, 2012 and December 31, 2011 was $0.4 million.

As a result of the forgoing factors, net loss in the fiscal quarter ended December 31, 2012 was $(7.3) million, or $(0.47) per common share, as compared to net loss of $(4.1) million, or $(0.27) per common share, during the same period in the prior fiscal year. Net loss in the six months ended December 31, 2012 was $(4.4) million, or $(0.28) per common share, as compared to net loss of $(11.7) million, or $(0.77) per common share, during the same period in the prior fiscal year.

Non-GAAP Financial Measures

In addition to net income (loss) determined in accordance with GAAP, we use certain non-GAAP financial measures, such as "EBITDAE" in assessing our operating performance. We believe that this non-GAAP financial measure serves as an appropriate measure to be used in evaluating the performance of our business.

We define EBITDAE as net income (loss) excluding the impact of income taxes, interest expense, depreciation and amortization expense, ESOP and share-based compensation expense, non-cash impairment losses and pension withdrawal expense, if any, and net gains and losses from derivatives and investments. EBITDAE as defined by us may not be comparable to similarly titled measures reported by other companies. We do not intend for non-GAAP financial measures to be considered in isolation or as a substitute for other measures prepared in accordance with GAAP.

Set forth below is a reconciliation of reported net loss to EBITDAE:

	Three Months Ended December 31,		Six Months Ended December 31,	
(In thousands)	2012	2011	2012	2011
	(Unaudited)		(Unaudited)	
Net loss, as reported(1)(2)	$(7,294)	$(4,110)	$(4,420)	$(11,694)
Income tax (benefit) expense	(19)	60	403	406
Interest expense	463	506		