

RARE ELEMENT RESOURCES LTD

Form 10-Q

November 06, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2015

OR

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**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: 001-34852

RARE ELEMENT RESOURCES LTD.

(Exact Name of Registrant as Specified in its Charter)

BRITISH COLUMBIA

(State of other jurisdiction of incorporation or
organization)

N/A

(I.R.S. Employer Identification No.)

225 Union Blvd., Suite 250
Lakewood, Colorado
(Address of Principal Executive Offices)

80228
(Zip Code)

(720) 278-2460

(Registrant's Telephone Number, including Area Code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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 (Do not check if a smaller reporting company)

Smaller reporting company

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Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes No

Number of issuer's common shares outstanding as of November 6, 2015: 52,941,880

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Reporting Currency, Financial and Other Information

All amounts in this report are expressed in thousands of United States (U.S.) dollars, unless otherwise indicated.

Financial information is presented in accordance with accounting principles generally accepted in the United States (U.S. GAAP).

References to Rare Element, the Company, we, our, and us mean Rare Element Resources Ltd., our predecessors, consolidated subsidiaries, or any one or more of them, as the context requires.

Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking information within the meaning of Canadian securities legislation and forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995 (collectively, forward-looking statements). Such forward-looking statements concern our development plans for the Bear Lodge Rare Earth Element Project (Bear Lodge REE Project or the Project), anticipated timing and outcome of metallurgical and process test work, plans to complete a demonstration-scale pilot plant, completion of a feasibility study (FS), projected timing for Project commissioning, future expenditures to comply with environmental and other laws and regulations, the impact of changes in foreign currency exchange rates on our financial statements, the viability and cost of proposed technology, our ability to continue as a going concern, and future capital and financing needs and our ability to meet these needs. These statements relate to analyses and other information that are based on forecasts of future results, estimates of amounts not yet determinable and the reasonable assumptions of management.

Any statements that express or involve discussions with respect to predictions, expectations, beliefs, plans, projections, objectives, assumptions or future events or performance often, but not always, using words or phrases such as expects anticipates, plans, estimates or intends (including negative or grammatical variations thereof) stating that certain actions, events or results may, could, would, might or will be taken, occur or be achieved are forward-looking statements of historical fact and may be forward-looking statements.

Forward-looking statements are subject to a variety of known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from our expectations and include, among others, the factors referenced in the Risk Factors section of our Annual Report on Form 10-K for the period ended December 31, 2014, including,

without limitation, risks associated with:

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our history of losses and need for additional financing;

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our ability to continue as a going concern without further financing;

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our lack of production from our mineral properties, including the Bear Lodge REE Project;

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numerous uncertainties that could affect the profitability or feasibility of the Bear Lodge REE Project;

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the potential outcome of the planned FS that may indicate Bear Lodge REE Project economics are less favorable than is expected;

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the exploration, development and operation of our Bear Lodge REE Project;

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increased costs affecting the Bear Lodge REE Project and our financial condition;

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volatile rare earth markets, including fluctuations in demand for, and prices of, rare earth products;

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the establishment of adequate distribution channels to place our entire future product suite;

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competition in the mining and rare earths industries, including an increase in global supplies or predatory pricing and dumping by our competitors;

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technological advancements and the establishment of substitutes for rare earth products;

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the specific product(s) from the Bear Lodge REE Project possibly having a limited number of customers, which could reduce our bargaining power, product pricing, and profitability;

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our proprietary, patent-pending, processing technology that could encounter unforeseen problems, unexpected costs or both in scaling up to commercial application;

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mineral reserve and mineral resource estimation;

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the permitting, licensing and regulatory approval processes for our planned operations;

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continued compliance with current environmental regulations and the possibility of new legislation, environmental regulations or permit requirements adverse to the mining industry, including measures regarding the mining industry and climate change;

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our dependence on and the potential difficulty of attracting and retaining key personnel and qualified management;

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a shortage of equipment and supplies;

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mining, chemical processing and resource exploration and development being potentially hazardous activities;

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operating in the resource industry, which can be highly speculative and subject to forces, including market forces, outside of our control;

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title to our properties or mining claims;

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insurance for our operations that could become unavailable, unaffordable or commercially unreasonable or exclude from coverage certain exposures of our business;

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increased competition affecting our ability to raise capital or acquire additional properties;

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negative impacts to our business or operations from market factors;

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our land reclamation and remediation requirements;

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information technology system disruptions, damage or failures;

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effects of proposed legislation on the mining industry and our business;

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foreign currency fluctuations;

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our executive officers, directors and consultants being engaged in other businesses;

costs associated with any unforeseen litigation;

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enforcement of civil liabilities in the United States and elsewhere;

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our common shares continuing not to pay cash dividends;

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our securities, including in relation to both company performance and general security market conditions;

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the requirements of the NYSE MKT for continued listing and the penny stock rules;

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tax consequences to U.S. shareholders related to our potential status as a passive foreign investment company ; and

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other factors, many of which are beyond our control.

This list is not exhaustive of the factors that may affect our forward-looking statements. Although we have attempted to identify important factors that could cause actual results to differ materially from those described in forward-looking statements, there may be other factors that cause results not to be as anticipated, estimated or intended. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary, possibly materially, from those anticipated, believed, estimated or expected. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. Except as required by law, we disclaim any obligation to revise or update any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. **We qualify all of the forward-looking statements contained in this Quarterly Report on Form 10-Q by the foregoing cautionary statements.** We advise you to carefully review the reports and documents we file from time to time with the United States Securities and Exchange Commission (the SEC), particularly our Annual Report on Form 10-K. The reports and documents filed by us with the SEC are available at www.sec.gov.

PART I FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****RARE ELEMENT RESOURCES LTD.
CONSOLIDATED BALANCE SHEETS**

(Expressed in thousands of U.S. dollars, except shares outstanding)

	September 30, 2015 (unaudited)	December 31, 2014 (audited)
ASSETS:		
CURRENT ASSETS		
Cash and cash equivalents	\$ 6,163	\$ 10,139
Interest receivable	26	6
Accounts receivable	16	21
Prepaid expenses	210	315
Total Current Assets	6,415	10,481
Equipment, net	245	344
Land	980	980
Mineral properties	27	27
Total Assets	\$ 7,667	\$ 11,832
LIABILITIES:		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	\$ 815	\$ 1,098
Asset retirement obligation, current portion	151	164
Total Current Liabilities	966	1,262
Asset retirement obligation, non-current portion	199	202
Total Liabilities	1,165	1,464
Commitments and Contingencies		
SHAREHOLDERS' EQUITY:		
Common shares, no par value - unlimited shares authorized; shares outstanding		
September 30, 2015 - 52,941,880,		
December 31, 2014 - 47,707,216	103,639	100,652
Additional paid-in capital	23,477	23,186
Accumulated deficit	(120,614)	(113,470)
Total Shareholders' Equity	6,502	10,368
	\$ 7,667	\$ 11,832

**Total Liabilities and Shareholders'
Equity**

See accompanying notes to consolidated interim financial statements

RARE ELEMENT RESOURCES LTD.**CONSOLIDATED UNAUDITED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**

(Expressed in thousands of U.S. dollars, except share and per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Operating expenses:				
Exploration and evaluation	\$ (1,517)	\$ (2,305)	\$ (3,834)	\$ (7,164)
Corporate administration	(850)	(1,038)	(2,779)	(3,585)
Depreciation	(24)	(60)	(99)	(163)
Total operating expenses	(2,391)	(3,403)	(6,712)	(10,912)
Non-operating income/(expenses):				
Interest income	8	14	26	65
Loss on currency translation	(189)	(212)	(458)	(361)
Gain on derivatives	-	-	-	116
Total non-operating income/(expenses)	(181)	(198)	(432)	(180)
Net loss	\$ (2,572)	\$ (3,601)	\$ (7,144)	\$ (11,092)
Other comprehensive income/(loss)				
Realized loss on available-for-sale securities	\$ -	\$ -	\$ -	\$ -
Unrealized gain/(loss) on available-for-sale securities	-	-	-	-
Total other comprehensive income/(loss)	-	-	-	-
	18,200	55,100	59,200	

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Net Earnings	\$	32,772	\$	39,263	\$	110,797	\$	117,178	
Basic Net Earnings	per Common Share	\$	0.55	\$	0.61	\$	1.83	\$	1.78
Diluted Net Earnings	per Common Share	\$	0.54	\$	0.60	\$	1.81	\$	1.75
Cash Dividends Declared	per Common Share	\$	0.19	\$.17	\$	0.55	\$	0.50

See notes to consolidated financial statements.

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**GRACO INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

(Unaudited)
(In thousands)

	Sep 26, 2008	Dec 28, 2007
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 5,250	\$ 4,922
Accounts receivable, less allowances of \$6,600 and \$6,500	146,820	140,489
Inventories	95,313	74,737
Deferred income taxes	25,609	21,650
Other current assets	5,624	7,034
Total current assets	278,616	248,832
Property, Plant and Equipment		

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Cost	322,933	306,073
Accumulated depreciation	(176,030)	(165,479)
Property, plant and equipment, net	146,903	140,594
Prepaid Pension	34,264	31,823
Goodwill	87,224	67,204
Other Intangible Assets, net	53,505	41,889
Other Assets	6,884	6,382
Total Assets	\$ 607,396	\$ 536,724
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable to banks	\$ 16,519	\$ 18,991
Trade accounts payable	24,559	27,379
Salaries, wages and commissions	19,408	20,470
Dividends payable	11,016	11,476
Other current liabilities	48,063	47,561
Total current liabilities	119,565	125,877
Long-term Debt	191,855	107,060
Retirement Benefits and Deferred Compensation	40,428	40,639
Uncertain Tax Positions	1,800	5,400
Deferred Income Taxes	19,257	13,074
Shareholders' Equity		
Common stock	59,522	61,964
Additional paid-in-capital	172,107	156,420
Retained earnings	10,111	32,986
Accumulated other comprehensive income (loss)	(7,249)	(6,696)
Total shareholders' equity	234,491	244,674
Total Liabilities and Shareholders' Equity	\$ 607,396	\$ 536,724

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)

	Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007
Cash Flows From Operating Activities		
Net Earnings	\$ 110,797	\$ 117,178
Adjustments to reconcile net earnings to		

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net cash provided by operating activities			
Depreciation and amortization	23,310	20,770	
Deferred income taxes	(3,850)	(3,059)	
Share-based compensation	7,072	6,297	
Excess tax benefit related to share-based payment arrangements	(2,923)	(4,154)	
Change in			
Accounts receivable	(4,989)	(7,383)	
Inventories	(16,466)	(907)	
Trade accounts payable	(775)	(1,477)	
Salaries, wages and commissions	(1,236)	(7,697)	
Retirement benefits and deferred compensation	(2,141)	(1,848)	
Other accrued liabilities	788	6,150	
Other	1,114	(1,589)	
Net cash provided by operating activities	110,701	122,281	
Cash Flows From Investing Activities			
Property, plant and equipment additions	(20,778)	(28,207)	
Proceeds from sale of property, plant and equipment	1,633	207	
Investment in life insurance	(1,499)	(1,499)	
Capitalized software and other intangible asset additions	(1,130)	(43)	
Acquisitions of businesses, net of cash acquired	(39,780)		--
Net cash used in investing activities	(61,554)	(29,542)	
Cash Flows From Financing Activities			
Net borrowings (payments) on short-term lines of credit	(2,779)	(1,704)	
Borrowings on long-term line of credit	188,869	85,680	
Payments on long-term line of credit	(104,074)		--
Excess tax benefit related to share-based payment arrangements	2,923	4,154	
Common stock issued	13,528	22,545	
Common stock retired	(114,341)	(164,910)	
Cash dividends paid	(33,693)	(32,800)	
Net cash provided by (used in) financing activities	(49,567)	(87,035)	
Effect of exchange rate changes on cash	748	(1,804)	
Net increase (decrease) in cash and cash equivalents	328	3,900	
Cash and cash equivalents			
Beginning of year	4,922	5,871	
End of period	\$ 5,250	\$ 9,771	

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of September 26, 2008 and the related statements of earnings for the thirteen and thirty-nine weeks ended September 26, 2008 and September 28, 2007, and cash flows for the thirty-nine weeks ended September 26, 2008 and September 28, 2007 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of September 26, 2008, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2007 Annual Report on Form 10-K.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

2. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007	Sep 26, 2008	Sep 28, 2007
Net earnings available to common shareholders	\$ 32,772	\$ 39,263	\$ 110,797	\$ 117,178
Weighted average shares outstanding for basic earnings per share	59,769	64,797	60,521	65,836
Dilutive effect of stock options computed using the treasury stock method and the average market price	596	921	647	998
Weighted average shares outstanding for diluted earnings per share	60,365	65,718	61,168	66,834
Basic earnings per share	\$ 0.55	\$ 0.61	\$ 1.83	\$ 1.78
Diluted earnings per share	\$ 0.54	\$ 0.60	\$ 1.81	\$ 1.75

Stock options to purchase 2,114,000 and 1,043,000 shares were not included in the 2008 and 2007 computations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the thirty-nine weeks ended September 26, 2008 is shown below (in thousands, except per share amounts):

	Option Shares	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 28, 2007	3,779	\$ 28.63	2,228	\$ 21.41
Granted	779	36.23		
Exercised	(412)	16.66		
Canceled	(210)	38.94		
Outstanding, September 26, 2008	3,936	\$ 30.85	2,193	\$ 24.94

The aggregate intrinsic value of exercisable option shares was \$25.4 million as of September 26, 2008, with a weighted average contractual term of 4.5 years. There were approximately 3.9 million vested share options and share options expected to vest as of September 26, 2008, with an aggregate intrinsic value of \$25.4 million, a weighted average exercise price of \$30.76 and a weighted average contractual term of 6.4 years.

Information related to options exercised in the first nine months of 2008 and 2007 follows (in thousands):

	Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007
Cash received	\$ 6,864	\$ 15,290
Aggregate intrinsic value	8,645	16,625
Tax benefit realized	3,100	6,200

The Company recognized year-to-date share-based compensation of \$7.1 million in 2008 and \$6.3 million in 2007. As of September 26, 2008, there was \$9.8 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.3 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and results:

	Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007
Expected life in years	6.0	6.0
Interest rate	3.2%	4.7%
Volatility	25.0%	26.1%
Dividend yield	2.1%	1.6%
Weighted average fair value per share	\$ 8.43	\$ 12.01

Under the Company's Employee Stock Purchase Plan, the Company issued 216,000 shares in 2008 and 202,000 shares in 2007. The fair value of the employees' purchase rights under this Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees' purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

	Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007
Expected life in years	1.0	1.0
Interest rate	1.5%	4.9%
Volatility	27.1%	24.4%
Dividend yield	2.1%	1.6%
Weighted average fair value per share	\$ 8.14	\$ 9.79

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4. The components of net periodic benefit cost (credit) for retirement benefit plans were as follows (in thousands):

Thirteen Weeks Ended

Thirty-nine Weeks Ended

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	Sep 26, 2008	Sep 28, 2007	Sep 26, 2008	Sep 28, 2007
Pension Benefits				
Service cost	\$ 920	\$ 1,231	\$ 3,724	\$ 4,211
Interest cost	2,896	2,855	9,186	8,622
Expected return on assets	(4,536)	(4,496)	(14,236)	(14,096)
Amortization and other	233	204	528	749
Net periodic benefit cost (credit)	\$ (487)	\$ (206)	\$ (798)	\$ (514)
Postretirement Medical				
Service cost	\$ 168	\$ 75	\$ 418	\$ 375
Interest cost	286	360	1,036	975
Amortization	(13)	(518)	(13)	55
Net periodic benefit cost (credit)	\$ 441	\$ (83)	\$ 1,441	\$ 1,405

The Company paid \$1.5 million in June 2008 and \$1.5 million in June 2007 for contracts insuring the lives of certain employees who are eligible to participate in certain non-qualified pension and deferred compensation plans. These insurance contracts will be used to fund the non-qualified pension and deferred compensation arrangements. The insurance contracts are held in a trust and are available to general creditors in the event of the Company's insolvency. Cash surrender value of \$2.7 million and \$1.5 million is included in other assets in the consolidated balance sheet as of September 26, 2008 and December 28, 2007, respectively.

5. Total comprehensive income was as follows (in thousands):

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007	Sep 26, 2008	Sep 28, 2007
Net earnings	\$ 32,772	\$ 39,263	\$ 110,797	\$ 117,178
Cumulative translation adjustment	(346)	88	(377)	202
Pension and postretirement medical liability adjustment	164	64	353	194
Gain (loss) on interest rate hedge contracts	(211)	(89)	(634)	(89)
Income taxes	23	9	107	(40)
Comprehensive income	\$ 32,402	\$ 39,335	\$ 110,246	\$ 117,445

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Components of accumulated other comprehensive income (loss) were (in thousands):

	Sep 26, 2008	Dec 28, 2007
Pension and postretirement medical liability adjustment	\$ (5,449)	\$ (5,672)
Gain (loss) on interest rate hedge contracts	(1,471)	(1,072)

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Cumulative translation adjustment	(329)	48
Total	\$ (7,249)	\$ (6,696)

6. The Company has three reportable segments: Industrial, Contractor and Lubrication. The Company does not track assets by segment. Sales and operating earnings by segment for the thirteen and thirty-nine weeks ended September 26, 2008 and September 28, 2007 were as follows (in thousands):

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007	Sep 26, 2008	Sep 28, 2007
Net Sales				
Industrial	\$ 117,685	\$ 107,791	\$ 365,028	\$ 327,137
Contractor	67,751	76,649	215,992	240,631
Lubrication	21,795	22,830	69,561	68,381
Consolidated	\$ 207,231	\$ 207,270	\$ 650,581	\$ 636,149
Operating Earnings				
Industrial	\$ 35,874	\$ 37,597	\$ 117,847	\$ 111,570
Contractor	15,226	21,016	49,663	66,662
Lubrication	3,409	2,584	12,333	7,844
Unallocated corporate (expense)	(1,980)	(2,661)	(7,897)	(7,739)
Consolidated	\$ 52,529	\$ 58,536	\$ 171,946	\$ 178,337

7. Major components of inventories were as follows (in thousands):

	Sep 26, 2008	Dec 28, 2007
Finished products and components	\$ 53,954	\$ 46,677
Products and components in various stages of completion	31,068	24,805
Raw materials and purchased components	43,977	37,311
	128,999	108,793
Reduction to LIFO cost	(33,686)	(34,056)
Total	\$ 95,313	\$ 74,737

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8. Information related to other intangible assets follows (dollars in thousands):

	Estimated Life (years)	Original Cost	Accumulated Amortization	Foreign Currency Translation	Book Value
September 26, 2008					

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Customer relationships	3 - 8	\$ 37,820	\$ (11,852)	\$ (40)	\$ 25,928
Patents, proprietary technology and product documentation	3 - 15	23,858	(10,373)	(17)	13,468
Trademarks, trade names and other	3 - 10	4,714	(3,524)	9	1,199
		66,392	(25,749)	(48)	40,595
Not Subject to Amortization: Brand names		12,910	-	--	12,910
Total		\$ 79,302	\$ (25,749)	\$ (48)	\$ 53,505
December 28, 2007					
Customer relationships and distribution network	4 - 8	\$ 26,102	\$ (11,092)	\$ 29	\$ 15,039
Patents, proprietary technology and product documentation	5 - 15	22,243	(7,720)	16	14,539
Trademarks, trade names and other	3 - 10	4,684	(2,555)	22	2,151
		53,029	(21,367)	67	31,729
Not Subject to Amortization: Brand names		10,160	-	--	10,160
Total		\$ 63,189	\$ (21,367)	\$ 67	\$ 41,889

Amortization of intangibles was \$2.7 million in the third quarter of 2008 and \$7.6 million year-to-date. Estimated annual amortization expense is as follows: \$10.1 million in 2008, \$9.7 million in 2009, \$8.7 million in 2010, \$7.7 million in 2011, \$7.0 million in 2012 and \$5.0 million thereafter.

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9. Components of other current liabilities were (in thousands):

	Sep 26, 2008	Dec 28, 2007
Accrued self-insurance retentions	\$ 8,098	\$ 7,842
Accrued warranty and service liabilities	7,591	7,084
Accrued trade promotions	5,727	6,480
Payable for employee stock purchases	4,107	5,829
Income taxes payable	3,132	678
Other	19,408	19,648
Total	\$ 48,063	\$ 47,561

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A liability is established for estimated future warranty and service claims that relate to current and prior period sales. The Company estimates warranty costs based on historical claim experience and other factors including evaluating specific product warranty issues. Following is a summary of activity in accrued warranty and service liabilities (in thousands):

	Thirty-nine Weeks Ended Sep 26, 2008	Year Ended Dec 28, 2007	
Balance, beginning of year	\$ 7,084	\$ 6,675	
Charged to expense	4,931	6,053	
Margin on parts sales reversed	3,014	3,186	
Reductions for claims settled	(7,438)	(8,830)	
Balance, end of period	\$ 7,591	\$ 7,084	

10. The examination of the Company's U.S. income tax returns for 2004 and 2005 was completed in the first quarter of 2008. Completion of the examination resulted in a payment of approximately \$1 million and reductions of uncertain tax positions totaling approximately \$4 million. The settlement of the examination decreased the Company's effective tax rate for the year-to-date to 33 percent.

With few exceptions, the Company is no longer subject to U.S. federal, state and local, or foreign income tax examinations by tax authorities for years prior to 2002.

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11. In February 2008, the Company acquired GlasCraft Inc. for approximately \$35 million cash. GlasCraft has an office and manufacturing facility in Indianapolis, Indiana and had sales of approximately \$18 million in 2007. It designs, manufactures and sells spray systems for the composites manufacturing industry and high performance dispense systems for the polyurethane foam and polyurea coatings industries. The products, brands, distribution channels and engineering capabilities of GlasCraft expand and complement the Company's Industrial Equipment business.

The purchase price was allocated based on estimated fair values as follows (in thousands):

Accounts receivable and prepaid expenses	\$	2,200
Inventories		3,700
Deferred income taxes		700
Property, plant and equipment		700
Identifiable intangible assets		18,200
Goodwill		17,700
Total purchase price		43,200
Current liabilities assumed		(1,000)
Deferred income taxes		(6,900)
Net assets acquired	\$	35,300

Identifiable intangible assets and weighted average estimated useful life are as follows (dollars in thousands):

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Product documentation (5 years)		\$ 900
Customer relationships (6 years)	14,100	
Proprietary technology (3 years)	500	
Total (6 years)		15,500
Brand name (indefinite useful life)	2,700	
Total identifiable intangible assets		\$18,200

None of the goodwill or identifiable intangible assets is expected to be deductible for tax purposes.

In fiscal September, the Company acquired the assets of Lubrication Scientifics, Inc. (LubeSci) for approximately \$5 million cash. LubeSci designed and manufactured automated lubrication equipment used in industrial markets and had sales of approximately \$3 million in 2007.

The purchase price has not been finalized and is subject to final determination of acquired asset and liability balances. The preliminary purchase price was allocated based on estimated fair values as follows (in thousands):

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Inventories and other current assets		\$ 500
Property, plant and equipment	600	
Identifiable intangible assets	900	
Goodwill	2,500	
Net assets acquired		\$ 4,500

Identifiable intangible assets and weighted average estimated useful life are as follows (dollars in thousands):

Customer relationships (5 years)		\$ 600
Proprietary technology (5 years)	300	
Total (5 years)		\$ 900

Goodwill and identifiable intangible assets are expected to be deductible for tax purposes.

12. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 157, "Fair Value Measurements." This statement establishes a consistent framework for measuring fair value and expands disclosures on fair value measurements. SFAS No. 157 was effective for the Company starting in fiscal 2008 with respect to financial assets and liabilities. The impact of the initial adoption of SFAS No. 157 in 2008 had no impact on the consolidated financial statements.

The Company uses significant other observable inputs to value the derivative instruments used to hedge interest rate volatility and net monetary positions. The fair market value of such instruments follows (in thousands):

	Sep 26, 2008	Dec 28, 2007
Gain (loss) on interest rate hedge contracts	\$ (2,334)	\$ (1,700)
Gain (loss) on foreign currency forward contracts	324	(282)
Total	\$ (2,010)	\$ (1,982)

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With respect to non-financial assets and liabilities, SFAS No. 157 is effective for the Company starting in fiscal 2009. The Company has not determined the impact, if any, the adoption of this statement as it pertains to non-financial assets and liabilities will have on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities." This statement expands disclosures but does not change accounting for derivative instruments and hedging activities. The statement is effective for the Company starting in fiscal 2009.

13. In October, the Company acquired the Airlessco® assets of Durotech Co. for approximately \$15 million cash. Airlessco® is a line of spray-painting equipment that complements the Company's Contractor Equipment business.

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Item 2. GRACO INC. AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The Company designs, manufactures and markets systems and equipment to move, measure, control, dispense and spray fluid materials. Management classifies the Company's business into three reportable segments: Industrial, Contractor and Lubrication. Key strategies include development of new products, expansion of distribution, new market penetration and completion of acquisitions.

The following Management's Discussion and Analysis reviews significant factors affecting the Company's results of operations and financial condition. This discussion should be read in conjunction with the financial statements and the accompanying notes to the financial statements.

Results of Operations

Net sales, net earnings and earnings per share were as follows (in millions except per share amounts and percentages):

	Thirteen Weeks Ended			Thirty-nine Weeks Ended		
	Sep 26, 2008	Sep 28, 2007	% Change	Sep 26, 2008	Sep 28, 2007	% Change
Net Sales	\$ 207.2	\$ 207.3	(0)%	\$ 650.6	\$ 636.1	2 %
Net Earnings	\$ 32.8	\$ 39.3	(17)%	\$ 110.8	\$ 117.2	(5)%
Diluted Net Earnings per Common Share	\$ 0.54	\$ 0.60	(10)%	\$ 1.81	\$ 1.75	3 %

Foreign currency translation rates had a favorable impact on sales and net earnings. Translated at consistent exchange rates, sales for the quarter and year-to-date were 2 percent and 1 percent lower than last year, respectively, and net earnings decreased 20 percent for the quarter and 12 percent year-to-date.

Sales include \$9 million from GlasCraft operations since the date of acquisition, with \$3.5 million in the third quarter.

Deteriorating economic conditions in the U.S. and other parts of the world affected sales growth. Strategic investments in product and market development, along with rising costs of doing business, continued to apply pressure on earnings.

Purchases and retirement of approximately 3.1 million shares of Company common stock, including approximately 0.9 million shares in the third quarter, had a positive impact on earnings per share.

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Consolidated Results

Sales by geographic area were as follows (in millions):

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007	Sep 26, 2008	Sep 28, 2007
Americas ¹	\$ 112.8	\$ 124.4	\$ 360.5	\$ 386.4
Europe ²	57.8	53.1	189.4	161.1
Asia Pacific	36.6	29.8	100.7	88.6
Consolidated	\$ 207.2	\$ 207.3	\$ 650.6	\$ 636.1

¹ North and South America, including the U.S.

² Europe, Africa and Middle East

Growth in Europe and Asia Pacific offset decreases in contractor and lubrication sales in the Americas. In Europe, sales for the quarter and year-to-date were 9 percent and 18 percent higher than last year, respectively. Translated at consistent exchange rates, sales in Europe increased 2 percent for the quarter and 7 percent year-to-date. Sales in Asia Pacific increased by 23 percent for the quarter and 14 percent year-to-date.

Gross profit margin, expressed as a percentage of sales, was 53.2 percent for the quarter, close to last year's percentage of 53.4 percent. Changes in geographic and product sales mix in Europe affected the margin rate for the quarter. Year-to-date gross profit margin percentage was 53.9 percent, up from 53.1 percent last year. Favorable currency translation rates added 1.1 percentage points to the year-to-date gross profit margin rate. The effects of higher material and other costs on gross margin rate have been

offset by the impact of pricing and manufacturing efficiencies.

Operating expenses are up 11 percent for the quarter and 12 percent for the year-to-date. The effects of currency translation contributed approximately 2 percentage points of the increase for the quarter and 3 percentage points year-to-date. Operating expenses in 2008 include \$1.5 million for the quarter from acquired GlasCraft operations and \$4 million year-to-date. Continued strategic investments in product and market development also contributed to the increase in operating expenses, including expenses related to the introduction of new product lines in the home center channel, new product development teams and additional sales and marketing personnel in developing countries. Compared to last year, product development expense was up \$2.5 million for the quarter and \$3.7 million year-to-date.

Year-to-date interest expense is \$3.5 million higher than last year due to borrowings used for the purchase and retirement of Company shares and for business acquisitions. Graco repurchased approximately 3.1 million shares of its common stock for \$114 million in the first nine months of 2008.

The Company's effective tax rate for the third quarter was 34 percent, up from 32 percent last year. The lower rate in 2007 resulted from expiring statutes of limitations and a higher than expected benefit upon filing of prior year tax returns. The completion of the examination of the Company's income tax returns in the first quarter of 2008 resulted in a lower year-to-date effective tax rate compared to last year.

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Segment Results

Certain measurements of segment operations compared to last year are summarized below:

Industrial

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 26, 2008	Sep 28, 2007	Sep 26, 2008	Sep 28, 2007
Net sales (in millions)				
Americas	\$ 54.1	\$ 51.6	\$ 169.0	\$ 156.7
Europe	36.4	34.7	122.2	104.0
Asia Pacific	27.2	21.5	73.8	66.4
Total	\$ 117.7	\$ 107.8	\$ 365.0	\$ 327.1
Operating earnings as a percentage of net sales	30%	35%	32%	34%

Strong sales in Asia Pacific (up 27 percent) drove the increase in Industrial segment sales for the quarter. Sales in this segment were 5 percent higher in the Americas and in Europe, although the increase in Europe came from currency translation. Year-to-date sales in this segment are up 18 percent in Europe (approximately 11 percentage points from currency translation), 11 percent in Asia Pacific and 8 percent in the Americas. Most of the sales growth in this segment came from high performance coatings and foam products.

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Operating earnings in this segment were affected by selling and product development initiatives and costs and expenses resulting from acquisition and integration related activities. The move of GlasCraft operations from Indiana to the Company's facilities in Ohio, South Dakota and Minnesota will be completed in the fourth quarter.

Contractor

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 26,	Sep 28,	Sep 26,	Sep 28,
	2008	2007	2008	2007
Net sales (in millions)				
Americas	\$ 41.7	\$ 53.5	\$ 135.5	\$ 171.2
Europe	19.4	16.6	61.3	52.1
Asia Pacific	6.7	6.6	19.2	17.3
Total	\$ 67.8	\$ 76.7	\$ 216.0	\$ 240.6

Operating earnings as a percentage of net sales

22%	27%	23%	28%
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In the Contractor segment, sales growth in Europe lessened the impact of continued softness in both the North American paint store and home center channels. Sales for the quarter in this segment were up 16 percent in Europe (including 6 percentage points from currency translation), flat in Asia Pacific and down 22 percent in the Americas. Year-to-date increases in Europe (18 percent increase, including 11 percentage points from currency translation) and in

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Asia Pacific (11 percent increase, including 2 percentage points from currency translation) were not enough to offset the 21 percent decrease in the Americas.

The decrease in sales without a corresponding decrease in expenses had a large impact on the operating earnings of this segment. Strategic spending in this segment was for developing products for new markets and the launch and production of new paint sprayer units in the home center channel.

Lubrication

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 26,	Sep 28,	Sep 26,	Sep 28,
	2008	2007	2008	2007
Net sales (in millions)				
Americas	\$ 17.0	\$ 19.3	\$ 56.1	\$ 58.4
Europe	2.1	1.8	5.8	5.1
Asia Pacific	2.7	1.7	7.7	4.9
Total	\$ 21.8	\$ 22.8	\$ 69.6	\$ 68.4

Operating earnings as a percentage of net sales

16%	11%	18%	11%
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In the Lubrication segment, third quarter sales increases in Europe and Asia Pacific were not enough to offset a decrease in the Americas. Year-to-date, the increases in Europe and Asia Pacific offset the decrease in the Americas.

Improvement in year-to-date operating profitability is related to the integration and consolidation of Lubrication operations completed in 2007, although segment profitability has also been affected by a sales decline in the higher-margin vehicle services products.

Management intends to integrate all LubeSci operations (acquired in fiscal September) into the Company's facility in Anoka, MN.

Liquidity and Capital Resources

In the first nine months of 2008, the Company used cash and borrowings under its long-term line of credit to purchase and retire \$114 million of Company shares. Other significant uses of cash included \$40 million for business acquisitions, \$34 million for payment of dividends and \$21 million for capital additions. Significant uses of cash in the first nine months of 2007 included \$165 million for purchases and retirement of Company common stock, \$33 million for payment of dividends and \$28 million for capital additions.

The increase in inventories since the end of 2007 reflects the acquisition of GlasCraft operations, the higher level of business activity in Europe and Asia Pacific, and a buildup to improve service levels and facilitate integration activities.

At September 26, 2008, the Company had various lines of credit totaling \$303 million, of which \$98 million was unused. Internally generated funds and unused financing sources provide the Company with the financial flexibility to meet liquidity needs.

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Outlook

The renewal of R&D tax credits will have a favorable impact, estimated at approximately \$1.5 million, on the Company's provision for income taxes and effective tax rate for the fourth quarter.

While economic conditions have made it difficult to see progress, management continues to implement strategies for business growth. The addition of the Airlessco® product line in October complements the Company's contractor business and the LubeSci acquisition in late August expands its presence in the industrial lubrication business. The strength of the Company's Industrial and international business thus far has softened the effect on financial results. As difficult economic conditions spread to other parts of the world, management will monitor and manage the business accordingly. The Company's strong financial condition and cash flow enable management to continue making long-term investments in key growth strategies including new product development, expanding distribution, entering new markets and pursuing strategic acquisitions.

SAFE HARBOR CAUTIONARY STATEMENT

A forward-looking statement is any statement made in this report and other reports that the Company files periodically with the Securities and Exchange Commission, or in press or earnings releases, analyst briefings and conference calls, which reflects the Company's current thinking on market trends and the Company's future financial performance at the time they are made. All forecasts and projections are forward-looking statements.

The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 by making cautionary statements concerning any forward-looking statements made by or on behalf of the Company. The Company cannot give any assurance that the results forecasted in any forward-looking statement will actually be achieved. Future results could differ materially from those expressed, due to the impact of changes in various factors. These risk factors include, but are not limited to: economic conditions in the United States and other major world economies, currency fluctuations, political instability, changes in laws and regulations, and changes in product demand. Please refer to Item 1A of, and Exhibit 99 to, the Company's Annual Report on Form 10-K for fiscal year 2007 for a more comprehensive discussion of these and other risk factors.

Investors should realize that factors other than those identified above and in Item 1A and Exhibit 99 might prove important to the Company's future results. It is not possible for management to identify each and every factor that may have an impact on the Company's operations in the future as new factors can develop from time to time.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes related to market risk from the disclosures made in the Company's 2007 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of the end of the fiscal quarter covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures. This evaluation was done under the supervision and with the participation of the Company's President and Chief Executive Officer, the Chief Financial Officer and Treasurer, the Vice President and Controller, and the Vice President, General Counsel and Secretary. Based upon that evaluation, they concluded that the Company's disclosure controls and procedures are effective in gathering, analyzing and disclosing information needed to satisfy the Company's disclosure obligations under the Exchange Act.

Changes in internal controls

During the quarter, there was no change in the Company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes to the Company's risk factors from those disclosed in the Company's 2007 Annual Report on Form 10-K.

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

Issuer Purchases of Equity Securities

On September 28, 2007, the Board of Directors authorized the Company to purchase up to 7,000,000 shares of its outstanding common stock, primarily through open-market transactions. This authorization expires on September 30, 2009.

In addition to shares purchased under the Board authorizations, the Company purchases shares of common stock held by employees who wish to tender owned shares to satisfy the exercise price or tax withholding on option exercises.

Information on issuer purchases of equity securities follows:

		Total Number of Shares Purchased as Part of Publicly	Maximum Number of Shares that May Yet Be Purchased Under the Plans or
Total	Average		

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Period	Number of Shares Purchased	Price Paid per Share	Announced Plans or Programs	Programs (at end of period)
Jun 28, 2008 – Jul 25, 2008	408,566	\$ 37.95	408,566	3,542,234
Jul 26, 2008 – Aug 22, 2008	399,000	\$ 37.40	399,000	3,143,234
Aug 23, 2008 – Sep 26, 2008	60,000	\$ 37.24	60,000	3,083,234

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Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 6. Exhibits

- 31.1 Certification of President and Chief Executive Officer pursuant to Rule 13a-14(a).
- 31.2 Certification of Chief Financial Officer and Treasurer pursuant to Rule 13a-14(a).
- 32 Certification of the President and Chief Executive Officer and the Chief Financial Officer and Treasurer pursuant to Section 1350 of Title 18, U.S.C.

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SIGNATURES

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Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

GRACO INC.

Date: October 22, 2008

By: /s/Patrick J. McHale
Patrick J. McHale
President and Chief Executive Officer
(Principal Executive Officer)

Date: October 22, 2008

By: /s/James A. Graner
James A. Graner
Chief Financial Officer and Treasurer
(Principal Financial Officer)

Date: October 22, 2008

By: /s/Caroline M. Chambers
Caroline M. Chambers
Vice President and Controller
(Principal Accounting Officer)