

JOHNSON CONTROLS INC

Form 10-Q

January 31, 2005

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

FORM 10-Q

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

For the quarterly period ended December 31, 2004

OR

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

For the transition period from _____ to _____

Commission File Number 1-5097

JOHNSON CONTROLS, INC.

(Exact name of registrant as specified in its charter)

Wisconsin
(State of Incorporation)

39-0380010
(I.R.S. Employer Identification No.)

5757 North Green Bay Avenue, P.O. Box 591, Milwaukee, WI 53201
(Address of principal executive office)

Registrant's telephone number, including area code: (414) 524-1200

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 is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

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

Class	Outstanding at December 31, 2004
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JOHNSON CONTROLS, INC.

FORM 10-Q

December 31, 2004

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Table of Contents**PART I. - FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****JOHNSON CONTROLS, INC.****CONSOLIDATED STATEMENT OF FINANCIAL POSITION**

(in millions; unaudited)

	December 31, 2004	September 30, 2004	December 31, 2003
ASSETS			
Cash and cash equivalents	\$ 240.7	\$ 169.5	\$ 302.6
Accounts receivable - net	3,994.7	4,073.6	3,410.7
Costs and earnings in excess of billings on uncompleted contracts	362.0	328.6	318.7
Inventories	949.8	887.2	810.7
Assets of discontinued operations	426.4	394.4	367.0
Other current assets	882.5	780.0	790.5
Current assets	6,856.1	6,633.3	6,000.2
Property, plant and equipment - net	3,614.1	3,473.3	3,079.5
Goodwill - net	3,756.3	3,609.1	3,143.7
Other intangible assets - net	299.1	291.0	267.8
Investments in partially-owned affiliates	325.3	314.9	425.9
Other noncurrent assets	825.7	769.2	753.8
Total assets	\$ 15,676.6	\$ 15,090.8	\$ 13,670.9
LIABILITIES AND SHAREHOLDERS' EQUITY			
Short-term debt	\$ 901.9	\$ 813.3	\$ 717.6
Current portion of long-term debt	217.5	226.8	130.9
Accounts payable	3,528.6	3,664.4	3,181.1
Accrued compensation and benefits	603.5	639.2	472.4
Accrued income taxes	20.4	47.4	100.2
Billings in excess of costs and earnings on uncompleted contracts	218.8	197.2	204.4
Liabilities of discontinued operations	119.8	128.1	97.0
Other current liabilities	1,012.9	885.2	827.9
Current liabilities	6,623.4	6,601.6	5,731.5
Long-term debt	1,668.5	1,630.6	1,830.6
Postretirement health and other benefits	163.6	164.1	167.1
Minority interests in equity of subsidiaries	294.8	268.7	229.5
Other noncurrent liabilities	1,344.7	1,219.5	1,130.6

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Shareholders' equity	5,581.6	5,206.3	4,581.6
Total liabilities and shareholders' equity	\$ 15,676.6	\$ 15,090.8	\$ 13,670.9

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

Table of Contents**JOHNSON CONTROLS, INC.****CONSOLIDATED STATEMENT OF INCOME**

(in millions, except per share data; unaudited)

	Three Months Ended December 31,	
	2004	2003
Net sales		
Products and systems*	\$ 6,016.4	\$ 5,428.8
Services*	959.1	864.1
	6,975.5	6,292.9
Cost of sales		
Products and systems	5,327.6	4,726.6
Services	805.1	720.7
	6,132.7	5,447.3
Gross profit	842.8	845.6
Selling, general and administrative expenses	597.4	592.1
Operating income	245.4	253.5
Interest income	4.4	1.9
Interest expense	(30.9)	(27.2)
Equity income	15.8	17.8
Miscellaneous - net	(4.6)	(24.6)
Other income (expense)	(15.3)	(32.1)
Income from continuing operations before income taxes and minority interests	230.1	221.4
Provision for income taxes	48.6	46.7
Minority interests in net earnings of subsidiaries	21.0	15.5
Income from continuing operations	160.5	159.2
Income from discontinued operations, net of income taxes	7.9	5.3
Net income	\$ 168.4	\$ 164.5

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Earnings available for common shareholders	\$ 168.4	\$ 162.7
Earnings per share from continuing operations		
Basic	\$ 0.84	\$ 0.87
Diluted	\$ 0.83	\$ 0.83
Earnings per share		
Basic	\$ 0.88	\$ 0.90
Diluted	\$ 0.87	\$ 0.86

* Products and systems consist of Automotive Group products and systems and Controls Group installed systems. Services are Controls Group technical and facility management services.
The accompanying notes are an integral part of the financial statements.

Table of Contents**JOHNSON CONTROLS, INC.****CONSOLIDATED STATEMENT OF CASH FLOWS**

(in millions; unaudited)

	Three Months Ended December 31,	
	2004	2003
Operating Activities		
Income from continuing operations	\$ 160.5	\$ 159.2
Adjustments to reconcile income from continuing operations to cash provided by operating activities		
Depreciation	158.7	140.1
Amortization of intangibles	5.8	4.9
Equity in earnings of partially-owned affiliates, net of dividends received	(15.4)	(4.4)
Minority interests in net earnings of subsidiaries	21.0	15.5
Deferred income taxes	(0.4)	7.2
Other	(1.6)	2.7
Changes in working capital, excluding acquisition of businesses		
Receivables	263.0	176.7
Inventories	(14.3)	10.7
Other current assets	(41.4)	30.3
Accounts payable and accrued liabilities	(327.6)	(384.7)
Accrued income taxes	16.8	43.8
Billings in excess of costs and earnings on uncompleted contracts	15.1	13.6
Cash provided by operating activities of continuing operations	240.2	215.6
Cash (used) provided by operating activities of discontinued operations	(5.7)	31.4
Cash provided by operating activities	234.5	247.0
Investing Activities		
Capital expenditures	(143.6)	(197.6)
Sale of property, plant and equipment	4.2	8.9
Acquisition of businesses, net of cash acquired	(33.1)	(36.6)
Recoverable customer engineering expenditures	(8.6)	(49.1)
Changes in long-term investments	(2.0)	5.2
Net investing activities of discontinued operations	(3.0)	(6.0)
Cash used by investing activities	(186.1)	(275.2)
Financing Activities		
Increase in short-term debt - net	79.8	592.7
Increase in long-term debt	3.4	49.9

Repayment of long-term debt	(76.7)	(423.9)
Payment of cash dividends	(3.6)	(5.4)
Other	11.2	6.8
Net financing activities of discontinued operations	8.7	(25.4)
Cash provided by financing activities	22.8	194.7
Increase in cash and cash equivalents	\$ 71.2	\$ 166.5

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

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(unaudited)

1. Financial Statements

In the opinion of the Company, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position, results of operations and cash flows for the periods presented. These condensed financial statements should be read in conjunction with the audited financial statements and notes thereto contained in the Company's Annual Report to Shareholders for the year ended September 30, 2004. The September 30, 2004 Consolidated Statement of Financial Position is derived from the audited financial statements, adjusted for discontinued operations (See Note 3). The results of operations for the three-month period ended December 31, 2004 are not necessarily indicative of the results which may be expected for the Company's 2005 fiscal year because of seasonal and other factors. Certain prior period amounts have been reclassified to conform to the current year's presentation.

2. Inventories

Inventories are valued at the lower of cost or market. Cost is determined using the last-in, first-out (LIFO) method for most inventories at domestic locations. The cost of other inventories is determined on the first-in, first-out (FIFO) method. Finished goods and work-in-process inventories include material, labor and manufacturing overhead costs. Inventories were comprised of the following:

(in millions)	December 31, 2004	September 30, 2004	December 31, 2003
Raw materials and supplies	\$ 498.5	\$ 485.2	\$ 459.0
Work-in-process	138.1	137.0	108.7
Finished goods	341.1	292.8	269.7
FIFO inventories	977.7	915.0	837.4
LIFO reserve	(27.9)	(27.8)	(26.7)
Inventories	\$ 949.8	\$ 887.2	\$ 810.7

3. Discontinued Operations

On January 10, 2005, the Company announced that it intends to sell its engine electronics business to Valeo for approximately \$330 million, or approximately \$437 million. The transaction, which is subject to regulatory approvals, is expected to be completed in the second quarter of fiscal 2005. This non-core business, which was a part of the Sagem SA automotive electronics business that was acquired in fiscal 2002, is reported as discontinued operations in the Consolidated Financial Statements. Under the requirements of Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the income statement components of the discontinued operations will be aggregated and presented on a single line in the Consolidated Statement of Income through the date of sale.

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)**

The following table summarizes the revenues and expenses of the discontinued operations:

(in millions)	Three Months Ended December 31,	
	2004	2003
Net sales	\$ 118.8	\$ 91.2
Cost of sales	99.8	75.5
Gross profit	19.0	15.7
Selling, general and administrative expenses	6.8	7.4
Operating income	12.2	8.3
Provision for income taxes	4.3	3.0
Net income	\$ 7.9	\$ 5.3
Earnings per share of discontinued operations		
Basic	\$ 0.04	\$ 0.03
Diluted	\$ 0.04	\$ 0.03

The Consolidated Statement of Financial Position at December 31, 2004 includes assets of discontinued operations of \$426.4 million, consisting of goodwill (\$157.2 million), accounts receivable (\$100.0 million), property, plant and equipment net (\$60.7 million), other intangible assets net (\$59.5 million) and other miscellaneous assets (\$49.0 million). Liabilities of discontinued operations at December 31, 2004 totaled \$119.8 million, consisting of accounts payable (\$89.6 million), accrued compensation (\$23.6 million) and other miscellaneous liabilities (\$6.6 million).

4. Product Warranties

The Company provides warranties to certain of its customers depending upon the specific product and terms of the customer purchase agreement. Most of the Company's product warranties are customer specific. A typical warranty program requires replacement of defective products within a specified time period from the date of sale. The Company records an estimate for future warranty-related costs based on actual historical return rates. Based on analysis of return rates and other factors, the warranty provisions are adjusted as necessary. While warranty costs have historically been within calculated estimates, it is possible that future warranty costs could exceed those estimates. The Company's product warranty liability is included in Other current liabilities in the Consolidated Statement of Financial Position.

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)**

The changes in the carrying amount of total product warranty liability for the three-month period ended December 31, 2004 were as follows:

(in millions)	
Balance as of September 30, 2004	\$ 69.8
Accruals for warranties issued during the period	10.2
Accruals related to pre-existing warranties (including changes in estimates)	(0.6)
Settlements made (in cash or in kind) during the period	(10.9)
Currency translation	2.6
Balance as of December 31, 2004	\$ 71.1

5. Stock-Based Compensation Stock Options

Effective October 1, 2002, the Company voluntarily adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation and adopted the disclosure requirements of SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure an amendment of FAS 123. In accordance with SFAS No. 148, the Company has adopted the fair value recognition provisions on a prospective basis and, accordingly, the expense recognized in the three-month period ended December 31, 2004 represents a pro rata portion of the fiscal 2005, 2004 and 2003 grants which are earned over a three-year vesting period.

The following table illustrates the pro forma effect on net income and earnings per share as if the fair value based method had been applied to all outstanding and unvested awards in each period:

(in millions)	Three Months Ended December 31,	
	2004	2003
Net income, as reported	\$ 168.4	\$ 164.5
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	3.4	3.6
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(4.7)	(5.5)
Pro forma net income	\$ 167.1	\$ 162.6
Earnings per share		
Basic - as reported	\$ 0.88	\$ 0.90
Basic - pro forma	\$ 0.88	\$ 0.89
Diluted - as reported	\$ 0.87	\$ 0.86
Diluted - pro forma	\$ 0.86	\$ 0.85

During December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, Share-Based Payment (SFAS 123R), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. Stock-based payments include stock option grants and certain transactions

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under other Company stock plans. The Company grants options to purchase common stock to some of its employees and directors under various plans at prices equal to the market value of the stock on the dates the options were granted. SFAS 123R is effective for all interim or annual periods beginning after June 15, 2005. The Company is currently evaluating the impact that the adoption of SFAS 123R will have on its consolidated financial position, results of operations and cash flows.

6. Guarantees

The Company has guaranteed the residual value related to the Company aircraft accounted for as synthetic leases. The guarantees extend through the lease maturity dates of September 2006. In the event the Company exercised its option not to purchase the aircraft for the remaining obligations at the scheduled maturity of the leases, the Company has guaranteed the majority of the residual values, not to exceed \$53 million in aggregate. The Company has recorded a liability of approximately \$3 million within Other noncurrent liabilities and a corresponding amount within Other noncurrent assets in the Consolidated Statement of Financial Position relating to the Company's obligation under the guarantees. These amounts are being amortized over the life of the guarantees.

7. Earnings Per Share

The following table reconciles the numerators and denominators used to calculate basic and diluted earnings per share:

(in millions)	Three Months Ended December 31,	
	2004	2003
<u>Income Available to Common Shareholders</u>		
Income from continuing operations	\$ 160.5	\$ 159.2
Preferred stock dividends, net of tax benefit		(1.8)
Basic income available to common shareholders	\$ 160.5	\$ 157.4
Income from continuing operations	\$ 160.5	\$ 159.2
Effect of dilutive securities:		
Compensation expense, net of tax benefit, arising from assumed conversion of preferred stock		(0.1)
Diluted income available to common shareholders	\$ 160.5	\$ 159.1
<u>Weighted Average Shares Outstanding</u>		
Basic weighted average shares outstanding	190.7	181.0

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Effect of dilutive securities:		
Stock options	2.9	3.3
Convertible preferred stock		7.5
Diluted weighted average shares outstanding	193.6	191.8
<u>Antidilutive Securities</u>		
Options to purchase common shares	0.4	0.1

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)****8. Goodwill and Other Intangible Assets**

The changes in the carrying amount of goodwill for the nine-month period ended September 30, 2004 and the three-month period ended December 31, 2004 were as follows:

(in millions)	Automotive Group	Controls Group	Total
Balance as of December 31, 2003	\$ 2,690.4	\$ 453.3	\$ 3,143.7
Goodwill from business acquisitions	458.0		458.0
Currency translation	(5.9)	13.3	7.4
Other	1.9	(1.9)	
Balance as of September 30, 2004	3,144.4	464.7	3,609.1
Goodwill from business acquisitions		9.0	9.0
Currency translation	125.8	14.7	140.5
Other	(2.3)		(2.3)
Balance as of December 31, 2004	\$ 3,267.9	\$ 488.4	\$ 3,756.3

The Company's other intangible assets, primarily from business acquisitions, are valued based on independent appraisals and consisted of:

(in millions)	December 31, 2004			September 30, 2004			December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Amortized intangible assets									
Patented technology	\$ 170.8	\$ (79.8)	\$ 91.0	\$ 169.4	\$ (76.6)	\$ 92.8	\$ 164.6	\$ (68.2)	\$ 96.4
Unpatented technology	81.1	(14.7)	66.4	75.0	(12.6)	62.4	75.1	(8.5)	66.6
Customer relationships	102.9	(8.2)	94.7	95.9	(6.4)	89.5	84.3	(4.2)	80.1
Miscellaneous	10.2	(8.0)	2.2	10.8	(7.6)	3.2	10.8	(6.7)	4.1
Total amortized intangible assets	365.0	(110.7)	254.3	351.1	(103.2)	247.9	334.8	(87.6)	247.2
Unamortized intangible assets									
Trademarks	38.8		38.8	37.1		37.1	11.7		11.7
Pension asset	6.0		6.0	6.0		6.0	8.9		8.9
Total unamortized	44.8		44.8	43.1		43.1	20.6		20.6

intangible assets

Total intangible

assets	\$ 409.8	\$ (110.7)	\$ 299.1	\$ 394.2	\$ (103.2)	\$ 291.0	\$ 355.4	\$ (87.6)	\$ 267.8
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Amortization of other intangible assets for the three-month periods ended December 31, 2004 and 2003 was \$6 million and \$5 million, respectively. Excluding the impact of any future acquisitions, the Company anticipates annual amortization of other intangible assets will approximate \$23 million for each of the next five years.

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A summary of comprehensive income is shown below:

(in millions)	Three Months ended December 31,	
	2004	2003
Net income	\$ 168.4	\$ 164.5
Realized and unrealized (losses) gains on derivatives	(4.7)	1.2
Foreign currency translation adjustments	199.3	147.6
Other comprehensive income	194.6	148.8
Comprehensive income	\$ 363.0	\$ 313.3

The higher foreign currency translation adjustments (CTA) for the three months ended December 31, 2004 was primarily due to the approximate 8% increase in the euro compared to an approximate 7% increase in the euro for the same period a year ago.

The Company has foreign currency-denominated debt obligations and cross-currency interest rate swaps which are designated as hedges of net investments in foreign subsidiaries. Gains and losses, net of tax, attributable to these hedges are deferred as CTA within the Accumulated other comprehensive income (loss) account. A net loss of approximately \$41 million and \$38 million was recorded for the three-month periods ending December 31, 2004 and 2003, respectively.

10. Segment Information

The Company has two operating segments, the Automotive Group and the Controls Group, which also constitute its reportable segments. The Automotive Group designs and manufactures products for motorized vehicles. The segment supplies interior systems and batteries for cars, light trucks and vans. The Controls Group provides facility systems and services including comfort, energy and security management for the non-residential buildings market.

Management's evaluation of the performance of the Company's segments excludes significant restructuring costs, discontinued operations and other significant non-recurring gains or losses. Financial information relating to the Company's reportable segments were as follows:

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(unaudited)

(in millions)	Three Months Ended December 31,	
	2004	2003
<u>Sales</u>		
Automotive Group	\$ 5,443.1	\$ 4,886.0
Controls Group	1,532.4	1,406.9
Total	\$ 6,975.5	\$ 6,292.9
<u>Operating Income</u>		
Automotive Group	\$ 202.6	\$ 198.9
Controls Group	42.8	54.6
Total	\$ 245.4	\$ 253.5

11. Income Taxes

The Company's estimated effective tax rate for continuing operations declined to 26.1% from 28.8% for the prior year due to continuing global tax planning initiatives. The Company utilized an effective rate for discontinued operations of 35.4% both periods, which approximates the local statutory rate. The current quarter rate for continuing operations further benefited from an \$11.5 million one time tax benefit related to a change in tax status of a foreign subsidiary during the quarter while the prior year first quarter benefited from a \$17.0 million favorable tax settlement related to prior periods (1991-1996).

The Company's Federal income tax returns and certain foreign income tax returns for fiscal years 1997-2001 are currently under various stages of audit by the Internal Revenue Service (IRS) and respective foreign tax authorities. Although the outcome of tax audits is always uncertain, management believes that its annual tax provisions include amounts sufficient to pay assessments, if any, which may be proposed by the taxing authorities. Nonetheless, the amounts ultimately paid, if any, upon resolution of the issues raised by the IRS may differ materially from the amounts accrued for each year. Company management expects that final resolution of these tax audits will occur over the next twelve months.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (Act). The Act creates a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign operations. The deduction is subject to a number of limitations and, as of today, uncertainty remains as to how to interpret numerous provisions in the Act. As such, we are not yet in a position to decide on whether, and to what extent, we might repatriate foreign earnings that have not yet been remitted to the U.S. Based on our analysis to date, however, it is reasonably possible that we may repatriate some amount between \$0 and \$560 million, which represents the Company's cumulative undistributed earnings of foreign subsidiaries subject to the Act. The respective tax liability ranges from \$0 to \$60 million. We expect to be in a position to finalize our assessment by September 2005.

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(unaudited)

12. Restructuring Costs

In the second quarter of fiscal year 2004, the Company executed a restructuring plan involving cost structure improvement actions and recorded an \$82.4 million restructuring charge within Selling, general and administrative (SG&A) expenses in the Consolidated Statement of Income. These costs primarily relate to workforce reductions of approximately 1,500 employees in the Automotive Group and 470 employees in the Controls Group. In addition, the restructuring plan called for four Automotive Group plants to be consolidated. Through December 31, 2004, all impacted employees from the Controls Group and approximately 1,170 employees from the Automotive Group have been separated from the Company. Employee severance and termination benefits are paid over the severance period granted to each employee and on a lump sum basis when required in accordance with individual severance agreements. A significant portion of the Automotive Group actions are concentrated in Europe as the Company focuses on significantly improving profitability in the region. The Controls Group restructuring actions involve activities in both North America and Europe. No further costs related to these specific actions are anticipated. The majority of the restructuring activities are expected to be completed during the current fiscal year.

The following table summarizes the Company's restructuring reserve, included within Other current liabilities in the Consolidated Statement of Financial Position:

(in millions)	Balance at September 30, 2004	Utilized		Balance at December 31, 2004
		Cash	Noncash	
Employee severance and termination benefits	\$ 41.8	\$ (6.0)		\$ 35.8
Currency translation	(0.4)		\$ 0.5	0.1
	\$ 41.4	\$ (6.0)	\$ 0.5	\$ 35.9

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The components of the Company's net periodic benefit costs associated with its defined benefit pension plans and other postretirement health and other benefits are shown in the tables below in accordance with SFAS No. 132 (revised 2003), Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88 and 106 :

(in millions)	Pension			
	U.S. Plans		Non-U.S. Plans	
	Three Months		Three Months	
	Ended		Ended December	
	December 31,		31,	
	2004	2003	2004	2003
Service cost	\$ 16.1	\$ 14.3	\$ 7.2	\$ 6.7
Interest cost	22.3	20.5	9.8	9.6
Employee contributions			(0.8)	(1.0)
Expected return on plan assets	(26.0)	(26.0)	(7.5)	(6.4)
Amortization of transitional obligation	(0.5)	(0.7)		
Amortization of net actuarial loss	4.9	2.6	1.7	0.8
Amortization of prior service cost	0.3	0.3	(0.1)	
Net periodic benefit cost	\$ 17.1	\$ 11.0	\$ 10.3	\$ 9.7

(in millions)	Postretirement	
	Health	
	and Other Benefits	
	Three Months	
	Ended December 31,	
	2004	2003
Service cost	\$ 1.4	\$ 1.3
Interest cost	2.6	2.8
Amortization of net actuarial loss	0.2	0.3
Amortization of prior service cost	(0.6)	(0.6)
Net periodic benefit cost	\$ 3.6	\$ 3.8

14. Contingencies

The Company is involved in a number of proceedings relating to environmental matters. Although it is difficult to estimate the liability related to these environmental matters, the Company believes that these matters will not have a materially adverse effect upon its capital expenditures, earnings or competitive position.

Additionally, the Company is involved in a number of product liability and various other suits incident to the operation of its businesses. Insurance coverages are maintained and estimated costs are recorded for claims and

suits of this nature. It is management's opinion that none of these will have a materially adverse effect on the Company's financial position, results of operations or cash flows.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders
of Johnson Controls, Inc.

We have reviewed the accompanying condensed consolidated statements of financial position of Johnson Controls, Inc. and its subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income and cash flows for each of the three-month periods ended December 31, 2004 and 2003. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statement of financial position as of September 30, 2004, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended (not presented herein), and in our report dated November 12, 2004 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated statement of financial position as of September 30, 2004, is fairly stated in all material respects in relation to the consolidated statement of financial position from which it has been derived.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Milwaukee, Wisconsin
January 31, 2005

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Comparison of Operating Results for the Three-Month Periods ended December 31, 2004 and 2003**

The following management discussion and analysis of financial condition and results of operations exclude the discontinued operations of the engine electronic business, as discussed in Note 3 to the Consolidated Financial Statements.

Sales

The Company's net sales for the three-month periods ended December 31, 2004 and 2003 were as follows:

(in millions)	2004	2003	% change
Automotive Group	\$ 5,443.1	\$ 4,886.0	11%
Controls Group	1,532.4	1,406.9	9%
Consolidated sales	\$ 6,975.5	\$ 6,292.9	11%

Consolidated net sales in the first quarter of fiscal 2005 were \$7.0 billion, rising 11% above the prior year period sales of \$6.3 billion. Growth was achieved by both the Automotive Group and the Controls Group.

Automotive Group

Automotive Group sales in the first quarter of fiscal 2005 grew 11% to \$5.4 billion from \$4.9 billion in the prior year. Excluding the impact of currency translation and acquisitions, segment sales were up 6% over the prior year.

Sales in North America increased 3% over the prior year. Both automotive battery sales and unit shipments increased year over year, with sales increasing 30% compared to the first quarter of the prior year. Excluding the impact of the acquisition of the remaining interest in the Company's battery joint venture, automotive battery sales increased 9% compared to the comparable prior year period. Interior systems sales were down 1% in the current quarter, which was slightly favorable to the 2.4% decrease in domestic industry vehicle production.

Segment sales in Europe for the current year rose 19% above the prior year period. Excluding the impact of currency translation, European sales were up 10%. The growth, which compares favorably to a slight decline in the estimated European industry production, was primarily attributable to new interiors business in the current year.

Sales in Asia and South America, which represent less than 10% of total segment sales, increased in comparison to the prior year, due to higher volumes across all major regions.

Table of Contents**Controls Group**

Controls Group sales in the current period were \$1.5 billion, 9% above the \$1.4 billion in the prior year period. Excluding the impact of currency translation and acquisitions, segment sales were up 3% over the prior year.

North American sales were 8% above the prior year. Sales of installed systems contracts grew 4%, with increased new construction business partially offset by decreases in existing buildings markets. Service sales were up 10%, primarily attributable to higher volumes of both technical and facility management services.

Excluding the positive effects of currency translation, segment sales in Europe were approximately 5% higher than the prior year. Sales increased in systems renovation, service and facility management businesses, while remaining relatively flat in the new construction market.

Sales in Asia, which represent less than 10% of segment revenue, were above the prior year, primarily attributable to strength in Japan and the favorable impact of currency translation.

Operating Income

The Company's operating income for the three-month periods ended December 31, 2004 and 2003 was as follows:

(in millions)	2004	2003	% change
Automotive Group	\$ 202.6	\$ 198.9	2%
Controls Group	42.8	54.6	-22%
Consolidated operating income	\$ 245.4	\$ 253.5	-3%

Consolidated operating income for the first quarter of fiscal 2005 was \$245 million, down 3% from the prior year's \$254 million. The Automotive Group was up slightly while the Controls Group decreased compared to the prior year period.

Automotive Group

Automotive Group operating income was \$203 million, 2% above the prior year period. The segment benefited from higher gross profits in Europe and lower Selling, General and Administrative (SG&A) expenses, somewhat offset by lower gross profits in North America. In Europe, gross profit was up primarily due to increased volumes of interior systems and operational improvements in both the interior systems and automotive battery businesses. The gross profit was also favorably affected by decreased launch costs. The gross profit decrease in North America was attributable to the timing of customer pricing concessions and higher raw material costs, partially offset by favorable product mix, lower launch costs and higher gross profits from automotive battery sales. Automotive Group SG&A expenses were lower primarily due to lower net engineering expenses.

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Controls Group

Controls Group operating income in the first quarter of the current year was \$43 million, 22% lower than the prior year period. The decrease was due to slightly higher gross profits in both North America and Europe, more than offset by higher SG&A expense. North American gross profit margins declined due to pricing pressures in the new construction market and the mix of growth among lines of business. North American operating margins declined primarily due to SG&A expenses associated with workforce reductions to improve the competitiveness of the systems business. European operating margins were also negatively impacted by SG&A expenses associated with workforce reductions.

Full Year Outlook

The Company has confirmed its outlook for the full year of 2005, including sales growth of 8 to 10% and double digit increases in operating and net income. For the Automotive Group, sales are expected to be 8% to 10% above the prior year, and operating margin is expected to improve slightly. This outlook assumes North American and European vehicle production levels will be flat to slightly lower in comparison to the prior year. Uncertainties continue in the automotive industry both with respect to vehicle sales and production schedules, as well as markedly higher raw material costs. These uncertainties could cause the Company's actual results to differ materially from the forecasted amounts. Controls Group sales are also projected to increase 8% to 10% above the prior year. The estimate anticipates growth in systems installation in both new and existing building markets and as well as growth in technical services.

Orders for control systems in the first quarter were above the prior year for performance contracting in the domestic market. Strong domestic market sectors included health care and state and local government. The new construction market strengthened in both North America and Europe.

The Controls Group backlog relates to its installed systems and technical service activity, accounted for using the percentage-of-completion method. At December 31, 2004, the unearned backlog to be executed within the next year was \$1.93 billion, 10% above the prior year level of \$1.75 billion.

Other Income/Expense

Net interest expense in the current period increased from the prior year period primarily as a result of higher debt levels in the current period. Management expects net interest expense for fiscal year 2005 to be between \$115 and \$120 million, down from previously issued guidance of \$125 to \$130 million. The decrease reflects the utilization of the proceeds from the sale of the discontinued operations to reduce short term borrowings. Equity income for the three months ended December 31, 2004 decreased approximately \$2 million year-over-year primarily due to lower earnings at certain Automotive Group joint ventures in China. Miscellaneous net expense in the current quarter was down approximately \$20 million from the prior year period. The decrease primarily reflects lower foreign currency losses in the current period and litigation expenses incurred in the prior period.

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Provision for Income Taxes

The Company's estimated effective tax rate for continuing operations declined to 26.1% from 28.8% for the prior year due to continuing global tax planning initiatives. The Company utilized an effective rate for discontinued operations of 35.4% both periods, which approximates the local statutory rate. The current quarter rate for continuing operations further benefited from an \$11.5 million one time tax benefit related to a change in tax status of a foreign subsidiary during the quarter while the prior year first quarter benefited from a \$17.0 million favorable tax settlement related to prior periods (1991-1996).

Minority Interests in Net Earnings of Subsidiaries

Minority interests in net earnings of subsidiaries in the current quarter increased from the prior year. The increase was primarily due to higher earnings at certain Automotive Group joint ventures in North America and Asia. Management has not changed its full-year estimate for minority interest in net earnings of subsidiaries which is approximately \$80 to \$90 million.

Income from Continuing Operations

Income from continuing operations for the three months ended December 31, 2004 was \$161 million, 1% above the prior year's \$159 million. The increased earnings were a result of lower miscellaneous expense, partially offset by lower operating and equity income and higher net interest expense. Diluted earnings per share from continuing operations for the three months ended December 31, 2004 were \$0.83, comparable to the prior year period.

Comparison of Financial Condition

Working Capital and Cash Flow

Working capital, excluding cash and debt, of \$1.1 billion at December 31, 2004 was \$0.2 billion higher than at fiscal year-end and \$0.3 billion higher than one year ago. The increase from year-end was due to lower accounts payable and accrued compensation and benefits and higher other current assets at December 31, 2004, partially offset by higher other current liabilities. The increase from one year ago primarily reflects higher accounts receivable, inventories and other current assets, partially offset by higher accounts payable and other current liabilities.

Cash provided by operating activities of continuing operations in the current quarter was \$240 million compared to \$216 million for the three-month period ended December 31, 2003. The slight increase primarily relates to favorable changes in working capital from continuing operations compared to the prior year period.

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Capital Expenditures

Capital spending for property, plant and equipment for the three-month period ended December 31, 2004 was \$144 million, down \$54 million from the comparable prior year period. The majority of the current quarter spending was attributable to the Automotive Group. Management has confirmed its estimate for fiscal 2005 capital expenditures of \$725 to \$775 million.

Capitalization

Total capitalization of \$8.4 billion at December 31, 2004 included short-term debt of \$0.9 billion, long-term debt (including the current portion) of \$1.9 billion and shareholders' equity of \$5.6 billion. The Company's total capitalization at September 30, 2004 and December 31, 2003 was \$7.9 billion and \$7.3 billion, respectively. Total debt as a percentage of total capitalization at December 31, 2004 was 33%, compared with 34% at fiscal year-end and 37% one year ago.

On January 10, 2005, the Company announced that it will sell its engine electronics business to Valeo for approximately 330 million, or about \$437 million. The transaction, which is subject to regulatory approvals, is expected to be completed in the second quarter of fiscal 2005. The engine electronics business generated revenues of \$436 million in fiscal 2004. This non-core business was a part of the Sagem SA automotive electronics business that was acquired in fiscal 2002.

The Company is in compliance with all covenants and other requirements set forth in its credit agreements and indentures. The Company believes its capital resources and liquidity position at December 31, 2004 were adequate to meet projected needs. Requirements for working capital, capital expenditures, dividends, debt maturities and any potential acquisitions in the remainder fiscal 2005 will continue to be funded from operations, supplemented by short- and long-term borrowings, if required.

Off-Balance Sheet Arrangements

In the ordinary course of business, the Company utilizes accounts receivable factoring arrangements in countries where programs of this type are typical. Under these arrangements, the Company may sell certain of its trade accounts receivable to financial institutions. The arrangements, in virtually all cases, do not contain recourse provisions against the Company for its customers' failure to pay. At December 31, 2004 the Company had sold \$188 million of foreign currency trade accounts receivable. The Company's use of these arrangements has not been a material source of liquidity for the Company. Management intends to discontinue financing its accounts receivables in fiscal 2005.

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Recent Accounting Pronouncements

During December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. Stock-based payments include stock option grants and certain transactions under other Company stock plans. The Company grants options to purchase common stock to some of its employees and directors under various plans at prices equal to the market value of the stock on the dates the options were granted. SFAS 123R is effective for all interim or annual periods beginning after June 15, 2005. The Company is currently evaluating the impact that the adoption of SFAS 123R will have on its consolidated financial position, results of operations and cash flows.

Cautionary Statements for Forward-Looking Information

The Company has made forward-looking statements in this document that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future risks and may include words such as believes, expects, outlook, forecasts or similar expressions. For those statements, the Company cautions that numerous important factors, including industry vehicle production levels and schedules, the ability to increase prices due to higher raw material costs, the strength of the U.S. or other economies, currency exchange rates, cancellation of commercial contracts, as well as those factors discussed in the company's Form 8-K filing (dated October 26, 2004), could affect the Company's actual results and could cause its actual consolidated results to differ materially from those expressed in any forward-looking statement made by, or on behalf of, the Company.

Other Financial Information

The interim financial information included in this 10-Q Report has not been audited by PricewaterhouseCoopers LLP (PwC). In reviewing such information, PwC has applied limited procedures in accordance with professional standards for reviews of interim financial information. Accordingly, you should restrict your reliance on their reports on such information. PwC is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their reports on the interim financial information because such reports do not constitute reports or parts of the registration statements prepared or certified by PwC within the meaning of Sections 7 and 11 of the Securities Act of 1933.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For the three-month period ended December 31, 2004, the Company did not experience any adverse changes in market risk exposures that materially affect the quantitative and qualitative disclosures presented in the Company's Annual Report to Shareholders for the year ended September 30, 2004.

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ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the Company's management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that such disclosure controls and procedures were effective in alerting them on a timely basis to material information relating to the Company required to be included in the Company's periodic filings under the Exchange Act.

There have been no changes in the Company's internal controls over financial reporting, or in factors that could significantly affect internal controls over financial reporting, subsequent to the date of the evaluation.

PART II. - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

There have been no significant changes in status since the last Report.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The Company entered into an Equity Swap Agreement, dated as of March 18, 2004 (the "Swap Agreement"), with Citibank, N.A. ("Citibank"). The Company selectively uses equity swaps to reduce market risk associated with its Company stock-based compensation plans, such as its deferred compensation plans and stock appreciation rights. Citibank has advised the Company that, in connection with the Swap Agreement, Citibank may purchase shares of the Company's stock in the market or in privately negotiated transactions up to an amount equal to \$135 million in aggregate market value at any given time. The Company disclaims that Citibank is an "affiliated purchaser" of the Company as such term is defined in Rule 10b-18(a)(3) under the Securities Exchange Act or that Citibank is purchasing any shares for the Company. The expiration date of the Swap Agreement is not currently determinable.

The following table presents information pursuant to Item 703(a) of Regulation S-K regarding the repurchase of the Company's common stock by the Company and purchases of the Company's common stock by Citibank in connection with the Swap Agreement during the three months ended December 31, 2004. The repurchases of the Company's common stock by the Company relate solely to stock option and restricted stock transactions that are treated as involving repurchases of Company common stock for purposes of this disclosure.

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Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of the Publicly Announced Program	Approximate Dollar Value of Shares that May Yet be Purchased under the Program⁽¹⁾
10/01/04 10/31/04 Purchases by Company				
Purchases by Citibank				\$ 37,505,000
Total				\$ 37,505,000
11/01/04 11/30/04 Purchases by Company	398	\$ 62.83		
Purchases by Citibank				\$ 30,620,000
Total	398	\$ 62.83		\$ 30,620,000
12/01/04 12/31/04 Purchases by Company				
Purchases by Citibank				\$ 27,152,000
Total				\$ 27,152,000

(1) The dollar amounts in this column relate solely to the approximate dollar value of shares that may be purchased under the Swap Agreement as of the end of the period in question.

ITEM 4. RESULTS OF VOTES OF SECURITY HOLDERS

The registrant held its Annual Meeting of Shareholders on January 26, 2005. Proxies for the meeting were solicited pursuant to Regulation 14; there was no solicitation in opposition to management's nominees for directors as listed in the Proxy Statement, and all such nominees (Natalie A. Black, Robert A. Cornog, William H. Lacy and Stephen A. Roell) were elected. Of the 159,033,490 shares voted, at least 150,941,613 shares granted authority to vote for these directors and no more than 8,091,877 shares withheld such authority.

The retention of PricewaterhouseCoopers LLP as an independent registered public accounting firm was approved by the shareholders with 153,607,093 shares voted for such appointment, 3,188,547 shares voted against and 2,237,850 shares abstained.

ITEM 6. EXHIBITS

Reference is made to the separate exhibit index contained on page 25 filed herewith.

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SIGNATURES

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.

JOHNSON CONTROLS, INC.

Date: January 31, 2005

By: /s/ Stephen A. Roell
Stephen A. Roell
Executive Vice President and
Chief Financial Officer

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JOHNSON CONTROLS, INC.

INDEX TO EXHIBITS

Exhibit No.	Description
12	Statement Regarding Computation of Ratio of Earnings to Fixed Charges for the Three Months Ended December 31, 2004.
15	Letter of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm, dated January 31, 2005, relating to Financial Information.
31.1	Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Periodic Financial Report by the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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received by us regarding accounting, internal accounting controls, or audit matters; monitors the rotation of partners of the independent auditors on our engagement team as required by law; reviews our critical accounting policies and estimates; and oversees any internal audit function. Additionally, the Audit Committee reviews and approves related person transactions and reviews and evaluates, on an annual basis, the Audit Committee's charter and performance. Our independent registered public accounting firm and management each periodically meet privately with our Audit Committee.

The current members of our Audit Committee are Messrs. Jacullo, Kamin, and Suttin, with Mr. Kamin serving as the chair of the Audit Committee. The Board has not yet determined a replacement for Mr. Suttin on the Audit Committee. All members of our Audit Committee meet the requirements for financial literacy under the applicable rules and regulations of the SEC and NASDAQ. Our Board has determined that Mr. Kamin is an audit committee financial expert as defined under the applicable rules of the SEC and has the requisite financial sophistication as defined under the applicable rules and regulations of NASDAQ. A description of Mr. Kamin's experience is set forth above under "Directors." Messrs. Jacullo, Kamin, and Suttin are independent directors as defined under the applicable rules and regulations of the SEC, NASDAQ and Public Company Accounting Oversight Board. The Audit Committee operates under a written charter that satisfies the applicable standards of the SEC and NASDAQ and is available on the "Investor Relations" section of our website, at <http://investors.tileshop.com>, under the "Governance Documents" heading. The Audit Committee met twelve times between January 1, 2015 and December 31, 2015.

Report of the Audit Committee of the Board of Directors

In accordance with its written charter, the Audit Committee assists the Board with fulfilling its oversight responsibility regarding the quality and integrity of the accounting, auditing and financial reporting practices of the Company. In discharging its oversight responsibilities regarding the audit process, the Audit Committee:

- (1) Reviewed and discussed the audited financial statements with management and the independent auditors;
- (2) Discussed with the independent auditors the material required to be discussed by PCAOB Auditing Standard No. 16, Communications With Audit Committees, with and without management present; and
- (3) Received the written disclosures and the letter from the independent auditors required by applicable requirements of the PCAOB Ethics and Independence Rule 3526, Communications with Audit Committees Concerning Independence, regarding the independent auditor's communications with the Audit Committee concerning independence, and discussed with the independent auditor the independent auditor's independence.

Based upon the review and discussions referred to above, the Audit Committee recommended to the Board that the audited financial statements be included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015, as filed with the Securities and Exchange Commission.

Peter H. Kamin, Chair
Peter J. Jacullo III
Adam L. Suttin

Compensation Committee

Our Compensation Committee reviews and recommends policies relating to compensation and benefits of our executive officers and employees. The Compensation Committee annually reviews and approves corporate goals and objectives relevant to compensation of our chief executive officer and other executive officers, evaluates the performance of these officers in light of those goals and objectives, and sets the compensation of these officers based on such evaluations. The Compensation Committee also reviews and makes recommendations to the Board with respect to director compensation and administers the issuance of stock options and other awards under our equity compensation plans. The Compensation Committee reviews and prepares the necessary compensation disclosures required by the SEC. Additionally, the Compensation Committee reviews and evaluates, on an annual basis, the Compensation Committee's charter and performance.

The current members of our Compensation Committee are Messrs. Jacullo, Krasnow and Watts, with Mr. Krasnow serving as the chair of the Compensation Committee. All of the members of our Compensation Committee are independent under the applicable rules and regulations of the SEC, NASDAQ and Section 162(m) of the Internal Revenue Code of 1986, as amended. The Compensation Committee operates under a written charter that satisfies the applicable standards of the SEC and NASDAQ, and which is available on the "Investor Relations" section of our website, at <http://investors.tileshop.com>, under the "Governance Documents" heading. The Compensation Committee met seven times between January 1, 2015 and December 31, 2015.

The Compensation Committee may approve executive compensation arrangements or, in its discretion, may recommend such matters to the full Board for approval. All executive compensation is based on assessments of executive performance, which are prepared by the Compensation Committee and submitted to the full Board for review and discussion. All Compensation Committee recommendations regarding director compensation are subject to approval by the full Board. Pursuant to its charter, the Compensation Committee may delegate any of its responsibilities to a subcommittee comprised of one or more members of the Compensation Committee; provided that the Compensation Committee is not permitted to delegate its responsibilities with respect to any executive compensation arrangements intended to comply with Section 162(m) of the Code by virtue of it being approved by a committee of "outside directors" or intended to be exempt from Section 16(b) under the Exchange Act by virtue of it being approved by a committee of "non-employee directors."

No executive officers may be present during any Compensation Committee voting or deliberations with respect to our Chief Executive Officer's compensation. Our Chief Executive Officer may, at the Compensation Committee's discretion, be present during any other voting or deliberations regarding compensation of our other executive officers.

Compensation Committee Interlocks and Insider Participation

The Compensation Committee currently consists of Messrs. Jacullo, Krasnow, and Watts and consisted of these same members in the fiscal year ended December 31, 2015. None of our Compensation Committee members has ever been an executive officer or employee of the Company. None of our executive officers currently serves, nor in the past year has served, as a member of the Board or Compensation Committee (or other Board committee performing equivalent functions) of any entity that has one or more executive officers serving on our Board or Compensation Committee.

Nominating and Corporate Governance Committee

Our Nominating and Corporate Governance Committee (“Governance Committee”) is responsible for making recommendations regarding corporate governance; identification, evaluation and nomination of candidates for directorships; and the structure and composition of our Board and committees thereof. In addition, the Governance Committee oversees our corporate governance guidelines, approves our committee charters, oversees compliance with our code of business conduct and ethics, contributes to succession planning, reviews actual and potential conflicts of interest of our directors and officers other than related person transactions reviewed by the Audit Committee, and oversees the Board self-evaluation process. Additionally, the Governance Committee reviews and evaluates, on an annual basis, the Governance Committee’s charter and performance.

The current members of our Governance Committee are Messrs. Cook, Kamin and Krasnow, with Mr. Cook serving as the chair of the Governance Committee. All of the members of our Governance Committee are independent under the applicable rules and regulations of NASDAQ. The Governance Committee operates under a written charter, which is available on the “Investor Relations” section of our website, at <http://investors.tileshop.com>, under the “Governance Documents” heading. The Governance Committee met three times between January 1, 2015 and December 31, 2015.

The Governance Committee considers the following criteria, among other criteria that it deems appropriate, in recommending candidates for service on the Board:

- Personal and professional integrity;
- Experience in corporate management, such as service as an officer of a publicly held company and a general understanding of marketing, finance and other elements relevant to the success of a publicly held company;
- Experience in the Company's industry;
- Experience as a member of the board of directors of another publicly held company;
- Academic expertise in the area of the Company's operations;
- Practical and mature business judgment, including the ability to make independent analytical inquires; and
- The manner in which a candidate's appointment to the Board would impact the overall composition of the Board with regard to diversity of viewpoint, professional experience, education, skill, race, gender and national origin.

In assessing director candidates, the Governance Committee considers diversity, age, skills, and such other factors as it deems appropriate given the current needs of the Board and the Company, to maintain a balance of knowledge, experience and capability. The Governance Committee does not have a formal diversity policy and does not follow any ratio or formula with respect to diversity in order to determine the appropriate composition of the Board. In the case of incumbent directors whose terms of office are set to expire, the Governance Committee reviews these directors' overall service to the Company during their terms, including the number of meetings attended, level of participation, quality of performance, and any other relationships and transactions that might impair the directors' independence. In the case of new director candidates, the Governance Committee also determines whether the nominee is independent for NASDAQ purposes, which determination is based upon applicable NASDAQ listing standards, applicable SEC rules and regulations and the advice of counsel, if necessary. The Governance Committee conducts any appropriate and necessary inquiries into the backgrounds and qualifications of possible candidates after considering the function and needs of the Board. The Governance Committee meets to discuss and consider the candidates' qualifications and then selects a nominee by majority vote.

The Governance Committee will consider director candidates recommended by stockholders. The Governance Committee does not intend to alter the manner in which it evaluates candidates, including the minimum criteria set forth above, based on whether or not the candidate was recommended by a stockholder.

To nominate a director for the 2017 Annual Meeting, stockholders must submit such nomination in writing to our Secretary at 14000 Carlson Parkway, Plymouth, Minnesota 55441 no later than the close of business on April 13, 2017, nor earlier than the close of business on March 14, 2017, provided, however, that in the event that the date of the 2017 Annual Meeting is advanced more than 30 days prior to July 12, 2017 or delayed more than 70 days following July 12, 2017, such notice must be received by the Company no earlier than 120 days prior to the 2017 Annual Meeting and no later than the later of 70 days prior to the date of the 2017 Annual Meeting or the 10th day following the day on which public announcement of the date of the 2017 Annual Meeting was first made by the Company.. You are advised to review the Company's Bylaws for requirements relating to director nominees.

VOTE REQUIRED

The Board recommends that you vote “For” each of the nominees to the Board set forth in this Proposal 1. Under our Bylaws, the election of each nominee requires the affirmative vote of a plurality of the votes cast by the stockholders entitled to vote on the election of directors at the Annual Meeting at which a quorum is present.

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PROPOSAL 2 — RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Audit Committee has appointed Ernst & Young LLP as the Company’s independent registered public accounting firm for the fiscal year ending December 31, 2016, and has further directed that management submit the selection of our independent registered public accounting firm for ratification by the stockholders at the Annual Meeting. Representatives of Ernst & Young LLP are expected to be present at the Annual Meeting. They will have an opportunity to make a statement if they so desire and will be available to respond to appropriate questions.

Neither the Company’s Bylaws nor other governing documents or law require stockholder ratification of the appointment of Ernst & Young LLP as the Company’s independent registered public accounting firm. However, the Audit Committee is submitting the appointment of Ernst & Young LLP to the stockholders for ratification as a matter of good corporate practice. If the stockholders fail to ratify the appointment, the Audit Committee will consider whether or not to retain that firm. Even if the appointment is ratified, the Audit Committee in its discretion may direct the appointment of a different independent registered public accounting firm at any time during the year if the Audit Committee determines that such a change would be in the best interests of the Company and its stockholders.

The affirmative vote of the holders of a majority of the shares present in person or represented by proxy and entitled to vote at the Annual Meeting will be required to ratify the appointment of Ernst & Young LLP.

Principal Accountant Fees and Services

The following table presents fees for professional services rendered by Ernst & Young, LLP our principal accountants for the fiscal year 2015 and 2014:

	2015	2014
Audit Fees(1)	\$ 595,000	\$ 671,532
Audit-Related Fees(2)	-	-
Tax Fees(3)	-	-
All Other Fees(4)	-	-
	\$ 595,000	\$ 671,532

- (1) Audit Fees were principally for services rendered for the audit and/or review of our consolidated financial statements.
- (2) Audit-Related Fees includes fees for services rendered in connection with the filing of registration statements with the SEC, and the issuance of accountant consents and comfort letters.
- (3) Tax Fees consist of fees billed in the indicated year for professional services with respect to tax compliance, tax advice and tax planning.
- (4) All Other Fees consist of fees billed in the indicated year for other permissible work that is not included within the above category descriptions.

Pre-Approval Policies and Procedures

Pursuant to its written charter, the Audit Committee is required to pre-approve the audit and non-audit services performed by our independent auditors. Notwithstanding the foregoing, separate Audit Committee pre-approval shall not be required (a) if the engagement for services is entered into pursuant to pre-approval policies and procedures established by the Audit Committee regarding the Company's engagement of the independent auditor (the "Pre-Approval Policy") as to matters within the scope of the Pre-Approval Policy or (b) for de minimus non-audit services that are approved in accordance with applicable SEC rules. The Audit Committee has determined that the rendering of the services other than audit services by its principal accountant is compatible with maintaining the principal accountant's independence. All services rendered by the Company's independent auditors were pre-approved by our Audit Committee expressly or pursuant to the Pre-Approval Policy.

VOTE REQUIRED

The Board recommends that you vote "For" the ratification of the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2016. Ratification of the appointment of Ernst & Young LLP requires the affirmative vote of a majority of the shares present in person or represented by proxy and voting on this proposal at the Annual Meeting.

PROPOSAL 3 — ADVISORY VOTE ON EXECUTIVE COMPENSATION

The Dodd-Frank Wall Street Reform and Consumer Protection Act and Section 14A of the Exchange Act require that we provide our stockholders with the opportunity to vote on a nonbinding advisory basis regarding the compensation of our named executive officers as disclosed in this proxy statement in accordance with the compensation disclosure rules of the SEC. In accordance with the preference of our stockholders, as expressed in a non-binding advisory vote on the frequency of advisory votes on executive compensation at the 2013 Annual Meeting of Stockholders, the Company has determined to hold annual advisory votes on the compensation of the named executive officers.

We seek to closely align the interests of our named executive officers with the interests of our stockholders. We designed our compensation program to reward our named executive officers for their individual performance and contributions to our overall business objectives and for achieving and surpassing the financial goals set by our Compensation Committee and our Board.

The vote on this resolution is not intended to address any specific element of compensation. Instead, the vote relates to the overall compensation of our named executive officers, as described in this proxy statement in accordance with the compensation disclosure rules of the SEC.

Accordingly, we ask our stockholders to vote on the following resolution at the Annual Meeting:

“RESOLVED, that the Company’s stockholders approve, on an advisory basis, the compensation of the named executive officers, as disclosed in the Company’s Proxy Statement for the 2016 Annual Meeting of Stockholders pursuant to the compensation disclosure rules of the Securities and Exchange Commission, including the 2015 Summary Compensation Table and the other related tables and disclosures.”

While the Board and especially the Compensation Committee intend to carefully consider the results of the vote on this proposal when making future decisions regarding executive compensation, the vote is not binding on the Company or the Board and is advisory in nature. To the extent there is any significant vote against the compensation of our named executive officers in this Proposal 3, the Compensation Committee will evaluate what actions may be necessary to address our stockholders’ concerns.

VOTE REQUIRED

The Board recommends that you vote “For” the non-binding advisory resolution approving the compensation of our named executive officers, as disclosed in this proxy statement.

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EXECUTIVE COMPENSATION

Compensation Discussion and Analysis

This section discusses our policies and decisions with respect to the compensation of our executive officers named in the “Summary Compensation Table” and the most important factors relevant to an analysis of these policies and decisions. The “named executive officers” to whom this discussion applies are:

- Chris R. Homeister, Chief Executive Officer;
- Kirk L. Gadelmann, Chief Financial Officer;
- Joseph Kinder, Senior Vice President – Supply Chain and Distribution; and
- Carl Randazzo, Senior Vice President – Real Estate and Development.

All of our named executive officers served as executive officers during the entire 2015 fiscal year.

The biographies for the above-listed executive officers were provided in our Annual Report on Form 10-K. On February 29, 2016, we hired Lynda Stout as our Senior Vice President – Retail Stores. Ms. Stout’s biography is set forth below:

Lynda Stout has been our Senior Vice President – Retail Stores since February 2016. Prior to joining the Company, Ms. Stout was a Senior Vice President Retail for Heritage Home Group, LLC from March 2014 through February 2016. Ms. Stout also worked in various roles including Vice President and General Manager at Ethan Allen Retail, Inc. from February 2005 through March 2014. Ms. Stout holds a B.S. in Human Resources from West Virginia University.

Overview

We recognize that our ability to excel depends on the integrity, knowledge, imagination, skill, diversity, and teamwork of our employees. To this end, we strive to create an environment of mutual respect, encouragement, and teamwork

that rewards commitment and performance and is responsive to the needs of our employees. The principles and objectives of our compensation and benefits programs for our employees generally, and for our named executive officers specifically, are to:

- Align compensation incentives with our corporate strategies, business, and financial objectives and the long-term interests of our stockholders;
- Motivate and reward executives whose knowledge, skills, and performance ensure our continued success; and
- Ensure that total compensation is fair, reasonable, and competitive.

Each of the primary elements of our executive compensation program is discussed in more detail below. While we have identified particular compensation objectives that each element of executive compensation serves, our compensation programs are designed to be flexible and complementary and to collectively serve all of the executive compensation objectives described above. Accordingly, whether or not specifically mentioned below, we believe that each individual element, to some extent, serves each of our objectives. Further, while each of our executive officers has not been, and may not be, compensated with all individual compensation elements, we believe that the compensation provided to each individual executive officer is, and will be, consistent with the overall compensation philosophy and objectives set forth above.

Compensation Determination Process

We review executive compensation annually, including evaluating our philosophy and compensation programs as circumstances require. As part of this review process, we expect to apply the values and the objectives outlined above, together with consideration for the levels of compensation that we would be willing to pay to ensure that our compensation remains competitive and that it is meeting our retention objectives in light of the cost to us if we were required to replace a key employee. In addition, we consider the results of non-binding advisory votes on executive compensation, commonly referred to as “say-on-pay” votes. At our 2015 Annual Meeting, we held a say-on-pay vote on the compensation of our named executive officers as described in the proxy statement for that meeting. Stockholders approved the compensation of the named executive officers by a favorable vote exceeding 99% of votes cast, including abstentions. We are mindful of the opinions of our stockholders and considered these results when deciding to retain our general compensation philosophy and core objectives for the upcoming fiscal year.

Prior to 2016, our Compensation Committee did not rely on a formal peer group when determining compensation, but made reference to general market data and considered establishing a group of comparable companies for this purpose. Additionally, our Compensation Committee considered engaging a compensation consultant to provide market data on a peer group of companies in our industry. We

believe that such information, together with other information obtained by the members of our Compensation Committee would help ensure that our compensation program remains competitive. Beginning in 2016, our Compensation Committee engaged Willis Towers Watson as a compensation consultant and considered executive compensation metrics on a peer group of companies in our industry when assessing executive compensation. We anticipate that our Compensation Committee will continue to make adjustments in executive compensation levels in the future as a result of this more formal market comparison process.

The compensation levels of our named executive officers reflect, to a significant degree, the varying roles and responsibilities of such executives. As a result of the assessment by our Board of the roles and responsibilities of our Chief Executive Officer, there is a compensation differential between his compensation levels and those of our other named executive officers.

Executive Compensation Program Components

Base Salary. Base salaries of our named executive officers are initially established through arm's-length negotiation at the time an executive is hired, taking into account such executive's qualifications, experience, and prior salary. Base salaries of our named executive officers are approved and reviewed periodically by our Chief Executive Officer, and in the case of our Chief Executive Officer's base salary, by our Board, and adjustments to base salaries are based on the scope of an executive's responsibilities, individual contribution, prior experience, and sustained performance. Decisions regarding salary increases may take into account the executive officer's current salary, equity or equity-linked interests, and the amounts paid to an executive officer's peers within our Company. In making decisions regarding salary increases, we may also draw upon the experience of members of our Board with other companies. Base salaries are also reviewed in the case of promotions or other significant changes in responsibility. No formulaic base salary increases are provided to our named executive officers. This strategy is consistent with our intent of offering base salaries that are cost-effective while remaining competitive.

Our Chief Executive Officer, Mr. Homeister, was hired in October 2013 as our Chief Operating Officer at an annual base salary of \$300,000. Effective January 1, 2015 and in connection with his promotion to Chief Executive Officer, Mr. Homeister's annual base salary was increased to \$400,000.

Our Chief Financial Officer, Mr. Geadelmann, was hired in August 2014 at an annual base salary of \$210,000. In February 2015, the Compensation Committee approved an increase to the annual base salary of Mr. Geadelmann to \$212,000.

In anticipation of the consummation of the Business Combination in August 2012, we entered into offer letter agreements with each of Messrs. Kinder and Randazzo, which provide for annual base salaries of \$200,000 each. In February 2014, the Compensation Committee approved increases to the base salaries of Messrs. Kinder and Randazzo

to \$208,000 each, on an annualized basis, and in February 2015, the Compensation Committee approved increases to the base salaries of Messrs. Kinder and Randazzo to \$212,000 each, on an annualized basis.

The actual base salaries earned by all of our named executive officers in 2015, 2014 and 2013 are set forth in the “Summary Compensation Table”. Upon joining the company in February 2016, Ms. Stout’s base salary was \$310,000. In April 2016, the Compensation Committee approved increases to the base salaries effective April 1, 2016 of Mr. Homeister to \$475,000, Mr. Geadelmann to \$250,000, and Messrs. Kinder and Randazzo to \$218,000.

2012 Omnibus Award Plan. In June 2012, our Board and stockholders adopted an equity award plan, which became effective upon the consummation of the transaction in August 2012 pursuant to which we became a public company (the “Business Combination”), which is described in our Annual Report on Form 10-K. The principal purpose of the equity award plan is to attract, retain, and motivate selected employees, consultants, and directors. As initially adopted, the equity award plan provided for stock-based compensation awards. In February 2013, the Compensation Committee and the Board amended the equity award plan to authorize grants of performance-based awards. At the same time, the plan was renamed the 2012 Omnibus Award Plan (the “Omnibus Plan”). The Compensation Committee of our Board administers the Omnibus Plan, subject to the right of our Board to assume authority for administration or delegate such authority to another committee of the Board. Awards under the Omnibus Plan may be granted to individuals who are then our officers, employees, directors, or consultants or are the officers, employees, directors, or consultants of our subsidiaries.

Under the Omnibus Plan, 2,500,000 shares of our common stock were initially reserved for issuance pursuant to a variety of stock-based compensation awards, including stock options and restricted stock awards. Subsequently, 2,500,000 shares of common stock were added to the Omnibus Plan effective January 1, 2013, pursuant to an automatic increase provision, that has since been eliminated.

In the event of a change of control, as such term is defined in the Omnibus Plan, the administrator may, in its sole discretion, accelerate vesting of awards issued under the Omnibus Plan such that 100% of any such award may become vested and exercisable. Additionally, the administrator has complete discretion to structure one or more awards under the Omnibus Plan to provide that such awards will

become vested and exercisable on an accelerated basis. The administrator may also make appropriate adjustments to awards under the Omnibus Plan and is authorized to provide for the acceleration, termination, assumption, substitution, or conversion of such awards in the event of a change of control or certain other unusual or nonrecurring events or transactions.

The types of awards we intend to grant under the Omnibus Plan are as follows:

Cash Performance Awards. In February 2013, 2014, and 2015, the Board and the Compensation Committee adopted specific performance targets and payout levels for each executive officer for the then-current fiscal year. Fiscal 2013 performance targets and payout levels for Mr. Homeister and fiscal 2014 performance targets and payouts for Mr. Geadelmann were determined upon commencement of employment with the Company. For fiscal 2013 and 2014, each of Messrs. Homeister, Geadelmann, Kinder and Randazzo was eligible to earn target cash incentive compensation equal to 50% of his base salary, based on our Adjusted Earnings Before Interest, Tax, Depreciation and Amortization (Adjusted EBITDA) for the year. The target incentive compensation was payable if we achieved the Adjusted EBITDA target set forth in our budget. Each of Messrs. Homeister, Geadelmann, Kinder and Randazzo was entitled to receive a partial incentive payment if we achieved at least 85% of our budgeted Adjusted EBITDA, and an incentive of up to double the target incentive amount if we achieved 115% of our budgeted Adjusted EBITDA and attained targeted sales goals. For fiscal 2013, Mr. Homeister's cash incentive arrangement was pro-rated for the partial year during which he was employed with the Company. For fiscal 2014, Mr. Geadelmann's cash incentive arrangement was pro-rated for the partial year during which he was employed with the Company.

For fiscal 2015, Mr. Homeister was eligible to earn target cash incentive compensation equal to 75% of his base salary and each of Messrs. Geadelmann, Kinder and Randazzo was eligible to earn target cash incentive compensation equal to 50% of his base salary, all based on our Adjusted EBITDA for the year. The target incentive compensation was payable if we achieved the Adjusted EBITDA target set forth in our budget. Each of Messrs. Homeister, Geadelmann, Kinder and Randazzo was entitled to receive a partial incentive payment if we achieved at least 85% of our budgeted Adjusted EBITDA, and an incentive of up to double the target incentive amount if we achieved 115% of our budgeted Adjusted EBITDA and attained targeted sales goals.

The Compensation Committee reviews and certifies performance following the end of each fiscal year and may also consider discretionary factors when making awards. As a result of this review, for fiscal 2013, the Compensation Committee approved incentive awards in the amount of \$30,000 to each of Messrs. Homeister, Kinder and Randazzo, partially based on the forgoing performance measures and partially based on discretion. The Compensation Committee did not approve any incentive awards based on the performance of the Company in fiscal 2014. For fiscal 2015, the Compensation Committee approved a payout of 55% of the target cash incentive compensation to Messrs. Homeister, Geadelmann, Kinder and Randazzo based on Company performance measures.

The cash bonuses for which our named executive officers were eligible in 2015 are set forth in the "Grants of Plan Based Awards in Fiscal Year 2015" table. The actual cash bonuses earned by all of our named executive officers in

2015, 2014 and 2013 are set forth in the “Summary Compensation Table.”

In March 2016, the Compensation Committee approved the 2016 executive compensation targets. Mr. Homeister is eligible to earn target cash incentive compensation equal to 75% of his base salary. Messrs. Geadelmann, Kinder, Randazzo, and Ms. Stout are eligible to earn target cash incentive compensation equal to 50% of their base salaries. Messrs. Homeister, Geadelmann, Kinder, Randazzo, and Ms. Stout are entitled to receive a partial incentive payment if we achieve at least 90% of our budgeted Adjusted EBITDA, and an incentive up to double the target incentive amount if we achieve 110% of our budgeted Adjusted EBITDA.

Equity and Equity-Linked Incentives. We intend to use equity incentive awards pursuant to our Omnibus Plan to link the interests of our named executive officers with those of our stockholders. The Omnibus Plan provides that the administrator may grant or issue stock options and restricted stock or any combination thereof. Stock options may be either nonqualified stock options or incentive stock options. We expect vesting of these equity incentive awards to be dependent in whole or in part on continued employment, in order to encourage the retention of our named executive officers through the vesting period of the awards. In some cases, vesting may also be partially based on the annual appreciation of our common stock. In determining the size of inducement and ongoing equity awards to our named executive officers, our Compensation Committee considers a number of internal factors, such as the relative job scope, the value of outstanding equity awards, individual performance history, prior contributions to us, and the size of prior awards, as well as external factors such as the levels of unvested equity awards held by our executive officers in relation to their peers at comparable companies. The Compensation Committee also intends to consider the foregoing factors for future awards.

In January 2015, we granted 150,000 non-qualified stock options to Mr. Homeister pursuant to the Omnibus Plan, which are subject to time-based vesting over a five-year period. The equity grants made to our named executive officers in 2015 are set forth in the “Grants of Plan Based Awards in Fiscal Year 2015” table and are discussed in the “Equity Grants” section of this item.

To date in 2016, we have granted 31,250 non-qualified stock options and 16,250 shares of restricted stock to Mr. Homeister, 12,500 non-qualified stock options and 6,500 shares of restricted stock to Mr. Geadelmann, and 9,375 non-qualified stock options and 5,000 shares of restricted stock to each of Mr. Randazzo and Mr. Kinder, all awarded under the Omnibus Plan. Additionally, upon joining the company in February 2016, we granted 100,000 non-qualified stock options to Ms. Stout, which were also awarded under the Omnibus Plan. The stock options granted to our named executive officers to date in 2016 contain service condition requirements and vest in five equal installments on the first five anniversaries of the grant date. The shares of restricted stock granted to date in 2016 contain service condition requirements and vest in five equal installments on the first five anniversaries of the grant date.

Retirement Savings. All of our full-time employees, including our named executive officers, are eligible to participate in The Tile Shop 401(k) Retirement Plan. Employees may elect to reduce their current compensation by up to the statutorily prescribed annual limit, which was \$18,000 in 2015 (or \$24,000 for employees over 50), and to have the amount of this reduction contributed to the 401(k) plan. In 2015, 2014 and 2013, we made a matching contribution of \$0.25 for every \$1.00 that each applicable employee contributed to the 401(k) plan, up to a maximum of 5% of such employee's salary. Each year, this matching contribution vests as to 20% of the aggregate matching contributions for such employee, such that all past and future matching contributions will be vested after the employee has been employed by us for a period of five years.

Perquisites. From time-to-time, we have provided certain of our named executive officers with perquisites that we believe are reasonable. We do not view perquisites as a significant element of our comprehensive compensation structure, but do believe they can be useful in attracting, motivating, and retaining executive talent. We believe that these additional benefits may assist our executive officers in performing their duties and provide time efficiencies for our executive officers in appropriate circumstances, and may consider providing additional perquisites in the future. There are no material perquisites to our named executive officers that are contractual obligations pursuant to written agreements. All future practices regarding perquisites will be approved and subject to periodic review by our Compensation Committee.

Tax Considerations. Our Board considers the potential effects of Section 162(m) of the Code on the compensation paid to our executive officers. Section 162(m) disallows a tax deduction for any publicly-held corporation for individual compensation exceeding \$1.0 million in any taxable year for the Chief Executive Officer and each of the next three most highly compensated executive officers (other than the Chief Financial Officer, if any), unless the compensation is "performance based" or based on another available exemption. We expect that our Compensation Committee will, where reasonably practicable, seek to qualify the variable compensation paid to our executive officers for an exemption from the deductibility limitations of Section 162(m), including by awarding stock options that satisfy the "qualified performance-based compensation" exception by virtue of being approved by a qualifying compensation committee of two or more outside directors, being issued pursuant to an underlying plan that sets the maximum number of shares that can be granted to any person within a specified period and compensating recipients based solely on an increase in the stock price after the grant date (i.e., the exercise price or base price is greater than or equal to the fair market value of the stock subject to the award on the grant date). In approving the amount and form of compensation for our executive officers in the future, our Compensation Committee will consider all elements of the cost to us of providing such compensation, including the potential impact of Section 162(m). However, our

Compensation Committee may, in its judgment, authorize compensation payments that do not comply with the exemptions in Section 162(m) when it believes that such payments are appropriate to attract and retain executive talent. Specifically, the restricted stock granted to Mr. Homeister in October 2013 was not “performance based.”

Compensation Committee Report

The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis with management. Based upon this review and discussion, the Compensation Committee recommended to the Board that the Compensation Discussion and Analysis be included in this proxy statement on Schedule 14A and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

Compensation Committee of the Board of Directors:

Todd Krasnow, Chairman

Peter J. Jacullo III

William E. Watts

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Summary Compensation Table for Fiscal 2015

The following table provides information regarding the compensation earned during the fiscal years ended December 31, 2013 through December 31, 2015 by each of the named executive officers for each year in which each was a named executive officer:

Name and Principal Position	Fiscal Year	Salary (\$)	Bonus (\$)(1)	Stock Awards (\$)(2)	Option Awards (\$)(2)	Non-Equity Incentive Plan Compensation (\$)(3)	Total (\$)
Chris R. Homeister(4) Chief Executive Officer	2015	400,000	-	-	592,479	165,000	1,157,479
	2014	300,000	-	-	294,430	-	594,430
	2013	75,000	(5) 30,000	1,447,000	2,740,180	-	4,292,180
Kirk L. Gadelmann(6) Chief Financial Officer	2015	212,000	-	-	-	58,300	270,300
	2014	81,932	(7) -	-	492,340	-	574,272
Joseph Kinder Senior Vice President - Operations	2015	212,000	-	-	-	58,300	270,300
	2014	208,000	-	-	-	-	208,000
	2013	200,000	30,000	-	-	-	230,000
Carl Randazzo Senior Vice President - Real Estate and Development	2015	212,000	-	-	-	58,300	270,300
	2014	208,000	-	-	-	-	208,000
	2013	200,000	30,000	-	-	-	230,000

(1) Represents incentive compensation earned in 2013 that was awarded at the discretion of the Compensation Committee.

(2) The value of stock awards and options in this table represent the fair value of such awards granted or modified during the fiscal year, as computed in accordance with FASB ASC 718. The assumptions used to determine the valuation of the awards are discussed in Note 9 to our consolidated financial statements, included herein.

(3) Represents incentive compensation paid based on the Company's achievement of Adjusted EBITDA financial goals for fiscal 2015. See "Non-Equity Incentive Plan Compensation" below for additional discussion.

- (4) From October 1, 2013 through December 31, 2014, Mr. Homeister served as Chief Operating Officer. Effective January 1, 2015, Mr. Homeister serves as the Company's Chief Executive Officer and President.
- (5) Includes pro rata base salary received by Mr. Homeister for services as Chief Operating Officer from October 1, 2013 through December 31, 2013.
- (6) Mr. Geadelmann was not a named executive officer in fiscal 2013.
- (7) Includes pro rata salary received by Mr. Geadelmann for services as Chief Financial Officer from August 12, 2014 through December 31, 2014.

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Grants of Plan-Based Awards for Fiscal 2015

The following table sets forth certain information regarding grants of plan-based awards during the fiscal year ended December 31, 2015:

Name	Grant Date	Estimated possible payouts under non-equity incentive plan awards (\$)(1)			All other awards: Number of securities underlying options (#)	Exercise or base price of option awards (\$/Sh)	Grant date fair value of stock and option awards (\$)	
		Threshold (\$)	Target (\$)	Maximum (\$)				
Chris R. Homeister	1/2/2015	-	-	-	150,000	(2)	8.73	592,479
Chris R. Homeister	N/A	15,000	300,000	600,000	-	-	-	-
Kirk L. Gadelmann	N/A	5,300	106,000	212,000	-	-	-	-
Joseph Kinder	N/A	5,300	106,000	212,000	-	-	-	-
Carl Randazzo	N/A	5,300	106,000	212,000	-	-	-	-

(1) Performance bonus based on the Company's achievement of Adjusted EBITDA financial goals for fiscal 2015. Mr. Homeister was eligible to earn target cash incentive compensation equal to 75% of his base salary, based on our Adjusted EBITDA for the year. Messrs. Gadelmann, Kinder and Randazzo were each eligible to earn target cash incentive compensation equal to 50% of their respective base salaries, based on our Adjusted EBITDA for the year. The target incentive compensation was payable if we achieved the Adjusted EBITDA target set forth in our budget. Messrs. Homeister, Gadelmann, Kinder and Randazzo were each entitled to receive a partial incentive payment if we achieved at least 85% of our budgeted Adjusted EBITDA, and an incentive of up to double the target incentive amount if we achieved 115% of our budgeted Adjusted EBITDA and attained targeted sales goals.

(2) Represents options to acquire shares of common stock. These options will vest and become exercisable in five equal annual installments beginning on January 2, 2016 based on continued service.

Offer Letter Agreements

In October 2013, as the result of arm's length negotiations, we entered into an offer letter agreement with Mr. Homeister setting forth the terms and conditions of his employment as our Chief Operating Officer. Pursuant to the

offer letter agreement, Mr. Homeister is entitled to receive severance benefits if his employment is terminated by us without cause at any time or if he resigns for good reason, subject to execution of a full release in our favor. In such an event, Mr. Homeister is entitled to continued payment of his base salary for six months and an additional payment in an amount equal to six times our contribution amount for the monthly health insurance premium for him during the month immediately prior to termination. Upon a change of control, Mr. Homeister is also entitled to full vesting acceleration with respect to any unvested equity awards if he is not offered employment by the successor entity, or if he is terminated without cause or constructively terminated prior to the first anniversary of the change of control. Effective January 1, 2015, we amended Mr. Homeister's offer letter agreement to reflect his new title of Chief Executive Officer and President and to memorialize certain compensation changes related to his promotion. All other terms of his offer letter agreement remain unchanged.

In June 2014, as the result of arm's length negotiations, we entered into an offer letter agreement with Mr. Geadelmann setting forth the terms and conditions of his employment as our Chief Financial Officer. Pursuant to the offer letter agreement, Mr. Geadelmann's employment with the Company is at-will, and, upon a change in control, his unvested equity awards may be accelerated at the sole discretion of the Compensation Committee.

In June 2012, as the result of arm's length negotiations, we entered into offer letter agreements with each of Messrs. Kinder and Randazzo, setting forth the terms and conditions of each such individual's respective employment effective upon consummation of the Business Combination. Pursuant to the offer letter agreements, each of Messrs. Kinder and Randazzo is entitled to receive severance benefits if his employment is terminated by us without cause at any time or if he resigns for good reason, subject to execution of a full release in our favor. In such an event, each of Messrs. Kinder and Randazzo is entitled to continued payment of his base salary for six months and an additional payment in an amount equal to six times our contribution amount for the monthly health insurance premium for him during the month immediately prior to termination. Upon a change of control, each of Messrs. Kinder and Randazzo is also entitled to full vesting acceleration with respect to any unvested equity awards if he is not offered employment by the successor entity, or if he is terminated without cause or is constructively terminated prior to the first anniversary of the change of control.

In connection with their offer letter agreements, each of Messrs. Homeister, Geadelmann, Kinder and Randazzo agreed not to compete, directly or indirectly, with us or solicit any of our employees or business contacts during the term of his employment and for a period of one year thereafter. Notwithstanding the foregoing, we may, at our election, extend the term of the non-compete and non-solicit obligations to which Messrs. Kinder and Randazzo are subject to for a period of two years following termination of employment, provided that we provide the applicable individual with continued payment of his base salary for twelve months (in lieu of six months) and an additional payment in an amount equal to twelve times (in lieu of six times) our contribution amount for the monthly health insurance premium for him during the month immediately prior to termination.

Non-Equity Incentive Plan Compensation

In February 2015, the Board and the Compensation Committee adopted specific performance targets and payout levels for each executive officer for the then-current fiscal year. For fiscal 2015, Mr. Homeister was eligible to earn target cash incentive compensation equal to 75% of his base salary and each of Messrs. Geadelmann, Kinder and Randazzo was eligible to earn target cash incentive compensation equal to 50% of his base salary, all based on our Adjusted EBITDA for the year. The target incentive compensation was payable if we achieved the Adjusted EBITDA target set forth in our budget. Each of Messrs. Homeister, Geadelmann, Kinder and Randazzo was entitled to receive a partial incentive payment if we achieved at least 85% of our budgeted Adjusted EBITDA, and an incentive of up to double the target incentive amount if we achieved 115% of our budgeted Adjusted EBITDA and attained targeted sales goals. For fiscal 2015, the Compensation Committee approved a payout of 55% of the target cash incentive compensation to Messrs. Homeister, Geadelmann, Kinder and Randazzo based on Company performance measures.

Equity Grants

In January 2015, in connection with his promotion to Chief Executive Officer, the Board granted Mr. Homeister non-qualified stock options to purchase 150,000 shares of the Company's common stock pursuant to the Omnibus Plan. The stock options are exercisable at 100% of the fair market value of the Company's common stock on the effective date of grant, will vest in equal installments over a five-year period beginning on January 2, 2016, and expire seven years from the date of the grant.

To date in 2016, we have granted 31,250 non-qualified stock options and 16,250 shares of restricted stock to Mr. Homeister, 12,500 non-qualified stock options and 6,500 shares of restricted stock to Mr. Geadelmann, and 9,375 non-qualified stock options and 5,000 shares of restricted stock to each of Mr. Randazzo and Mr. Kinder, all awarded under the Omnibus Plan. The stock options granted to our named executive officers to date in 2016 contain service condition requirements and vest in five equal installments on the first five anniversaries of the grant date. The shares of restricted stock granted to date in 2016 contain service condition requirements and vest in five equal installments on the first five anniversaries of the grant date.

We have provided for the acceleration of vesting of equity awards granted to each of Messrs. Homeister, Kinder and Randazzo in the event of a change of control of our Company. In the event of a change of control, if the individual is terminated without cause or is otherwise constructively terminated prior to the first anniversary of the change of control, the vesting of any unvested awards will be accelerated in full immediately prior to such termination. We believe that these acceleration opportunities will further align the interests of our executives with those of our stockholders by providing our executives an opportunity to benefit alongside our stockholders in a corporate transaction.

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Outstanding Equity Awards at Fiscal Year-end for Fiscal 2015

The following table sets forth certain information regarding outstanding equity awards held by the named executive officers as of December 31, 2015:

Name	Option Awards				Equity Incentive Plan	Stock Awards			
	Grant Date	Number of Securities Underlying Unexercised Options Exercisable (#)	Number of Securities Underlying Options Unexercisable (#)	Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price (\$)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (\$)	
Chris R. Homeister	10/1/2013	100,000	100,000	(1) -	28.94	10/1/2023	-	-	
Chris R. Homeister	10/1/2013	-	-	-	-	-	25,000	(2) 410,000	
Chris R. Homeister	2/13/2014	10,000	40,000	(3) -	13.17	2/13/2021	-	-	
Chris R. Homeister	1/2/2015	-	150,000	(4) -	8.73	1/2/2022	-	-	
Kirk L. Geadelmann	8/12/2014	20,000	80,000	(5) -	10.93	8/12/2021	-	-	
Joseph Kinder	8/21/2012	192,500	55,000	(6) 82,500	(7) 10.00	8/21/2022	-	-	
Carl Randazzo	8/21/2012	192,500	55,000	(6) 82,500	(7) 10.00	8/21/2022	-	-	

(1) These options become exercisable in two equal annual installments beginning on October 1, 2016.

(2) These shares of restricted stock will become unrestricted in two equal annual installments beginning on October 1, 2016.

(3) These options become exercisable in four equal annual installments beginning on February 13, 2016.

(4) These options become exercisable in five equal annual installments beginning on January 2, 2016.

- (5) These options become exercisable in four equal annual installments beginning on August 12, 2016.
- (6) These options become exercisable on August 21, 2016.
- (7) These options become exercisable on August 21, 2016 provided that the Company meets or exceeds certain annual stock price increase targets.

Option Exercises and Stock Vested for Fiscal 2015

None of the named executive officers exercised options during the fiscal year ended December 31, 2015. The following named executive officer had restricted common stock vest during the fiscal year ended December 31, 2015.

Name	Stock Awards	
	Number of Shares Acquired	Value Realized on Vesting (\$)
Chris R. Homeister	12,500	151,625

Pension Benefits

The Company did not sponsor any defined benefit pension or other actuarial plan for its named executive officers during the fiscal year ended December 31, 2015.

Nonqualified Deferred Compensation

No nonqualified deferred compensation was paid to or earned by the named executive officers during the fiscal year ended December 31, 2015.

Potential Payments Upon Termination or Change in Control

As discussed above in connection with each named executive officer's offer letter agreement, each named executive officer, with the exception of Mr. Geadelmann, may be eligible to receive severance benefits in the event that his employment is terminated by the Company without cause or by the named executive officer for good reason. Additionally, each named executive officer, with the exception of Mr. Geadelmann, is entitled to full vesting of any outstanding equity awards in the event of a change of control, if the individual is not offered employment by the successor entity, or if the individual is terminated without cause or is otherwise constructively terminated prior to the first anniversary of the change of control. Upon a change of control, Mr. Geadelmann's unvested equity awards may be accelerated at the sole discretion of the Compensation Committee.

The amounts payable to each of the named executive officers, assuming that each individual's employment had terminated on December 31, 2015, under each scenario are as follows:

Name	In Connection with a Change in Control \$(1)	By Company Not for Cause \$(2)	By NEO for Good Reason \$(2)
Chris R. Homeister	3,126,737	205,118	205,118
Kirk L. Geadelmann	-	(3) -	-
Joseph Kinder	788,168	111,118	111,118
Carl Randazzo	783,050	106,000	106,000

- (1) Represents lapse of the risks of forfeiture on all outstanding shares of restricted stock, in the case of Mr. Homeister, and full vesting of all outstanding options to purchase common stock, in the case of the other named executive officers.
- (2) Represents payments of six months of base salary and company-contributed health-insurance costs, with the exception of Mr. Randazzo who does not participate in company-sponsored health insurance.
- (3) In the event of a change in control, Mr. Geadelmann's unvested equity awards may be accelerated at the sole discretion of the Compensation Committee.

DIRECTOR COMPENSATION

Each of our non-employee directors receives an annual fee of \$100,000 and, in fiscal year 2015, the chairperson of our Board received an additional annual fee of \$150,000, which will become an annual fee of \$75,000 effective as of the Annual Meeting. Additionally, as of the Annual Meeting, the chair of the Audit Committee will receive an additional annual fee of \$40,000 and the chairs of each of the Compensation Committee and Governance Committee will receive an additional annual fee of \$15,000. The annual period for these fees runs based on the anniversary date of the Business Combination.

On August 21, 2014, each of Messrs. Kamin, Krasnow, Jacullo, Suttin, and Watts elected to receive compensation fully in the form of restricted common stock granted pursuant to the Omnibus Plan upon the anniversary of consummation of the Business Combination. The number of shares of our restricted common stock granted were equal to the quotient obtained by dividing (i) the amount of the annual fee payable to such non-employee director in the form of restricted stock, as set forth above, by (ii) the average closing price on NASDAQ of our common stock over 30 trading days immediately preceding the date of grant. Messrs. Kamin, Krasnow, Jacullo, and Suttin each received 9,270 shares of restricted stock. Mr. Watts received 23,176 shares of restricted stock. The risks of forfeiture for the restricted stock grants lapsed on August 21, 2015.

Upon his election to the Board on September 22, 2014, Mr. Cook elected to receive compensation fully in the form of restricted common stock granted pursuant to the Omnibus Plan upon anniversary of consummation of the Business Combination. Mr. Cook received 8,146 shares of restricted stock as director compensation in accordance with the above-described terms pro-rated to reflect his period of service on the Board. The risks of forfeiture for this restricted stock grant lapsed on August 21, 2015.

On August 21, 2015, Messrs. Cook, Krasnow, Jacullo, Rucker and Watts elected to receive compensation fully in the form of restricted common stock granted pursuant to the Omnibus Plan upon the anniversary of consummation of the Business Combination. Messrs. Kamin and Suttin had elected to receive compensation as one-half restricted stock and one-half cash compensation, payable quarterly. The number of shares of our restricted common stock granted were equal to the quotient obtained by dividing (i) the amount of the annual fee payable to such non-employee director in the form of restricted stock, as set forth above, by (ii) the average closing price on NASDAQ of our common stock over 30 trading days immediately preceding the date of grant. Messrs. Cook, Krasnow, Jacullo, and Rucker each received 7,205 shares of restricted stock. Messrs. Kamin and Suttin each received 3,602 shares of restricted stock. Mr. Watts received 18,012 shares of restricted stock. The risks of forfeiture for the restricted stock grants will lapse on August 21, 2016, contingent upon the applicable non-employee director's continued service on our Board. If any restricted stock remains for which the risks of forfeiture have not lapsed at the time of a non-employee director's termination of service on the Board, the Company has the option to purchase such shares of restricted stock at a price set forth in the agreements governing such restricted stock. As of December 31, 2015, Messrs. Kamin and Suttin had each received one payment of cash compensation for the period of August 21, 2015 through November 30, 2015.

Director Compensation Table for Fiscal 2015

The following table summarizes the compensation paid to each non-employee director in the fiscal year ended December 31, 2015:

Name	Fees Earned or Paid in		Stock Awards	All Other Compensation	Total (\$)
	Cash (\$)		(\$)(1)(2)	(\$)	
Christopher T. Cook	-		89,702	-	89,702
Peter H. Kamin	13,978	(3)	44,845	-	58,823
Todd Krasnow	-		89,702	-	89,702
Peter J. Jacullo III	-		89,702	-	89,702
Robert A. Rucker	-		89,702	34,635	(4) 124,337
Adam L. Suttin	13,978	(3)	44,845	-	58,823
William E. Watts	-		224,249	-	224,249

- (1) The table reflects the grant date fair value of the sole award to each director in fiscal 2015, as discussed in the narrative above.
- (2) The aggregate number of shares of restricted stock held by each of the directors listed in the table above as of December 31, 2015 was as follows: Messrs. Cook, Krasnow, Jacullo, and Rucker 7,205 shares each, Messrs. Kamin and Suttin 3,602 shares each, and Mr. Watts 18,012 shares. These shares of restricted stock were granted to the directors on August 21, 2015. The risks of forfeiture will lapse in full on August 21, 2016.
- (3) Represents one payment of \$13,978 paid to each of Messrs. Kamin and Suttin in fiscal year 2015 for the period from August 21, 2015 to November 30, 2015 due to the election to receive in cash one-half of director compensation for the period from August 21, 2015 to August 21, 2016.

- (4) Represents payments received by Mr. Rucker as an employee of the Company from January 1, 2015 through July 31, 2015 and as a consultant to the Company from August 1, 2015 through December 31, 2015, pursuant to the amendment to terms of employment entered into between the Company and Mr. Rucker as of January 1, 2015 in connection with his transition away from the role of Chief Executive Officer and President.

Rule 10b5-1 Trading Plans

Our directors and executive officers may adopt written plans, known as Rule 10b5-1 plans, in which they will contract with a broker to buy or sell shares of our common stock on a periodic basis. Under a Rule 10b5-1 plan, a broker executes trades pursuant to parameters established by the director or officer when entering into the plan, without further direction from the director or officer. The director or officer may amend or terminate the plan in some circumstances. Our directors and executive officers may also buy or sell additional shares outside of a Rule 10b5-1 plan when they are not in possession of material, nonpublic information.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Other than as described below, since the beginning of our 2015 fiscal year, there have been no transactions, or series of transactions to which we were a participant or will be a participant, in which:

- the amounts involved exceeded or will exceed \$120,000; and
- any of our directors, executive officers, holders of more than 5% of our common stock or any member of their immediate family, as used in Item 404 of Item S-K of the 1934 Act and interpreted by the SEC in related guidance (collectively, the “Related Persons”) had or will have a direct or indirect material interest.

We employ Adam Rucker, son of Robert A. Rucker, a member of our Board, as a Director of Information Technology. In fiscal 2015, we paid Adam Rucker a total of \$127,158, consisting of \$104,583 in base salary and \$22,575 as a cash bonus, which cash bonus was earned in fiscal 2015 and paid in fiscal 2016. In February 2015, we granted an option to purchase 8,000 shares of our common stock to Adam Rucker at an exercise price per share of \$8.45 that vests over a five year period. Adam Rucker was granted a second award in July 2015 of 1,916 stock options at a strike price of \$14.19 that vest over five years. The combined grant date fair value of these awards was \$43,538. Adam Rucker also received the standard benefits provided to other Company employees during 2015.

Compensation arrangements with our named executive officers and directors are described elsewhere in this proxy statement. There are no family relationships among any of our directors or executive officers. From time to time, the Company employs related persons and other family members of its officers and directors. Consistent with the policy described below, all such employment arrangements involving amounts exceeding \$50,000 are reviewed by the Audit Committee. The Company may also sell products to related persons and related persons may purchase products or

services from Company vendors for individual use. If such arrangements fall within the terms of the policy described below, they will also be reviewed by the Audit Committee.

Policies and Procedures for Related Person Transactions

Effective upon consummation of the Business Combination, our Board adopted a written related person transaction policy that sets forth the policies and procedures for the review and approval or ratification of related person transactions. This policy is administered by our Audit Committee and covers any transaction, arrangement, or relationship, or any series of similar transactions, arrangements, or relationships, in which we were or are to be a participant, the amount involved exceeds \$50,000 and a related person had or will have a direct or indirect material interest. While the policy covers related person transactions in which the amount involved exceeds \$50,000, the policy states that related person transactions in which the amount involved exceeds \$120,000 are required to be disclosed in applicable filings as required by the Securities Act, Exchange Act, and related SEC rules and regulations. Our Board determined to set the threshold for approval of related person transactions in the policy at an amount lower than that which is required to be disclosed under the Securities Act, Exchange Act, and related SEC rules and regulations because we believe that it is appropriate for our Audit Committee to review transactions or potential transactions in which the amount involved exceeds \$50,000, as opposed to \$120,000. Pursuant to this policy, our Audit Committee will consider (a) the relevant facts and circumstances of the related person transaction, including if the related person transaction is on terms comparable to those that could be obtained in arm's length dealings with an unrelated third-party, (b) the extent of the related person's interest in the related person transaction, (c) whether the related person transaction contravenes the conflict of interest and corporate opportunity provisions of our Code of Business Conduct and Ethics, (d) whether the relationship underlying the related person transaction at issue is believed to serve the best interest of us and our stockholders, and (e) the effect that a director's related person transaction may have on such director's status as an independent member of the Board and eligibility to serve on committees of the Board pursuant to SEC rules and NASDAQ listing standards.

Each director, director nominee and executive officer will present to our Audit Committee each proposed related person transaction to which such director, director nominee or executive officer is a party, including all relevant facts and circumstances relating thereto, and

will update the Audit Committee as to any material changes to any related person transaction. All related person transactions may only be consummated if our Audit Committee has approved or ratified such transaction in accordance with the guidelines set forth in the policy. Related party transactions do not include: (i) the payment of compensation by the Company to an executive officer or director of the Company; (ii) indebtedness due from a related person for transactions in the ordinary course of business; (iii) a transaction in which the interest of the related person arises solely from ownership of a class of securities of the Company where all holders of that class of securities receive the same benefit, on a pro-rata basis, from the transaction; or (iv) a transaction in which the rates or charges involved are determined by competitive bids. Additionally, certain types of transactions have been pre-approved by our audit committee under the policy as not involving a material interest. These pre-approved transactions include transactions in the ordinary course of business where the related party's interest arises only: (a) from his or her position as a director of another entity that is party to the transaction; (b) from an equity interest of less than 5% in another entity that is party to the transaction; or (c) from a limited partnership interest of less than 5%, subject to certain limitations. No director will be permitted to participate in the approval of a related person transaction for which he or she is a related party.

No director will be permitted to participate in the approval of a related person transaction for which he or she is a related party.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth, as of May 16, 2016, information regarding beneficial ownership of our common stock by:

- each person, or group of affiliated persons, known by us to beneficially own more than 5% of our common stock;
- each of our named executive officers;
- each of our directors; and
- all of our executive officers and directors as a group.

Beneficial ownership is determined according to the rules of the SEC, and generally means that a person has beneficial ownership of a security if he, she, or it possesses sole or shared voting or investment power of that security, including options that are currently exercisable or exercisable within 60 days of May 16, 2016. Except as indicated by the footnotes below, we believe, based on the information furnished to us, that the persons named in the table below have sole voting and investment power with respect to all shares of common stock shown that they beneficially own, subject to community property laws where applicable. The information does not necessarily indicate beneficial ownership for any other purpose.

Common stock subject to options currently exercisable or exercisable within 60 days of May 16, 2016 are deemed to be outstanding for computing the percentage ownership of the person holding these options and the percentage ownership of any group in which the holder is a member but are not deemed outstanding for computing the percentage of any other person.

We have based our calculation of the percentage of beneficial ownership based on 51,498,838 shares of our common stock outstanding on May 16, 2016.

Unless otherwise noted below, the address for each of the stockholders in the table below is c/o Tile Shop Holdings, Inc., 14000 Carlson Parkway, Plymouth, Minnesota, 55441.

Name	Number of Shares Beneficially Owned	Percent
5% Stockholders:		
Tile Shop, Inc.(1)	5,802,428	11.3 %

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Nabron International, Inc.(2)	5,740,537	11.1	%
Tremblant Capital Group(3)	4,704,484	9.1	%
JWTS, Inc.(4)	4,441,180	8.6	%
Franklin Resources, Inc.(5)	2,935,979	5.7	%
Executive officers and Directors:			
Chris R. Homeister(6)	211,150	*	
Kirk L. Geadelmann(7)	26,500	*	
Joseph Kinder(8)	197,500	*	
Carl Randazzo(9)	197,500	*	
Christopher T. Cook(10)	75,351	*	
Peter J. Jacullo III(3)(11)	4,707,274	9.1	%
Peter H. Kamin(12)	1,299,711	2.5	%
Todd Krasnow(13)	188,704	*	
Robert A. Rucker(2)(14)	6,059,633	11.8	%
Adam L. Suttin(15)	456,450	*	
William E. Watts(16)	148,327	*	
All Executive Officers and Directors as a Group (12 persons)	13,568,100	26.1	%

* Represents beneficial ownership of less than one percent (1%) of the outstanding common stock.

- (1) Based on a Schedule 13D/A filed with the SEC on June 13, 2013 by The Tile Shop, Inc., a Minnesota corporation (“TS, Inc.”), and Robert A. Rucker (“Rucker”) and on Form 5 filed with the SEC on February 9, 2016 by Rucker. Rucker is the sole director of TS, Inc. and may be deemed to have sole voting and investment power over the securities held by TS, Inc.
- (2) Based on a Form 4 filed with the SEC on March 18, 2016 by Nabron International, Inc., a Bahamas company (“Nabron”), Raymond Long Sing Tang (“Tang”), Jill Marie Franklin (“Franklin”), and Louise Mary Garbarino (“Garbarino”). Tang, Franklin, and Garbarino are directors of Nabron and may be deemed to have shared voting and investment power over the securities held by Nabron. The business address of Nabron is 2nd Floor, Le Prince de Galles, 3-5 Avenue des Citronniers, Monaco, 09 MC98000.

- (3) Based on a schedule 13G/A filed with the SEC on February 16, 2016 by Tremblant Capital Group (“Tremblant”). The business address of Tremblant is 767 Fifth Ave, New York, New York, 10153.
- (4) Based on a Schedule 13D/A filed with the SEC on June 13, 2013 by JWTS, Inc., a Delaware corporation (“JWTS”) and Peter J. Jacullo III (“Jacullo”). Jacullo is the sole director of JWTS and may be deemed to have sole voting and investment power over the securities held by JWTS. The business address of JWTS is c/o Peter J. Jacullo III 61 High Ridge Avenue, Ridgefield, Connecticut 06877.
- (5) Based on a Schedule 13G/A filed with the SEC on February 10, 2016 by Franklin Resources, Inc. (“FRI”), Charles B. Johnson, Rupert H. Johnson, and Franklin Advisers, Inc. FRI delegates investment management authority over and voting rights with respect to certain of its beneficially owned securities to certain of its Investment Management Subsidiaries pursuant to investment management contracts. When FRI delegates such voting rights, FRI treats the Investment Management Subsidiary as having sole investment discretion or voting authority, as the case may be, unless the agreement specifies otherwise. Accordingly, each Investment Management Subsidiary reports on Schedule 13G that it has sole investment discretion and voting authority over the securities covered by any such investment management agreement, unless otherwise noted in the Schedule 13G. As a result, for purposes of Rule 13d-3 under the Act, the Investment Management Subsidiaries listed in the Schedule 13G may be deemed to be the beneficial owners of the securities reported. The business address of FRI is One Franklin Parkway, San Mateo, CA 94403-1906.
- (6) Includes 41,250 shares of restricted common stock held by Mr. Homeister and options to purchase 150,000 shares of common stock that are currently exercisable or will become exercisable within 60 days of May 16, 2016.
- (7) Includes 6,500 shares of restricted common stock held by Mr. Geadelmann and options to purchase 20,000 shares of common stock that are currently exercisable or will become exercisable within 60 days of May 16, 2016.
- (8) Includes 5,000 shares of restricted common stock held by Mr. Kinder and options to purchase 192,500 shares of common stock that are currently exercisable or will become exercisable within 60 days of May 16, 2016.
- (9) Includes 5,000 shares of restricted common stock held by Mr. Randazzo and options to purchase 192,500 shares of common stock that are currently exercisable or will become exercisable within 60 days of May 16, 2016.
- (10) Includes 7,205 shares of restricted common stock held by Mr. Cook.
- (11) Includes 7,205 shares of restricted common stock held by Mr. Jacullo.
- (12) Includes 3,602 shares of restricted common stock held by Mr. Kamin, 7,453 shares of common stock held by the Peter H. Kamin Family Foundation (“Kamin Foundation”), 379,059 shares of common stock held by the Peter H. Kamin Revocable Trust dated February 2003 (“2003 Trust”), 228,216 shares of common stock held by the Peter H. Kamin Childrens Trust dated March 1997 (“1997 Trust”), 135,361 shares of common stock held by the Peter H. Kamin GST Trust (“GST”), and 160,723 shares of common stock held by 3K Limited Partnership (“3K” and, together with Mr. Kamin, Kamin Foundation 2003 Trust, 1997 Trust, GST, and 3K, the “Kamin Entities”). Mr. Kamin is a trustee of the Kamin Foundation, the sole trustee of the 2003 Trust, the sole trustee of the 1997 Trust, a trustee of GST, and sole general partner of 3K and may be deemed to have sole voting and investment power over the securities held by these entities.
- (13) Includes 7,205 shares of restricted common stock held by Mr. Krasnow, 2,600 shares of common stock held by Mr. Krasnow’s spouse, 10,000 shares of common stock held by Hobart Road Charitable Remainder CRUT (“Hobart Road”), 5,000 shares of common stock held by the Todd & Deborah Krasnow Charitable Remainder CRUT (“CRUT”), and 15,000 shares of common stock held by the Todd & Deborah Krasnow Foundation (“Krasnow Foundation”). Mr. Krasnow is a trustee of each of Hobart Road, the CRUT and the Krasnow Foundation and may be deemed to have sole voting and investment power over the securities held by these entities. Mr. Krasnow disclaims beneficial ownership of the shares of common stock held by his spouse, except to the extent of his pecuniary interest therein.
- (14) Includes 7,205 shares of restricted common stock held by Mr. Rucker that are subject to a repurchase option held by the Company.
- (15)

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Includes 3,602 shares of restricted common stock held by Mr. Suttin and 33,689 shares of common stock held by the Adam L. Suttin Irrevocable Family Trust. Mr. Suttin's spouse is the trustee of the trust and Mr. Suttin disclaims beneficial ownership of the shares of common stock held by the trust, except to the extent of his pecuniary interest therein.

- (16) Includes 18,012 shares of restricted common stock held by Mr. Watts.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires the Company's directors and executive officers, and persons who own more than ten percent of a registered class of the Company's equity securities, to file with the SEC initial reports of ownership and reports of changes in ownership of common stock and other equity securities of the Company. Officers, directors and greater than ten percent stockholders are required by SEC regulation to furnish the Company with copies of all Section 16(a) forms they file.

To the Company's knowledge, based on a review of the copies of such reports furnished to the Company, the officers, directors and greater than ten percent stockholders complied with all Section 16(a) filing requirements during the fiscal year ended December 31, 2015, except that Nabron International, Inc., a greater than ten percent shareholder, filed a Form 4 on September 15, 2015 to report nine sales of Company equity securities that occurred from May 18, 2015 through May 29, 2015.

FORM 10-K INFORMATION

A COPY OF THE COMPANY'S ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2015 (WITHOUT EXHIBITS), ACCOMPANIES THIS NOTICE OF MEETING AND PROXY STATEMENT. NO PART OF THE ANNUAL REPORT IS INCORPORATED HEREIN AND NO PART THEREOF IS TO BE CONSIDERED PROXY SOLICITING MATERIAL. THE COMPANY WILL FURNISH WITHOUT CHARGE TO EACH PERSON WHOSE PROXY IS BEING SOLICITED, UPON WRITTEN REQUEST OF ANY SUCH PERSON, ANY EXHIBIT DESCRIBED IN THE LIST ACCOMPANYING THE FORM 10-K, UPON THE PAYMENT, IN ADVANCE, OF REASONABLE FEES RELATED TO THE COMPANY'S FURNISHING SUCH EXHIBIT(S). REQUESTS FOR COPIES OF SUCH EXHIBIT(S) SHOULD BE DIRECTED TO THE COMPANY'S SECRETARY AT 14000 CARLSON PARKWAY, PLYMOUTH, MINNESOTA 55441.

OTHER MATTERS

The Board and management know of no other matters that will be presented for consideration at the Annual Meeting. However, since it is possible that matters of which the Board and management are not now aware may come before the meeting or any adjournment of the meeting, the proxies confer discretionary authority with respect to acting thereon, and the persons named in such properly executed proxies intend to vote, act and consent in accordance with their best judgment with respect thereto. Upon receipt of such proxies (in the form enclosed) in time for voting, the shares represented thereby will be voted as indicated thereon and in the proxy statement.

By Order of the Board of Directors

Chris R. Homeister

Chief Executive Officer and Director

Plymouth, Minnesota

May 26, 2016

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