KEY TRONIC CORP
Form 10-Q
February 13, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

DECEMBER 31, 2011 FOR THE PERIOD ENDED DECEMBER 31, 2011

OR

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

FOR THE PERIOD FROM TO .

Commission File Number 0-11559

KEY TRONIC CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-0849125**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

N. 4424 Sullivan Road

Spokane Valley, Washington 99216

(509) 928-8000

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 during the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

As of January 28, 2012, 10,446,687 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

We , us , our , Company , KeyTronicEMS and KeyTronic , unless the context otherwise requires, means Key Tronic Corporation and its subsidiaries.

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PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	December 31, 2011	July 2, 2011
	(in thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 596	$ 1,232
Trade receivables, net (allowance for doubtful accounts of $0 and $111)	47,479	40,350
Inventories	53,245	41,554
Deferred income tax asset	4,742	3,900
Other	4,016	4,549
Total current assets	110,078	91,585
Property, plant and equipment net	16,556	14,917
Other assets:		
Deferred income tax asset	7,553	4,219
Other	574	1,643
Total other assets	8,127	5,862
Total assets	$ 134,761	$ 112,364
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 41,170	$ 26,149
Accrued compensation and vacation	4,276	4,436
Current portion of other long-term obligations	781	761
Other	3,905	1,932
Total current liabilities	50,132	33,278
Long-term liabilities:		
Revolving loan	7,483	6,000
Deferred income tax liability	811	1,542
Other long-term obligations	7,554	3,521
Total long-term liabilities	15,848	11,063
Total liabilities	65,980	44,341
Commitments and contingencies (Note 7)		
Shareholders equity:		
Common stock, no par value (in thousands) - shares authorized 25,000; issued and outstanding 10,447 and 10,399 shares, respectively	41,442	41,014

Retained earnings	29,690	25,269
Accumulated other comprehensive (loss) income	(2,351)	1,740
Total shareholders equity	68,781	68,023
Total liabilities and shareholders equity	$ 134,761	$ 112,364

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended		Six Months Ended	
	December 31, 2011	January 1, 2011	December 31, 2011	January 1, 2011
	(in thousands, except per share amounts)			
Net sales	$ 84,454	$ 61,038	$ 154,215	$ 124,378
Cost of sales	77,586	55,592	142,342	112,962
Gross profit on sales	6,868	5,446	11,873	11,416
Research, development and engineering expenses	1,157	961	2,113	1,875
Selling, general and administrative expenses	2,916	2,770	5,350	5,202
Income from operations	2,795	1,715	4,410	4,339
Interest expense	124	75	227	147
Income before income taxes	2,671	1,640	4,183	4,192
Income tax (benefit) provision	(503)	(93)	(238)	717
Net income	$ 3,174	$ 1,733	$ 4,421	$ 3,475
Net income per share Basic	$ 0.30	$ 0.17	$ 0.42	$ 0.34
Weighted average shares outstanding Basic	10,447	10,345	10,432	10,321
Net income per share Diluted	$ 0.30	$ 0.17	$ 0.42	$ 0.33
Weighted average shares outstanding Diluted	10,479	10,448	10,462	10,420

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended		Six Months Ended	
	December 31, 2011	January 1, 2011	December 31, 2011	January 1, 2011
	(in thousands)			
Comprehensive income:				
Net income	$ 3,174	$ 1,733	$ 4,421	$ 3,475
Other comprehensive income:				
Unrealized gain (loss) on foreign exchange contracts	222	410	(4,091)	1,083
Comprehensive income	$ 3,396	$ 2,143	$ 330	$ 4,558

Other comprehensive income for the three months ended December 31, 2011 and January 1, 2011 is reflected net of tax of approximately $115,000 and $221,000, respectively. Other comprehensive income for the six months ended December 31, 2011 and January 1, 2011 is reflected net of tax of approximately ($2.1) million and $572,000, respectively.

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended	
	December 31, 2011	January 1, 2011
	(in thousands)	
Increase (decrease) in cash and cash equivalents:		
Cash flows from operating activities:		
Net income	$ 4,421	$ 3,475
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	1,154	1,082
Accretion of deferred gain on sale of building		(39)
Provision for obsolete inventory	158	152
Provision for warranty	60	75
(Recovery of) provision for doubtful accounts	(111)	15
Gain on disposal of assets		(13)
Share-based compensation expense	300	256
Deferred income taxes	(2,596)	621
Changes in operating assets and liabilities:		
Trade receivables	(7,018)	(3,152)
Inventories	(11,849)	(6,965)
Other assets	(1,159)	(2,683)
Accounts payable	15,022	(4,148)
Accrued compensation and vacation	(160)	(980)
Other liabilities	2,626	(711)
Cash provided by (used in) operating activities	848	(13,015)
Cash flows from investing activities:		
Purchase of property and equipment	(2,765)	(2,772)
Proceeds from sale of fixed assets	9	15
Proceeds from life insurance		113
Cash used in investing activities	(2,756)	(2,644)
Cash flows from financing activities:		
Payment of financing costs		(50)
Capital lease payments	(339)	
Borrowings under revolving credit agreement	53,865	60,779
Repayment of revolving credit agreement	(52,382)	(44,552)
Proceeds from exercise of stock options	128	349
Cash provided by financing activities	1,272	16,526
Net (decrease) increase in cash and cash equivalents	(636)	867
Cash and cash equivalents, beginning of period	1,232	770
Cash and cash equivalents, end of period	$ 596	$ 1,637
Supplemental cash flow information:		
Interest payments	$ 174	$ 227

Income tax payments, net of refunds	$	227	$	276

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(Unaudited)

	Shares	Common Shares	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
			(in thousands)		
Balances, July 2, 2011	10,399	$ 41,014	$ 25,269	$ 1,740	$ 68,023
Net income			4,421		4,421
Unrealized loss on foreign exchange contracts				(4,091)	(4,091)
Exercise of stock options	48	128			128
Stock-based compensation		300			300
Balances, December 31, 2011	10,447	$ 41,442	$ 29,690	$ (2,351)	$ 68,781

See accompanying notes to condensed consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The consolidated financial statements included herein have been prepared by Key Tronic Corporation and subsidiaries (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in our annual consolidated financial statements have been condensed or omitted. The year-end condensed consolidated balance sheet information was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The financial statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period. The results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes included in the Company s Annual Report on Form 10-K for the fiscal year ended July 2, 2011.

The Company s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three and six month periods ended December 31, 2011 and January 1, 2011 were 13 week and 26 week periods, respectively. Fiscal year 2012 will end on June 30, 2012 which is a 52 week year, and fiscal year 2011 which ended on July 2, 2011, was also a 52 week year.

2. Significant Accounting Policies

Reclassifications

As discussed in Note 5, in the first quarter fiscal year 2012 financial statements the Company reclassified certain deferred tax assets and liabilities on its July 2, 2011 balance sheet. The reclassification was not material to the July 2, 2011 financial statements.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences and benefits attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis, as well as operating losses and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences and carryforwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities for a change in tax rates is recognized in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that is more likely than not to be realized.

We utilize a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments based on new assessments and changes in estimates and which may not accurately forecast actual outcomes. Our policy is to recognize interest and penalties related to the underpayment of income taxes as a component of income tax expense. To date, we have not incurred charges for interest or penalties in relation to the underpayment of income taxes. The tax years 1993 through the present remain open to examination by the major taxing jurisdictions to which we are subject. Refer to Note 5 for further discussions.

Earnings Per Common Share

Basic earnings per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed by dividing net income by the

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combination of other potentially dilutive weighted average common shares and the weighted average number of common shares outstanding during the period using the treasury stock method. The computation assumes the proceeds from the exercise of equity awards were used to repurchase common shares at the average market price during the period. The computation of diluted earnings per common share does not assume conversion, exercise, or contingent issuance of common stock equivalent shares that would have an anti-dilutive effect on earnings per share.

Fair Value of Financial Instruments

The carrying values of financial instruments reflected on the balance sheets at December 31, 2011 and January 1, 2011, reasonably approximate their fair value. Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of long-term debt is estimated to be $7.5 million and $6.0 million, respectively, as of December 31, 2011 and July 2, 2011, which approximates the carrying values.

Share-based Compensation

The Company s incentive plan provides for equity and liability awards to employees and non-employee directors in the form of stock options, stock appreciation rights (SARs), restricted stock, restricted stock units, stock awards, stock units, performance shares, performance units, and other stock based or cash-based awards. Compensation cost is recognized on a straight-line basis over the requisite employee service period, which is generally the vesting period, and is recorded as employee compensation expense in cost of goods sold and selling general and administrative expenses. Share-based compensation is recognized only for those awards that are expected to vest, with forfeitures estimated at the date of grant based on historical experience and future expectations.

On October 21, 2010, the Company obtained shareholder approval of the 2010 Incentive Plan at the Annual Shareholder Meeting. As a result, the Company replaced the cash-settlement feature with a net-share-settlement feature for the SARs granted during the fourth quarter of fiscal 2010. Therefore the awards were reclassified from liability awards to equity awards effective October 21, 2010 at a weighted average fair value of $2.89.

On July 27, 2011, the Company granted 184,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $4.40 and a grant date weighted average fair market value of $2.20. In addition to service conditions, these SARs contain a performance condition. The additional performance condition is based upon the achievement of Return on Invested Capital (ROIC) goals relative to a peer group. All awards with performance conditions are measured over the vesting period and are charged to compensation expense over the requisite service period based on the number of shares expected to vest. The SARs cliff vest after a three-year period from date of grant and expire five years from date of grant.

The grant date fair value for the awards granted during the first quarter of fiscal year 2012 were estimated using the Black Scholes option valuation method with the following weighted average assumptions as of July 27, 2011:

Expected dividend yield	0.00%
Risk free interest rate	1.16%
Expected volatility	65.50%
Expected life	4.00

Total share-based compensation expense recognized during the three and six months ended December 31, 2011 and January 1, 2011 was as follows (in thousands):

	Three Months Ended		Six Months Ended	
	December 31, 2011	**January 1, 2011**	**December 31, 2011**	**January 1, 2011**
Stock Appreciation Rights	$ 154	$ 114	$ 300	$ 256

As of December 31, 2011 total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately $1.0 million. This expense is expected to be recognized over a weighted average period of 1.77 years.

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No options to purchase shares of common stock were exercised during the three months ended December 31, 2011 and 18,334 options to purchase shares of common stock were exercised during the three months ended January 1, 2011, with an immaterial amount of intrinsic value for the three months ended January, 1, 2011. Options to purchase 47,500 and 84,133 shares of common stock were exercised during the six months ended December 31, 2011 and January 1, 2011, respectively, with an immaterial amount of intrinsic value for both periods presented.

Recently Issued Accounting Standards

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04). ASU 2011-04 amends Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements* (ASC 820) by: (1) clarifying that the highest-and-best-use and valuation-premise concepts only apply to measuring the fair value of non-financial assets; (2) allowing a reporting entity to measure the fair value of the net asset or net liability position in a manner consistent with how market participants would price the net risk position, if certain criteria are met; (3) providing a framework for considering whether a premium or discount can be applied in a fair value measurement; (4) providing that the fair value of an instrument classified in a reporting entity s shareholders equity is estimated from the perspective of a market participant that holds the identical item as an asset; and (5) expanding the qualitative and quantitative fair value disclosure requirements. The expanded disclosures include, for Level 3 items, a description of the valuation process and a narrative description of the sensitivity of the fair value to changes in unobservable inputs and interrelationships between those inputs if a change in those inputs would result in a significantly different fair value measurement. ASU 2011-04 also requires disclosures about the highest-and-best-use of a non-financial asset when this use differs from the asset s current use and the reasons for such a difference. In addition, this ASU amends Accounting Standards Codification 820, *Fair Value Measurements*, to require disclosures to include any transfers between Level 1 and Level 2 of the fair value hierarchy. These amendments are effective for fiscal years beginning after December 15, 2011 and for interim periods within those fiscal years. The amendments of ASU 2011-04, when adopted, are not expected to have a material impact on the Company s consolidated financial statements.

In June 2011, the FASB issued Accounting Standards Update 2011-05, *Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 requires entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. Under the two-statement approach, the first statement would include components of net income, and the second statement would include components of other comprehensive income. This ASU does not change the items that must be reported in other comprehensive income. These provisions are effective for fiscal years beginning after December 15, 2011 and for interim periods within those fiscal years; however, early adoption is permitted. The provisions of ASU 2011-05, when adopted, are not expected to have a material impact on the Company s consolidated financial statements.

In December 2011, the FASB issued Accounting Standards Update 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income* in Accounting Standards Update 2011-05. ASU 2011-12 defers only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. The Board has reinstated the requirements for the presentation of reclassifications out of accumulated other comprehensive income that were in place before the issuance of Update 2011-05. The amendments of ASU 2011-12 are not expected to have a material impact on the Company s consolidated financial statements.

In December 2011, the FASB issued Accounting Standards Update 2011-11, *Disclosures about Offsetting Assets and Liabilities*. The amendments in this Update will enhance disclosures required by U.S. GAAP by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement. The amendments are effective for fiscal years beginning after January 1, 2013 and for interim periods within those fiscal years. The amendments of ASU 2011-11 are not expected to have a material impact on the Company s consolidated financial statements.

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3. Inventories

The components of inventories consist of the following (in thousands):

	December 31, 2011	July 2, 2011
Finished goods	$ 7,939	$ 5,660
Work-in-process	5,751	4,821
Raw materials and supplies	39,555	31,073
Total	$ 53,245	$ 41,554

4. Long-Term Debt

Note Payable   Bank

On October 15, 2010, the Company entered into an amended credit agreement with Wells Fargo Bank, N.A. thereby increasing its revolving line of credit facility for up to $30 million and extending the term of the credit agreement to October 15, 2013. On January 30, 2012, the Company entered into a second amendment to the credit agreement thereby extending the term to October 15, 2016. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a Base Rate or a Fixed Rate , as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of the Company s trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The revolving line of credit is secured by substantially all of the assets of the Company.

The Company must comply with certain financial covenants, including a cash flow leverage ratio and a trading ratio. The credit agreement requires the Company to maintain a minimum profit threshold, limits the maximum operating lease expenditures and restricts the Company from declaring or paying dividends in cash or stock. The Company is in compliance with all financial covenants for all periods presented.

As of December 31, 2011, the Company had availability to borrow an additional $22.5 million under the Wells Fargo Bank, N.A. line of credit. The outstanding balance under the credit facility was $7.5 million as of December 31, 2011 and the interest rate being paid on the outstanding balance was in the range of 2.48% - 3.25%. As of July 2, 2011, the outstanding balance under the credit facility was $6.0 million and the interest rate on the outstanding balance was in the range of 2.48% - 3.25%.

5. Income Taxes

The Company has a domestic net operating loss (NOL) and tax credit carryforwards of approximately $10.4 million and $7.7 million, respectively, as of December 31, 2011. In accordance with ASC 740, *Income Taxes*, management assesses the Company s recent operating results and estimated future taxable income. Based on the Company s continued and increased profitability and estimated future repatriation from foreign subsidiaries, the Company believes it is more likely than not that the NOL s and a majority of the tax credits will be fully utilized prior to their expiration. The Company has a valuation allowance of approximately $0.9 million related to certain research and development tax credits at December 31, 2011 because it is anticipated that those credits will expire prior to utilization.

The Company expects to repatriate a portion of its foreign earnings based on increased sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company currently expects to repatriate approximately $8.8 million in the future. As such, earnings are recognized in the United States, and the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax have been recorded as part of deferred taxes as of December 31, 2011. All other unremitted foreign earnings are expected to remain permanently reinvested in planned fixed assets purchases in foreign locations.

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The Company has a wholly owned foreign subsidiary in Mexico that utilizes certain tax credits related to production assets that currently offset all of the income tax liabilities under general Mexican income tax law. However, the Company is subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The Company anticipates that it will be taxable under IETU for the foreseeable future based on projected assets used in its operations. The effect of IETU and an associated presidential decree has been included in the effective tax rate for the quarter ending December 31, 2011.

The Company is required to pay taxes in China on its statutory foreign profits. Its subsidiary in China had statutory profits during the quarter ended December 31, 2011 and it is anticipated that the Chinese subsidiary will utilize the remainder of its NOL carryforward during the fiscal year ending June 30, 2012. Accordingly, there is no valuation allowance related to the Chinese NOL.

The Company s effective tax rate differs from the federal tax rate as follows (in thousands):

	Three Months Ended	
	December 31, 2011	**January 1, 2011**
Federal income tax expense at statutory rate	$ 927	$ 558
Foreign earnings taxed at lower rates	(229)	(551)
Effect of foreign currency rate changes	106	
Recognition of tax credits	(1,469)	
Change in valuation allowance	183	(13)
Other	(21)	(87)
Income tax provision	$ (503)	$ (93)

	Six Months Ended	
	December 31, 2011	**January 1, 2011**
Federal income tax expense at statutory rate	$ 1,441	$ 1,425
Foreign earnings taxed at lower rates	(274)	(542)
Effect of foreign currency rate changes	(151)	
Recognition of tax credits	(1,469)	
Change in valuation allowance	183	(13)
Other	32	(167)
Income tax provision	$ (238)	$ 703

ASC 740 requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. During the fourth quarter of the year ended July 2, 2011, the Company recorded an unrecognized tax benefit of approximately $0.8 million which is related to certain R&D tax credits generated in 2010 and prior years. In the fourth quarter of 2011, a second and distinct unit of account was identified for potential additional R&D credits and the Company initiated a study to analyze the relevant case law and the specific facts and circumstances in this area. During the quarter ended December 31, 2011, the Company recognized an additional $4.0 million of additional tax credits based upon the updated results of this study. For the additional R&D tax credits recorded in December 2011, the Company also recorded $2.0 million of additional unrecognized tax benefits based upon its assessment under ASC 740. The Company accounted for these credits and the related net unrecognized tax benefits as a change in estimate and as a discrete item in December 2011.

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The July 2, 2011 balance sheet in the accompanying financial statements includes two reclassifications that were not reflected in the July 2, 2011 Form 10-K. The reclassifications decreased the short term deferred tax asset by approximately $0.6 million with a corresponding decrease in the current portion of the deferred tax liability. There was also a reclassification to decrease the long term portion of the deferred tax asset by approximately $3.6 million with a corresponding decrease in the deferred tax liability. These balance sheet reclassifications related to the netting of the deferred tax accounts within the same tax jurisdiction and did not impact the Company s working capital, cash flows or income statement accounts and were not material to the July 2, 2011 consolidated financial statements.

6. Earnings Per Share

Basic earnings per share (EPS) is calculated by dividing net income (the numerator) by the weighted-average number of common shares outstanding (the denominator) during the period. Diluted EPS is computed by including both the weighted-average number of shares outstanding and any dilutive common share equivalents in the denominator. The following table presents a reconciliation of the denominator and the number of antidilutive common share awards that were not included in the diluted earnings per share calculation. These antidilutive securities occur when equity awards outstanding have an option price greater than the average market price for the period:

	Three Months Ended (in thousands, except per share information)	
	December 31, 2011	January 1, 2011
Net income	$ 3,174	$ 1,733
Weighted average shares outstanding - basic	10,447	10,345
Effect of dilutive common stock options	32	103
Weighted average shares outstanding - diluted	10,479	10,448
Earnings per share - basic	$ 0.30	$ 0.17
Earnings per share - diluted	$ 0.30	$ 0.17
Antidilutive options not included in diluted earnings per share	707	541

	Six Months Ended (in thousands, except per share information)	
	December 31, 2011	January 1, 2011
Net income	$ 4,421	$ 3,475
Weighted average shares outstanding - basic	10,432	10,321
Effect of dilutive common stock options	30	99
Weighted average shares outstanding - diluted	10,462	10,420
Earnings per share - basic	$ 0.42	$ 0.34
Earnings per share - diluted	$ 0.42	$ 0.33
Antidilutive options not included in diluted earnings per share	707	541

7. Commitments and Contingencies

Purchase Commitments

The Company had no material firm commitments to contractors and suppliers for capital expenditures at December 31, 2011.

Leases

The Company leases certain facilities, equipment, and automobiles under non-cancelable lease agreements. These agreements expire on various dates over the next ten years.

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Warranties

The Company provides warranties on certain product sales. Allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from management s estimates, adjustments to recognize additional cost of sales may be required in future periods. The Company s warranty reserve was approximately $10,000 as of December 31, 2011 and July 2, 2011.

8. Fair Value Measurements

The Company has adopted ASC 820, *Fair Value Measurements*, which defines fair value, establishes a framework for assets and liabilities being measured and reported at fair value and expands disclosures about fair value measurements. There are three levels of fair value hierarchy inputs used to value assets and liabilities which include: Level 1 inputs are quoted market prices for identical assets or liabilities; Level 2 inputs other than quoted market prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and Level 3 inputs are unobservable inputs for the asset or liability.

The following table summarizes the Company s financial assets and liabilities that are required to be measured at fair value on a recurring basis as of December 31, 2011 and July 2, 2011 (in thousands):

	December 31, 2011			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Liabilities:				
Foreign currency forward contracts	$	$ (3,556)	$	$ (3,556)

	July 2, 2011			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$	$ 2,723	$	$ 2,723
Financial Liabilities:				
Foreign currency forward contracts	$	$ (82)	$	$ (82)

The Company currently has forward contracts to hedge known future cash outflows for expenses denominated in the Mexican peso. These contracts are measured on a recurring basis based on the foreign currency spot rates and forward rates quoted by banks or foreign currency dealers. These contracts are marked to market using level 2 input criteria every period with the unrealized gain or loss, net of tax, reported as a component of shareholders equity in accumulated other comprehensive income, as they qualify for hedge accounting.

9. Derivative Financial Instruments

The Company has entered into foreign currency forward contracts which are accounted for as cash flow hedges in accordance with ASC 815, *Derivatives and Hedging*. The effective portion of the gain or loss on the derivative is reported as a component of accumulated other comprehensive income and is reclassified into earnings in the same period in which the underlying hedged transaction affects earnings. The derivative s effectiveness represents the change in fair value of the hedge that offsets the change in fair value of the hedged item.

The Company transacts business in Mexico and is subject to the risk of foreign currency exchange rate fluctuations. The Company enters into foreign currency forward contracts to manage the foreign currency fluctuations for Mexican peso denominated payroll, utility, tax, and accounts payable expenses. The foreign currency forward contracts have terms that were effective to the underlying transactions being hedged.

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As of December 31, 2011, the Company had outstanding foreign currency forward contracts with a total notional amount of $41.9 million. These contract maturity dates extend through June 2014. The Company entered into foreign currency forward contracts of $3.6 million and settled $4.0 million of such contracts during the three months ended December 31, 2011. During the same period of the previous year, the Company entered into foreign currency forward contracts of $2.9 million and settled $3.5 million of such contracts.

For the six months ended December 31, 2011, the Company entered into forward contracts of $12.2 million and settled $8.2 million of such contracts. During the same period of the previous year, the Company entered into foreign currency forward contracts of $6.8 million and settled $7.5 million of such contracts.

Subsequent to December 31, 2011, the Company entered into an additional $5.0 million foreign currency forward contracts.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of December 31, 2011 and July 2, 2011 (in thousands):

Derivatives Designated as Hedging Instruments	Balance Sheet Location	December 31, 2011 Fair Value	July 2, 2011 Fair Value
Foreign currency forward contracts	Other current assets	$	$ 1,645
Foreign currency forward contracts	Other long-term assets	$	$ 1,078
Foreign currency forward contracts	Other current liabilities	$ (839)	$
Foreign currency forward contracts	Other long-term liabilities	$ (2,717)	$ (82)

The following tables summarize the gain on derivative instruments, net of tax, on the Consolidated Statements of Income for the three months ended December 31, 2011 and January 1, 2011, respectively (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of October 1, 2011	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of December 31, 2011
Settled foreign currency forward contracts for the three months ended December 31, 2011	$ (170)	$ 15	$ 155	$
Unsettled foreign currency forward contracts	(2,403)	52		(2,351)
Total	$ (2,573)	$ 67	$ 155	$ (2,351)

Derivatives Designated as Hedging Instruments	AOCI Balance as of October 2, 2010	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of January 1, 2011
Settled foreign currency forward contracts for the three months ended January 1, 2011	$ 107	$ 139	$ (246)	$
Unsettled foreign currency forward contracts	324	517		841
Total	$ 431	$ 656	$ (246)	$ 841

The following tables summarize the gain on derivative instruments, net of tax, on the Consolidated Statements of Income for the six months ended December 31, 2011 and January 1, 2011, respectively (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of July 2, 2011	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of December 31, 2011
Settled foreign currency forward contracts for the six months ended December 31, 2011	$ 534	$ (469)	$ (65)	$
Unsettled foreign currency forward contracts	1,206	(3,557)		(2,351)
Total	$ 1,740	$ (4,026)	$ (65)	$ (2,351)

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Derivatives Designated as Hedging Instruments	AOCI Balance as of July 3, 2010	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of January 1, 2011
Settled foreign currency forward contracts for the six months ended January 1, 2011	$ 173	$ 349	$ (522)	$
Unsettled foreign currency forward contracts	(415)	1,256		841
Total	$ (242)	$ 1,605	$ (522)	$ 841

The Company does not enter into derivative instruments for trading or speculative purposes. The Company s counterparties to the foreign currency forward contracts are major banking institutions. These institutions do not require collateral for the contracts and the Company believes that the risk of the counterparties failing to meet their contractual obligations is remote. As of December 31, 2011, the net amount of existing loss expected to be reclassified into earnings within the next 12 months is approximately ($0.6) million.

As of December 31, 2011, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

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

FORWARD-LOOKING STATEMENTS

References in this report to the Company , Key Tronic , we , our , or us mean Key Tronic Corporation together with its subsidiaries, except where the context otherwise requires.

This Quarterly Report contains forward-looking statements in addition to historical information. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in the forward-looking statements. Risks and uncertainties that might cause such differences include, but are not limited to those outlined in Management s Discussion and Analysis of Financial Condition and Results of Operations Risks and Uncertainties that May Affect Future Results. Readers are cautioned not to place undue reliance on forward-looking statements, which reflect management s opinions only as of the date hereof. The Company undertakes no obligation to update forward-looking statements to reflect developments or information obtained after the date hereof and disclaims any obligation to do so. Readers should carefully review the risk factors described in periodic reports the Company files from time to time with the Securities and Exchange Commission, including Year-end Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Overview

KeyTronicEMS is a leader in electronic manufacturing services and solutions to original equipment manufacturers of a broad range of products. We provide engineering services, worldwide procurement and distribution, materials management, world-class manufacturing and assembly services, in-house testing, and expertise in providing customer service. Our international production capability provides our customers with benefits of improved supply-chain management, reduced inventories, lower transportation costs, and reduced product fulfillment time. We continue to make investments in all of our operating facilities to give us the production capacity and logistical advantages to continue to win new business. The following information should be read in conjunction with the consolidated financial statements included herein and with Item 1A, Risk Factors.

Our mission is to provide our customers with superior manufacturing and engineering services at the lowest total cost for the highest quality products, and create long-term mutually beneficial business relationships.

Executive Summary

Net sales of $84.5 million for the second quarter of fiscal year 2012 increased by 38.4 percent as compared to net sales of $61.0 million for the second quarter of fiscal year 2011. The increase in net sales was primarily driven by an increase in revenues related to new programs for both new and longstanding customers, partially offset by the negative impact of the uncertain macroeconomic environment. We believe that we are well positioned in the electronics manufacturing services (EMS) industry to win new business in coming periods and profitably grow our revenue as the economy recovers.

The concentration of our top five customers sales increased to 71.8 percent of total sales in the second quarter of fiscal year 2012 from 56.2 percent in same period of the prior fiscal year. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies computer accessories and electronic whiteboards. The total number of our customers generating revenue during the second quarter of fiscal year 2012 was 40 customers, as compared to 26 customers during the same period of the previous fiscal year.

Sales to our largest customers may vary significantly from quarter to quarter depending on the size and timing of customer program commencement, forecasts, delays, and design modifications. We remain dependent on continued sales to our significant customers and most contracts with customers are not firm long-term purchase commitments. We seek to maintain flexibility in production capacity by employing skilled temporary and short-term labor and by utilizing short-term leases on equipment and manufacturing facilities. In addition, our capacity and core competencies for printed circuit board assemblies (PCBAs), precision molding, tool making, assembly, and engineering can be applied to a wide variety of products.

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Gross profit as a percent of sales was 8.1 percent for the second quarter of fiscal year 2012 as compared to 8.9 percent for same quarter of the prior fiscal year. The decrease in gross profit as a percentage of net sales was primarily due to an increase in material costs as a percentage of net sales. The increase in material cost was primarily related to a change in the mix of customer programs and a higher material content in certain products, partially offset by increased leverage of certain overhead costs.

Operating income as a percentage of sales for the second quarter of fiscal year 2012 was 3.3 percent compared to 2.8 percent for the same quarter of the prior fiscal year. The increase in operating income as a percentage of sales was primarily due to our continued success in leveraging operating expenses, partially offset by a lower gross margin.

Net income for the second quarter of fiscal 2012 was $3.2 million or $0.30 per diluted share, as compared to $1.7 million or $0.17 per diluted share for the second quarter of fiscal 2011. The increase in net income as a percent of sales for the second quarter of fiscal year 2012 as compared to the same period in fiscal year 2011 is the result of an improvement in operating income as discussed above and in further detail in the Results of Operations section. In addition, the second quarter of fiscal 2012 results included a $1.1 million income tax benefit resulting from the recognition of certain research and development tax credits.

We maintain a strong balance sheet with a current ratio of 2.2 and a long-term debt to equity ratio of 0.11. Total cash provided by operating activities as defined on our cash flow statement was $0.8 million during the six months ended December 31, 2011. We maintain sufficient liquidity for our expected future operations and had $7.5 million in borrowings on our $30.0 million revolving line of credit with Wells Fargo Bank, N.A. of which $22.5 million remained available at December 31, 2011. We believe cash flow generated from operations, our borrowing capacity, and equipment lease financing should provide adequate capital for planned growth.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. These estimates and assumptions are based on historical results as well as future expectations. Actual results could vary from our estimates and assumptions.

The accounting policies and estimates listed below are those that we believe are the most critical to our consolidated financial condition and results of operations. They are also the accounting policies that typically require our most difficult, subjective and complex judgments and estimates, often for matters that are inherently uncertain. Please refer to the discussion of critical accounting policies in our most recent Annual Report on Form 10-K for the fiscal year ended July 2, 2011, for further details.

- Inactive, Obsolete, and Surplus Inventory Reserve
- Allowance for Doubtful Accounts
- Accrued Warranty
- Income Taxes
- Stock-Based Compensation
- Impairment of Long-Lived Assets
- Derivatives and Hedging Activity

RESULTS OF OPERATIONS

Comparison of the Three Months Ended December 31, 2011 with the Three Months Ended January 1, 2011

The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes.

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The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended December 31, 2011 as compared to the three months ended January 1, 2011. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended					
	December 31, 2011	% of net sales	January 1, 2011	% of net sales	$ change	% point change
Net sales	$ 84,454	100.0%	$ 61,038	100.0%	$ 23,416	%
Cost of sales	77,586	91.9	55,592	91.1	21,994	0.8
Gross profit	6,868	8.1	5,446	8.9	1,422	(0.8)
Operating expenses:						
Research, development and engineering	1,157	1.4	961	1.6	196	(0.2)
Selling, general and administrative	2,916	3.5	2,770	4.5	146	(1.0)
Total operating expenses	4,073	4.8	3,731	6.1	342	(1.3)
Operating income	2,795	3.3	1,715	2.8	1,080	0.5
Interest expense, net	124	0.1	75	0.1	49	
Income before income taxes	2,671	3.2	1,640	2.7	1,031	0.5
Income tax benefit	(503)	(0.6)	(93)	(0.2)	(410)	(0.4)
Net income	$ 3,174	3.8%	$ 1,733	2.8%	$ 1,441	1.0%
Effective income tax rate	(18.8)%		(5.7)%			

Net Sales

The increase in net sales from prior year was primarily driven by an approximate $32.3 million increase in revenues related to new programs for both new and longstanding customers. This increase was partially offset by an $8.8 million net decline related to demand from current customer programs, partially offset by the negative impact of program losses of approximately $0.1 million.

During the three months ended December 31, 2011, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and expect to see revenue growth in the second half of our fiscal year, driven by increased production levels of new programs for both new and longstanding customers. Sales in the third quarter of fiscal year 2012 are expected to be in the range of $92 million to $97 million. Future results will depend on actual levels of customers orders, the timing of the start up of production of new product programs and the impact of the industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Gross Profit

Gross profit as a percentage of sales for the three months ended December 31, 2011 was 8.1 percent compared to 8.9 percent for the three months ended January 1, 2011. This 0.8 percentage point decrease is primarily related to a 3.0 percentage points increase in material costs, as a percent of net sales, resulting from higher material content in certain new product offerings, partially offset by a 2.2 percentage points improvement in leveraging of certain overhead costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $178,000 and $72,000 for obsolete inventory during the three months ended December 31, 2011 and January 1, 2011, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were $1.2 million and $1.0 million during the three months ended December 31, 2011 and January 1, 2011, respectively. This $0.2 million increase is primarily related to an increase in labor related expenses resulting from an increase in headcount.

Total research, development, and engineering (RD&E) expenses as a percent of net sales were 1.4 percent and 1.6 percent during the three months ended December 31, 2011 and January 1, 2011, respectively. This 0.2 percentage point improvement in RD&E is primarily related to our continued success in leveraging operating expenses as a percent of net sales.

Total selling general and administrative (SG&A) expenses were $2.9 million during the three months ended December 31, 2011 compared to $2.8 million during the three months ended January 1, 2011. This $0.1 million increase in SG&A during the three months ended December 31, 2011 as compared to the three months ended January 1, 2011 is primarily related to an increase in labor related expenses resulting from an increase in headcount.

Total selling general and administrative (SG&A) expenses as a percent of net sales were 3.5 percent during the three months ended December 31, 2011 compared to 4.5 percent during the three months ended January 1, 2011. This 1.0 percentage point improvement in SG&A is primarily related to our continued success in leveraging operating expenses as a percent of net sales.

Total operating expenses were $4.0 million or 4.8 percent of net sales for the three months ended December 31, 2011 and $3.7 million or 6.1 percent of net sales for the three months ended January 1, 2011. The 1.3 percentage points improvement in operating expenses as a percent of net sales is primarily related to our successful leveraging of RD&E and SG&A expenses as a percent of net sales.

Interest

Interest expense increased to $124,000 during the three months ended December 31, 2011 from $75,000 during the three months ended January 1, 2011. The increase in interest expense is primarily due to an increase in our capital lease obligations and to a lesser extent a decrease in interest income.

Income Taxes

The effective tax rate for the three months ended December 31, 2011 was (18.8) percent compared to (5.7) percent for the same period in fiscal year 2011. The increased tax benefit is primarily attributable to additional Federal R&D tax credits recognized during the second quarter. For further information on taxes see footnote 5 of the Notes to Consolidated Financial Statements .

Our judgments regarding deferred tax assets and liabilities may change due to changes in market conditions, changes in estimates, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance will be adjusted accordingly and any increase or decrease will result in an additional deferred income tax expense or benefit in subsequent periods.

RESULTS OF OPERATIONS

Comparison of the Six Months Ended December 31, 2011 with the Six Months Ended January 1, 2011

The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes.

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The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the six months ended December 31, 2011 as compared to the six months ended January 1, 2011. It is provided to assist in assessing differences in our overall performance (in thousands):

	Six Months Ended					
	December 31, 2011	% of net sales	January 1, 2011	% of net sales	$ change	% point change
Net sales	$ 154,215	100.0%	$ 124,378	100.0%	$ 29,837	%
Cost of sales	142,342	92.3	112,962	90.8	29,380	1.5
Gross profit	11,873	7.7	11,416	9.2	457	(1.5)
Operating expenses:						
Research, development and engineering	2,113	1.4	1,875	1.5	238	(0.1)
Selling, general and administrative	5,350	3.5	5,202	4.2	148	(0.7)
Total operating expenses	7,463	4.8	7,077	5.7	386	(0.9)
Operating income	4,410	2.9	4,339	3.5	71	(0.6)
Interest expense, net	227	0.1	147	0.1	80	
Income before income taxes	4,183	2.7	4,192	3.4	(9)	(0.7)
Income tax (benefit) provision	(238)	(0.2)	717	0.6	(955)	(0.8)
Net income	$ 4,421	2.9%	$ 3,475	2.8%	$ 946	0.1%
Effective income tax rate	(5.7)%		17.1%			

Net Sales

The increase in net sales from prior year was primarily driven by an approximate $54.2 million increase in revenues related to new programs for both new and longstanding customers. This increase was partially offset by a $21.3 million net decline related to decreased demand from current customer programs and to a lesser extent a $3.1 million decline related to program losses.

During the six months ended December 31, 2011, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and expect to see revenue growth in the second half of our fiscal year, driven by increased production levels of new programs for both new and longstanding customers. Sales in the third quarter of fiscal year 2012 are expected to be in the range of $92 million to $97 million. Future results will depend on actual levels of customers   orders, the timing of the start up of production of new product programs and the impact of the industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Gross Profit

Gross profit as a percentage of sales for the six months ended December 31, 2011 was 7.7 percent compared to 9.2 percent for the six months ended January 1, 2011. This 1.5 percentage point decrease is primarily related to a 3.0 percentage points increase in material cost, as a percent of net sales, resulting from higher material content in certain new product offerings partially offset by a 1.5 percentage points improvement in leveraging of certain overhead costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $270,000 and $152,000 for obsolete inventory for the six months ended December 31, 2011 and January 1, 2011, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

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Operating Expenses

Total research, development, and engineering (RD&E) expenses were $2.1 million and $1.9 million during the six months ended December 31, 2011and January 1, 2011, respectively. This $0.2 million increase is primarily related to an increase in labor related expenses resulting from an increase in headcount.

Total research, development, and engineering (RD&E) expenses as a percent of net sales were 1.4 percent and 1.5 percent during the six months ended December 31, 2011 and January 1, 2011, respectively. This 0.1 percentage point improvement in RD&E is primarily related to our continued success in leveraging operating expenses as a percent of net sales.

Total selling general and administrative (SG&A) expenses were $5.4 million and $5.2 million during the six months ended December 31, 2011 and January 1, 2011, respectively. This $0.2 million increase in SG&A during the six months ended December 31, 2011 as compared with the six months ended January 1, 2011 is primarily related to an increase in labor related expenses resulting from an increase in headcount.

Total selling general and administrative (SG&A) expenses as a percent of net sales were 3.5 percent during the six months ended December 31, 2011 compared to 4.2 percent during the six months ended January 1, 2011. This 0.7 percentage point improvement in SG&A is primarily related to our continued success in leveraging operating expenses as a percent of net sales.

Total operating expenses were $7.5 million or 4.8 percent of net sales during the six months ended December 31, 2011 and $7.1 million or 5.7 percent of net sales during the six months ended January 1, 2011. The 0.9 percentage point improvement in operating expenses as a percent of net sales is primarily related to our successful leveraging of RD&E and SG&A expenses as a percent of net sales.

Interest

Interest expense increased to $227,000 during the six months ended December 31, 2011 from $147,000 during the six months ended January 1, 2011. The increase in interest expense is primarily due to an increase in our capital lease obligations and to a lesser extent a decrease in interest income.

Income Taxes

The effective tax rate for the six months ended December 31, 2011 was (5.7) percent compared to 17.1 percent for the same period in fiscal 2011. The decreased effective tax rate is primarily attributable to additional federal R&D tax credits recognized during the second quarter. For further information on taxes see footnote 5 of the Notes to Consolidated Financial Statements .

Our judgments regarding deferred tax assets and liabilities may change due to changes in market conditions, changes in foreign investment requirements, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance will be adjusted accordingly and any increase or decrease will result in an additional deferred income tax expense or benefit in subsequent periods.

Backlog

On December 31, 2011, we had an order backlog of approximately $53.2 million. This compares with a backlog of approximately $37.9 million on January 1, 2011. The increase in backlog at December 31, 2011, when compared to January 1, 2011, reflects an increase in expected revenue during the remainder of fiscal year 2012. Order backlog consists of purchase orders received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash provided by operating activities for the six months ended December 31, 2011 was $0.8 million, compared to net cash used in operating activities of $13.0 million during the same period of the prior fiscal year.

This $13.8 million year-over-year increase is derived from the $0.8 million cash provided by operating activities for the first six months of fiscal 2012 and the $13.0 million cash used in operating activities for the same period of the

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prior year. This year-over-year change is primarily related to an $11.9 million increase in inventory, a $7.0 million increase in accounts receivable, and partially offset by a $15.0 million increase in accounts payable during the six months ended December 31, 2011. As compared to a $13.0 million of cash flows used in operating activities during the six months ended January 1, 2011, which resulted primarily from a $7.0 million increase in inventory, a $4.1 million decrease in accounts payable, and a $3.2 million increase in trade receivables. The increase in inventory and accounts receivable during the six months ended December 31, 2011 was attributable to our revenue growth and anticipated growth in production levels for a number of new programs. The increase in accounts payable during the six months ended December 31, 2011 was primarily driven by the timing of purchases and cash payments resulting from our growth in revenues and production. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases and negotiated supplier terms. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate.

Investing Cash Flow

Cash flows used in investing activities were $2.8 million during the six months ended December 31, 2011 as compared to $2.7 million during the six months ended January 1, 2011. Our investing cash flows primarily consist of capital expenditures to purchase manufacturing facilities and equipment to support production and to a lesser extent leasehold improvements at our corporate headquarters. During the first six months of fiscal year 2012 our investing activities included $1.8 million related to the purchase of a building and land in Juarez, Mexico.

Operating and capital leases are often utilized when potential technical obsolescence and funding requirement advantages outweigh the benefits of equipment ownership. Capital expenditures and periodic lease payments are expected to be financed with internally generated funds.

Financing Cash Flow

Cash flows provided by financing activities were $1.3 million during the six months ended December 31, 2011 as compared to $16.5 million in the same period of the previous fiscal year. Our primary financing activity during the first six months of fiscal year 2012 and 2011 was borrowing and repayment under our revolving line of credit facility. Our credit agreement with Wells Fargo Bank N.A. provides a revolving line of credit facility of up to $30 million, subject to availability. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a Base Rate or a Fixed Rate , as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month LIBOR plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of our trailing four quarters EBITDA.

As of December 31, 2011, we were in compliance with our loan covenants and approximately $22.5 million was available under the revolving line of credit facility. The outstanding balance under the credit facility was $7.5 million as of December 31, 2011 and the interest rate being paid on the outstanding balance was 2.48% 3.25%.

Our cash requirements are affected by the level of current operations and new EMS programs. We believe that projected cash from operations, funds available under the revolving credit facility and leasing capabilities will be sufficient to meet our working and fixed capital requirements for the foreseeable future.

Contractual Obligations

We have included a summary of our Contractual Obligations in our annual report on Form 10-K for the fiscal year ended July 2, 2011. There have been no other material changes in contractual obligations outside the ordinary course of business since July 2, 2011.

RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

The following risks and uncertainties could affect our actual results and could cause results to differ materially from past results or those contemplated by our forward-looking statements. When used herein, the words expects , believes , anticipates and similar expressions are intended to identify forward-looking statements.

Potential Fluctuations in Quarterly Results of Operations

Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global macroeconomic environment, volatility in overall demand for our

customers products, success of customers programs, timing of new programs, new product introductions or technological advances by us, our customers and our competitors, and changes in pricing policies by us, our customers, our suppliers, and our competitors. Our customer base is diverse in the markets they serve, however, decreases in demand, particularly from customers that supply the banking, consumer products, and gambling industries, could affect future quarterly results. Additionally, our customers could be impacted by the illiquidity of the credit markets which could directly impact our operating results.

Component procurement, production schedules, personnel and other resource requirements are based on estimates of customer requirements. Occasionally, our customers may request accelerated production that can stress resources and reduce operating margins. In addition, because many of our operating expenses are relatively fixed, a reduction in customer demand can harm our gross profit and operating results. The products which we manufacture for our customers have relatively short product lifecycles. Therefore, our business, operating results and financial condition are dependent in a significant way on our ability to obtain orders from new customers and new product programs from existing customers.

Operating results can also fluctuate if changes are made to significant estimates and assumptions. Significant estimates and assumptions include the allowance for doubtful receivables, provision for obsolete and non-saleable inventory, stock-based compensation, the valuation allowance on deferred tax assets, impairment of long-lived assets, long-term incentive compensation accrual, and the provision for warranty costs.

Economic Conditions

Recently there have been adverse conditions and uncertainty in the global economy as the result of unstable global financial and credit markets, inflation, and recession. These unfavorable economic conditions and the weakness of the credit market could affect the demand for our customers products. The current global macroeconomic environment may affect some of our customers that could reduce orders and change forecasts which could adversely affect our sales in future periods. Additionally, the financial strength of our customers and suppliers and their ability to obtain and rely on credit financing may affect their ability to fulfill their obligations to us and have an adverse affect on our financial results.

Credit Markets

The current illiquidity and financial instability in the credit markets could adversely impact lenders and potentially limit the ability of our suppliers and customers to borrow. This may affect their ability to fulfill their obligations to us and have an adverse effect on our financial results.

Dependence on Suppliers

We are dependent on many suppliers, including sole source suppliers, to provide key components and raw materials used in manufacturing customers products. We have seen supply shortages in certain electronic components. This can result in longer lead times and the inability to meet our customers request for flexible production and extended shipment dates. Additionally, force majeure issues in Japan have caused supply constraints from some suppliers. If demand for components outpaces supply, capacity delays could affect future operations. Delays in deliveries from suppliers or the inability to obtain sufficient quantities of components and raw materials could cause delays or reductions in shipment of products to our customers which could adversely affect our operating results and damage customer relationships.

Concentration of Credit Risk

Cash and cash equivalents are exposed to concentrations of credit risk. We place our cash with high credit quality institutions. At times, such balances may be in excess of the federal depository insurance limit or may be on deposit at institutions which are not covered by insurance. If such institutions were to become insolvent during which time it held our cash and cash equivalents in excess of the insurance limit, it could be necessary to obtain other credit financing to operate our facilities.

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Competition

The EMS industry is intensely competitive. Competitors may offer customers lower prices on certain high volume programs. This could result in price reductions, reduced margins and loss of market share, all of which would materially and adversely affect our business, operating results, and financial condition. If we were unable to provide comparable or better manufacturing services at a lower cost than our competitors, it could cause sales to decline. In addition, competitors can copy our non-proprietary designs after we have invested in development of products for customers, thereby enabling such competitors to offer lower prices on such products due to savings in development costs.

Concentration of Major Customers

At present, our customer base is concentrated and could become more or less concentrated. There can be no assurance that our principal customers will continue to purchase products from us at current levels. Moreover, we typically do not enter into long-term volume purchase contracts with our customers, and our customers have certain rights to extend or delay the shipment of their orders. We, however, require that our customers contractually agree to buy back inventory purchased within specified lead times to build their products if not used.

The loss of one or more of our major customers, or the reduction, delay or cancellation of orders from such customers, due to economic conditions or other forces, could materially and adversely affect our business, operating results and financial condition. Specifically, some of our major customers provide products to the banking and gambling industries which have been adversely affected by the unfavorable economic environment. The contraction in demand from our customers in these industries could continue to impact our customer orders and continue to have a negative impact on our operations over the foreseeable future. Additionally, if one or more of our customers were to become insolvent or otherwise unable to pay for the manufacturing services provided by us, our operating results and financial condition would be adversely affected.

Foreign Manufacturing Operations and Currencies

Most of the products manufactured by us are produced at our facilities located in Mexico and China. These international operations may be subject to a number of risks, including:

- difficulties in staffing and managing foreign operations;
- political and economic instability (including acts of terrorism, civil unrest, forms of violence and outbreaks of war), which could impact our ability to ship and/or receive product;
- unexpected changes in regulatory requirements and laws;
- longer customer payment cycles and difficulty collecting accounts receivable;
- export duties, import controls and trade barriers (including quotas);
- governmental restrictions on the transfer of funds;
- burdens of complying with a wide variety of foreign laws and labor practices;
- fluctuations in currency exchange rates, which could affect component costs, local payroll, utility and other expenses;

- inability to utilize net operating losses generated by our foreign operations to reduce our U.S. income taxes; and

- our foreign locations may be impacted by hurricanes, earthquakes, water shortages, tsunamis, floods, typhoons, fires, extreme weather conditions and other natural or manmade disasters.

Our operations in certain foreign locations receive favorable income tax treatment in the form of tax credits or other incentives. In the event that such tax incentives are not extended, are repealed, or we no longer qualify for such programs, our taxes may increase, which would reduce our net income.

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us could directly or indirectly affect our financial results. Future currency fluctuations are dependent upon a number of factors and cannot be easily predicted. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. However, unexpected losses could occur from future fluctuations in exchange rates.

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Additionally, certain foreign jurisdictions restrict the amount of cash that can be transferred to the U.S or impose taxes and penalties on such transfers of cash. To the extent we have excess cash in foreign locations that could be used in, or is needed by, our operations in the United States, we may incur significant penalties and/or taxes to repatriate these funds.

Dependence on Key Personnel

Our future success depends in large part on the continued service of our key technical, marketing and management personnel and on our ability to continue to attract and retain qualified employees. There can be no assurance that we will be successful in attracting and retaining such personnel. The loss of key employees could have a material adverse effect on our business, operating results and financial condition.

New Program, New Product, and New Customer Risk

The markets for our customers products is characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and short product life cycles. The introduction of products embodying new technologies or the emergence of new industry standards can render existing products obsolete or unmarketable. Our success will depend upon our customers ability to enhance existing products and to develop and introduce, on a timely and cost-effective basis, new products that keep pace with technological developments and emerging industry standards and address evolving and increasingly sophisticated customer requirements. Failure of our customers to do so could substantially harm our customers competitive positions. There can be no assurance that our customers will be successful in identifying, developing and marketing products that respond to technological change, emerging industry standards or evolving customer requirements.

Start-up costs, the management of labor and equipment resources in connection with the establishment of new programs and new customer relationships, and the need to obtain required resources in advance can adversely affect our gross margins and operating results. These factors are particularly evident in the ramping stages of new programs. These factors also affect our ability to efficiently use labor and equipment. We are currently managing a number of new programs. Consequently, our exposure to these factors has increased. In addition, if any of these new programs or new customer relationships were terminated, our operating results could be harmed, particularly in the short term. We may not be able to recoup these start-up costs or replace anticipated new program revenues.

Interest Rate Risk

We are exposed to interest rate risk under our revolving line of credit with interest rates based on various levels of margin added to published prime rate and LIBOR rates depending on the calculation of a certain financial covenant.

Compliance with Current and Future Environmental Regulation

We are subject to a variety of domestic and foreign environmental regulations relating to the use, storage, and disposal of materials used in our manufacturing processes. If we fail to comply with any present or future regulations, we could be subject to future liabilities or the suspension of current manufacturing operations. In addition, such regulations could restrict our ability to expand our operations or could require us to acquire costly equipment, substitute materials, or incur other significant expenses to comply with government regulations.

Dilution and Stock Price Volatility

Holders of the common stock will suffer immediate dilution to the extent outstanding equity awards are exercised to purchase common stock. Our stock price may be subject to wide fluctuations and possible rapid increases or declines over a short time period. These fluctuations may be due to factors specific to us such as variations in quarterly operating results or changes in earnings estimates, or to factors relating to the EMS industry or to the securities markets in general, which, in recent years, have experienced significant price fluctuations. These fluctuations often have been unrelated to the operating performance of the specific companies whose stocks are traded.

Disclosure and Internal Controls

Management does not expect that our disclosure controls and internal controls and procedures will prevent all errors or fraud. A control system is designed to give reasonable, but not absolute, assurance that the objectives of the control system are met. In addition, any control system reflects resource constraints and the benefits of controls must be considered relative to their costs. Inherent limitations of a control system may include: judgments in decision making may be faulty, breakdowns can occur simply because of error or mistake and controls can be circumvented by collusion or management override. Due to the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

Managing Growth

Our business is experiencing rapid growth which can place considerable additional demands upon our management team and our operational, financial and management information systems. Our ability to manage growth effectively requires us to continue to implement and improve these systems; avoid cost overruns; maintain customer, supplier and other favorable business relationships during possible transition periods; continue to develop the management skills of our managers and supervisors; and continue to train, motivate and manage our employees. Our failure to effectively manage growth could have a material adverse effect on our results of operations.

Manufacturing Process

We manufacture and design products to our customers specifications, and, in some cases, our manufacturing processes and facilities may need to comply with applicable statutory and regulatory requirements. For example, medical devices that we manufacture or design, as well as the facilities and manufacturing processes that we use to produce them, are regulated by the Food and Drug Administration and non-U.S. counterparts of this agency. In addition, our customers products and the manufacturing processes that we use to produce them often are highly complex. As a result, products that we manufacture may at times contain manufacturing or design defects, and our manufacturing processes may be subject to errors or not be in compliance with applicable statutory and regulatory requirements. Defects in the products we manufacture or design, whether caused by a design, manufacturing or component failure or error, or deficiencies in our manufacturing processes, may result in delayed shipments to customers or reduced or cancelled customer orders. If these defects or deficiencies are significant, our business reputation may also be damaged. The failure of the products that we manufacture or our manufacturing processes and facilities to comply with applicable statutory and regulatory requirements may subject us to legal fines or penalties and, in some cases, require us to shut down or incur considerable expense to correct a manufacturing process or facility. In addition, these defects may result in liability claims against us or expose us to liability to pay for the recall of a product. Even if our customers are responsible for the defects, they may not, or may not have resources to, assume responsibility for any costs or liabilities arising from these defects, which could expose us to additional liability claims.

Energy Prices

Certain components that we use in our manufacturing process are petroleum-based. In addition, we, along with our suppliers and customers, rely on various energy sources in our transportation activities. While significant uncertainty currently exists about the future levels of energy prices, a significant increase is possible. Increased energy prices could cause an increase to our raw material costs and transportation costs. In addition, increased transportation costs of certain of our suppliers and customers could be passed along to us. We may not be able to increase our product prices enough to offset these increased costs. In addition, any increase in our product prices may reduce our future customer orders and profitability.

Computer Viruses and Similar Events

We rely on information technology networks and systems to process, transmit and store electronic information. In particular, we depend on our information technology infrastructure for a variety of functions, including worldwide financial reporting, inventory management, procurement, invoicing and email communications. Any of these systems may be susceptible to outages due to fire, floods, power loss, telecommunications failures, terrorist attacks and similar events. Despite the implementation of network security measures, our systems and those of third parties on which we rely may also be vulnerable to computer viruses, break-ins and similar disruptions. If we or our vendors are unable to prevent such outages and breaches, our operations could be disrupted.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

We are subject to the risk of fluctuating interest rates in the normal course of business. Our major market risk relates to our secured debt. Our revolving credit facility is secured by substantially all of our assets. The interest rates applicable to our revolving credit facility fluctuate with the JP Morgan Chase Bank prime rate and LIBOR rates. There was outstanding $7.5 million in borrowings under our revolving credit facility as of December 31, 2011, and the range of interest being paid on the outstanding balance was 2.48% - 3.25%. See Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity and Note 4 Long-Term Debt to the Consolidated Financial Statements for additional information regarding our revolving line of credit.

Foreign Currency Exchange Risk

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us would directly or indirectly affect our financial results. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There was outstanding $41.9 million of foreign currency forward contracts as of December 31, 2011. The fair value of these contracts was $3.6 million. See Note 9 Derivative Financial Instruments to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company s Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of December 31, 2011, the Company s disclosure controls and procedures are effective based on that criteria.

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during our second quarter ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting (as defined in Exchange Act Rules 13a 15(f) and 15d 15(f)).

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PART II. OTHER INFORMATION:

Item 1. Legal Proceedings

We are involved in various legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Item 1A. Risk Factors

Information regarding risk factors appear in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 3, Quantitative and Qualitative Disclosures about Market Risk of this Form 10-Q.

There are no material changes to the risk factors set forth in Part I Item 1A in the Company s Annual Report on Form 10-K for the year ended July 2, 2011.

Item 4. Removed and Reserved

Item 6. Exhibits

(31.1)	Certification of Chief Executive Officer (Exchange Act Rules 13(a)-14 and 15(d)-14)
(31.2)	Certification of Chief Financial Officer (Exchange Act Rules 13(a)-14 and 15(d)-14)
(32.1)	Certification of Chief Executive Officer (18 U.S.C. 1350)
(32.2)	Certification of Chief Financial Officer (18 U.S.C. 1350)
101.INS	XBRL Instance Document *
101.SCH	XBRL Taxonomy Extension Schema Document *
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document *
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document *
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document *

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities and Exchange Act of 1934, as amended and otherwise are not subject to liability under those sections.

SIGNATURES

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

KEY TRONIC CORPORATION

/s/ Craig D. Gates
Craig D. Gates
President and Chief Executive Officer

Date: February 13, 2012

(Principal Executive Officer)

/s/ RONALD F. KLAWITTER
Ronald F. Klawitter
Executive Vice President of Administration, Chief Financial Officer and Treasurer
(Principal Financial Officer)

Date: February 13, 2012

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