

KEY TRONIC CORP
Form 10-Q
February 04, 2016

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

FORM 10-Q

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

FOR THE PERIOD ENDED DECEMBER 26, 2015

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 (State of Incorporation) N. 4424 Sullivan Road Spokane Valley, Washington 99216 (509) 928-8000	91-0849125 (I.R.S. Employer Identification No.)
---	--

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 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 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

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

As of January 22, 2016, 10,710,606 shares of common stock, no par value (the only class of common stock), were outstanding.

KEY TRONIC CORPORATION

Index

	Page No.
PART I. <u>FINANCIAL INFORMATION:</u>	
Item 1. <u>Financial Statements (Unaudited):</u>	<u>3</u>
<u>Consolidated Balance Sheets</u>	<u>3</u>
<u>Consolidated Statements of Income</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income (Loss)</u>	<u>5</u>
<u>Consolidated Statements of Cash Flows</u>	<u>6</u>
<u>Consolidated Statements of Shareholders' Equity</u>	<u>7</u>
<u>Notes to Consolidated Financial Statements</u>	8-18
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19-31
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>32</u>
Item 4. <u>Controls and Procedures</u>	<u>32</u>
PART II. <u>OTHER INFORMATION:</u>	
Item 1. <u>Legal Proceedings</u>	<u>33</u>
Item 1A. <u>Risk Factors</u>	<u>33</u>
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds*	
Item 3. Defaults upon Senior Securities*	
Item 4. Mine Safety Disclosures*	
Item 5. Other Information*	
Item 6. <u>Exhibits</u>	<u>33</u>
<u>Signatures</u>	<u>34</u>

* Items are not applicable

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

PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands)

	December 26, 2015	June 27, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	\$1,193	\$372
Trade receivables, net of allowance for doubtful accounts of \$210 and \$97	60,840	72,852
Inventories	97,909	91,594
Other	14,226	13,646
Total current assets	174,168	178,464
Property, plant and equipment, net	26,032	26,974
Other assets:		
Deferred income tax asset	9,631	6,723
Goodwill	9,957	9,957
Other intangible assets, net	6,492	7,055
Other	1,660	1,621
Total other assets	27,740	25,356
Total assets	\$227,940	\$230,794
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$56,839	\$61,528
Accrued compensation and vacation	7,382	9,467
Current portion of debt	5,000	5,000
Other	13,999	10,794
Total current liabilities	83,220	86,789
Long-term liabilities:		
Term loan	23,750	26,250
Revolving loan	12,660	11,631
Deferred income tax liability	—	501
Other long-term obligations	6,423	4,855
Total long-term liabilities	42,833	43,237
Total liabilities	126,053	130,026
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,711 and 10,706 shares, respectively	44,944	44,136
Retained earnings	63,999	61,395
Accumulated other comprehensive loss	(7,056	) (4,763
Total shareholders' equity	101,887	100,768
Total liabilities and shareholders' equity	\$227,940	\$230,794
See accompanying notes to consolidated financial statements.		

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited, in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	December 26, 2015	December 27, 2014	December 26, 2015	December 27, 2014
Net sales	\$116,403	\$114,311	\$242,612	\$200,653
Cost of sales	107,293	105,072	224,583	187,176
Gross profit	9,110	9,239	18,029	13,477
Research, development and engineering expenses	1,506	1,297	3,062	2,633
Selling, general and administrative expenses	5,201	5,425	10,784	10,032
Total operating expenses	6,707	6,722	13,846	12,665
Operating income	2,403	2,517	4,183	812
Interest expense, net	521	404	1,054	593
Income before income taxes	1,882	2,113	3,129	219
Income tax provision	95	487	525	116
Net income	\$1,787	\$1,626	\$2,604	\$103
Net income per share — Basic	\$0.17	\$0.15	\$0.24	\$0.01
Weighted average shares outstanding — Basic	10,710	10,552	10,708	10,550
Net income per share — Diluted	\$0.16	\$0.14	\$0.23	\$0.01
Weighted average shares outstanding — Diluted	11,418	11,471	11,279	11,442

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited, in thousands)

	Three Months Ended		Six Months Ended	
	December 26, 2015	December 27, 2014	December 26, 2015	December 27, 2014
Comprehensive income (loss):				
Net income	\$1,787	\$1,626	\$2,604	\$103
Other comprehensive income (loss):				
Unrealized gain (loss) on hedging instruments, net of tax	687	(3,564	) (2,293	) (5,350
Comprehensive income (loss)	\$2,474	\$(1,938	) \$311	\$(5,247

Other comprehensive income (loss) for the three months ended December 26, 2015 and December 27, 2014 is reflected net of tax provision (benefit) of approximately \$0.4 million and \$(1.8) million, respectively. Other comprehensive income (loss) for the six months ended December 26, 2015 and December 27, 2014 is reflected net of tax benefit of approximately \$(1.2) million and \$(2.8) million, respectively.

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW
(Unaudited, in thousands)

	Six Months Ended	
	December 26, 2015	December 27, 2014
Operating activities:		
Net income	\$2,604	\$103
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	3,034	2,808
Excess tax benefit from share-based compensation	(402)	(50)
Provision for obsolete inventory	515	139
Provision for warranty	40	42
(Recovery of) provision for doubtful accounts	(19)	84
Gain on disposal of assets	—	(6)
Share-based compensation expense	426	344
Deferred income taxes	(2,227)	3,588
Changes in operating assets and liabilities, net of acquisition:		
Trade receivables	12,031	2,274
Inventories	(6,830)	5,902
Other assets	(756)	(3,499)
Accounts payable	(4,689)	(584)
Accrued compensation and vacation	(2,085)	(2,321)
Other liabilities	1,665	(3,661)
Cash provided by operating activities	3,307	5,163
Investing activities:		
Payment for acquisition, net of cash acquired	—	(47,964)
Purchase of property and equipment	(7,544)	(4,701)
Proceeds from sale of fixed assets	6,183	3,924
Cash used in investing activities	(1,361)	(48,741)
Financing activities:		
Payment of financing costs	(56)	(11)
Proceeds from issuance of long term debt	—	35,000
Repayments of long term debt	(2,500)	(1,250)
Borrowings under revolving credit agreement	101,397	69,050
Repayment of revolving credit agreement	(100,368)	(57,058)
Proceeds from accounts receivable purchase agreement	—	1,147
Payments towards accounts receivable purchase agreement	—	(8,969)
Excess tax benefit from share-based compensation	402	50
Proceeds from exercise of stock options	—	17
Cash (used in) provided by financing activities	(1,125)	37,976
Net increase (decrease) in cash and cash equivalents	821	(5,602)
Cash and cash equivalents, beginning of period	372	5,803
Cash and cash equivalents, end of period	\$1,193	\$201
Supplemental cash flow information:		
Interest payments	\$1,032	\$664
Income tax payments, net of refunds	\$836	\$1,788
See accompanying notes to consolidated financial statements.		

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Unaudited, in thousands)

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balances, June 27, 2015	10,706	\$44,136	\$61,395	\$(4,763)	) \$100,768
Net income	—	—	2,604	—	2,604
Unrealized loss on hedging instruments, net	—	—	—	(2,293)	) (2,293)
Exercise of stock appreciation rights	13	—	—	—	—
Shares withheld for taxes	(8)	) (20)	) —	—	(20)
Share-based compensation		426	—	—	426
Excess tax benefit from share-based compensation		402	—	—	402
Balances, December 26, 2015	10,711	\$44,944	\$63,999	\$(7,056)	) \$101,887

See accompanying notes to consolidated financial statements.

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 June 27, 2015. 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 26, 2015 and December 27, 2014 were 13 and 26 week periods, respectively. Fiscal year 2016 will end on July 2, 2016 which is a 53 week year. Fiscal year 2015 which ended on June 27, 2015, was a 52 week year.

2. Significant Accounting Policies

Reclassifications

Certain prior period reclassifications were made to conform with the current period presentation. These reclassifications had no effect on reported income, comprehensive income, cash flows, total assets, or shareholders' equity as previously reported.

Earnings Per Common Share

Basic earnings per common share (EPS) is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted EPS is computed by dividing net income (loss) by the 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 EPS does not assume conversion, exercise, or contingent issuance of common stock equivalent shares that would have an anti-dilutive effect on EPS.

Derivative Instruments and Hedging Activities

The Company has entered into foreign currency forward contracts and an interest rate swap 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 (AOCI) 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 uses derivatives to manage the variability of foreign currency fluctuations of expenses in our Mexico facilities and interest rate risk associated with certain borrowings under the Company's debt arrangement. The foreign currency forward contracts and interest rate swaps have terms that are matched to the underlying transactions being hedged. As a result, these transactions fully offset the hedged risk and no ineffectiveness has been recorded.

The Company's foreign currency forward contracts and interest rate swaps potentially expose the Company to credit risk to the extent the counterparties may be unable to meet the terms of the agreement. The Company minimizes such risk by seeking high quality counterparties. The Company's counterparties to the foreign currency forward contracts and interest rate swaps 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. The

Company does not enter into derivative instruments for trading or speculative purposes.

8

Income Taxes

We compute our interim income tax provision through the use of an estimated annual effective tax rate (ETR) applied to year-to-date operating results and specific events that are discretely recognized as they occur. In determining the estimated annual ETR, we analyze various factors, including projections of our annual earnings, taxing jurisdictions in which the earnings will be generated, the impact of state and local income taxes, our ability to use tax credits and net operating loss carryforwards, and available tax planning alternatives. Discrete items, including the effect of changes in tax laws, tax rates, and certain circumstances with respect to valuation allowances or other unusual or non-recurring tax adjustments, are reflected in the period in which they occur as an addition to, or reduction from, the income tax provision, rather than included in the estimated annual ETR. Refer to Note 6 for further discussions.

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 1998 through the present remain open to examination by the major U.S. taxing jurisdictions to which we are subject.

Impairment of Goodwill and Other Intangible Assets

The Company records intangible assets that are acquired individually or with a group of other assets in the financial statements at acquisition. In accordance with ASC 350, Goodwill and Other Intangible Assets, goodwill and intangible assets acquired in a business combination and determined to have an indefinite useful life are not amortized but are required to be reviewed for impairment at least annually or when events or circumstances indicate that carrying value may exceed fair value. The Company's acquired intangible assets are subject to amortization over their estimated useful lives and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an intangible asset may not be recoverable.

Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09 (ASU 2014-09), Revenue from Contracts with Customers. The guidance in this Update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under current guidance. This may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. In August 2015, the FASB issued an amendment to defer the effective date of ASU 2014-09 for all entities by one year. This Update is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016. Companies have the option of using either a full or modified

retrospective approach in applying this standard. The Company is in the process of assessing the impact of ASU 2014-09 on its consolidated financial statements.

In August 2014, the FASB issued Accounting Standards Update 2014-15 (ASU 2014-15), Presentation of Financial Statements - Going Concern. The guidance in this Update applies to all entities. The amendments require management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the amendments (1) provide a definition of the term substantial doubt, (2) require an evaluation every reporting period including interim periods, (3) provide principles for considering the mitigating effect of management's plans, (4) require certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) require an express statement and other disclosures when substantial doubt is not alleviated, and (6) require an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The amendments of ASU 2014-15, when adopted, are not expected to have a material impact on the Company's consolidated financial statements.

In April 2015, the FASB issued Accounting Standards Update 2015-03 (ASU 2015-03), Simplifying the Presentation of Debt Issuance Costs. The guidance in this Update changes the presentation of debt issuance costs in financial statements. Under the new guidance, an entity presents such costs in the balance sheet as a direct deduction from the related debt liability rather than as an asset. Amortization of the costs is reported as interest expense. This guidance is effective for the Company beginning in the first quarter of fiscal year 2017 and early adoption is permitted in an interim period with any adjustments reflected as of the beginning of the fiscal year that includes that interim period. The guidance is not expected to have a significant impact to the Company's consolidated financial statements.

In July 2015, the FASB issued final guidance that simplifies the subsequent measurement of inventory for which cost is determined by methods other than last-in first-out ("LIFO") and the retail inventory method. For inventory within the scope of the new guidance, entities will be required to compare the cost of inventory to only one measure, its net realizable value, and not the three measures required by the existing guidance. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The new guidance should not change how entities initially measure the cost of inventory. The guidance will be effective for the Company in the fiscal year beginning July 3, 2017. Early adoption is permitted. We have not yet determined the impact this new guidance may have on our financial statements.

In September 2015, the FASB issued Accounting Standards Update 2015-16 (ASU 2015-16), Simplifying the Accounting for Measurement-Period Adjustments. The amendments in this Update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this Update require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. We are currently evaluating the impact of adopting this new guidance on our consolidated financial statements.

In November 2015, the FASB issued Accounting Standards Update 2015-17, Income Taxes. The amendments in this Update require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The guidance will be effective for the Company beginning after December 15, 2016, and interim periods within those annual periods. Earlier application is permitted for all entities. The Company retrospectively adopted this ASU during the second quarter of fiscal year 2016. The following table summarizes the adjustments made to conform prior period classifications with the new guidance (in thousands):

	June 27, 2015		
	As Filed	Reclass	As Adjusted
Current deferred income tax assets	\$6,643	\$(6,643)) \$—
Long-term deferred income tax assets	80	6,643	6,723
Long-term deferred income tax liabilities	(501)	) —	(501)
Net deferred tax assets	\$6,222	\$—	\$6,222

3. Inventories

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

	December 26, 2015	June 27, 2015
Finished goods	\$11,307	\$8,019
Work-in-process	16,997	15,220
Raw materials and supplies	69,605	68,355
	\$97,909	\$91,594

4. Long-Term Debt

On September 3, 2014, the Company added a five-year term loan in the amount of \$35.0 million used to acquire all of the outstanding shares of CDR Manufacturing, Inc. (dba Ayrshire Electronics). For further information on the acquisition of Ayrshire, see footnote 12 of the “Notes to Consolidated Financial Statements.” On August 6, 2015, the Company entered into a First Amendment to the amended and restated credit agreement extending the limit on our line of credit facility to \$45.0 million as evidenced by the Second Replacement Revolving Note.

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 the 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 1.75%, LIBOR plus 2.00%, or LIBOR plus 2.25% 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.

As of December 26, 2015, the Company had an outstanding balance under the credit facility of \$12.7 million, \$0.4 million in outstanding letters of credit and \$31.9 million available for future borrowings. The interest rate on the outstanding line of credit balance was in the range of 2.33% - 3.50%. As of June 27, 2015, the Company had an outstanding balance under the credit facility of \$11.6 million, \$0.3 million in outstanding letters of credit and \$18.0 million available for future borrowings. The interest rate on the outstanding line of credit balance was in the range of 2.28% - 3.25%.

The outstanding principal balance of the term loan bears interest at a fixed rate per annum of the daily one month LIBOR plus 1.75%, 2.00% or 2.25% depending on the ratio of the Company’s funded debt to EBITDA, except that the term loan bore interest at LIBOR plus 2.00% from September 3, 2014 through December 14, 2014 regardless of the Company’s cash flow leverage ratio. Principal on the term loan is payable in equal quarterly installments of \$1.25 million which commenced on December 15, 2014 and will continue through June 15, 2019, with a final installment of all remaining unpaid principal due on August 31, 2019. The Company had an outstanding balance of \$28.8 million under the term loan as of December 26, 2015. As of June 27, 2015, the Company had an outstanding balance of \$31.3 million under the term loan.

The Company must comply with certain financial covenants, including a cash flow leverage ratio, an asset coverage ratio, and a fixed charge coverage ratio. The credit agreement requires the Company to maintain a minimum profit threshold, limits the maximum capital lease expenditures and restricts the Company from declaring or paying dividends in cash or stock without prior bank approval. The Company is in compliance with all financial covenants for all periods presented.

5. Trade Accounts Receivable Purchase Programs

Sale Programs

On June 25, 2014, the Company entered into an Account Purchase Agreement with Wells Fargo Bank, N.A. (“WFB”) which provides that the Company may sell and assign to WFB and WFB may purchase from the Company the accounts receivable of certain Company customers in a maximum aggregate amount of \$50.0 million. The initial term of the agreement is 36 months with successive 12 month renewal terms. On December 18, 2014, the Company modified the original Account Purchase Agreement with WFB to allow the Company to account for the factored receivables as a true-sale. On July 16, 2015, the Company modified the Account Purchase Agreement with WFB to

decrease the maximum aggregate amount of receivables available to factor from \$50.0 million to \$20.0 million. The decrease in the aggregate amount available was due to a change in customer mix and to reduce fees related to the program. The Company also has an Account Purchase Agreement with Orbian Financial Services ("Orbian") which allows the Company to account for factored receivables as a true-sale.

Total accounts receivables sold during the six months ended December 26, 2015 and December 27, 2014 was approximately \$34.8 million and \$3.3 million, respectively. Accounts receivables sold and not yet collected was \$1.4 million and \$0.9 million as of December 26, 2015 and June 27, 2015, respectively. The receivables that were sold were removed from the condensed consolidated balance sheets and the cash received is reflected as cash provided by operating activities in the condensed consolidated statements of cash flows.

6. Income Taxes

The Company expects to repatriate a portion of its foreign earnings based on increased net 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 \$10.8 million of foreign earnings in the future. As such, these earnings would be 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 of expected repatriation of foreign earnings have been recorded as part of deferred taxes as of December 26, 2015. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed assets purchases and improvements in foreign locations.

The Company has available approximately \$6.6 million of gross federal research and development tax credits as of December 26, 2015. 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. Accordingly, as of December 26, 2015, the Company has recorded \$3.7 million of unrecognized tax benefits associated with these federal tax credits, resulting in a net deferred tax benefit of approximately \$2.9 million.

7. Earnings Per Share

The following tables present a reconciliation of the denominator in the basic and diluted EPS calculation 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 26, 2015	December 27, 2014
Net income	\$ 1,787	\$ 1,626
Weighted average shares outstanding—basic	10,710	10,552
Effect of dilutive common stock awards	708	919
Weighted average shares outstanding—diluted	11,418	11,471
Net income per share—basic	\$ 0.17	\$ 0.15
Net income per share—diluted	\$ 0.16	\$ 0.14
Antidilutive SARs not included in diluted earnings per share	456	208
	Six Months Ended	
	(in thousands, except per share information)	
	December 26, 2015	December 27, 2014
Net income	\$ 2,604	\$ 103
Weighted average shares outstanding—basic	10,708	10,550
Effect of dilutive common stock awards	571	892
Weighted average shares outstanding—diluted	11,279	11,442
Earnings per share—basic	\$ 0.24	\$ 0.01
Earnings per share—diluted	\$ 0.23	\$ 0.01
Antidilutive SARs not included in diluted earnings per share	456	208

8. 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, research, development and engineering, 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.

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 evaluated quarterly to determine the likelihood that performance metrics will be achieved during the performance period. These awards 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 below were estimated using the Black Scholes option valuation method:

	July 29, 2015	October 31, 2014
SARs Granted	248,166	213,166
Strike Price	\$10.26	\$8.22
Fair Value	\$3.65	\$3.04

Total share-based compensation expense recognized during the three months ended December 26, 2015 and December 27, 2014 was approximately \$237,000 and \$179,000, respectively. Total share-based compensation recognized during the six months ended December 26, 2015 and December 27, 2014 was approximately \$426,000 and \$344,000, respectively. As of December 26, 2015, total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately \$1.3 million. This expense is expected to be recognized over a weighted average period of 2.10 years.

During the three months ended December 26, 2015, 10,000 SARs were exercised, with an immaterial amount of intrinsic value. No options to purchase shares of common stock or SARs were exercised during the three months ended December 27, 2014. During the six months ended December 26, 2015, 13,333 SARs were exercised, with an immaterial amount of intrinsic value. During the six months ended December 27, 2014, 4,930 options to purchase shares of common stock were exercised, with an immaterial amount of intrinsic value.

9. Commitments and Contingencies

Litigation and Other Matters

The Company is party to certain lawsuits or claims in the ordinary course of business. The Company does not believe that these proceedings, individually or in the aggregate, will have a material adverse effect on the financial position, results of operations or cash flow of the Company.

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 \$42,000 and \$115,000 as of December 26, 2015 and June 27, 2015, respectively.

10. 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 fair value of assets/(liabilities) of the Company's derivatives that are required to be measured on a recurring basis as of December 26, 2015 and June 27, 2015 (in thousands):

	December 26, 2015			Total
	Level 1	Level 2	Level 3	Fair Value
Financial Liabilities:				
Interest rate swaps	\$—	\$ (436)	\$—	\$ (436)
Foreign currency forward contracts	\$—	\$ (10,256)	\$—	\$ (10,256)
	June 27, 2015			
	Level 1	Level 2	Level 3	Total
				Fair Value
Financial Assets:				
Interest rate swaps	\$—	\$ 25	\$—	\$ 25
Financial Liabilities:				
Interest rate swaps	\$—	\$ (443)	\$—	\$ (443)
Foreign currency forward contracts	\$—	\$ (6,799)	\$—	\$ (6,799)

The Company currently has forward contracts to hedge known future cash outflows for expenses denominated in the Mexican peso and interest rate swaps to mitigate risk associated with certain borrowings under the Company's debt arrangement. 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 loss, as they qualify for hedge accounting.

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at December 26, 2015 and June 27, 2015, reasonably approximate their fair value. The Company's long-term debt primarily consists of a revolving line of credit and a term loan. Borrowings under the revolving line of credit bear interest at either a "Base Rate" or a "Fixed Rate," as elected by the Company. Each of these rates is a variable floating rate dependent upon current market conditions and the Company's current credit risk as discussed in footnote 4.

As a result of the determinable market rate for our revolving credit and term loan debt, they are classified within Level 2 of the fair value hierarchy. The discounted cash flow of the revolving line of credit is estimated to be \$12.7 million and \$11.6 million as of December 26, 2015 and June 27, 2015, respectively, with a carrying value that reasonably approximates the fair value. The discounted cash flow of the term loan is estimated to be \$28.8 million as of December 26, 2015 and \$31.3 million as of June 27, 2015, respectively, with a carrying value that reasonably approximates the fair value.

11. Derivative Financial Instruments

As of December 26, 2015, the Company had outstanding foreign currency forward contracts with a total notional amount of \$66.5 million. The maturity dates for these contracts extend through December 2018. For the three months ended December 26, 2015, the Company did not enter into foreign currency forward contracts and settled \$5.2 million of such contracts. During the same period of the previous year, the Company entered into \$5.7 million of foreign currency forward contracts and settled \$5.0 million of such contracts.

For the six months ended December 26, 2015, the Company entered into foreign currency forward contracts of \$12.0 million and settled \$10.6 million of such contracts. During the same period of the previous year, the Company entered into foreign currency forward contracts of \$17.3 million and settled \$10.3 million of such contracts.

On October 1, 2014, the Company entered into an interest rate swap contract with an effective date of September 1, 2015 and a termination date of September 3, 2019, with a notional amount of \$25.0 million related to the borrowings outstanding under the term loan and line of credit. This interest rate swap pays the Company variable interest at the one month LIBOR rate, and the Company pays the counter party a fixed interest rate. The fixed interest rate for the contract is 1.97% that replaces the one month LIBOR rate component of our contractual interest to be paid to WFB as

part of our debt facilities. Based on the terms of the interest rate swap contract and the underlying borrowings outstanding under the term loan, the interest rate contract was determined to be effective, and thus qualifies as a cash flow hedge.

Edgar Filing: KEY TRONIC CORP - Form 10-Q

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of June 28, 2014	Portion Recorded In AOCI	Reclassified From AOCI Into Cost of Sales	AOCI Balance as of December 27, 2014
Forward Contracts	Cost of sales	\$2,403	\$(4,419	) \$(790	) \$(2,806)
Interest rate swap	Interest expense	—	(141	) —	(141)
Total		\$2,403	\$(4,560	) \$(790	) \$(2,947)

15

The Company does not enter into derivative instruments for trading or speculative purposes. The Company's counterparties to the foreign currency forward contracts and interest rate swaps are major financial 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 26, 2015, the net amount of unrealized loss expected to be reclassified into earnings within the next 12 months is approximately \$2.8 million. As of December 26, 2015, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

12. Acquisition

On September 3, 2014, the Company acquired all of the outstanding stock of Ayrshire, resulting in Ayrshire becoming a wholly owned subsidiary of the Company. Ayrshire provides printed circuit board assembly and other electronic manufacturing services to a diversified customer base through manufacturing facilities operated by Ayrshire or its subsidiaries in Minnesota, Arkansas, Mississippi, and Kentucky and through a sheltered maquiladora facility in Reynosa, Mexico. The Reynosa, Mexico operations were moved to the Company's existing facility in Juarez, Mexico. This acquisition expands our printed circuit board assembly capacity, total revenue, and adds to and diversifies our customer base with the addition of many new multi-national companies. The total cash payment of approximately \$48.0 million was funded through borrowings on our term loan, revolving line of credit, and cash on hand. The Company incurred approximately \$775,000 of costs related to due diligence and closing this acquisition.

The following table summarizes the purchase price paid for Ayrshire and the fair value of the assets acquired and liabilities assumed as of the date of acquisition (in thousands):

	Estimated Fair Values At September 3, 2014	
Purchase price paid	\$48,010	
Cash acquired	(46)
Purchase price, net of cash received	\$47,964	
Cash	\$46	
Accounts Receivable	21,211	
Inventories	21,772	
Other Current Assets	1,013	
Fixed Assets	7,823	
Favorable Leases	2,941	
Customer Relationships	2,833	
Non-Compete Agreements	196	
Goodwill	8,217	
Other Assets	42	
Accounts Payable	(11,070)
Accrued Salaries and Wages	(2,188)
Other Current Liabilities	(2,408)
Deferred Tax Liability	(2,418)
Fair Value of Assets Acquired	\$48,010	

The Ayrshire acquisition was accounted for using the acquisition method of accounting whereby the total purchase price is allocated to tangible and intangible assets and liabilities based on their fair values on the date of acquisition. The Company determined the purchase price allocations on the acquisition based on estimates of the fair values of the assets acquired and liabilities assumed.

The following summary pro forma condensed consolidated financial information reflects the Ayrshire acquisition as if it had occurred on June 30, 2014 for purposes of the statements of income. This summary pro forma information is not necessarily representative of what the Company's results of operations would have been had this acquisition in fact occurred on June 30, 2014 and is not intended to project the Company's results of operations for any future period.

Pro forma condensed consolidated financial information for the six months ended December 26, 2015 and December 27, 2014 (in thousands):

	Six Months Ended (unaudited)	
	December 26, 2015	December 27, 2014
Net sales	\$242,612	\$224,132
Net income	\$2,604	\$721

13. Goodwill and Other Intangible Assets

In accordance with ASC 350 Intangibles – Goodwill and Other Intangibles, goodwill is not amortized, but must be analyzed for impairment at least annually. The Company recorded goodwill in connection with the Ayrshire and Sabre acquisitions resulting primarily from the synergies that resulted from the Company’s acquisitions and the assembled workforce. The goodwill is not amortized for financial accounting purposes. The goodwill from the acquisitions is not deductible for tax purposes.

On March 30, 2015, the Company completed its annual impairment test. The Company concluded that it is more likely than not that the fair value of goodwill is greater than the carrying value. Goodwill was recorded at \$10.0 million as of December 26, 2015 and June 27, 2015.

The components of acquired intangible assets are as follows (in thousands):

	December 26, 2015			
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:				
Non-Compete Agreements	3 - 5	\$568	\$(273)	) \$295
Customer Relationships	10	4,803	(870)	) 3,933
Favorable Lease Agreements	4 - 7	2,941	(677)	) 2,264
Total		\$8,312	\$(1,820)	) \$6,492
	June 27, 2015			
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:				
Non-Compete Agreements	3 - 5	\$568	\$(204)	) \$364
Customer Relationships	10	4,803	(630)	) 4,173
Favorable Lease Agreements	4 - 7	2,941	(423)	) 2,518
Total		\$8,312	\$(1,257)	) \$7,055

Amortization expense was approximately \$282,000 for both the three months ended December 26, 2015 and December 27, 2014. Amortization expense was approximately \$563,000 and \$421,000 for the six months ended December 26, 2015 and December 27, 2014, respectively.

Aggregate amortization expense relative to existing intangible assets by fiscal year is currently estimated to be as follows (in thousands):

Fiscal Years Ending	Amount
2016 ⁽¹⁾	\$565
2017	1,128
2018	1,073
2019	818
2020	783
Thereafter	2,125
Total amortization expense	\$6,492

(1) Represents estimated amortization for the remaining six-month period ending July 2, 2016.

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", "KeyTronicEMS", "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 (EMS) and solutions to original equipment manufacturers of a broad range of products including consumer products, communications, medical, defense, automotive, electronics, educational, gaming, industrial and computer markets. We provide engineering services, worldwide procurement and distribution, materials management, world-class manufacturing and assembly services, in-house testing, and unparalleled customer service. Our combined capabilities are proving to be a desirable offering to our expanded customer base.

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, capabilities 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 Part II Item 1A, Risk Factors included as part of this filing.

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 by employing our "Trust, Commitment, Results" philosophy.

Acquisitions

On September 3, 2014, we completed the acquisition of all the outstanding shares of CDR Manufacturing, Inc. (dba Ayrshire Electronics), which added five locations (four in North America and one in Mexico). Subsequent to the acquisition, the Reynosa, Mexico operations were transferred to the Company's existing Juarez, Mexico facilities. This acquisition expands our printed circuit board assembly capacity, total revenue, and adds to and diversifies our customer base with the addition of many new multi-national companies.

Executive Summary

During the quarter, we saw sequential profit growth, as our new programs continue to ramp and more than offset the reduced demand from a certain customer that has significantly impacted our results in recent quarters. We continue to see a robust pipeline of potential new business and recently won four new programs, involving industrial equipment, consumer products and lighting devices.

In the second half of fiscal year 2016, we expect the ramp of new programs will continue to outpace the previously discussed decline of a longstanding customer. Even as we onboard several new customers and programs, we anticipate that we will continue to see gradually improving operating efficiencies in coming periods.

The concentration of our top three customers' net sales decreased to 30.5 percent of total sales in the second quarter of fiscal year 2016 from 36.9 percent in the same period of the prior fiscal year. We continue to diversify our customer base by adding additional programs and customers.

Net 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 net 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, precision molding, sheet metal fabrication, tool making, assembly, and engineering can be applied to a wide variety of products.

Gross profit as a percent of net sales was 7.8 percent for the second quarter of fiscal year 2016 as compared to 8.1 percent for the same quarter of the prior fiscal year. The decrease in gross profit as a percentage of net sales was primarily related to inefficiencies of ramping new programs which were partially offset by a decrease in certain material related costs compared to the prior year.

Operating income as a percentage of net sales for the second quarter of fiscal year 2016 was 2.1 percent compared to 2.2 percent for the same quarter of the prior fiscal year. The decrease in operating income as a percentage of net sales was primarily due to a decrease in gross margin as discussed above.

Net income for the second quarter of fiscal year 2016 was \$1.8 million or \$0.16 per share, as compared to net income of \$1.6 million or \$0.14 per share for the second quarter of fiscal year 2015. The increase in net income for the second quarter of fiscal year 2016 as compared to the same period in fiscal year 2015 is primarily due to the recognition of certain research and development (R&D) credits which became available to the Company as a result of the Protecting Americans from Tax Hikes (PATH) Act of 2015 being signed into law by the President during December 2015.

Our pipeline of potential new business is also increasingly robust, involving programs with greater long-term revenue potential and higher quantity requirements. Our increased competitiveness in the EMS marketplace is being driven by the growing recognition of the advantages of Mexico-based production for North America consumption, opportunities presented by the acquisition of Ayrshire, as well as by the growing number of opportunities where we can capitalize on the continued expansion of our new sheet metal fabrication capabilities in concert with our plastic molding, printed circuit, and product assembly capabilities. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

For the third quarter of fiscal year 2016, the Company expects to report revenue in the range of \$117 million to \$122 million. Future results will depend on actual levels of customers' orders, the timing of the startup of production of new product programs and the impact of the industry-wide shortages in the global supply chain.

We maintain a strong balance sheet with a current ratio of 2.1 and a debt to equity ratio of 0.4 as of December 26, 2015. Total cash provided by operating activities as defined on our cash flow statement was \$3.3 million for the six months ended December 26, 2015. We maintain sufficient liquidity for our expected future operations and had \$12.7 million in borrowings on our \$45.0 million revolving line of credit with Wells Fargo Bank, N.A. of which \$31.9 million remained available at December 26, 2015. We believe cash flows generated from operations, our borrowing capacity, and leasing opportunities 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.

Inactive, Obsolete, and Surplus Inventory Reserve

Revenue Recognition

Allowance for Doubtful Accounts

Accrued Warranty

Income Taxes

Share-Based Compensation

Impairment of Long-Lived Assets

Derivatives and Hedging Activity

Long-Term Incentive Compensation Accrual

Impairment of Goodwill

Business Combinations

Please refer to the discussion of critical accounting policies in our most recent Annual Report on Form 10-K for the fiscal year ended June 27, 2015, for further details.

RESULTS OF OPERATIONS

Comparison of the Three Months Ended December 26, 2015 with the Three Months Ended December 27, 2014
The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes.

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended December 26, 2015 as compared to the three months ended December 27, 2014. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended					\$ change	% point change	
	December 26, 2015	% of net sales		December 27, 2014	% of net sales			
Net sales	\$116,403	100.0	% \$114,311	100.0	% \$2,092	—		%
Cost of sales	107,293	92.2	% 105,072	91.9	% 2,221	0.3		%
Gross profit	9,110	7.8	% 9,239	8.1	% (129	) (0.3)	%
Research, development and engineering	1,506	1.3	% 1,297	1.1	% 209	0.2		%
Selling, general and administrative	5,201	4.5	% 5,425	4.7	% (224	) (0.2)	%
Total operating expenses	6,707	5.8	% 6,722	5.8	% (15) —		%
Operating income	2,403	2.1	% 2,517	2.2	% (114	) (0.1)	%
Interest expense, net	521	0.4	% 404	0.4	% 117	—		%
Income before income taxes	1,882	1.6	% 2,113	1.8	% (231	) (0.2)	%
Income tax provision	95	0.1	% 487	0.4	% (392	) (0.3)	%
Net income	\$1,787	1.5	% \$1,626	1.4	% \$161	0.1		%
Effective income tax rate	5.0	%	23.0	%				

Net Sales

Net sales of \$116.4 million for the second quarter of fiscal year 2016 increased by 1.8 percent as compared to net sales of \$114.3 million for the second quarter of fiscal year 2015.

The \$2.1 million increase in net sales from the prior year period was driven by new program wins and partially offset by a decrease in demand due to a single longstanding customer.

Gross Profit

Gross profit as a percentage of net sales for the three months ended December 26, 2015 was 7.8 percent compared to 8.1 percent for the three months ended December 27, 2014. This 0.3 percentage point decrease is primarily related to an increase in overhead and other costs primarily related to inefficiencies of ramping new programs which were partially offset by a decrease in material costs during three months ended December 26, 2015. 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 \$110,000 and \$20,000 for obsolete inventory during the three months ended December 26, 2015 and December 27, 2014, 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 \$1.5 million during the three months ended December 26, 2015 compared to \$1.3 million during the three months ended December 27, 2014. Total RD&E expenses as a percent of net sales were 1.3 percent and 1.1 percent during the three months ended December 26, 2015 and December 27, 2014, respectively. This 0.2 percentage point increase in RD&E as a percentage of net sales is due to an increase in personnel costs during the three months ended December 26, 2015.

Total selling, general and administrative (SG&A) expenses were \$5.2 million during the three months ended December 26, 2015 compared to \$5.4 million during the three months ended December 27, 2014. Total SG&A expenses as a percentage of net sales were 4.5 percent during the three months ended December 26, 2015 compared to 4.7 percent during the three months ended December 27, 2014. This decrease as a percentage of net sales is attributable to lower sales commission resulting from a change in revenue mix during three months ended December 26, 2015.

Interest

Interest expense increased to \$521,000 during the three months ended December 26, 2015 from \$404,000 during the three months ended December 27, 2014. The increase in interest expense is primarily related to an increase in the average balance outstanding on our line of credit that was primarily used to fund the growth in operations and to a lesser extent, factored receivables used for working capital purposes.

Income Taxes

The effective tax rate for the three months ended December 26, 2015 was 5.0 percent compared to 23.0 percent for the same period in fiscal year 2015. The effective tax rate decreased from the prior year primarily due to the recognition of certain federal R&D credits which became available to the Company as a result of PATH Act of 2015 being signed into law by the President during December 2015. For further information on taxes see footnote 6 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 deferred tax assets and liability 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 26, 2015 with the Six Months Ended December 27, 2014

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

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the six months ended December 26, 2015 as compared to the six months ended December 27, 2014. It is provided to assist in assessing differences in our overall performance (in thousands):

	Six Months Ended					\$ change		
	December 26, 2015	% of net sales		December 27, 2014	% of net sales		% point change	
Net sales	\$242,612	100.0	% \$200,653	100.0	% \$41,959	—	%	
Cost of sales	224,583	92.6	% 187,176	93.3	% 37,407	(0.7))%	
Gross profit	18,029	7.4	% 13,477	6.7	% 4,552	0.7	%	
Research, development and engineering	3,062	1.3	% 2,633	1.3	% 429	—	%	
Selling, general and administrative	10,784	4.4	% 10,032	5.0	% 752	(0.6))%	
Total operating expenses	13,846	5.7	% 12,665	6.3	% 1,181	(0.6))%	
Operating income	4,183	1.7	% 812	0.4	% 3,371	1.3	%	
Interest expense, net	1,054	0.4	% 593	0.3	% 461	0.1	%	
Income before income taxes	3,129	1.3	% 219	0.1	% 2,910	1.2	%	
Income tax provision	525	0.2	% 116	0.1	% 409	0.1	%	

Edgar Filing: KEY TRONIC CORP - Form 10-Q

Net income	\$2,604	1.1	%	\$103	0.1	%	\$2,501	1.0	%
Effective income tax rate	16.8	%		53.0	%				

23

Net Sales

Net sales of \$242.6 million for the six months ended December 26, 2015 increased by 20.9 percent as compared to net sales of \$200.7 million for the six months ended December 27, 2014.

The \$42.0 million increase in net sales from the prior year period was primarily driven by an increase in revenue related to new program wins as well as the inclusion of Ayrshire for the entire six months ended December 26, 2015.

Gross Profit

Gross profit as a percentage of net sales for the six months ended December 26, 2015 was 7.4 percent compared to 6.7 percent for the six months ended December 27, 2014. This 0.7 percentage point increase is primarily related to a decrease in material related costs partially offset by an increase in certain overhead costs related to the inefficiencies associated with ramping production of new products. 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 \$515,000 and \$139,000 for obsolete inventory during the six months ended December 26, 2015 and December 27, 2014, 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 \$3.1 million and \$2.6 million during the six months ended December 26, 2015 and December 27, 2014, respectively. Total RD&E expenses as a percent of net sales were 1.3 percent during the six months ended December 26, 2015 and December 27, 2014, respectively.

Total selling, general and administrative (SG&A) expenses were \$10.8 million during the six months ended December 26, 2015 compared to \$10.0 million during the six months ended December 27, 2014. Total SG&A expenses as a percentage of net sales were 4.4 percent during the six months ended December 26, 2015 compared to 5.0 percent during the six months ended December 27, 2014. This 0.6 percentage point decrease in SG&A is primarily related to approximately \$0.8 million of non-recurring closing costs associated with the Ayrshire acquisition incurred during the six months ended December 27, 2014.

Interest

Interest expense increased to \$1.1 million during the six months ended December 26, 2015 from \$0.6 million during the six months ended December 27, 2014. The increase in interest expense is primarily related to the inclusion of a complete period of the term loan balance outstanding for the six months ended December 26, 2015 when compared to the prior period and an increase in the average balance outstanding on our line of credit which was primarily used to fund the growth in operations.

Income Taxes

The effective tax rate for the six months ended December 26, 2015 was 16.8 percent compared to 53.0 percent for the same period in fiscal year 2015. The effective tax rate decreased from the prior year primarily due to the recognition of certain federal R&D credits which became available to the Company as a result of PATH Act of 2015 being signed into law by the President during December 2015. For further information on taxes see footnote 6 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 deferred tax assets and liability 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 26, 2015, we had an order backlog of approximately \$123.3 million. This compares with a backlog of approximately \$97.8 million on December 27, 2014. The increase in backlog at December 26, 2015, when compared to December 27, 2014, reflects an increase in demand and new programs. 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 net sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash provided by operating activities for the six months ended December 26, 2015 was \$3.3 million, compared to net cash provided by operating activities of \$5.2 million during the same period of the prior fiscal year.

The \$3.3 million of net cash provided by operating activities for the six months ended December 26, 2015 is primarily related to \$2.6 million of net income for the period and a \$12.0 million decrease in accounts receivable, partially offset by a \$6.8 million increase in inventory and a \$4.7 million decrease in accounts payable. This compares to \$5.2 million of cash flows provided by operating activities during the six months ended December 27, 2014, which resulted primarily from a \$5.9 million decrease in inventory and a \$2.3 million decrease in accounts receivable partially offset by a \$0.6 million decrease in accounts payable.

Accounts receivable fluctuates based on the timing of shipments, terms offered and collections that occurred during the quarter. While overall net sales are not typically seasonal in nature, we ship the majority of our product during the latter half of the quarter. In addition, accounts receivable will fluctuate based upon the amount of accounts receivable sold under our account purchase agreements. During the six months ended December 26, 2015, we received cash proceeds of approximately \$34.8 million from accounts receivable sold to financial institutions, which were removed from our Consolidated Balance Sheet. During the same period of the previous year, we received cash proceeds of approximately \$3.3 million from accounts receivable sold under these programs. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases and negotiated supplier terms.

Investing Cash Flow

Cash used in investing activities was \$1.4 million during the six months ended December 26, 2015 as compared to \$48.7 million during the six months ended December 27, 2014. Our primary investing activities during the six months ended December 26, 2015, were purchasing equipment to support increased production levels for new programs and the sale and leaseback of some of this equipment. Our primary investing activity during the six months ended December 27, 2014, was the acquisition of Ayrshire as discussed in further detail in footnote 12 of the "Notes to Consolidated Financial Statements."

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. During the six months ended December 26, 2015, we received \$6.2 million of cash resulting from the sale and leaseback of equipment under operating leases. During the same period of the prior year we received \$3.9 million of cash resulting from the sale and leaseback transactions.

Financing Cash Flow

Cash used in financing activities was \$1.1 million during the six months ended December 26, 2015 as compared to cash provided by financing activities of \$38.0 million in the same period of the previous fiscal year. Our primary financing activities during the six months ended December 26, 2015, was repayment on our term loan of \$2.5 million as well as 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 \$45.0 million, subject to availability. Our primary financing activity during the six months ended December 27, 2014, was borrowing on our term loan of \$35.0 million related to the Ayrshire acquisition as well as borrowing and repayment under both our revolving line of credit facility and Accounts Receivable Purchase Program.

As of December 26, 2015, we were in compliance with our loan covenants and approximately \$31.9 million was available under the revolving line of credit facility. As of December 27, 2014, approximately \$17.7 million was available under the revolving line of credit facility.

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. As of December 26, 2015, we had approximately \$1.2 million of cash held by foreign subsidiaries. If cash is to be repatriated in the future from these foreign subsidiaries, the Company could be subject to additional income taxes payable in the U.S. The total amount of tax payments required for the amount of foreign subsidiary cash on hand as of December 26, 2015 would approximate \$119,000. We have accrued for expected future repatriation of foreign earnings as discussed in footnote 6 of the “Notes to Consolidated Financial Statements.”

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

We have included a summary of our Contractual Obligations in our annual report on Form 10-K for the fiscal year ended June 27, 2015. There have been no material changes in contractual obligations outside the ordinary course of business since June 27, 2015.

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 other similar expressions are intended to identify forward-looking statements.

We may experience 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 education, 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. Conversely, our customers may abruptly lower or cancel production which may lead to a sudden, unexpected increase in inventory or accounts receivable for which we may not be reimbursed even when under contract with our customers. 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, valuation of goodwill, impairment of long-lived assets, long-term incentive compensation accrual, the provision for warranty costs, the impact of hedging activities and purchase price allocation.

We are exposed to general economic conditions, which could have a material adverse impact on our business, operating results and financial condition.

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 net 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 effect on our financial results.

The majority of our net sales come from a small number of customers and a decline in net sales to any of these customers could adversely affect our business.

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, typically 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 impact our customer orders and 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.

We depend on a limited number of suppliers for certain components that are critical to our manufacturing processes. A shortage of these components or an increase in their price could interrupt our operations and result in a significant change in our results of operations.

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. 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.

We operate in a highly competitive industry; if we are not able to compete effectively in the EMS industry, our business could be adversely affected.

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 net sales to decline. In addition, competitors can copy our non-proprietary designs and processes 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.

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.

Our ability to secure and maintain sufficient credit arrangements is key to our continued operations.

There is no assurance that we will be able to retain or renew our credit agreements in the future. In the event the business grows rapidly or the uncertain macroeconomic climate continues, additional financing resources could be necessary in the current or future fiscal years. There is no assurance that we will be able to obtain equity or debt financing at acceptable terms, or at all in the future. For a summary of our banking arrangements, see Note 4 Long-Term Debt of the "Notes to Consolidated Financial Statements."

Our operations may be subject to certain risks.

We manufacture product in facilities located in Mexico, China and the United States. These operations may be subject to a number of risks, including:

- difficulties in staffing and managing onshore and offshore operations;
- political and economic instability (including acts of terrorism, pandemics, civil unrest, forms of violence and outbreaks of war), which could impact our ability to ship, manufacture, 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;

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

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.

Fluctuations in foreign currency exchange rates could increase our operating costs.

We have manufacturing operations located in Mexico and China. A significant portion of our operations are denominated in the Mexican peso and the Chinese currency, the renminbi ("RMB"). Currency exchange rates fluctuate daily as a result of a number of factors, including changes in a country's political and economic policies. Volatility in the currencies of our entities and the United States dollar could seriously harm our business, operating results and financial condition. The primary impact of currency exchange fluctuations is on the cash, receivables, payables and expenses of our operating entities. As part of our hedging strategy, we currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. We currently do not hedge expenses denominated in RMB. Unexpected losses could occur from increases in the value of these currencies relative to the United States dollar.

Our success will continue to depend to a significant extent on our 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.

If we are unable to maintain our technological and manufacturing process expertise, our business could be adversely affected.

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 and inefficiencies related to new or transferred programs can adversely affect our operating results and such costs may not be recoverable if such new programs or transferred programs are canceled.

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.

Customers may change production timing and demand schedules which makes it difficult for us to schedule production and capital expenditures and to maximize the efficiency of our manufacturing capacity.

Changes in demand for customer products reduce our ability to accurately estimate the future requirements of our customers. This makes it difficult to schedule production and maximize utilization of our manufacturing capacity. We must determine the levels of business that we will seek and accept from customers, set production schedules, commit to procuring inventory, and allocate personnel and resources, based on our estimates of our customers' requirements. Customers can require sudden increases and decreases in production which can put added stress on resources and

reduce margins. Sudden decreases in production can lead to excess inventory on hand which may or may not be reimbursed by our customers even when under contract.

Continued growth could further lead to capacity constraints. We may need to transfer production to other facilities, acquire new facilities, or outsource production which could negatively impact gross margin.

An adverse change in the interest rates for our borrowings could adversely affect our financial condition.

We are exposed to interest rate risk under our revolving line of credit and term loan. We currently hedge a portion of our term loan with an interest rate swap. We have not historically hedged the interest rate on our credit facility; therefore, unless we do so, significant changes in interest rates could adversely affect our results of operations. Refer to the discussion in note 4, "Long-Term Debt" to the consolidated financial statements for further details of our debt obligations. We are also exposed to interest rate risk on our factoring activities.

Compliance or the failure to comply with current and future environmental laws or regulations could cause us significant expense.

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.

Our stock price is volatile.

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.

Due to inherent limitations, there can be no assurance that our system of disclosure and internal controls and procedures will be successful in preventing all errors, theft and fraud, or in informing management of all material information in a timely manner.

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.

If we do not manage our growth effectively, our profitability could decline.

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.

If our manufacturing processes and services do not comply with applicable statutory and regulatory requirements, or if we manufacture products containing design or manufacturing defects, demand for our services may decline and we may be subject to liability claims.

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 canceled 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. Our customers are required to indemnify us against liability associated with designing products to meet their specifications. However, 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 price increases may negatively impact our results of operations.

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.

Disruptions to our information systems, including security breaches, losses of data or outages, could adversely affect our operations.

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.

We are involved in various legal proceedings.

In the past, we have been notified of claims relating to various matters including contractual matters, intellectual property rights or other issues arising in the ordinary course of business. In the event of such a claim, we may be required to spend a significant amount of money to defend or otherwise address the claim. Any litigation, even where a claim is without merit, could result in substantial costs and diversion of resources. Accordingly, the resolution or adjudication of such disputes, even those encountered in the ordinary course of business, could have a material adverse effect on our business, consolidated financial conditions and results of operations.

Increases in our own market capitalization and changes in securities laws and regulations will increase our costs and risk of noncompliance.

As a result of our increased market capitalization as of the end of our second quarter of fiscal year 2013, we are required to file as an accelerated filer. As such, we are subject to additional requirements contained in the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) and more recently the Dodd-Frank Act. The Sarbanes-Oxley and Dodd-Frank Acts required or will require changes in some of our corporate governance, securities disclosure and compliance practices. In response to the requirements of the Sarbanes-Oxley and Dodd-Frank Acts, the SEC and NASDAQ promulgated new rules and additional rulemaking is expected in the future. Compliance with these new rules and future rules has increased and may increase further our legal, financial and accounting costs as well as a potential risk of noncompliance. Absent significant changes in related rules, which we cannot assure, we anticipate some level of increased costs related to these new regulations to continue indefinitely. We also expect these developments to make it more difficult and more expensive to obtain director and officer liability insurance, and we may be forced to accept reduced coverage or incur substantially higher costs to obtain coverage. Likewise, these developments may make it more difficult for us to attract and retain qualified members of our Board of Directors or qualified management personnel. Further, the costs associated with the compliance with and implementation of procedures under these and future laws and related rules could have a material impact on our results of operations. In addition, the costs associated with noncompliance with additional securities laws and regulations could also impact our business.

We may encounter complications with acquisitions, which could potentially harm our business.

Any current or future acquisitions may require additional equity financing, which could be dilutive to our existing shareholders, or additional debt financing, which could potentially affect our credit ratings. Any downgrades in our credit ratings associated with an acquisition could adversely affect our ability to borrow by resulting in more restrictive borrowing terms. To integrate acquired businesses, we must implement our management information systems, operating systems and internal controls, and assimilate and manage the personnel of the acquired operations. The integration of acquired businesses may be further complicated by difficulties managing operations in geographically dispersed locations. The integration of acquired businesses may not be successful and could result in disruption by diverting management's attention from the core business. In addition, the integration of acquired businesses may require that we incur significant restructuring charges or other increases in our expenses and working capital requirements, which reduce our return on invested capital.

Acquisitions may involve numerous other risks and challenges including but not limited to: potential loss of key employees and customers of the acquired companies; the potential for deficiencies in internal controls at acquired companies; lack of experience operating in the geographic market or industry sector of the acquired business; constraints on available liquidity, and exposure to unanticipated liabilities of acquired companies. These and other factors could harm our ability to achieve anticipated levels of profitability at acquired operations or realize other anticipated benefits of an acquisition, and could adversely affect our consolidated business and operating results. Our goodwill and identifiable intangible assets could become impaired, which could reduce the value of our assets and reduce net income in the year in which the write-off occurs.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. The Company also ascribes value to certain identifiable intangible assets, which consists of customer relationships, non-compete agreements, and favorable leases, as a result of the acquisitions of Sabre and Ayrshire. The Company may incur impairment charges on goodwill or identifiable intangible assets if it determines that the fair values of goodwill or identifiable intangible assets are less than their current carrying values. The Company evaluates, on a regular basis, whether events or circumstances have occurred that indicate all, or a portion, of the carrying amount of goodwill may no longer be recoverable, in which case an impairment charge to earnings would become necessary. Refer to Notes 2 and 13 to the consolidated financial statements and 'critical accounting policies and estimates' in management's discussion and analysis of financial condition and results of operations for further discussion regarding the impairment testing of goodwill and identifiable intangible assets.

A decline in general economic conditions or global equity valuations could impact the judgments and assumptions about the fair value of the Company's businesses and the Company could be required to record impairment charges on

its goodwill or other identifiable intangible assets in the future, which could impact the Company's consolidated balance sheet, as well as the Company's consolidated statement of operations. If the Company was required to recognize an impairment charge in the future, the charge would not impact the Company's consolidated cash flows, current liquidity, capital resources, and covenants under its existing credit facilities.

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 and term loan are secured by substantially all of our assets. The interest rates applicable to our revolving credit facility and term loan fluctuate with the Wells Fargo Bank, N.A. prime rate and LIBOR rates. There was outstanding \$12.7 million in borrowings under our revolving credit facility and \$28.8 million outstanding on our term loan as of December 26, 2015. 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 credit facility and term loan. During the second quarter of fiscal year 2015, we entered into an interest rate swap contract with a notional amount of \$25.0 million related to the borrowings outstanding under the term loan and revolving credit facility. As of December 26, 2015, our only material interest rate risk is associated with our revolving credit facility and term loan. Through the use of the interest rate swap, as described above, we fixed the basis on which we pay interest, thus eliminating much of our interest rate risk. See Note 11 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

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 \$66.5 million of foreign currency forward contracts as of December 26, 2015. The fair value of these contracts was \$(10.3) million. See Note 11 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 4. 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 26, 2015, the Company’s disclosure controls and procedures are effective based on that criteria.

Due to inherent limitations of any internal control system, management acknowledges that there are limitations as to the effectiveness of internal controls over financial reporting and therefore recognize that only reasonable assurance can be gained from any internal control system. Accordingly, our internal control system may not detect or prevent material misstatements in our financial statements and projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during the three months ended December 26, 2015 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)).

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 June 27, 2015.

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

(Principal Executive Officer)

Date: February 4, 2016

/s/ Brett R. Larsen

Brett R. Larsen

Executive Vice President of Administration, Chief Financial
Officer and Treasurer

(Principal Financial Officer)

Date: February 4, 2016