

KMG CHEMICALS INC
Form 10-Q
March 12, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended January 31, 2012

or

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

For the transition period from to .

Commission file number: 000-29278

KMG CHEMICALS, INC.

(Exact name of registrant as specified in its charter)

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Texas
(State or other jurisdiction of
incorporation or organization)

75-2640529
(I.R.S. Employer
Identification No.)

9555 West Sam Houston Parkway South,
Suite 600 Houston, Texas
(Address of principal executive offices)

77099
(Zip Code)

(713) 600-3800
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

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 March 12, 2012, there were 11,361,769 shares of the registrant's common stock outstanding.

Table of Contents

TABLE OF CONTENTS

<u>PART I - FINANCIAL INFORMATION</u>	3
<u>ITEM 1. FINANCIAL STATEMENTS</u>	3
<u>CONDENSED CONSOLIDATED BALANCE SHEETS AS OF JANUARY 31, 2012 AND JULY 31, 2011</u>	3
<u>CONDENSED CONSOLIDATED STATEMENTS OF INCOME FOR THE THREE AND SIX MONTHS ENDED JANUARY 31, 2012 AND 2011</u>	4
<u>CONDENSED CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME FOR THE THREE AND SIX MONTHS ENDED JANUARY 31, 2012 AND 2011</u>	5
<u>CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED JANUARY 31, 2012 AND 2011</u>	6
<u>NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u>	7
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	16
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK</u>	21
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	21
<u>PART II - OTHER INFORMATION</u>	21
<u>ITEM 1. LEGAL PROCEEDINGS</u>	21
<u>ITEM 1A. RISK FACTORS</u>	21
<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	21
<u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>	21
<u>ITEM 5. OTHER INFORMATION</u>	21
<u>ITEM 6. EXHIBITS</u>	21
<u>SIGNATURES</u>	23

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****KMG CHEMICALS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands except for share and per share data)

	September 30, January 31, 2012 (Unaudited)	September 30, July 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 1,941	\$ 1,826
Accounts receivable:		
Trade, net of allowances of \$16 at January 31, 2012 and \$414 at July 31, 2011	30,750	36,410
Other	3,154	4,359
Inventories, net	42,914	41,770
Current deferred tax assets	721	726
Prepaid expenses and other current assets	853	2,126
Total current assets	80,333	87,217
PROPERTY, PLANT AND EQUIPMENT, net	70,109	71,826
DEFERRED TAX ASSETS	1,166	1,176
GOODWILL	3,778	3,778
INTANGIBLE ASSETS, net	19,126	19,493
OTHER ASSETS, net	3,120	3,099
TOTAL ASSETS	\$ 177,632	\$ 186,589
LIABILITIES & STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 22,825	\$ 24,899
Accrued liabilities	5,550	6,235
Book overdraft		2,852
Current deferred tax liabilities	7	7
Current portion of long-term debt		8,000
Total current liabilities	28,382	41,993
LONG-TERM DEBT, net of current portion	41,000	41,279
DEFERRED TAX LIABILITIES	6,385	5,381
OTHER LONG-TERM LIABILITIES	1,352	1,406
Total liabilities	77,119	90,059

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COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS EQUITY

Preferred stock, \$.01 par value, 10,000,000 shares authorized, none issued		
Common stock, \$.01 par value, 40,000,000 shares authorized, 11,355,137 shares issued and outstanding at January 31, 2012 and 11,318,941 shares issued and outstanding at July 31, 2011	114	113
Additional paid-in capital	25,573	25,256
Accumulated other comprehensive loss	(2,998)	(1,233)
Retained earnings	77,824	72,394
Total stockholders equity	100,513	96,530
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 177,632	\$ 186,589

See notes to condensed consolidated financial statements.

Table of Contents

KMG CHEMICALS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(in thousands except for per share data)

	September 30, Three Months Ended January 31, 2012	September 30, Three Months Ended January 31, 2011	September 30, Six Months Ended January 31, 2012	September 30, Six Months Ended January 31, 2011
NET SALES	\$ 69,650	\$ 64,936	\$ 142,957	\$ 127,040
COST OF SALES	51,596	46,670	105,722	91,406
Gross Profit	18,054	18,266	37,235	35,634
DISTRIBUTION EXPENSES	5,846	7,166	11,983	13,374
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	7,076	6,294	13,612	11,894
Operating income	5,132	4,806	11,640	10,366
OTHER INCOME (EXPENSE):				
Interest income	1	1	1	1
Interest expense	(556)	(599)	(1,106)	(1,194)
Other, net	(72)	(241)	(147)	(190)
Total other expense, net	(627)	(840)	(1,252)	(1,383)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	4,505	3,966	10,388	8,983
Provision for income taxes	(1,781)	(1,506)	(4,096)	(3,007)
INCOME FROM CONTINUING OPERATIONS	2,724	2,460	6,292	5,976
DISCONTINUED OPERATIONS:				
Loss from discontinued operations, before income taxes	(337)	(47)	(380)	(47)
Income tax benefit	75	11	85	11
Loss from discontinued operations	(262)	(36)	(295)	(36)

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NET INCOME	\$	2,462	\$	2,424	\$	5,997	\$	5,940
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EARNINGS PER SHARE:

Basic

Income from continuing operations	\$	0.24	\$	0.21	\$	0.55	\$	0.53
Loss from discontinued operations		(0.02)				(0.02)		

Net income	\$	0.22	\$	0.21	\$	0.53	\$	0.53
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Diluted

Income from continuing operations	\$	0.23	\$	0.21	\$	0.55	\$	0.52
Loss from discontinued operations		(0.02)				(0.03)		

Net income	\$	0.21	\$	0.21	\$	0.52	\$	0.52
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WEIGHTED AVERAGE SHARES OUTSTANDING:

Basic		11,353		11,308		11,351		11,303
Diluted		11,516		11,495		11,515		11,477

See notes to condensed consolidated financial statements.

Table of Contents**KMG CHEMICALS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME****(UNAUDITED)****(in thousands)**

	September 30, Three Months Ended January 31, 2012	September 30, Three Months Ended January 31, 2011	September 30, Six Months Ended January 31, 2012	September 30, Six Months Ended January 31, 2011
NET INCOME	\$ 2,462	\$ 2,424	\$ 5,997	\$ 5,940
OTHER COMPREHENSIVE INCOME (LOSS):				
Foreign currency translation gain (loss)	(1,340)	(297)	(1,765)	1,181
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	(1,340)	(297)	(1,765)	1,181
TOTAL COMPREHENSIVE INCOME	\$ 1,122	\$ 2,127	\$ 4,232	\$ 7,121

See notes to condensed consolidated financial statements.

Table of Contents**KMG CHEMICALS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)****(in thousands)**

	September 30, Six Months Ended January 31, 2012	September 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 5,997	\$ 5,940
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,545	3,846
Amortization of loan costs included in interest expense	54	54
Stock-based compensation expense	239	374
Inventory valuation adjustment	125	30
(Gain) Loss on disposal of property	(44)	113
Deferred income tax expense	1,003	442
Tax benefit from stock-based awards	(121)	(196)
Changes in operating assets and liabilities:		
Accounts receivable trade	5,261	247
Accounts receivable other	1,144	(434)
Inventories	(1,566)	(632)
Prepaid expenses and other current assets	1,160	939
Accounts payable	(1,875)	1,641
Accrued liabilities	(468)	(1,933)
Net cash provided by operating activities	14,454	10,431
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property, plant and equipment	(2,687)	(4,009)
Proceeds from sale of property	27	59
Change in restricted cash		189
Net cash used in investing activities	(2,660)	(3,761)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings (payments) under revolver credit agreement	3,054	(3,000)
Principal payments on borrowings on term loan	(11,333)	(4,000)
Proceeds from exercise of stock options and warrants		200
Tax benefit from stock-based awards	121	196
Book overdraft	(2,852)	
Payment of dividends	(567)	(452)
Net cash used in financing activities	(11,577)	(7,056)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(102)	114

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NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	115	(272)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,826	4,728
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 1,941	\$ 4,456

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid for interest	\$ 1,030	\$ 1,188
Cash paid for income taxes	\$ 2,241	\$ 2,479

See notes to condensed consolidated financial statements.

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Basis of Presentation

(1) Basis of Presentation. The (a) consolidated balance sheet as of July 31, 2011, which has been derived from audited consolidated financial statements, and (b) the unaudited condensed consolidated financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those requirements, certain footnotes or other financial information that are normally required by generally accepted accounting principles in the United States of America (GAAP) have been condensed or omitted. The Company believes that the disclosures made are adequate to make the information not misleading and in the opinion of management reflect all adjustments, including those of a normal recurring nature, that are necessary for a fair presentation of financial position and results of operations for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of results of operations to be expected for the full year. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended July 31, 2011.

These condensed consolidated financial statements are prepared using certain estimates by management and include the accounts of KMG Chemicals, Inc. and its subsidiaries (collectively, the Company). All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to the prior period consolidated financial statements to conform to the current period presentation.

Disposition of Business

(2) Disposition of Business. The Company sold its animal health business to Bayer Healthcare LLC on March 1, 2012, including inventory, equipment and product registrations. The Company retained the real estate and buildings at its facility in Elwood, KS. The Company sold the business for approximately \$10.3 million, including \$1.0 million held in escrow. The purchase price was paid in cash, subject to the escrow. The escrowed amount is to be held pending final acceptance by the United States Environmental Agency (EPA) of certain studies being performed at the request of EPA on tetrachlorvinphos, the active ingredient used in Rabon products. The escrowed funds are to be released to the Company once EPA has finally accepted the studies, the buyer has voluntarily canceled the products, or after five years. The escrowed funds are to be released to the buyer if EPA cancels the products to which the studies pertain before the funds are distributed to the Company. Management believes that EPA will accept the studies within five years.

The Company will continue to operate the facility in Elwood, KS to manufacture products for the buyer under a transition services agreement for one year, subject to two six-month extensions.

Table of Contents

Earnings Per Share

(3) Earnings Per Share. Basic earnings per share have been computed by dividing net income by the weighted average shares outstanding. Diluted earnings per share have been computed by dividing net income by the weighted average shares outstanding plus potentially dilutive common shares. The following table presents information necessary to calculate basic and diluted earnings per share for periods indicated:

	September 30, Three Months Ended January 31,		September 30, Six Months Ended January 31,	
	2012	2011	2012	2011
	(Amounts in thousands, except per share data)			
Income from continuing operations	\$ 2,724	\$ 2,460	\$ 6,292	\$ 5,976
Loss from discontinued operations	(262)	(36)	(295)	(36)
Net income	\$ 2,462	\$ 2,424	\$ 5,997	\$ 5,940
Weighted average shares outstanding-basic	11,353	11,308	11,351	11,303
Dilutive effect of options and stock awards	163	187	164	174
Weighted average shares outstanding-diluted	11,516	11,495	11,515	11,477
BASIC EARNINGS PER SHARE				
Basic earnings per share from continuing operations	\$ 0.24	\$ 0.21	\$ 0.55	\$ 0.53
Basic earnings per share on loss from discontinued operations	(0.02)		(0.02)	
Basic earnings per share	\$ 0.22	\$ 0.21	\$ 0.53	\$ 0.53
DILUTED EARNINGS PER SHARE				
Diluted earnings per share from continuing operations	\$ 0.23	\$ 0.21	\$ 0.55	\$ 0.52
Diluted earnings per share on loss from discontinued operations	(0.02)		(0.03)	
Diluted earnings per share	\$ 0.21	\$ 0.21	\$ 0.52	\$ 0.52

Outstanding stock based awards are not included in the computation of diluted earnings per share under the treasury stock method, if including them would be anti-dilutive. There were no shares of potentially dilutive securities not included in the computation of diluted earnings per share for the three and six months ended January 31, 2012, respectively, and there were approximately 1,500 and less than 1,000 shares of potentially dilutive securities not included in the computation of diluted earnings per share for the three and six months ended January 31, 2011, respectively.

Inventories

(4) Inventories. Inventories are summarized in the following table (in thousands):

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	September 30, January 31, 2012	September 30, July 31, 2011
Raw materials	\$ 8,512	\$ 7,475
Work in process	849	1,034
Supplies	1,412	1,405
Finished products	32,479	32,189
Less reserve for inventory obsolescence	(338)	(333)
Inventories, net	\$ 42,914	\$ 41,770

Table of Contents

Property, Plant and Equipment

(5) Property, Plant and Equipment. Property, plant and equipment and related accumulated depreciation and amortization are summarized as follows (in thousands):

	September 30, January 31, 2012	September 30, July 31, 2011
Land	\$ 9,507	\$ 10,081
Buildings & improvements	35,865	35,795
Equipment	46,100	44,098
Leasehold improvements	143	143
	91,615	90,117
Less accumulated depreciation and amortization	(27,224)	(24,388)
	64,391	65,729
Construction-in-progress	5,718	6,097
Property, plant and equipment, net	\$ 70,109	\$ 71,826

Stock-Based Compensation

(6) Stock-Based Compensation. The Company has stock-based incentive plans which are described in more detail in note 11 to the consolidated financial statements in the Company's Annual Report on Form 10-K for fiscal year 2011. The Company recognized stock-based compensation costs of approximately \$28,000 and \$193,000 for the three months ended January 31, 2012 and 2011, respectively, and recognized \$239,000 and \$374,000 for the six months ended January 31, 2012 and 2011, respectively, which are recorded as selling, general and administrative expenses in the condensed consolidated statements of income.

As of January 31, 2012, the unrecognized compensation costs related to stock-based awards was approximately \$840,000 expected to be recognized over a weighted-average period of 2.0 years.

A summary of stock option and stock activity is presented below.

Stock Options

A summary of activity for the six months ended January 31, 2012 is presented below. No options were granted in the first six months of fiscal years 2012 or 2011.

September 30, Shares	September 30, Weighted- Average Exercise Price
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Outstanding on August 1, 2011	222,000	\$	3.98
Granted			
Exercised			
Forfeited/Expired			
Outstanding on January 31, 2012	222,000		3.98

The following table summarizes information about stock options outstanding at January 31, 2012 based on fully vested (currently exercisable) stock option awards and stock options awards expected to vest:

	September 30, Options Outstanding	September 30, Weighted- Average Exercise Price	September 30, Weighted- Average Remaining Contractual Term (years)	September 30, Aggregate Intrinsic Value (in thousands) (1)
Fully vested and currently exercisable	177,000	\$ 3.88	4.9	\$ 2,572
Expected to vest	45,000	4.37	11.1	631
Total outstanding stock options	222,000	3.98	6.1	\$ 3,203

(1) The aggregate intrinsic value is computed based on the closing price of the Company's stock on January 31, 2012.

Table of Contents

There were no options exercised in the three and six months ended January 31, 2012. The total intrinsic value of options exercised during the six months ended January 31, 2011 was approximately \$546,000.

Performance Shares

On August 1, 2011, there were 209,305 non-vested performance shares outstanding which reflected the maximum number of shares under the awards. During the six months ended January 31, 2012, there were no awards vested and there were 123,811 performance-based stock awards granted. The fair value of the awards was measured on the grant dates of October 11, 2011 and October 28, 2011 using the Company's closing stock price of \$14.16 and \$15.30, respectively. Stock-based compensation expense on the awards will be recognized on a straight line basis over the requisite service period beginning on the date of grant through the end of the measurement period ending July 31, 2014, based on the number of shares expected to vest at the end of the measurement period. As of January 31, 2012, the non-vested performance-based stock awards consisted of Series 1 and Series 2 awards granted to certain executives and employees in fiscal years 2012, 2011 and 2010, as summarized below.

Date of Grant	September 30, Series Award	September 30, Maximum Award (Shares)	September 30, Closing Stock Price (Fair Value) on Grant Date	September 30, 3-Year Measurement Period Ending	September 30, Expected Percentage of Vesting	September 30, Shares Expected to Vest
Fiscal Year 2012 Award						
10/28/2011	Series 1	15,300	\$ 15.30	07/31/2014	55%	8,415
10/28/2011	Series 2	10,200	\$ 15.30	07/31/2014	0%	
		25,500				8,415
10/11/2011	Series 1	58,987	\$ 14.16	07/31/2014	55%	32,443
10/11/2011	Series 2	39,324	\$ 14.16	07/31/2014	0%	
		98,311				32,443
Fiscal Year 2011 Award						
12/7/2010	Series 1	61,980	\$ 15.65	07/31/2013	30%	18,594
12/7/2010	Series 2	41,318	\$ 15.65	07/31/2013	0%	
		103,298				18,594
Fiscal Year 2010 Award						
3/17/2010	Series 1	63,605	\$ 15.55	07/31/2012	30%	19,081
3/17/2010	Series 2	42,402	\$ 15.55	07/31/2012	0%	
		106,007				19,081
Total		333,116				78,533

Series 1: Vesting for the Series 1 awards is subject to a performance requirement composed of certain revenue growth objectives and average annual return on invested capital or equity objectives measured across a three year period. These objectives are measured quarterly using the Company's budget, actual results and long-term projections. For the fiscal year 2012, 2011 and 2010 awards, the expected percentage of vesting is based on performance through January 31, 2012 and reflects the percentage of shares projected to vest for the respective awards at the end of their measurement periods.

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Series 2: Vesting for the Series 2 awards is subject to performance requirements pertaining to the growth rate in the Company's basic earnings per share over a three year period. The achievement of performance requirements is measured quarterly using the Company's budget, actual results and long-term projections. For the fiscal year 2012, 2011 and 2010 awards, the expected percentage of vesting is based on performance through January 31, 2012 and reflects the percentage of shares projected to vest for the respective awards at the end of their measurement periods.

The weighted-average grant-date fair value of performance awards outstanding at January 31, 2012 and August 1, 2011 was \$14.97 and \$15.60, respectively. The weighted-average grant date fair value of performance awards granted during the first six months of fiscal year 2012 was \$14.39.

Table of Contents**Time Based Shares**

A summary of activity for time-based stock awards for the six months ended January 31, 2012 is presented below:

	September 30, Shares	September 30, Weighted-Average Grant-Date Fair Value
Non-vested on August 1, 2011	24,939	\$ 16.03
Granted		
Vested (1)	(12,141)	15.24
Forfeited		
Non-vested on January 31, 2012	12,798	15.60

- (1) During the six month period ended January 31, 2012 there were 12,992 shares vested. The number of shares presented here includes an adjustment of 851 shares which do not represent shares that vested during the six months ended January 31, 2012. The adjustment was related to the fiscal year 2011 non-employee director stock grant and reflects the difference between the number of shares reported as granted and the number of shares vested over the twelve month service period of the award ended November 30, 2011. The number of shares granted was calculated based on the aggregate monetary value of the award divided by the Company's closing stock price on the respective date of grant. The number of shares vested at the end of each of the three month service periods over the twelve month service period ending November 30, 2011 was based on the Company's closing stock price at the end of each of the three month periods. There were no time-based shares granted during the six months ended January 31, 2012. The total fair value of shares vested during the six months ended January 31, 2012 and 2011 was approximately \$200,000 and \$175,000, respectively.

Intangible Assets

(7) **Intangible Assets.** Intangible assets are summarized as follows (in thousands):

	Spte 30, Number of Years Weighted Average	Spte 30, Original Cost	Spte 30, Accumulated Amortization	Spte 30, January 31, 2012 Carrying Amount	Spte 30, July 31, 2011 Accumulated Amortization	Spte 30, July 31, 2011 Carrying Amount
	Range of useful life	Amortization Period				
Intangible assets subject to amortization:						
Creosote supply contract	10	10.0	\$ 4,000	\$ (4,000)	\$ (3,955)	\$ 45
Animal health trademarks	4.5	4.1	364	(364)	(364)	
Animal health product registrations and other related assets	5-20	18.4	6,165	(2,173)	3,992	(2,005)
Electronic chemicals-related contracts	3-8	3.8	1,164	(1,033)	131	(1,014)
Electronic chemicals-related trademarks and patents	10-15	12.0	117	(41)	76	(36)
Electronic chemicals value of product qualifications	5	5.0	1,300	(477)	823	(347)
Total intangible assets subject to amortization		12.8	\$ 13,110	\$ (8,088)	5,022	\$ (7,721)
						5,389

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Intangible assets not subject to amortization:		
Creosote product registrations	5,339	5,339
Penta product registrations	8,765	8,765
Total intangible assets not subject to amortization	14,104	14,104
Total intangible assets, net	\$ 19,126	\$ 19,493

Intangible assets subject to amortization are amortized over their estimated useful lives. Amortization expense was approximately \$161,000 and \$282,000 for the three month periods ended January 31, 2012 and 2011, respectively, and \$367,000 and \$586,000 for the six month periods ended January 31, 2012 and 2011, respectively.

Table of Contents

Dividends

(8) Dividends. Dividends of approximately \$284,000 (\$0.025 per share) and \$226,000 (\$0.02 per share) were declared and paid in the second quarter of fiscal years 2012 and 2011, respectively. Dividends of approximately \$567,000 (\$0.05 per share) and \$452,000 (\$0.04 per share) were declared and paid in the first six months of fiscal years 2012 and 2011, respectively.

Segment Information

(9) Segment Information. The Company previously had four reportable segments – Electronic Chemicals, Penta, Creosote and Animal Health. The Company re-evaluated the criteria used to determine operating segments and concluded that its Penta and Creosote product lines met the criteria of a single operating segment. As a result, effective August 1, 2011, the Company's reportable segments were revised to reflect a change from four to three reportable segments – Electronic Chemicals, Wood Treating Chemicals and Animal Health. Prior year information has been reclassified to conform to the current period presentation.

	September 30, Three Months Ended January 31, 2012		September 30, Three Months Ended January 31, 2011 (Amounts in thousands)		September 30, Six Months Ended January 31, 2012		September 30, Six Months Ended January 31, 2011	
Sales								
Electronic Chemicals	\$	38,596	\$	36,001	\$	76,974	\$	72,794
Wood Treating Chemicals		28,380		25,807		61,541		49,967
Animal Health		2,674		3,128		4,442		4,279
Total sales for reportable segments	\$	69,650	\$	64,936	\$	142,957	\$	127,040
Depreciation and amortization								
Electronic Chemicals	\$	1,484	\$	1,117	\$	2,903	\$	2,873
Wood Treating Chemicals		113		220		273		438
Animal Health		126		193		252		385
Other – general corporate		57		76		117		150
Total consolidated depreciation and amortization	\$	1,780	\$	1,606	\$	3,545	\$	3,846
Segment income (loss) from operations (1)								
Electronic Chemicals	\$	2,521	\$	1,331	\$	5,184	\$	4,356
Wood Treating Chemicals		3,250		4,372		8,471		8,201
Animal Health		201		144		(391)		(253)
Total segment income from operations	\$	5,972	\$	5,847	\$	13,264	\$	12,304

September 30,
January 31,
2012

September 30,
July 31,
2011

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Assets			
Electronic Chemicals	\$	106,850	\$ 116,139
Wood Treating Chemicals		46,907	45,917
Animal Health		14,584	15,074
Total assets for reportable segments	\$	168,341	\$ 177,130

(1) Segment income (loss) from operations includes corporate overhead expenses which are allocated based on segment net sales. Corporate overhead expenses allocated to segment income (loss) from operations for the three and six months ended January 31, 2012 and 2011 were as follows:

	September 30, Three Months Ended January 31,		September 30, Six Months Ended January 31,	
	2012	2011	2012	2011
	(Amounts in thousands)			
Electronic Chemicals	\$ 1,367	\$ 952	\$ 2,506	\$ 1,884
Wood Treating Chemicals	1,057	840	2,006	1,575
Animal Health	48	137	156	249
Total corporate overhead expense allocation	\$ 2,472	\$ 1,929	\$ 4,668	\$ 3,708

Table of Contents

A reconciliation of total segment information to consolidated amounts is as follows:

	September 30, January 31, 2012	September 30, July 31, 2011
	(Amounts in thousands)	
Assets:		
Total assets for reportable segments	\$ 168,341	\$ 177,130
Total assets for discontinued operations (1)	594	644
Cash and cash equivalents	1,751	1,479
Prepaid and other current assets	3,233	3,749
Other	3,713	3,587
Total assets	\$ 177,632	\$ 186,589

	September 30, Three Months Ended January 31,		September 30, Six Months Ended January 31,	
	2012	2011	2012	2011
Sales:				
Total sales for reportable segments	\$ 69,650	\$ 64,936	\$ 142,957	\$ 127,040
Net sales	\$ 69,650	\$ 64,936	\$ 142,957	\$ 127,040
Segment income from operations:				
Total segment income from operations	\$ 5,972	\$ 5,847	\$ 13,264	\$ 12,304
Other corporate expense (2)	(840)	(1,041)	(1,624)	(1,938)
Operating income	5,132	4,806	11,640	10,366
Interest income	1		1	1
Interest expense	(556)	(599)	(1,106)	(1,194)
Other expense, net	(72)	(241)	(147)	(190)
Income from continuing operations before income taxes	\$ 4,505	\$ 3,966	\$ 10,388	\$ 8,983

(1) Reflects long-term deferred tax assets related to discontinued operations as of January 31, 2012 and July 31, 2011.

(2) Other corporate expense primarily represents employee stock-based compensation expenses and those expenses associated with the company's operation as a public entity such as board compensation, audit expense and fees related to the listing of our stock.

Long-Term Obligations

(10) Long-Term Obligations. The Company's debt consisted of the following (in thousands):

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	September 30, January 31, 2012	September 30, July 31, 2011
Senior Secured Debt:		
Note Purchase Agreement, maturing on December 31, 2014, interest rate of 7.43%	\$ 20,000	\$ 20,000
Secured Debt:		
Term Loan Facility, maturing on December 31, 2012, variable interest rates based on LIBOR plus 2.00%		11,333
Revolving Loan Facility, maturing on December 31, 2016, variable interest rates based on LIBOR plus 2.00% (2.30% at January 31, 2012)	21,000	17,946
Total debt	41,000	49,279
Current portion of long-term debt		(8,000)
Long-term debt, net of current portion	\$ 41,000	\$ 41,279

To finance the acquisition of the electronic chemicals business in December 2007, the Company entered into a credit agreement and a note purchase agreement with Wachovia Bank, National Association, a subsidiary of Wells Fargo & Co., Bank of America, N.A., The Prudential Insurance Company of America, and Pruco Life Insurance Company. The credit agreement included a term loan facility and a revolving loan facility. The Company amended the credit agreement in March 2010, and amended it again in November 2011. The November 2011 amendment of the credit facility raised the maximum amount that may be borrowed under the revolving loan facility from \$50.0 million to \$60.0 million, extended the maturity date of the credit agreement to December 31, 2016 and allowed advances under the revolving loan facility without reference to a borrowing base restriction. The financial covenant for debt to capitalization was replaced by a current ratio minimum of 1.5 to 1.0. The Company had previously paid off all outstanding advances under the credit facility's term loan commitment, and in the November 2011 amendment, that aspect of the facility was deleted. The revolving loan bears interest at a varying rate of LIBOR plus a margin based on our funded debt to earnings before interest, taxes, depreciation and amortization (EBITDA).

Table of Contents

	September 30, Margin
Ratio of Funded Debt to EBITDA	
Equal to or greater than 3.0 to 1.0	2.75%
Equal to or greater than 2.5 to 1.0, but less than 3.0 to 1.0	2.50%
Equal to or greater than 2.0 to 1.0, but less than 2.5 to 1.0	2.25%
Equal to or greater than 1.5 to 1.0, but less than 2.0 to 1.0	2.00%
Less than 1.5 to 1.0	1.75%

Advances outstanding under the revolving loan bear interest as of February 29, 2012 at 2.24% per year (LIBOR plus 2.00%).

Before the term loan facility was paid off and removed from the credit facility, the term facility required principal payments of \$458,333 per month for the first 24 months, then, beginning January 2010, principal payments became \$666,667 per month for the balance of the term prior to maturity. The purchase of the electronic chemical assets from General Chemical on March 29, 2010 was funded with available cash and borrowings on the revolving loan. During the first quarter of fiscal year 2012 the Company repaid the outstanding balance of the term loan with borrowings on the revolving loan. At January 31, 2012, the amount outstanding on the revolving loan was \$21.0 million. On March 2, 2012, the Company used the proceeds received on the sale of its animal health business to repay \$10.0 million of the balance on the revolving loan. The amount outstanding on the revolving loan was \$11.0 million on March 2, 2012.

In fiscal year 2008 the Company also entered into a \$20.0 million note purchase agreement with the Prudential Insurance Company of America. Advances under the note purchase agreement mature December 31, 2014, and bear interest at 7.43% per annum. Principal is payable at maturity. At January 31, 2012, \$20.0 million was outstanding under the note purchase agreement.

Loans under the amended and restated credit facility and the note purchase agreement are secured by the Company's assets, including inventory, accounts receivable, equipment, intangible assets, and real property. The credit facility and the note purchase agreement have restrictive covenants, including that the Company must maintain a fixed charge coverage ratio of 1.5 to 1.0, a ratio of funded debt to EBITDA of 3.0 to 1.0, and a current ratio of at least 1.5 to 1.0. For purposes of calculating these financial covenant ratios, we use a pro forma EBITDA. On January 31, 2012, the Company was in compliance with all of its debt covenants.

Income Taxes

(11) Income Taxes. Income tax expense for the interim periods was computed using the effective tax rate estimated to be applicable for the full fiscal year. The effective tax rate for continuing operations for the three months of fiscal years 2012 and 2011 was 39.5% and 38.0%, respectively and 39.4% and 33.5% for the six months of fiscal year 2012 and 2011, respectively. Income tax expense for the first six months of fiscal year 2011 was reduced by \$410,000 for the reversal of a portion of the valuation allowance related to a foreign subsidiary.

Discontinued Operations

(12) Discontinued Operations. In fiscal year 2008 the Company discontinued operations of its herbicide product line that had comprised the agricultural chemical segment. During the three and six months ended January 31, 2012 and 2011, there were no sales reported in discontinued operations, and the Company reported a net loss from discontinued operations of \$262,000 and \$295,000 in the three and six months ended January 31, 2012, respectively, and \$36,000 for the three and six months ended January 31, 2011, respectively, in connection with the dismantling of related equipment and the accident described in note 13.

Litigation and Other Contingencies

(13) Litigation and Other Contingencies. The Company is subject to contingencies, including litigation relating to environmental laws and regulations, commercial disputes and other matters. Certain of these contingencies are discussed below. The ultimate resolution of these contingencies is subject to significant uncertainty, and should the Company fail to prevail in any of them or should several of them be resolved against the Company in the same reporting period, these matters could, individually or in the aggregate, be material to the consolidated financial statements. The ultimate outcome of these matters, however, cannot be determined at this time, nor can the amount of any potential loss be

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reasonably estimated, and as a result no amounts have been recorded in the Company's condensed consolidated financial statements except where noted.

The Company discontinued the operation of its agricultural chemical herbicide, referred to as MSMA, but in connection with that product line it was a member of the MSMA task force. In 2007 Albaugh, Inc. sued an entity related to the MSMA task force, Arsonate Herbicide Products, Limited) (AHP), claiming that AHP overbilled it for certain task force expenses. The Company had been a member of the task force with two other companies. Although Albaugh, Inc. had agreed to reimburse AHP for certain task force expenses for MSMA studies and registration support costs, it claims that it was overbilled for many years. The case was tried in October 2009 in the U.S. District Court for the So. District of Iowa, and styled as *Albaugh, Inc. vs. Arsonate Herbicide Products, Limited*. The court rendered a judgment on May 6, 2011 against AHP for approximately \$945,000, plus interest. AHP has appealed that verdict to the United States Court of Appeals for the Eighth Circuit, No. 11-2284. The Company intends to vigorously defend against any attempt to collect the judgment against AHP from the Company.

Table of Contents

On November 29, 2011, there was an explosion in the MSMA unit at the Company's Matamoros facility where that agricultural chemical herbicide product had once been made. The unit was being demolished by a third-party contractor when the accident occurred, and two of the contractor's employees were injured, one fatally. The event had no impact on facility operations or production.

A lawsuit was filed against our subsidiary, KMG de Mexico, relating to the title to the land on which our facility in Matamoros is located. The plaintiffs claim that their title to the land is superior to the person from whom our subsidiary bought the land. The plaintiffs are seeking to have our subsidiary's purchase overturned, and to recover the land and certain improvements or their value. The lawsuit was initially filed in 1998 in Matamoros, Mexico under *Adolfo Cazares Rosas, et al vs. KMG de Mexico and Guillermo Villarreal*. In January 2008, the case was sent by the appeals court back to the lower court to obtain additional factual information, and on April 20, 2009 the plaintiffs were required to re-file the case in the First Civil Court in Matamoros, Tamaulipas, Mexico as *Adolfo Cazares, Luis Escudero and Juan Cue vs. KMG de Mexico and Guillermo Villarreal*. In June 2011 the lower court ruled against KMG de Mexico, and held that the plaintiffs had superior title to the land. The Company has appealed that verdict, and intends to vigorously defend KMG de Mexico in the appellate court.

When it purchased assets from Air Products, Inc. (Air Products) in December 2007, the Company agreed to be responsible for the applicable sales tax on the personal property that it purchased. The Colorado Department of Revenue audited the purchase, and in November 2009 issued a deficiency notice to Air Products for unpaid sales tax on the purchase of approximately \$819,000, before interest and penalties. The Company assumed the defense of the matter as allowed under its indemnity of Air Products. The issue is whether certain property at the Company's Pueblo, Co facility should be classified as personal property subject to sales tax, or whether the property should be classified as real property not subject to tax. The matter is now being reviewed internally at the Colorado Department of Revenue. If a satisfactory resolution is not reached, the dispute would be subject to arbitration. In the second quarter of fiscal year 2012, the Company recognized approximately \$100,000, including taxes, penalties and interest, related to certain property that it concluded was personal property and subject to sales tax.

The Company's subsidiary in Italy is currently under examination by the taxing authority there for the period ended July 31, 2009. Adjustments were proposed by the taxing authority at the end of April 2011 that would result in approximately \$1.6 million (including interest and penalties) of additional income tax, if all the adjustments are sustained. The Company has provided additional information in response to the proposed adjustments, and intends to vigorously defend its tax positions. The ultimate outcome of this examination is subject to uncertainty and no amount has been recorded in the Company's consolidated financial statements.

The Company is subject to federal, state, local and foreign laws and regulations and potential liabilities relating to the protection of the environment and human health and safety including, among other things, the cleanup of contaminated sites, the treatment, storage and disposal of wastes, the emission of substances into the air or waterways, and various health and safety matters. The Company expects to incur substantial costs for ongoing compliance with such laws and regulations. The Company may also face governmental or third-party claims, or otherwise incur costs, relating to cleanup of, or for injuries resulting from, contamination at sites associated with past and present operations. The Company accrues for environmental liabilities when a determination can be made that they are probable and reasonably estimable.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

We manufacture, formulate and distribute specialty chemicals globally. We operate businesses engaged in electronic chemicals, industrial wood treating chemicals and animal health products. Our electronic chemicals are used in the manufacturing of semiconductors. Our wood treating chemicals, pentachlorophenol (penta) and creosote are used by our industrial customers primarily to extend the useful life of utility poles and railroad cross-ties. Our animal health products include biotech feed additives, farm and ranch hygiene products and pesticide products used on cattle, other livestock and poultry to protect the animals from flies and other pests.

Sale of the Animal Health Business

On March 1, 2012, we sold certain assets of our animal health segment to Bayer Healthcare, LLC for a purchase price of approximately \$10.3 million, including to \$1.0 million held in escrow. The purchase price was paid in cash, subject to the escrow, and used to reduce the amount outstanding on our revolving indebtedness. The escrowed amount is being held pending final acceptance by EPA of certain studies being performed at its request on tetrachlorvinphos, the active ingredient used in Rabon products. The escrowed funds are to be released to us once EPA has finally accepted the studies, the buyer has voluntarily canceled the products, or after five years. The escrowed funds are to be released to the buyer if EPA cancels products to which the studies pertain before the funds are distributed to us. Management believes that EPA will finally accept the studies within five years. The sale included inventory, equipment and product registrations. We retained the real estate and building at our facility in Elwood, KS, and we will operate it to manufacture products for the buyer under a transition services agreement for one year, subject to two six-month extensions.

Results of Operations**Three and Six Month Periods Ended January 31, 2012 compared with Three and Six Month Periods Ended January 31, 2011***Segment Data*

Segment data is presented for our three reportable segments for the three and six month periods ended January 31, 2012 and 2011. The segment data should be read in conjunction with our condensed consolidated financial statements and related notes thereto included elsewhere in this report. We previously had four reportable segments for electronic chemicals, penta, creosote and animal health. We have re-evaluated the criteria used to determine operating segments, and we have concluded that our two wood treating product segments met the criteria of a single operating segment. As a result our reportable segments were revised to reflect a change from four to three reportable segments, electronic chemicals, wood treating chemicals and animal health. Prior year information has been reclassified to conform to the current period presentation.

	September 30, Three Months Ended January 31, 2012		September 30, Three Months Ended January 31, 2011		September 30, Six Months Ended January 31, 2012		September 30, Six Months Ended January 31, 2011	
	(Amounts in thousands)							
Sales								
Electronic Chemicals	\$	38,596	\$	36,001	\$	76,974	\$	72,794
Wood Treating Chemicals		28,380		25,807		61,541		49,967
Animal Health		2,674		3,128		4,442		4,279
Net sales	\$	69,650	\$	64,936	\$	142,957	\$	127,040

Net Sales

Net sales increased \$4.7 million, or 7.3%, to \$69.7 million in the second quarter of fiscal year 2012 as compared to \$64.9 million for the same period of the prior year. For the six months, net sales increased \$15.9 million, or 12.5%, to \$143.0 million in the first six months of fiscal year 2012 as compared with \$127.0 million for the same period of the prior year.

In the second quarter of fiscal year 2012, the electronic chemicals segment had net sales of \$38.6 million, an increase of \$2.6 million, or 7.2%, as compared to \$36.0 million for the prior year period. For the six month period, the segment had net sales of \$77.0 million, an increase of \$4.2 million, or 5.7%, as compared to \$72.8 million in the prior year. We implemented price increases in the second half of fiscal 2011 in response to increased raw material costs. We expect demand for our electronic chemicals products to improve in calendar 2012, including

additional business from a new semiconductor fabrication facility that came on stream.

Table of Contents

Net sales of wood treating chemicals increased \$2.6 million, or 10.0%, to \$28.4 million in the second quarter of fiscal year 2012 as compared to \$25.8 million for the prior year period. For the six month period, the segment had net sales of \$61.5 million, an increase of \$11.6 million, or 23.2%, as compared to \$50.0 million in the prior year. The increase in sales for the quarter was due to increases in price, while the increase for the six month period was attributable fairly evenly to higher volumes and increases in price. We expect to see generally flat demand in the segment through the balance of the fiscal year.

Net sales of animal health pesticides decreased by \$454,000, or 14.5%, to \$2.7 million in the second quarter of fiscal year 2012 as compared with \$3.1 million in the prior year period. For the six month period, the segment had net sales of \$4.4 million, an increase of \$163,000, or 3.8%, as compared to \$4.3 million in the prior year. Seasonal usage of animal health pesticides is dependent upon varying seasonal patterns, weather conditions and weather-related pressure from pests, as well as customer marketing programs and requirements. Our revenue from the animal health pesticides segment is seasonal and weighted to the third and fourth quarters of our fiscal year.

Gross Profit

Gross profit decreased by \$212,000, or 1.2%, to \$18.1 million in the second quarter of fiscal year 2012 from \$18.3 million in the same quarter the prior year. Gross profit as a percentage of sales decreased to 25.9% in the second quarter of fiscal year 2012 from 28.1% in the second quarter of fiscal year 2011. For the six month period, we had gross profit of \$37.2 million, an increase of \$1.6 million, or 4.5%, as compared to \$35.6 million in the prior year. Gross profit as a percentage of sales decreased for the six months to 26.0% in fiscal year 2012 from 28.0% in the prior fiscal year 2011.

The decrease in aggregate gross profit for the quarter was due to lower gross profit margins from our electronic chemicals segment and for the six month period the increase came from improved sales in our wood treating chemicals segment. As a percentage of sales, however, gross profit margins were down for the quarter and for the six months of fiscal year 2012 as compared to the prior year's first quarter, because of a reduction in gross profit margins in both our electronic chemicals and wood treating segments, and due to the fact that a greater percentage of revenues in our wood treating chemicals segment came from our lower margin product. In our electronic chemicals segment, even though we have consolidated most production from four sites in fiscal year 2011 to two primary sites now, margins were impacted by higher cost inventory that had been produced during the plant consolidation initiative. Also during the second quarter of fiscal year 2012, we incurred a \$501,000 charge for an adjustment to our electronic chemicals inventory as a result of our plant consolidation and exit from the tolling arrangements. In wood treating chemicals, we also experienced increases in raw material costs, but we also had increased sales in our lower margin creosote product line. In response to those increased raw material costs, we implemented price increases during the first half of fiscal year 2012 in all segments. The pricing action in the electronic chemicals segment and, now that our consolidation is complete, lower manufacturing costs during fiscal year 2012 should have a favorable impact on margins, most notably in the second half of the fiscal year.

Other companies may include certain of the costs that we record in cost of sales as distribution expenses or selling, general and administrative expenses, and may include certain of the costs that we record in distribution expenses or selling, general and administrative expenses as a component of cost of sales, resulting in a lack of comparability between our gross profit and that reported by other companies.

Distribution Expenses

Distribution expenses decreased \$1.3 million, or 18.4%, to \$5.8 million in the second quarter of fiscal year 2012 as compared with \$7.2 million in the prior year period. Distribution expenses were approximately 8.4% and 11.0% of net sales for the second quarter of fiscal years 2012 and 2011, respectively. For the six month period, we had distribution expenses of \$12.0 million, a decrease of \$1.4 million, or 10.4%, as compared to \$13.4 million in the prior year. Distribution expense as a percentage of sales decreased for the six months to 8.4% in fiscal year 2012 from 10.5% in the prior fiscal year 2011. The improvement in distribution expenses came in electronic chemicals, where we were able to optimize our supply chain on completion of our integration effort. The decline in distribution expense as a percentage of revenue was attributable fairly evenly to efficiency improvements in the electronic chemicals business and an increase in the weighting of wood treating chemicals' share of total revenue.

Selling, General and Administrative Expenses

Selling, general, and administrative expenses increased \$782,000, or 12.4% to \$7.1 million in the second quarter of fiscal year 2012 from \$6.3 million in the same quarter of fiscal year 2011. Those expenses were 10.2% and 9.7% of sales in the second quarter of fiscal years 2012 and 2011, respectively. For the six month period, we had selling, general and administrative expenses of

Table of Contents

\$13.6 million, an increase of \$1.7 million, or 14.4%, as compared to \$11.9 million in the prior year. Those expenses as a percentage of sales were flat for the six months at 9.5% in fiscal year 2012 and 9.4% in the prior fiscal year 2011. For the three months ended January 31, 2012, the increase over the prior year was primarily for non-recurring environmental costs of \$731,000 and for the six months ended January 31, 2012, the increase was mainly due to higher employee related costs and non-recurring environmental costs of \$588,000 and \$866,000, respectively. The environmental expenses were for waste disposal at our Tuscaloosa facility in connection with waste generated on installation of new dissolving equipment and from disposal of out of specification material.

Certain reclassifications of prior year amounts have been made to conform to current year presentation. During fiscal year 2011, we began classifying certain expenses as selling, general and administrative expenses which had been classified as distribution expenses in prior periods. Accordingly, for the three and six month periods ended January 31, 2011, \$185,000 and \$349,000, respectively, were reclassified to reflect the current year presentation.

Interest Expense

Interest expense was \$556,000 in the second quarter of fiscal year 2012 as compared with \$599,000 in the second quarter of fiscal year 2011. Interest expense was \$1.1 million in the first six months of fiscal year 2012 as compared with \$1.2 million in the first six months of fiscal year 2011. The decrease was due to lower borrowings on our loan facility in fiscal year 2012 as compared to the same period of the prior year.

Income Taxes

Our effective tax rate for continuing operations was 39.5% and 38.0% in the second quarter of fiscal years 2012 and 2011, respectively, and 39.4% and 33.5% for the first six months of fiscal years 2012 and 2011, respectively. The prior year period income tax expense was net of a discrete period adjustment of \$410,000 reflecting the reversal of a portion of the valuation allowance related to a foreign subsidiary.

Discontinued Operations

Discontinued operations reflected a net loss of \$262,000 and \$295,000 for the three and six month periods ended January 31, 2012, and a net loss of \$36,000 for the three and six month periods ended January 31, 2011. The Company incurred costs in each of the periods in connection with the dismantling of the production facility related to the agricultural chemical segment that was discontinued in fiscal year 2008. The current year periods included costs related to the accident described in note 13 to the condensed consolidated financial statements.

Liquidity and Capital Resources*Cash Flows*

Net cash provided by operating activities was \$14.5 million for the first six months of fiscal year 2012 as compared to \$10.4 million for the comparable period in 2011. Net income adjusted for depreciation and amortization increased cash \$9.5 million in the first six months of fiscal year 2012 as compared to \$9.8 million over the same period of the prior year. Cash flows from operating activities during the current period were favorably impacted by a decrease in accounts receivable of \$5.3 million primarily from normal collection patterns and from timing of sales across our segments.

Net cash used in investing activities in the first six months of fiscal 2012 was \$2.7 million as compared with \$3.8 million in the prior year period, all of which was for additions to property, plant and equipment in both fiscal years. In fiscal year 2012, the majority of the additions were for electronic chemicals distribution and production equipment. In fiscal year 2011, the additions were primarily for expansion at our Hollister, CA facility and for equipment at Pueblo, CO.

Net cash used in financing activities was \$11.6 million in the first six months of fiscal year 2012 as compared to \$7.1 million in the comparable prior year period. In the first six months of fiscal year 2012, we made principal payments of \$11.3 million on the term loan indebtedness to pay it off entirely, had net borrowings on our revolving loan of \$3.1 million and cleared the book overdraft outstanding at July 31, 2011 of \$2.9 million. The book overdraft represented the amount in excess of the bank cash balance necessary to fund the checks that were paid but not yet cleared. In the prior year period, we had a net payment on our revolving loan of \$3.0 million and principal payments on our term loan of \$4.0 million. In the six month periods ended January 31, 2012 and 2011, we paid dividends of \$567,000 and \$452,000, respectively. It is our policy to pay dividends from available cash after taking into consideration our profitability, capital requirements, financial condition, growth, business opportunities and other factors which our board of directors may deem relevant.

Working Capital

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We have a revolving line of credit under an amended and restated credit agreement. At January 31, 2012, we had \$21.0 million outstanding under that revolving facility.

Management believes that our current credit facility, combined with cash flows from operations, will adequately provide for our working capital needs for current operations for the next twelve months.

Table of Contents*Long Term Obligations*

To finance the acquisition of the electronic chemicals business in December 2007, we entered into a credit agreement and a note purchase agreement with Wachovia Bank, National Association, a subsidiary of Wells Fargo & Co., Bank of America, N.A., The Prudential Insurance Company of America, and Pruco Life Insurance Company. The credit facility included a revolving loan facility and a term loan facility.

We amended the credit agreement in March 2010, and amended it again in November 2011. The November 2011 amendment of the credit facility raises the maximum amount that may be borrowed under the revolving loan facility from \$50.0 million to \$60.0 million, extends the maturity date of the credit agreement to December 31, 2016 and allows advances under the revolving loan facility without reference to a borrowing base restriction. The financial covenant for debt to capitalization was replaced by a current ratio minimum of 1.5 to 1.0. During the first quarter of fiscal year 2012 we paid off all outstanding advances under the credit facility's term loan commitment, and in the November 2011 amendment, that aspect of the facility was deleted.

Advances under the revolving loan mature December 31, 2016. They each bear interest at varying rate of LIBOR plus a margin based on our funded debt to EBITDA, as described below.

Ratio of Funded Debt to EBITDA	September 30, Margin
Equal to or greater than 3.0 to 1.0	2.75%
Equal to or greater than 2.5 to 1.0, but less than 3.0 to 1.0	2.50%
Equal to or greater than 2.0 to 1.0, but less than 2.5 to 1.0	2.25%
Equal to or greater than 1.5 to 1.0, but less than 2.0 to 1.0	2.00%
Less than 1.5 to 1.0	1.75%

Advances outstanding under the revolving loan bear interest as of February 29, 2012 at 2.24% per year (LIBOR plus 2.00%). Before the term loan facility was paid off and removed from the credit facility, the term facility required principal payments of \$458,333 per month for the first 24 months, then beginning January 2010 principal payments became \$666,667 per month for the balance of the term prior to maturity. At January 31, 2012, \$21.0 million was outstanding on the revolving facility. On March 2, 2012, we repaid \$10.0 million of the balance on the revolving loans from proceeds received from the sale of the animal health business. After that payment, the amount outstanding on the revolving loan was \$11.0 million on March 2, 2012.

The financing for the acquisition of the electronic chemicals business in fiscal year 2008 included a \$20.0 million note purchase agreement with the Prudential Insurance Company of America. Advances under the note purchase agreement mature December 31, 2014, and bear interest at 7.43% per annum. Principal is payable at maturity. At January 31, 2012, \$20.0 million was outstanding under the note purchase agreement.

Loans under the amended and restated credit facility and the note purchase agreement are secured by our assets, including inventory, accounts receivable, equipment, intangible assets and real property. The credit facility and the note purchase agreement have restrictive covenants, including that we must maintain a fixed charge coverage ratio of 1.5 to 1.0, a ratio of funded debt to EBITDA of 3.0 to 1.0, and a current ratio of at least 1.5 to 1.0. For purposes of calculating these financial covenant ratios, we use a pro forma EBITDA. On January 31, 2012, we were in compliance with all of our debt covenants.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements, such as financing or unconsolidated variable interest entities.

Table of Contents

Disclosure Regarding Forward Looking Statements

We are including the following discussion to inform our existing and potential security holders generally of some of the risks and uncertainties that can affect us and to take advantage of the safe harbor protection for forward-looking statements that applicable federal securities law affords. From time to time, our management or persons acting on our behalf make forward-looking statements to inform existing and potential security holders about our company. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, intend, plan, project, forecast, may, should, goal, expect, probably or similar expressions, we are making forward-looking statements. Many risks and uncertainties may impact the matters addressed in these forward-looking statements. Our forward-looking statements speak only as of the date made and we will not update forward-looking statements unless the securities laws require us to do so.

Some of the key factors which could cause our future financial results and performance to vary from those expected include:

the loss of primary customers;

our ability to implement productivity improvements, cost reduction initiatives or facilities expansions;

market developments affecting, and other changes in, the demand for our products and the entry of new competitors or the introduction of new competing products;

availability or increases in the price of our primary raw materials or active ingredients;

the timing of planned capital expenditures;

our ability to identify, develop or acquire, and market additional product lines and businesses necessary to implement our business strategy and our ability to finance such acquisitions and development;

the condition of the capital markets generally, which will be affected by interest rates, foreign currency fluctuations and general economic conditions;

cost and other effects of legal and administrative proceedings, settlements, investigations and claims, including environmental liabilities which may not be covered by indemnity or insurance;

the effects of weather, earthquakes, other natural disasters and terrorist attacks;

the ability to obtain registration and re-registration of our products under applicable law;

the political and economic climate in the foreign or domestic jurisdictions in which we conduct business; and

other United States or foreign regulatory or legislative developments which affect the demand for our products generally or increase the environmental compliance cost for our products or impose liabilities on the manufacturers and distributors of such products. The information contained in this report, including the information set forth under the heading "Risk Factors", identifies additional factors that could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions and, therefore, the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report and the exhibits and other documents incorporated herein by reference, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to certain market risks in the ordinary course of our business, arising primarily from changes in interest rates and to a lesser extent foreign currency exchange rate fluctuations. Generally we do not utilize derivative financial instruments or hedging transactions to manage that risk. Our exposure to interest rate risk and foreign currency risk is discussed in our Annual Report on Form 10-K for the fiscal year ended July 31, 2011. There has been no material change in that information.

ITEM 4. CONTROLS AND PROCEDURES

The term disclosure controls and procedures is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission. Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There were no changes to our internal control over financial reporting during the quarterly period covered by this Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth in note 14 to the condensed consolidated financial statements included in Item 1 of Part I of this report is incorporated herein by reference.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors contained in our Annual Report on Form 10-K for the fiscal year ended July 31, 2011.

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

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 5. OTHER INFORMATION

The Nominating and Corporate Governance Committee will consider recommendations for directors made by shareholders for fiscal year 2013, if such recommendations are received in writing, addressed to the chair of the committee, Mr. John C. Hunter, in care of the Company, at 9555 W. Sam Houston Parkway S., Suite 600, Houston, Texas 77099 by July 2, 2012.

ITEM 6. EXHIBITS

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The financial statements are filed as part of this report in Part 1, Item 1. The following documents are filed as exhibits. Documents marked with an asterisk (*) are management contracts or compensatory plans, and portions of documents marked with a dagger (†) have been granted confidential treatment.

Table of Contents

- 10.49 Third Amendment to Amended and Restated Credit Agreement with Wells Fargo Bank, National Association dated November 23, 2011, incorporated herein by this reference.
- 10.50 Amendment No. 3 to Note Purchase Agreement and Limited Consent dated November 23, 2011, and incorporated herein by this reference.
- 31.1 Certificates under Section 302 the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer.
- 31.2 Certificates under Section 302 the Sarbanes-Oxley Act of 2002 of the Chief Financial Officer.
- 32.1 Certificates under Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer.
- 32.2 Certificates under Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Financial Officer.

Table of Contents

SIGNATURES

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

KMG Chemicals, Inc.

By: /s/ J. Neal Butler
J. Neal Butler
President and Chief Executive Officer

Date: March 12, 2012

By: /s/ John V. Sobchak
John V. Sobchak
Vice President and Chief Financial Officer

Date: March 12, 2012