

KMG CHEMICALS INC
Form 10-Q
December 10, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(One)

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

For the quarterly period ended October 31, 2012

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

For the transition period from to .

Commission file number: 001-35577

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 December 7, 2012, there were 11,498,872 shares of the registrant's common stock outstanding.

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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 amounts)

	October 31, 2012 (Unaudited)	July 31, 2012
Assets		
Current assets		
Cash and cash equivalents	\$ 4,180	\$ 1,633
Accounts receivable		
Trade, net of allowances of \$89 at October 31, 2012 and \$16 at July 31, 2012	26,344	28,933
Other	1,280	960
Inventories, net	46,129	40,661
Current deferred tax assets	1,424	1,417
Prepaid expenses and other	1,595	2,057
Total current assets	80,952	75,661
Property, plant and equipment, net	68,629	68,026
Deferred tax assets	1,154	1,129
Goodwill	3,778	3,778
Intangible assets, net	14,903	14,980
Restricted cash	1,000	1,000
Other assets, net	3,268	3,116
Total assets	\$ 173,684	\$ 167,690
Liabilities and stockholders equity		
Current liabilities		
Accounts payable	\$ 23,953	\$ 21,855
Accrued liabilities	4,374	4,303
Employee incentive accrual	839	2,227
Income taxes payable	2,647	292
Total current liabilities	31,813	28,677
Long-term debt, net of current maturities	22,000	24,000
Deferred tax liabilities	6,825	7,046
Other long-term liabilities	1,227	1,200
Total liabilities	61,865	60,923
Commitments and contingencies		
Stockholders equity		

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Preferred stock, \$0.01 par value, 10,000,000 shares authorized, none issued		
Common stock, \$0.01 par value, 40,000,000 shares authorized, 11,412,400 shares issued and outstanding at October 31, 2012 and 11,405,808 shares issued and outstanding at July 31, 2012	114	114
Additional paid-in capital	26,203	26,022
Accumulated other comprehensive loss	(3,267)	(4,339)
Retained earnings	88,769	84,970
Total stockholders' equity	111,819	106,767
Total liabilities and stockholders' equity	\$ 173,684	\$ 167,690

See accompanying notes to condensed consolidated financial statements.

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

(UNAUDITED)

(In thousands, except for per share amounts)

	Three Months Ended October 31,	
	2012	2011
Net sales	\$ 65,336	\$ 71,539
Cost of sales	45,248	52,864
Gross profit	20,088	18,675
Distribution expenses	7,053	6,070
Selling, general and administrative expenses	5,931	5,614
Operating income	7,104	6,991
Other income/(expense)		
Interest expense, net	(411)	(550)
Other, net	(50)	(75)
Total other expense, net	(461)	(625)
Income from continuing operations before income taxes	6,643	6,366
Provision for income taxes	(2,435)	(2,505)
Income from continuing operations	4,208	3,861
Discontinued operations:		
Loss from discontinued operations, before income taxes	(102)	(526)
Income tax benefit	36	200
Loss from discontinued operations	(66)	(326)
Net income	\$ 4,142	\$ 3,535
Earnings per share:		
Basic		
Income from continuing operations	\$ 0.36	\$ 0.34
Loss from discontinued operations		(0.03)
Net income	\$ 0.36	\$ 0.31
Diluted		
Income from continuing operations	\$ 0.36	\$ 0.34
Loss from discontinued operations		(0.03)
Net income	\$ 0.36	\$ 0.31

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Weighted average shares outstanding:

Basic	11,436	11,348
Diluted	11,564	11,511

See accompanying notes to condensed consolidated financial statements.

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KMG CHEMICALS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

(In thousands)

	Three Months Ended October 31,	
	2012	2011
Net income	\$ 4,142	\$ 3,535
Other comprehensive income/ (loss)		
Foreign currency translation gain/ (loss)	1,072	(425)
Total other comprehensive income/ (loss)	1,072	(425)
Total comprehensive income	\$ 5,214	\$ 3,110

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended October 31,	
	2012	2011
Cash flows from operating activities		
Net income	\$ 4,142	\$ 3,535
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	1,757	1,765
Amortization of loan costs included in interest expense	17	27
Stock-based compensation expense	181	211
Bad debt expense	73	
Inventory valuation adjustment	(209)	45
Loss on disposal of property	9	4
Loss on sale of animal health business	57	
Deferred income tax expense/(benefit)	(221)	576
Tax deficiency from stock-based awards		30
Changes in operating assets and liabilities		
Accounts receivable - trade	2,723	4,505
Accounts receivable - other	(315)	(385)
Inventories	(5,038)	524
Other current and noncurrent assets	310	459
Accounts payable	1,901	719
Accrued liabilities and other	(1,400)	(162)
Income taxes payable	2,345	1,729
Net cash provided by operating activities	6,332	13,582
Cash flows from investing activities		
Additions to property, plant and equipment	(1,523)	(1,800)
Net cash used in investing activities	(1,523)	(1,800)
Cash flows from financing activities		
Net borrowings/(payments) under revolver credit agreement	(2,000)	6,054
Principal payments on borrowings on term loan		(11,333)
Tax deficiency from stock-based awards		(30)
Book overdraft		(2,852)
Payment of dividends	(342)	(283)
Net cash used in financing activities	(2,342)	(8,444)
Effect of exchange rate changes of cash	80	(15)
Net increase in cash and cash equivalents	2,547	3,323
Cash and cash equivalents at beginning of period	1,633	1,826

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Cash and cash equivalents at end of period	\$ 4,180	\$ 5,149
Supplemental disclosures of cash flow information		
Cash paid for interest	\$ 394	\$ 527
Cash paid for income taxes	\$ 295	\$ 253
See accompanying notes to condensed consolidated financial statements.		

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The consolidated balance sheet as of July 31, 2012, which has been derived from audited consolidated financial statements, and 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, 2012.

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.

During the third quarter of fiscal year 2012 the Company sold its animal health business and reported the related results of operations as discontinued operations in its condensed consolidated statements of income. Previously reported amounts for the prior year have been adjusted for the effects of discontinued operations (See Note 3).

2. Recent Accounting Standards

The Company has considered all recently issued accounting standards updates and SEC rules and interpretive releases.

In July 2012, the Financial Accounting Standards Board issued updated accounting guidance amending the method an entity uses to test indefinite-lived assets for impairment. Under previous guidance, an entity was required to test indefinite-lived assets for impairment on at least an annual basis, in two steps. First, an entity had to compare the fair value of the asset with its carrying amount. If the fair value of the asset was less than its carrying amount, then the second step of the test had to be performed to measure the amount of the impairment loss, if any. Under the updated guidance, an entity is not required to calculate the fair value of the asset, unless it determines that it is more likely than not that its fair value is less than its carrying amount. An entity has the option to first assess qualitative factors to determine whether it is more likely than not that the asset's fair value is less than its carrying amount. Performing the two-step impairment test is unnecessary, when the asset's fair value is determined to be more likely than not to be greater than its carrying amount. The updated guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual or interim indefinite-lived assets impairment tests performed prior to July 27, 2012, if an entity's financial statements for the most recent annual period have not yet been issued. The Company early adopted the updated guidance for its annual impairment test for indefinite-lived assets performed as of July 31, 2012, which did not have a material impact on the consolidated financial statements. Based on the Company's assessment, it was determined that it was not more likely than not that the fair value of its indefinite-lived intangible assets was greater than the carrying amount, and that there would be no impairment of the assets.

3. Discontinued Operations

In fiscal year 2008 the Company discontinued operations of its herbicide product line that had comprised the agricultural chemical segment. In connection with the dismantling of related equipment the Company incurred costs of \$35,000 and \$43,000 for the three months ended October 31, 2012 and 2011, respectively, reported as loss from discontinued operations, before income taxes.

On March 1, 2012, the Company sold its animal health business that had comprised the animal health segment to Bayer Healthcare LLC. During the first quarter of fiscal year 2013 the Company recorded costs of \$67,000 for certain post-closing adjustments and costs which were reported as a loss from discontinued operations, before income taxes. This amount included \$57,000 that was recognized as loss on sale of the business.

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The results of operations on the animal health business reported in discontinued operations were as follows, in thousands:

	Three Months Ended October 31,	
	2012	2011
Net sales	\$	\$ 1,768
Loss before income tax	(10)	(483)

4. 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:

	Three Months Ended October 31,	
	2012	2011
	(Amounts in thousands, except per share data)	
Income from continuing operations	\$ 4,208	\$ 3,861
Loss from discontinued operations	(66)	(326)
Net income	\$ 4,142	\$ 3,535
Weighted average shares outstanding-basic	11,436	11,348
Dilutive effect of options and stock awards	128	163
Weighted average shares outstanding-diluted	11,564	11,511
Basic earnings per share		
Basic earnings per share from continuing operations	\$ 0.36	\$ 0.34
Basic earnings per share on loss from discontinued operations		(0.03)
Basic earnings per share	\$ 0.36	\$ 0.31
Diluted earnings per share		
Diluted earnings per share from continuing operations	\$ 0.36	\$ 0.34
Diluted earnings per share on loss from discontinued operations		(0.03)
Diluted earnings per share	\$ 0.36	\$ 0.31

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 months ended October 31, 2012 and there were approximately 7,300 shares of potentially dilutive securities not included in the computation of diluted earnings per share for the three months ended October 31, 2011.

5. Inventories

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

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	October 31, 2012	July 31, 2012
Raw materials	\$ 6,427	\$ 5,846
Work in process	1,247	896
Supplies	1,436	1,405
Finished products	37,350	33,007
Less reserve for inventory obsolescence	(331)	(493)
Inventories, net	\$ 46,129	\$ 40,661

Table of Contents**6. Property, Plant and Equipment**

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

	October 31, 2012	July 31, 2012
Land	\$ 9,410	\$ 9,034
Buildings and improvements	35,920	35,578
Equipment	46,608	45,924
Leasehold improvements	143	143
	92,081	90,679
Less accumulated depreciation and amortization	(30,707)	(28,824)
	61,374	61,855
Construction-in-progress	7,255	6,171
Property, plant and equipment, net	\$ 68,629	\$ 68,026

7. 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 2012. The Company recognized stock-based compensation costs of approximately \$181,000 and \$211,000 for the three months ended October 31, 2012 and 2011, and the related tax benefits of \$66,000 and \$83,000, respectively, for the three months ended October 31, 2012 and 2011. Stock-based compensation costs are recorded as selling, general and administrative expenses in the condensed consolidated statements of income.

As of October 31, 2012, the unrecognized compensation costs related to stock-based awards was approximately \$249,000 which is expected to be recognized over a weighted-average period of 1.3 years.

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

Stock Options

A summary of activity for the three months ended October 31, 2012 is presented below. No options were granted in the first three months of fiscal years 2013 or 2012:

	Shares	Weighted-Average Exercise Price
Outstanding on August 1, 2012	180,000	\$ 4.13
Granted		
Exercised		
Forfeited/expired		
Outstanding on October 31, 2012	180,000	4.13

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

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	Options Outstanding	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands) ⁽¹⁾
Fully vested and currently exercisable	150,000	\$ 4.09	5.41	\$ 1,949
Expected to vest	30,000	4.37	10.86	381
Total outstanding stock options	180,000	4.13	6.32	\$ 2,330

⁽¹⁾ The aggregate intrinsic value is computed based on the closing price of the Company's stock on October 31, 2012. There were no options exercised in the three months ended October 31, 2012 or 2011.

Table of Contents**Performance Shares**

On August 1, 2012, there were 227,609 non-vested performance shares outstanding which reflected the maximum number of shares under the awards. During the three months ended October 31, 2012, there were no awards vested or granted. As of October 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 and 2011, as summarized below.

Date of Grant	Series Award	Maximum Award (Shares)	Grant Date Fair Value	Measurement Period Ending	Expected Percentage of Vesting	Shares Expected to Vest
Fiscal Year 2012 Award						
2/27/2012	Series 1	300	\$ 18.08	07/31/2014	20%	60
2/27/2012	Series 2	200	\$ 18.08	07/31/2014	0%	
		500				60
10/28/2011	Series 1	15,300	\$ 15.30	07/31/2014	20%	3,060
10/28/2011	Series 2	10,200	\$ 15.30	07/31/2014	0%	
		25,500				3,060
10/11/2011	Series 1	58,987	\$ 14.16	07/31/2014	20%	11,797
10/11/2011	Series 2	39,324	\$ 14.16	07/31/2014	0%	
		98,311				11,797
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
Total		227,609				33,511

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 and 2011 awards, the expected percentage of vesting is based on performance through October 31, 2012 and reflects the percentage of shares projected to vest for the respective awards at the end of their measurement periods.

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 and 2011 awards, the expected percentage of vesting is based on performance through October 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 October 31, 2012 and August 1, 2012 was \$15.10.

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

	Shares	Weighted-Average Grant-Date Fair Value
Non-vested on August 1, 2012	5,769	\$ 15.65
Granted ⁽¹⁾	6,592	18.42
Vested ⁽¹⁾	(6,592)	18.42
Forfeited		
Non-vested on October 31, 2012	5,769	15.65

⁽¹⁾ Reflects shares granted to non-employee directors on August 28, 2012 for service for the three month period ended August 31, 2012. The shares vest on the date of grant and the Company recognizes compensation expense related to the awards over the three-month service period in accordance with GAAP.

8. Intangible Assets

Intangible assets are summarized as follows (in thousands):

	Number of Years Weighted Average Amortization Period	Original Cost	October 31, 2012	
			Accumulated Amortization	Carrying Amount
Intangible assets subject to amortization: (range of useful life):				
Creosote supply contract (10 years)	10.0	\$ 4,000	\$ (4,000)	\$
Electronic chemicals-related contracts (3-8 years)	3.8	1,164	(1,061)	103
Electronic chemicals-related trademarks and patents (10-15 years)	12.0	117	(49)	68
Electronic chemicals-value of product qualifications (5 years)	5.0	1,300	(672)	628
Total intangible assets subject to amortization	8.0	\$ 6,581	\$ (5,782)	799
Intangible assets not subject to amortization:				
Creosote product registrations				5,339
Penta product registrations				8,765
Total intangible assets not subject to amortization				14,104
Total intangible assets, net				\$ 14,903

	Number of Years Weighted Average Amortization Period	Original Cost	July 31, 2012	
			Accumulated Amortization	Carrying Amount

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Intangible assets subject to amortization: (range of useful life):				
Creosote supply contract (10 years)	10.0	\$ 4,000	\$ (4,000)	\$
Electronic chemicals-related contracts (3-8 years)	3.8	1,164	(1,053)	111
Electronic chemicals-related trademarks and patents (10-15 years)	12.0	117	(46)	71
Electronic chemicals-value of product qualifications (5 years)	5.0	1,300	(606)	694
Total intangible assets subject to amortization	8.0	\$ 6,581	\$ (5,705)	876
Intangible assets not subject to amortization:				
Creosote product registrations				5,339
Penta product registrations				8,765
Total intangible assets not subject to amortization				14,104
Total intangible assets, net				\$ 14,980

Intangible assets subject to amortization are amortized over their estimated useful lives. Amortization expense was approximately \$77,000 and \$206,000 for the three month periods ended October 31, 2012 and 2011, respectively.

9. Dividends

Dividends of approximately \$342,000 (\$0.03 per share) and \$283,000 (\$0.025 per share) were declared and paid in the first quarter of fiscal years 2013 and 2012, respectively.

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The Company has two reportable segments – electronic chemicals and wood treating chemicals. The Company sold its animal health business on March 1, 2012, and that former segment is now reported as discontinued operations. Prior year information has been reclassified to conform to the current period presentation.

	Three Months Ended October 31,	
	2012	2011
	(Amounts in thousands)	
Sales		
Electronic chemicals	\$ 39,507	\$ 38,378
Wood treating chemicals	25,700	33,161
 Total sales for reportable segments	 \$ 65,207	 \$ 71,539
 Depreciation and amortization		
Electronic chemicals	\$ 1,550	\$ 1,419
Wood treating chemicals	107	160
Discontinued operations		126
Other	100	60
 Total consolidated depreciation and amortization	 \$ 1,757	 \$ 1,765
 Segment income from operations ⁽¹⁾		
Electronic chemicals	\$ 5,072	\$ 2,663
Wood treating chemicals	3,366	5,221
 Total segment income from operations	 \$ 8,438	 \$ 7,884

⁽¹⁾ Segment income from operations includes allocated corporate overhead expenses.

Corporate overhead expenses allocated to segment income from operations for the three months ended October 31, 2012 and 2011 were as follows:

	Three Months Ended October 31,	
	2012	2011
	(Amounts in thousands)	
Electronic chemicals	\$ 1,403	\$ 1,139
Wood treating chemicals	1,145	949
 Total corporate overhead expense allocation	 \$ 2,548	 \$ 2,088

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

	Three Months Ended October 31,	
	2012	2011
	(Amounts in thousands)	
Sales		
Total sales for reportable segments	\$ 65,207	\$ 71,539
Other ⁽¹⁾	129	
Net sales	\$ 65,336	\$ 71,539
Segment income from operations		
Total segment income from operations	\$ 8,438	\$ 7,884
Other corporate expense ⁽²⁾	(1,334)	(893)
Operating income	7,104	6,991
Interest expense, net	(411)	(550)
Other expense, net	(50)	(75)
Income from continuing operations before income taxes	\$ 6,643	\$ 6,366

(1) Reflects fees from the transition services agreement in connection with the sale of the animal health business.

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

11. Long-Term Obligations

The Company's debt consisted of the following (in thousands):

	October 31, 2012	July 31, 2012
	(Amounts in thousands)	
Senior secured debt		
Note purchase agreement, maturing on December 31, 2014, interest rate of 7.43%	\$ 20,000	\$ 20,000
Secured debt		
Revolving loan facility, maturing on December 31, 2016, variable interest rates based on LIBOR plus 2.00% (2.11% at October 31, 2012)	2,000	4,000
Total debt	22,000	24,000
Current maturities of long-term debt		
Long-term debt, net of current maturities	\$ 22,000	\$ 24,000

To finance the acquisition of the electronic chemicals business in December 2007, the Company entered into an amended and restated 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 term loan facility and a revolving loan facility.

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The Company amended these facilities in November 2011 to increase the amount that may be borrowed under the revolving loan to \$60.0 million, extending the maturity to December 31, 2016 and allowing 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, the Company 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.

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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).

Ratio of Funded Debt to EBITDA	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 at 2.11% as of October 31, 2012 (LIBOR plus 2.00%). The amount outstanding on the revolving loan at October 31, 2012 was \$2.0 million.

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. 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 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 October 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 (as adjusted for extraordinary items, with lender consent) of 3.0 to 1.0, and a current ratio of at least 1.5 to 1.0.

12. Income Taxes

Income tax expense for the interim periods was computed using the effective tax rate based on the application of an estimated annual effective income tax rate applied to year-to-date income before income tax expense. In determining the estimated annual effective income tax rate, we analyze various factors, including forecasts of projected annual earnings and the ability to use tax credits and net operating loss carry forwards. The effective tax rate for continuing operations for the three months ended October 31, 2012 and 2011 was 36.7% and 39.3%, respectively. In general, differences between these effective tax rates and the rate of 35.0% are primarily due to foreign and state income taxes.

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

The Company records legal costs associated with loss contingencies as expenses in the period in which they are incurred.

A lawsuit was filed against the Company's wholly-owned subsidiary, KMG de Mexico, relating to the title to the land on which its 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

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title to the land, but that verdict was overturned on appeal in May 2012, and the case has been returned to the trial court for further action. The Company intends to continue to vigorously defend KMG de Mexico.

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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 of additional income tax (including interest and penalties), if all the adjustments are sustained. The Company 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 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.

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 and industrial wood treating chemicals. Our electronic chemicals are sold to the semiconductor industry, where they are used primarily to clean and etch silicon wafers in the production 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 crossties.

Sale of the Animal Health Business

On March 1, 2012, we sold certain assets of our animal health business to Bayer Healthcare, LLC for a purchase price of approximately \$10.2 million, including \$1.0 million held in escrow. The escrowed amount is being held pending final acceptance by the United States Environmental Protection Agency of certain studies being performed at its request on tetrachlorvinphos. We retained the real estate and building at our facility in Elwood, Kansas, and we 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 Month Period Ended October 31, 2012 compared with Three Month Period Ended October 31, 2011***Segment Data*

Segment data is presented for our two reportable segments for the three month periods ended October 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. Our animal health business was sold in March 2012, and results of that former segment are included as discontinued operations. Prior year information has been reclassified to conform to the current period presentation.

	Three Months Ended October 31,	
	2012	2011
	(Amounts in thousands)	
Sales		
Electronic chemicals	\$ 39,507	\$ 38,378
Wood treating chemicals	25,700	33,161
 Total sales for reportable segments	 \$ 65,207	 \$ 71,539

Net Sales

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Segment net sales decreased \$6.3 million, or 8.9%, to \$65.2 million in the first quarter of fiscal year 2013 as compared to \$71.5 million for the same period of the prior year. Although net sales in our electronic chemicals segment were up \$1.1 million in the first quarter of fiscal year 2013 over the prior year period, that increase was offset by a \$7.5 million decline in net sales in our wood treating chemicals segment.

In the first quarter of fiscal year 2013, the electronic chemicals segment had net sales of \$39.5 million, an increase of \$1.1 million, or 2.9%, as compared to \$38.4 million for the prior year period. The first quarter sales for fiscal year 2013 were affected by weakening demand, particularly in Europe. We expect demand for our electronic chemicals products to decline in the second quarter of fiscal 2013 from first quarter levels before strengthening in the second half of the fiscal year in calendar 2013.

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Net sales of wood treating chemicals decreased \$7.5 million, or 22.5%, to \$25.7 million in the first quarter of fiscal year 2013 as compared to \$33.2 million for the prior year period. The decrease in net sales for the quarter was due to a decrease in creosote sales volume. Creosote sales volume in the first quarter of fiscal 2013 was adversely impacted by customers pre-treating railroad ties with boron solutions as a way of reducing the amount of creosote needed. Some customers have adopted that practice as a way of holding down costs in response to higher creosote pricing. We anticipate further weakening of demand for wood treating chemicals in the second fiscal quarter before strengthening in the second half of fiscal 2013.

Gross Profit

Gross profit increased by \$1.4 million, or 7.6%, to \$20.1 million in the first quarter of fiscal year 2013 from \$18.7 million in the same quarter of the prior year. Gross profit as a percentage of sales increased to 30.7% in the first quarter of fiscal year 2013 from 26.1% in the first quarter of fiscal year 2012. The increase in aggregate gross profit for the quarter was due to the completed integration of our fiscal 2010 acquisition in the electronic chemicals segment, and due to the reduced weighting of creosote in our overall product portfolio. Creosote is our lowest gross margin product, and sales of that product decline as a percentage of our total revenue, the decline has the effect of increasing our overall gross profit margin.

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 increased to \$7.1 million in the first quarter of fiscal year 2013 from \$6.1 million in the prior year period, a 16.2% increase. Distribution expenses were approximately 10.8% and 8.5% of net sales for the first quarter of fiscal years 2013 and 2012, respectively. The increase in distribution expenses was primarily attributable to an increase in average freight costs and a decline in tender of performance by our lowest cost carrier.

Selling, General and Administrative Expenses

Selling, general, and administrative expenses increased \$317,000, or 5.6%, to \$5.9 million in the first quarter of fiscal year 2013 from \$5.6 million in the same quarter of fiscal year 2012. Those expenses were 9.1% and 7.8% of net sales in the first quarter of fiscal years 2013 and 2012, respectively. The increase in the current period was due to \$577,000 of additional project costs primarily for consulting and professional services.

Interest Expense, net

Interest expense was \$411,000 and \$550,000 in the first quarter of fiscal years 2013 and 2012, respectively. The decrease was due to lower borrowings on our loan facility in fiscal year 2013 as compared to the same period of the prior year, in part because we paid off the outstanding balance on our term loan under that facility in the first quarter of fiscal year 2012.

Income Taxes

Our effective tax rate for continuing operations was 36.7% and 39.3% in the first quarter of fiscal years 2013 and 2012, respectively.

Our Mexico subsidiary has undistributed earnings. It is our intention to continue to remain permanently reinvested in Mexico on its prior year cumulative undistributed earnings. Additionally, any undistributed earnings of the Italian subsidiary are considered to be permanently reinvested. Accordingly, no provision for United States income taxes has been provided with respect to undistributed earnings. Upon repatriation of those earnings, we will be subject to both United States income taxes (subject to an adjustment for foreign tax credits) and potentially withholding taxes payable to the foreign country.

Discontinued Operations

Discontinued operations reflected a loss, before income taxes, of \$102,000 and \$526,000 for the first quarter of fiscal year 2013 and 2012, respectively. We sold our animal health business in March 2012. In the first quarter of fiscal year 2013, we had certain post-closing adjustments related to that sale, and the loss in fiscal year 2012 included a first quarter loss of \$483,000 from that business. We also incurred expense in each

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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.

Table of Contents**Liquidity and Capital Resources***Cash Flows*

Net cash provided by operating activities was \$6.3 million for the first three months of fiscal year 2013 as compared to \$13.6 million for the comparable period in 2012. Net income adjusted for depreciation and amortization increased cash by \$5.9 million in fiscal year 2013 as compared to \$5.3 million over the same period of the prior year. Cash flows from operating activities during the current period were favorably impacted by \$2.7 million due to a reduction in trade accounts receivable from lower sales in our electronic chemicals segment in the first quarter of fiscal year 2013 versus the fourth quarter of fiscal year 2012, and also favorably impacted by \$1.9 million of increased accounts payable from the timing of payments and inventory purchases in our wood treating segment. Operating cash flows were unfavorably impacted by a \$5.0 million increase in inventories primarily due to the timing of creosote purchases and, to a lesser extent, higher inventories in our electronic chemicals segment.

Net cash used by investing activities in the first quarter of fiscal 2013 was \$1.5 million as compared to \$1.8 million in the prior year period, in each case for additions to property, plant and equipment.

Net cash used in financing activities was \$2.3 million in the first quarter of fiscal year 2013 as compared to \$8.4 million in the prior year period. In the first three months of fiscal year 2013, we made payments of \$2.0 million on our revolving loan. In the prior year period we made principal payments of \$11.3 million on the term loan indebtedness to pay it off entirely, borrowed \$6.1 million on our revolving loan, 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 three month periods ended October 31, 2012 and 2011, we paid dividends of \$342,000 and \$283,000, 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

We have a revolving line of credit under an amended and restated credit agreement. At October 31, 2012, we had \$2.0 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.

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 November 2011, raising the maximum amount that may be borrowed under the revolving loan facility from \$50.0 million to \$60.0 million, extending the maturity date of the credit agreement to December 31, 2016 and allowing 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	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%

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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 under the revolving loan bear interest at 2.11% as of October 31, 2012 (LIBOR plus 2.00%). At October 31, 2012, \$2.0 million was outstanding on the revolving facility.

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Before the term loan facility was paid off in October 2011, 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. On March 2, 2012, we repaid \$10.0 million of the balance on the revolving loan facility from proceeds received from the sale of the animal health business.

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 October 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 October 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, other than operating leases.

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, shall, expect, 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 energy, our primary raw materials and active ingredients;

the timing of planned capital expenditures;

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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.

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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.

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, 2012. 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 13 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, 2012.

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, 2013.

ITEM 6. EXHIBITS

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.

- 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.

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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: December 10, 2012

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

Date: December 10, 2012