

KEY TRONIC CORP  
Form 10-Q  
November 09, 2012

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

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FORM 10-Q

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

FOR THE PERIOD ENDED SEPTEMBER 29, 2012

OR

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

FOR THE PERIOD FROM            TO            .

Commission File Number 0-11559

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KEY TRONIC CORPORATION  
(Exact name of registrant as specified in its charter)

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Washington (State of Incorporation) N. 4424 Sullivan Road Spokane Valley, Washington 99216 (509) 928-8000	91-0849125 (I.R.S. Employer Identification No.)
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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements during the past 90 days. Yes  No

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of October 26, 2012, 10,488,856 shares of common stock, no par value (the only class of common stock), were outstanding.

KEY TRONIC CORPORATION

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\* Items are not applicable

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

## PART I: FINANCIAL INFORMATION

## Item 1: Financial Statements

## KEY TRONIC CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands)

	September 29, 2012	June 30, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$1,801	\$502
Trade receivables, net (allowance for doubtful accounts of \$54 and \$0)	56,691	60,709
Inventories	56,912	58,439
Deferred income tax asset	3,835	5,201
Other	6,240	4,639
Total current assets	125,479	129,490
Property, plant and equipment—net	17,463	17,306
Other assets:		
Deferred income tax asset	2,416	2,703
Other	1,980	1,413
Total other assets	4,396	4,116
Total assets	\$147,338	\$150,912
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$37,918	\$43,025
Accrued compensation and vacation	7,162	6,337
Current portion of other long-term obligations	739	729
Other	4,080	3,163
Total current liabilities	49,899	53,254
Long-term liabilities:		
Revolving loan	11,093	15,011
Deferred income tax liability	1,301	1,094
Other long-term obligations	1,141	2,945
Total long-term liabilities	13,535	19,050
Total liabilities	63,434	72,304
Commitments and contingencies (Note 7)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,489 and 10,481 shares, respectively	42,692	42,372
Retained earnings	40,639	36,895
Accumulated other comprehensive income (loss)	573	(659)
Total shareholders' equity	83,904	78,608
Total liabilities and shareholders' equity	\$147,338	\$150,912
See accompanying notes to consolidated financial statements.		

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

	Three Months Ended	
	September 29, 2012	October 1, 2011
Net sales	\$97,508	\$69,761
Cost of sales	88,033	64,756
Gross profit	9,475	5,005
Research, development and engineering expenses	1,250	956
Selling, general and administrative expenses	2,529	2,434
Total operating expenses	3,779	3,390
Operating income	5,696	1,615
Interest expense, net	116	103
Income before income taxes	5,580	1,512
Income tax provision	1,836	265
Net income	\$3,744	\$1,247
Net income per share — Basic	\$0.36	\$0.12
Weighted average shares outstanding — Basic	10,486	10,418
Net income per share — Diluted	\$0.35	\$0.12
Weighted average shares outstanding — Diluted	10,830	10,446
See accompanying notes to consolidated financial statements.		

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

	Three Months Ended	
	September 29, 2012	October 1, 2011
Comprehensive income:		
Net income	\$3,744	\$1,247
Other comprehensive income:		
Unrealized gain (loss) on foreign exchange contracts, net of tax	1,232	(4,313 )
Comprehensive income (loss)	\$4,976	\$(3,066 )

Other comprehensive income (loss) for the three months ended September 29, 2012 and October 1, 2011 is reflected net of tax of approximately \$0.6 million and \$(2.2) million, respectively.

See accompanying notes to consolidated financial statements.

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

	Three Months Ended	
	September 29, 2012	October 1, 2011
Increase (decrease) in cash and cash equivalents:		
Cash flows from operating activities:		
Net income	\$3,744	\$1,247
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	612	573
Excess tax benefit from exercise of stock options	(103)	) —
Provision for obsolete inventory	174	92
Provision for warranty	—	60
Provision for (recovery of) doubtful accounts	54	(111)
Share-based compensation expense	208	146
Deferred income taxes	1,226	204
Changes in operating assets and liabilities:		
Trade receivables	3,964	(7,816)
Inventories	1,353	(5,266)
Other assets	(1,550)	) (497)
Accounts payable	(5,107)	) 6,419
Accrued compensation and vacation	825	(782)
Other liabilities	622	(56)
Cash provided by (used in) operating activities	6,022	(5,787)
Cash flows from investing activities:		
Purchase of property and equipment	(739)	) (396)
Cash used in investing activities	(739)	) (396)
Cash flows from financing activities:		
Principal payments on long term debt	(178)	) (169)
Borrowings under revolving credit agreement	31,494	24,768
Repayment of revolving credit agreement	(35,412)	) (19,429)
Excess tax benefit from exercise of stock options	103	—
Proceeds from exercise of stock options	9	128
Cash (used in) provided by financing activities	(3,984)	) 5,298
Net increase (decrease) in cash and cash equivalents	1,299	(885)
Cash and cash equivalents, beginning of period	502	1,232
Cash and cash equivalents, end of period	\$1,801	\$347
Supplemental cash flow information:		
Interest payments	\$133	\$42
Income tax payments, net of refunds	\$479	\$116
See accompanying notes to consolidated financial statements.		

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

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, June 30, 2012	10,481	\$42,372	\$36,895	\$ (659 )	\$78,608
Net income	—	—	3,744	—	3,744
Unrealized gain on foreign exchange contracts, net	—	—	—	1,232	1,232
Exercise of stock options	8	9	—	—	9
Stock-based compensation	—	208	—	—	208
Tax benefit from exercise of stock options	—	103	—	—	103
Balances, September 29, 2012	10,489	\$42,692	\$40,639	\$ 573	\$83,904

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. Basis of Presentation

The consolidated financial statements included herein have been prepared by Key Tronic Corporation and subsidiaries (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in our annual consolidated financial statements have been condensed or omitted. The year-end condensed consolidated balance sheet information was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The financial statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period. The results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012. The Company's reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three month periods ended September 29, 2012 and October 1, 2011 were 13 week periods. Fiscal year 2013 will end on June 29, 2013 which is a 52 week year, and fiscal year 2012 which ended on June 30, 2012, was also a 52 week year.

2. Significant Accounting Policies

Income Taxes

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

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

We utilize a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments based on new assessments and changes in estimates and which may not accurately forecast actual outcomes. Our policy is to recognize interest and penalties related to the underpayment of income taxes as a component of income tax expense. To date, we have not incurred charges for interest or penalties in relation to the underpayment of income taxes. The tax years 1997 through the present remain open to examination by the major U.S. taxing jurisdictions to which we are subject. Refer to Note 5 for further discussions.

Earnings Per Common Share



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Basic earnings per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed by dividing net income by the combination of other potentially dilutive weighted average common shares and the weighted average number of common shares outstanding during the period using the treasury stock method. The computation assumes the proceeds from the exercise of equity awards were used to repurchase common shares at the average market price during the period. The computation of diluted earnings per common share does not assume conversion, exercise, or contingent issuance of common stock equivalent shares that would

have an anti-dilutive effect on earnings per share.

#### Share-based Compensation

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

On July 27, 2011, the Company granted 184,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of \$4.40 and a grant date weighted average fair market value of \$2.20. On January 26, 2012, the Company granted 32,000 SARs under the 2010 Incentive Plan to certain key employees at a strike price of \$6.30 and a grant date weighted average fair market value of \$3.08. On July 25, 2012, the Company granted 210,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of \$7.44 and a grant date weighted average fair market value of \$3.71.

In addition to service conditions, these SARs contain a performance condition. The additional performance condition is based upon the achievement of Return on Invested Capital (ROIC) goals relative to a peer group. All awards with performance conditions are measured over the vesting period and are charged to compensation expense over the requisite service period based on the number of shares expected to vest. The SARs cliff vest after a three-year period from date of grant and expire five years from date of grant.

The grant date fair value for the awards granted were estimated using the Black Scholes option valuation method with the following weighted average assumptions on grant date:

	July 25, 2012	January 26, 2012	July 27, 2011
Expected dividend yield	— %	— %	— %
Risk – free interest rate	0.46 %	0.52 %	1.16 %
Expected volatility	66.50 %	64.90 %	65.50 %
Expected life	4.00	4.00	4.00

Total share-based compensation expense recognized during the three months ended September 29, 2012 and October 1, 2011 was as follows (in thousands):

	Three Months Ended	
	September 29, 2012	October 1, 2011
Stock Appreciation Rights	\$208	\$146

As of September 29, 2012 total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately \$1.3 million. This expense is expected to be recognized over a weighted average period of 2.12 years.

Options to purchase 7,500 shares of common stock were exercised during the three months ended September 29, 2012 and 47,500 options to purchase shares of common stock were exercised during the three months ended October 1, 2011, with an immaterial amount of intrinsic value for each of the periods presented.

#### Recently Issued Accounting Standards

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

Management has assessed the potential impact of other recently issued, but not yet effective, accounting standards and determined that the provisions are either not applicable to the Company, or are not anticipated to have a material impact on the consolidated financial statements.

### 3. Inventories

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

	September 29, 2012	June 30, 2012
Finished goods	\$10,414	\$9,805
Work-in-process	6,788	6,340
Raw materials and supplies	39,710	42,294
	\$56,912	\$58,439

### 4. Long-Term Debt

#### Note Payable – Bank

On October 15, 2010, the Company entered into an amended credit agreement with Wells Fargo Bank, N.A. thereby increasing its revolving line of credit facility for up to \$30.0 million. On January 30, 2012, the Company entered into a second amendment to the credit agreement extending the term to October 15, 2016. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a “Base Rate” or a “Fixed Rate”, as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of the Company’s trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The revolving line of credit is secured by substantially all of the assets of the Company.

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

As of September 29, 2012, the Company had availability to borrow an additional \$18.9 million under the line of credit. The outstanding balance under the credit facility was \$11.1 million as of September 29, 2012 and the interest rate on the outstanding balance was 3.25%. As of June 30, 2012, the outstanding balance under the credit facility was \$15.0 million and the interest rate on the outstanding balance was in the range of 2.35% - 3.25%.

### 5. Income Taxes

The Company expects to repatriate a portion of its foreign earnings based on increased sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company currently expects to repatriate approximately \$7.9 million of foreign earnings in the future. As such, these earnings would be recognized in the United States, and the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax of expected repatriation of foreign earnings have been recorded as part of deferred taxes as of September 29, 2012. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed assets purchases in foreign locations.

The Company has available approximately \$5.9 million of federal research and development tax credits. ASC 740 requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. Accordingly, as of September 29, 2012, the Company had previously recorded \$2.9 million of unrecognized tax benefits associated with these federal tax credits.

The Company has a wholly owned foreign subsidiary in Mexico that utilizes certain tax credits related to production assets that currently offset all of the income tax liabilities under general Mexican income tax law. However, the Company is subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The Company anticipates that it will be taxable under IETU for the foreseeable future based on projected assets used in its operations. The effect of IETU and an associated presidential decree has been included in the effective tax rate for the three months ended September 29, 2012.

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

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	Three Months Ended	
	September 29, 2012	October 1, 2011
Federal income tax provision at statutory rate	\$1,897	\$514
Foreign earnings taxed at lower rates	(112)	(45)
Effect of foreign currency rate changes	(67)	(258)
Other	118	54
Income tax provision	\$1,836	\$265

#### 6. Earnings Per Share

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

	Three Months Ended	
	(in thousands, except per share information)	
	September 29, 2012	October 1, 2011
Net income	\$ 3,744	\$ 1,247
Weighted average shares outstanding—basic	10,486	10,418
Effect of dilutive common stock options	344	28
Weighted average shares outstanding—diluted	10,830	10,446
Earnings per share—basic	\$ 0.36	\$ 0.12
Earnings per share—diluted	\$ 0.35	\$ 0.12
Antidilutive options not included in diluted earnings per share	—	707

#### 7. Commitments and Contingencies

##### Purchase Commitments

The Company had approximately \$0.5 million of firm commitments to suppliers for capital expenditures at September 29, 2012.

##### Leases

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

##### Warranties

The Company provides warranties on certain product sales. Allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from management's estimates, adjustments to recognize additional cost of sales may be required in future periods. The Company's warranty reserve was approximately \$19,000 and \$23,000 as of September 29, 2012 and June 30, 2012, respectively.

#### 8. Fair Value Measurements

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

The following table summarizes the fair values of assets/(liabilities) of the Company's derivatives that are required to be measured on a recurring basis as of September 29, 2012 and June 30, 2012 (in thousands):

	September 29, 2012			Total
	Level 1	Level 2	Level 3	Fair Value
Financial Assets:				
Foreign currency forward contracts	\$—	\$1,506	\$—	\$1,506
Financial Liabilities:				
Foreign currency forward contracts	\$—	\$(632)	\$—	\$(632)
	June 30, 2012			Total
	Level 1	Level 2	Level 3	Fair Value
Financial Assets:				
Foreign currency forward contracts	\$—	\$858	\$—	\$858
Financial Liabilities:				
Foreign currency forward contracts	\$—	\$(1,851)	\$—	\$(1,851)

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

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at September 29, 2012 and June 30, 2012, reasonably approximate their fair value. The Company's long-term debt primarily consists of a revolving line of credit. Borrowings under this revolving line of credit bear interest at the higher of Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5% to 2.5%, or the Federal Funds rate plus 1.5%. Each of these rates is a variable floating rate dependent upon current market conditions and the Company's current credit risk. As a result of the determinable market rate for our revolving credit debt it is classified within Level 2 of the fair value hierarchy. The discounted cash flow of the revolving line of credit is estimated to be \$11.1 million and \$15.0 million, respectively, as of September 29, 2012 and June 30, 2012, which carrying value approximates the fair value.

#### 9. Derivative Financial Instruments

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

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

As of September 29, 2012, the Company had outstanding foreign currency forward contracts with a total notional amount of \$52.2 million. These contract maturity dates extend through March 2015. The Company did not enter into any foreign currency forward contracts during the three months ended September 29, 2012. However, the Company settled \$5.5 million of foreign currency forward contracts during the three months ended September 29, 2012. For the three months ended October 1, 2011, the Company entered into foreign currency forward contracts of \$8.6 million and settled \$4.2 million of such contracts.

Subsequent to September 29, 2012, the Company entered into \$10.6 million of forward contracts that extended our hedge position through September 2015.



The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of September 29, 2012 and June 30, 2012 (in thousands):

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Derivatives Designated as Hedging Instruments	Balance Sheet Location	September 29, 2012	June 30, 2012
		Fair Value	Fair Value
Foreign currency forward contracts	Other current assets	\$ 171	\$ 199
Foreign currency forward contracts	Other long-term assets	\$ 1,335	\$ 659
Foreign currency forward contracts	Other current liabilities	\$(435)	\$(923)
Foreign currency forward contracts	Other long-term liabilities	\$(197)	\$(928)

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the three months ended September 29, 2012 and October 1, 2011, respectively (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of June 30, 2012	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of September 29, 2012
Settled foreign currency forward contracts for the three months ended September 29, 2012	\$ 118	\$ 153	\$ (271)	\$—
Unsettled foreign currency forward contracts	(777)	1,350	—	573
Total	\$(659)	\$ 1,503	\$ (271)	\$ 573

Derivatives Designated as Hedging Instruments	AOCI Balance as of July 2, 2011	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of October 1, 2011
Settled foreign currency forward contracts for the three months ended October 1, 2011	\$ 268	\$(47)	\$(221)	\$—
Unsettled foreign currency forward contracts	1,472	(4,045)	—	(2,573)
Total	\$ 1,740	\$(4,092)	\$(221)	\$(2,573)

The Company does not enter into derivative instruments for trading or speculative purposes. The Company's counterparties to the foreign currency forward contracts are major financial institutions. These institutions do not require collateral for the contracts and the Company believes that the risk of the counterparties failing to meet their contractual obligations is remote. As of September 29, 2012, the net amount of unrealized loss expected to be reclassified into earnings within the next 12 months is approximately \$(0.2) million.

As of September 29, 2012, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

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

### FORWARD-LOOKING STATEMENTS

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

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

Year-end Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Overview

KeyTronicEMS is a leader in electronic manufacturing services and solutions to original equipment manufacturers of a broad range of products. We provide engineering services, worldwide procurement and distribution, materials management, world-class manufacturing and assembly services, in-house testing, and expertise in providing customer service. Our international

production capability provides our customers with benefits of improved supply-chain management, reduced inventories, lower transportation costs, and reduced product fulfillment time. We continue to make investments in all of our operating facilities to give us the production capacity and logistical advantages to continue to win new business. The following information should be read in conjunction with the consolidated financial statements included herein and with Part II Item 1A, Risk Factors included as part of this filing.

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

#### Executive Summary

Net sales of \$97.5 million for the first quarter of fiscal year 2013 increased by 39.8 percent as compared to net sales of \$69.8 million for the first quarter of fiscal year 2012. The increase in net sales was primarily driven by an increase in revenues related to new programs for both new and longstanding customers and a net increase in demand related to current customer programs, partially offset by the negative impact of the uncertain macroeconomic environment and program losses. We believe that we are well positioned in the electronic manufacturing services (EMS) industry to win new business in coming periods and profitably grow our revenue as the economy recovers.

The concentration of our top five customers' sales increased to 73.1 percent of total sales in the first quarter of fiscal year 2013 from 71.5 percent in the same period of the prior fiscal year. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies, computer accessories and electronic whiteboards. At the end of the first quarter of fiscal year 2013, we were generating revenue from 168 separate programs and 51 distinct customers as compared to 135 programs and 36 customers at the end of the first quarter of fiscal year 2012. Some of these new customers have programs that represent small annual sales while others have multi-million-dollar potential.

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

Gross profit as a percent of sales was 9.7 percent for the first quarter of fiscal year 2013 as compared to 7.2 percent for the same quarter of the prior fiscal year. The increase in gross profit as a percentage of net sales was primarily due to a decrease in material-related costs as a percentage of net sales as well as increased leverage of certain overhead costs. Operating income as a percentage of sales for the first quarter of fiscal year 2013 was 5.8 percent compared to 2.3 percent for the same quarter of the prior fiscal year. The increase in operating income as a percentage of sales was primarily due to the increase in gross profit and our continued success in leveraging our operating expenses.

Net income for the first quarter of fiscal year 2013 was \$3.7 million or \$0.35 per diluted share, as compared to \$1.2 million or \$0.12 per diluted share for the first quarter of fiscal year 2012. The increase in net income as a percent of sales for the first quarter of fiscal year 2013 as compared to the same period in fiscal year 2012, is the result of an increase in net sales coupled with an improvement in our gross margin and operating income as discussed above and in further detail in the "Results of Operations" section.

We maintain a strong balance sheet with a current ratio of 2.5 and a long-term debt to equity ratio of 0.15. Total cash provided by operating activities as defined on our cash flow statement was \$6.0 million during the first quarter of fiscal year 2013. We maintain sufficient liquidity for our expected future operations and had \$11.1 million in borrowings on our \$30.0 million revolving line of credit with Wells Fargo Bank, N.A. of which \$18.9 million remained available at September 29, 2012. We believe cash flow generated from operations, our borrowing capacity, and leasing opportunities should provide adequate capital for planned growth.

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets,

liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. These estimates and assumptions are based on historical results as well as future expectations. Actual results could vary from our estimates and assumptions.

The accounting policies and estimates listed below are those that we believe are the most critical to our consolidated financial condition and results of operations. They are also the accounting policies that typically require our most difficult, subjective and complex judgments and estimates, often for matters that are inherently uncertain including.

Inactive, Obsolete, and Surplus Inventory Reserve

Allowance for Doubtful Accounts

Accrued Warranty

Income Taxes

Stock-Based Compensation

Impairment of Long-Lived Assets

Derivatives and Hedging Activity

Please refer to the discussion of critical accounting policies in our most recent Annual Report on Form 10-K for the fiscal year ended June 30, 2012, for further details.

## RESULTS OF OPERATIONS

Comparison of the Three Months Ended September 29, 2012 with the Three Months Ended October 1, 2011  
The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes.

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended September 29, 2012 as compared to the three months ended October 1, 2011. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended		October 1, 2011	% of net sales	\$ change	% point change	
	September 29, 2012	% of net sales					
Net sales	\$97,508	100.0	% \$69,761	100.0	% \$27,747	—	%
Cost of sales	88,033	90.3	% 64,756	92.8	% 23,277	(2.5)	)%
Gross profit	9,475	9.7	% 5,005	7.2	% 4,470	2.5	%
Research, development and engineering	1,250	1.3	% 956	1.4	% 294	(0.1)	)%
Selling, general and administrative	2,529	2.6	% 2,434	3.5	% 95	(0.9)	)%
Total operating expenses	3,779	3.9	% 3,390	4.9	% 389	(1.0)	)%
Operating income	5,696	5.8	% 1,615	2.3	% 4,081	3.5	%
Interest expense, net	116	0.1	% 103	0.1	% 13	—	%
Income before income taxes	5,580	5.7	% 1,512	2.2	% 4,068	3.5	%
Income tax provision	1,836	1.9	% 265	0.4	% 1,571	1.5	%
Net income	\$3,744	3.8	% \$1,247	1.8	% \$2,497	2.0	%
Effective income tax rate	32.9	%	17.5	%			

### Net Sales

The increase in net sales from the prior year period was primarily driven by an approximate \$19.9 million increase in revenues related to new programs for both new and longstanding customers as well as a \$7.9 million net increase in revenues related to increased demand from current customer programs, partially offset by the impact of an uncertain macroeconomic environment. Additionally, program losses of approximately \$0.1 million had a negative impact on our results of operations.

During the three months ended September 29, 2012, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and expect to see a modest growth in revenue during the remainder of the year, driven by increased production levels of new programs for both new and longstanding customers. For the second quarter of fiscal year 2013, the Company expects to report revenue in the range of \$93 million to \$99 million, and earnings in the range of \$0.32 to \$0.38 per diluted share. Future results will depend on actual levels of customers' orders, the timing of the startup of production of new product programs and the impact of the industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Gross Profit

Gross profit as a percentage of sales for the three months ended September 29, 2012 was 9.7 percent compared to 7.2 percent

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for the three months ended October 1, 2011. This 2.5 percentage point increase is primarily related to a 0.5 percentage point decrease in material related costs as a percent of net sales, as well as a 2.0 percentage points improvement in leveraging of certain overhead costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately \$0.2 million and \$0.1 million for obsolete inventory during the three months ended September 29, 2012 and October 1, 2011, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

#### Operating Expenses

Total research, development, and engineering (RD&E) expenses were \$1.3 million and \$1.0 million during the three months ended September 29, 2012 and October 1, 2011, respectively. This \$0.3 million increase is primarily related to an increase in labor related expenses.

Total RD&E expenses as a percent of net sales were 1.3 percent and 1.4 percent during the three months ended September 29, 2012 and October 1, 2011, respectively. This 0.1 percentage point decrease in RD&E is primarily related to our continued success in leveraging operating expenses as a percent of net sales.

Total selling, general and administrative (SG&A) expenses were \$2.5 million during the three months ended September 29, 2012 compared to \$2.4 million during the three months ended October 1, 2011. This \$0.1 million increase in SG&A is primarily related to an increase in labor related expenses. This is partially offset by the positive impact of a non-recurring adjustment of approximately \$0.5 million related to the elimination of a deferred compensation liability.

Total SG&A expenses as a percent of net sales were 2.6 percent during the three months ended September 29, 2012 compared to 3.5 percent during the three months ended October 1, 2011. This 0.9 percentage point decrease in SG&A is primarily related to our continued success in leveraging operating expenses as a percent of net sales and the non-recurring adjustment discussed above.

Total operating expenses were \$3.8 million or 3.9 percent of net sales for the three months ended September 29, 2012 and \$3.4 million or 4.9 percent of net sales for the three months ended October 1, 2011. The 1.0 percentage point decrease in operating expenses as a percent of net sales is primarily related to our successful leveraging of RD&E and SG&A expenses as a percent of net sales.

#### Interest

Interest expense increased to \$116,000 during the three months ended September 29, 2012 from \$103,000 during the three months ended October 1, 2011. The slight increase was related to an increase in the average balance outstanding, as interest rates remained flat quarter to quarter.

#### Income Taxes

The effective tax rate for the three months ended September 29, 2012 was 32.9 percent compared to 17.5 percent for the same period in fiscal year 2012. The increase in the effective tax rate was related to a change in foreign currency rates and R&D tax credits not being extended during the period that includes the three months ended September 29, 2012. For further information on taxes see footnote 5 of the "Notes to Consolidated Financial Statements".

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

#### Backlog

On September 29, 2012, we had an order backlog of approximately \$81.0 million. This compares with a backlog of approximately \$53.2 million on October 1, 2011. The increase in backlog at September 29, 2012, when compared to October 1, 2011, reflects an increase in new customers and programs. Order backlog consists of purchase orders



received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future sales.

**CAPITAL RESOURCES AND LIQUIDITY**

Operating Cash Flow

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Net cash provided by operating activities for the three months ended September 29, 2012 was \$6.0 million, compared to net cash used in operating activities of \$5.8 million during the same period of the prior fiscal year. Cash flows provided by operating activities increased primarily due to improved working capital management and higher net income.

This \$11.8 million year-over-year increase is primarily related to a \$1.4 million decrease in inventory, and a \$4.0 million decrease in accounts receivable offset by a \$5.1 million decrease in accounts payable during the three months ended September 29, 2012. This compares to a \$5.8 million of cash flows used in operating activities during the three months ended October 1, 2011, which resulted primarily from a \$5.3 million increase in inventory, a \$7.8 million increase in accounts receivable, which were offset by a \$6.4 million increase in accounts payable. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts receivable fluctuates based on the timing of shipments, terms offered and collections that occurred during the quarter. While overall sales are not typically seasonal in nature, we ship the majority of our product during the latter half of the quarter. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases and negotiated supplier terms.

#### Investing Cash Flow

Cash used in investing activities was \$0.7 million during the three months ended September 29, 2012 as compared to \$0.4 million during the three months ended October 1, 2011. Our investing cash flows primarily consist of capital expenditures to purchase manufacturing equipment to support production and to a lesser extent leasehold improvements at our corporate headquarters.

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

#### Financing Cash Flow

Cash used in financing activities was \$4.0 million during the three months ended September 29, 2012 as compared to cash provided by financing activities of \$5.3 million in the same period of the previous fiscal year. Our primary financing activity during the first three months of fiscal year 2013 and 2012 was borrowing and repayment under our revolving line of credit facility. Our credit agreement with Wells Fargo Bank N.A. provides a revolving line of credit facility of up to \$30.0 million, subject to availability. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a "Base Rate" or a "Fixed Rate", as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month LIBOR plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of our trailing four quarters EBITDA.

As of September 29, 2012, we were in compliance with our loan covenants and approximately \$18.9 million was available under the revolving line of credit facility. The outstanding balance under the credit facility was \$11.1 million as of September 29, 2012 and the interest rate being paid on the outstanding balance was 3.25%.

Our cash requirements are affected by the level of current operations and new EMS programs. We believe that projected cash from operations, funds available under the revolving credit facility and leasing capabilities will be sufficient to meet our working and fixed capital requirements for the foreseeable future. As of September 29, 2012, we had approximately \$1.8 million of cash held by foreign subsidiaries. If cash is to be repatriated in the future from these foreign subsidiaries, the Company could be subject to additional income taxes payable in the U.S. The total amount of tax payments required for the amount of foreign subsidiary cash on hand as of September 29, 2012 would approximate \$82,000. We have accrued for expected future repatriation of foreign earnings as discussed in footnote 5 of the "Notes to Consolidated Financial Statements".

#### CONTRACTUAL OBLIGATIONS

We have included a summary of our Contractual Obligations in our annual report on Form 10-K for the fiscal year ended June 30, 2012. There have been no material changes in contractual obligations outside the ordinary course of business since June 30, 2012.

#### RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

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

We may experience fluctuations in quarterly results of operations.

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

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

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

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

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

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

The Company's ability to secure and maintain sufficient credit arrangements is key to its continued operations. There is no assurance that the Company will be able to retain or renew its credit agreements in the future. In the event the business grows rapidly or the uncertain macroeconomic climate continues, additional financing resources could be necessary in the current or future fiscal years. There is no assurance that the Company will be able to obtain equity or debt financing at acceptable terms, or at all in the future. For a summary of the Company's banking arrangements, see Note 4, Long-Term Debt, of the "Notes to Consolidated Financial Statements" in this Annual Report on Form 10-K. We depend on a limited number of suppliers for components that are critical to our manufacturing processes. A shortage of these components or an increase in their price could interrupt our operations and result in a significant change in our results of operations.

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

Cash and cash equivalents are exposed to concentrations of credit risk.

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

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

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

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

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

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

Our international operations may be subject to certain risks.

Most of the products we manufacture are in facilities located in Mexico and China. These international operations may be subject to a number of risks, including:

- difficulties in staffing and managing foreign operations;
- political and economic instability (including acts of terrorism, civil unrest, forms of violence and outbreaks of war), which could impact our ability to ship, manufacture, and/or receive product;
- unexpected changes in regulatory requirements and laws;
- longer customer payment cycles and difficulty collecting accounts receivable;
- export duties, import controls and trade barriers (including quotas);
- governmental restrictions on the transfer of funds;
- burdens of complying with a wide variety of foreign laws and labor practices;
- fluctuations in currency exchange rates, which could affect component costs, local payroll, utility and other expenses;
- inability to utilize net operating losses generated by our foreign operations to reduce our U.S. income taxes; and
- our foreign locations may be impacted by hurricanes, earthquakes, water shortages, tsunamis, floods, typhoons, fires, extreme weather conditions and other natural or man-made disasters.

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

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us could directly or indirectly affect our financial results. Future currency fluctuations are dependent upon a number of factors and cannot be easily predicted. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. However, unexpected losses could occur from future fluctuations in exchange rates. Additionally, certain foreign jurisdictions restrict the amount of cash that can be transferred to the U.S or impose taxes and penalties on such transfers of cash. To the extent we have excess cash in foreign locations that could be used in, or is needed by, our operations in the United States, we may incur significant penalties and/or taxes to repatriate these funds.

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

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

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



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

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

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

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

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

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

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

Our stock price is volatile.

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

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

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

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

Our business is experiencing rapid growth which can place considerable additional demands upon our management team and our operational, financial and management information systems. Our ability to manage growth effectively requires us to continue to implement and improve these systems; avoid cost overruns; maintain customer, supplier and



other favorable business relationships during possible transition periods; continue to develop the management skills of our managers and supervisors; and continue to train, motivate and manage our employees. Our failure to effectively manage growth could have a material adverse effect on our results of operations.

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

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

Energy price increases may negatively impact our results of operations.

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

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

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

We are involved in various legal proceedings.

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



### Item 3. Quantitative and Qualitative Disclosures About Market Risk

#### Interest Rate Risk

We are subject to the risk of fluctuating interest rates in the normal course of business. Our major market risk relates to our secured debt. Our revolving credit facility is secured by substantially all of our assets. The interest rates applicable to our revolving credit facility fluctuate with the Wells Fargo Bank, N.A. prime rate and LIBOR rates. There was outstanding \$11.1 million in borrowings under our revolving credit facility as of September 29, 2012, and the interest being paid on the outstanding balance was 3.25%. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources and Liquidity” and Note 4 – “Long-Term Debt” to the Consolidated Financial Statements for additional information regarding our revolving line of credit.

#### Foreign Currency Exchange Risk

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us would directly or indirectly affect our financial results. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There was outstanding \$52.2 million of foreign currency forward contracts as of September 29, 2012. The fair value of these contracts was \$0.9 million. See Note 9 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company’s Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of September 29, 2012, the Company’s disclosure controls and procedures are effective based on that criteria.

#### Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during three months ended September 29, 2012 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)).

### PART II. OTHER INFORMATION:

#### Item 1. Legal Proceedings

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

#### Item 1A. Risk Factors

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

There are no material changes to the risk factors set forth in Part I Item 1A in the Company’s Annual Report on Form 10-K for the year ended June 30, 2012.

#### Item 4. Mine Safety Disclosures

None



Item 6. Exhibits

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

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

SIGNATURES

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

KEY TRONIC CORPORATION

/s/ CRAIG D. GATES

Craig D. Gates  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: November 9, 2012

/s/ RONALD F. KLAWITTER

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

Date: November 9, 2012