KEY TRONIC CORP
Form 10-Q
February 08, 2018

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

FORM 10-Q

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x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE PERIOD ENDED DECEMBER 30, 2017
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE PERIOD FROM TO .
Commission File Number 0-11559

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

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

N. 4424 Sullivan Road
Spokane Valley, Washington 99216
(509) 928-8000

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

As of February 6, 2018, 10,759,680 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

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

PART I: FINANCIAL INFORMATION
Item 1: Financial Statements
KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands)

	December 30, 2017	July 1, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$450	$373
Trade receivables, net of allowance for doubtful accounts of $0 and $84	57,437	65,193
Inventories, net	108,873	101,590
Other	13,804	11,037
Total current assets	180,564	178,193
Property, plant and equipment, net	28,473	30,496
Other assets:		
Deferred income tax asset	7,463	6,981
Goodwill	9,957	9,957
Other intangible assets, net	4,258	4,800
Other	2,097	2,413
Total other assets	23,775	24,151
Total assets	$232,812	$232,840
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$61,537	$53,078
Accrued compensation and vacation	6,482	10,005
Current portion of debt, net	5,841	5,841
Other	9,810	8,829
Total current liabilities	83,670	77,753
Long-term liabilities:		
Term loans	15,852	18,773
Revolving loan	15,633	18,335
Other long-term obligations	844	1,412
Total long-term liabilities	32,329	38,520
Total liabilities	115,999	116,273
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,760 and 10,760 shares, respectively	46,048	45,797
Retained earnings	73,753	73,545
Accumulated other comprehensive loss	(2,988)	(2,775)
Total shareholders' equity	116,813	116,567
Total liabilities and shareholders' equity	$232,812	$232,840

See accompanying notes to consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	December 30, 2017	December 31, 2016	December 30, 2017	December 31, 2016
Net sales	$111,725	$118,517	$220,942	$235,652
Cost of sales	102,925	108,905	204,297	216,331
Gross profit	8,800	9,612	16,645	19,321
Research, development and engineering expenses	1,495	1,603	3,005	3,187
Selling, general and administrative expenses	5,654	5,462	10,825	10,797
Total operating expenses	7,149	7,065	13,830	13,984
Operating income	1,651	2,547	2,815	5,337
Interest expense, net	616	552	1,210	1,141
Income before income taxes	1,035	1,995	1,605	4,196
Income tax provision	1,259	467	1,397	876
Net income (loss)	$(224)	$1,528	$208	$3,320
Net income (loss) per share — Basic	$(0.02)	$0.14	$0.02	$0.31
Weighted average shares outstanding — Basic	10,760	10,758	10,760	10,753
Net income (loss) per share — Diluted	$(0.02)	$0.14	$0.02	$0.30
Weighted average shares outstanding — Diluted	10,760	10,968	10,760	10,919

See accompanying notes to consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	December 30, 2017	December 31, 2016	December 30, 2017	December 31, 2016
Comprehensive income (loss):				
Net income (loss)	$ (224)	$ 1,528	$ 208	$ 3,320
Other comprehensive income (loss):				
Unrealized loss on hedging instruments, net of tax	(1,225)	(1,266)	(213)	(2,266)
Comprehensive income (loss)	$ (1,449)	$ 262	$ (5)	$ 1,054

Other comprehensive income (loss) for the three months ended December 30, 2017 and December 31, 2016, is reflected net of tax benefit of approximately $(0.6) million and $(0.7) million, respectively. Other comprehensive income (loss) for the six months ended December 30, 2017 and December 31, 2016, is reflected net of tax benefit of approximately $(0.1) million and $(1.2) million, respectively.
See accompanying notes to consolidated financial statements.

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

	Six Months Ended	
	December 30, 2017	December 31, 2016
Operating activities:		
Net income	$208	$ 3,320
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	3,889	3,430
Amortization of deferred loan costs	15	—
Provision for obsolete inventory	26	306
Provision for warranty	21	63
Recovery of doubtful accounts	(84)	(1)
Loss on disposal of assets	11	109
Share-based compensation expense	251	355
Deferred income taxes	(372)	(900)
Changes in operating assets and liabilities:		
Trade receivables	7,840	(4,765)
Inventories	(7,309)	8,594
Other assets	(3,522)	836
Accounts payable	8,459	(7,789)
Accrued compensation and vacation	(3,523)	(1,876)
Other liabilities	990	1,448
Cash provided by operating activities	6,900	3,130
Investing activities:		
Purchase of property and equipment	(2,155)	(4,936)
Proceeds from sale of fixed assets	982	101
Cash used in investing activities	(1,173)	(4,835)
Financing activities:		
Payment of financing costs	(12)	(193)
Proceeds from long term debt	—	3,919
Repayments of long term debt	(2,936)	(2,500)
Borrowings under revolving credit agreement	91,707	79,260
Repayments of revolving credit agreement	(94,409)	(78,403)
Tax withholding from exercise of share-based compensation	—	(116)
Cash (used in) provided by financing activities	(5,650)	1,967
Net increase in cash and cash equivalents	77	262
Cash and cash equivalents, beginning of period	373	1,018
Cash and cash equivalents, end of period	$450	$ 1,280
Supplemental cash flow information:		
Interest payments	$1,202	$ 1,127
Income tax payments, net of refunds	$516	$ 418

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, July 1, 2017	10,760	$ 45,797	$ 73,545	$ (2,775)	$ 116,567
Net income	—	—	208	—	208
Unrealized loss on hedging instruments, net	—	—	—	(213)	(213)
Share-based compensation	—	251	—	—	251
Balances, December 30, 2017	10,760	$ 46,048	$ 73,753	$ (2,988)	$ 116,813

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 July 1, 2017.

The Company's reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three and six month periods ended December 30, 2017 and December 31, 2016, were 13 and 26 week periods, respectively. Fiscal year 2018 will end on June 30, 2018, which is a 52 week year. Fiscal year 2017 which ended on July 1, 2017, was a 52 week year.

2. Significant Accounting Policies

Earnings Per Common Share

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

Derivative Instruments and Hedging Activities

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

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

The Company's foreign currency forward contracts, foreign currency swaps and interest rate swap potentially expose the Company to credit risk to the extent the counterparty may be unable to meet the terms of the agreement. The Company minimizes such risk by utilizing a counterparty with a strong credit rating. The Company's counterparty to the foreign currency forward contracts, foreign currency swaps and interest rate swap is a major banking institution. This institution does not require collateral for the contracts, and the Company believes that the risk of the counterparty failing to meet their contractual obligations is remote. The Company does not enter into derivative instruments for trading or speculative purposes.

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 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 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. The tax years 1998 through the present remain open to examination by the major U.S. taxing jurisdictions to which we are subject. Refer to Note 6 for further discussions.

Impairment of Goodwill and Other Intangible Assets

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

Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09 (ASU 2014-09), Revenue from Contracts with Customers. The guidance in this Update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under current guidance. This may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. This Update is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. As such, the guidance is effective for the Company beginning in the first quarter of fiscal year 2019. The Company is in the process of implementation in accordance with the planned effective date. Implementation activities are focused on the review of significant customer contracts, identification and development of additional systems capabilities to enable the Company to make reasonable estimates of revenue during the manufacturing process, and the design and implementation of relevant internal controls. The Company has assessed that the impact of the new guidance will result in a change of the Company's revenue recognition model for electronics manufacturing services from "point in time" upon physical delivery to an "over time" model and believes this transition may have a material impact on the Company's consolidated financial statements upon adoption primarily as it will recognize an increase in contract assets for unbilled receivables with a corresponding reduction in finished goods and work-in-process inventory. The new guidance allows for two transition methods in application (i) retrospective approach, or (ii) modified retrospective approach. The Company will adopt the standard using the modified retrospective approach, which will result in an

adjustment for the cumulative effect of applying this guidance to contracts in process as of the adoption date. Under this approach, prior financial statements presented will not be restated. Additionally, disclosures required for revenue recognition will include qualitative and quantitative information about contracts with customers, significant judgments and changes in judgments, and assets recognized from costs to obtain or fulfill a contract. Such disclosures are more extensive than what is required under existing GAAP.

In February 2016, the FASB issued Accounting Standards Update 2016-02, Leases which supersedes ASC 840 Leases and creates a new topic, ASC 842 Leases. This update requires lessees to recognize a lease asset and a lease liability for all leases, including operating leases, with a term greater than 12 months on its balance sheet. The update also expands the required quantitative and qualitative disclosures surrounding leases. This update is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years, with earlier adoption permitted. This update will be applied using a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. Upon initial evaluation, the Company believes the new guidance will have a material impact on its consolidated balance sheets when adopted. The Company is currently assessing the timing of adoption.

In August 2016, the FASB issued Accounting Standards Update 2016-15, Classification of Certain Cash Receipts and Cash Payments. This update provides guidance on how to record eight specific cash flow issues. This update is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted and a retrospective transition method to each period should be presented. The Company is currently evaluating the effect of this update on its consolidated financial statements.

In January 2017, the FASB issued Accounting Standards Update 2017-04, Simplifying the Test for Goodwill Impairment. Under the new standard, goodwill impairment would be measured as the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying value of goodwill. This ASU eliminates existing guidance that requires an entity to determine goodwill impairment by calculating the implied fair value of goodwill by hypothetically assigning the fair value of a reporting unit to all of its assets and liabilities as if that reporting unit had been acquired in a business combination. This update is effective prospectively to impairment tests beginning January 1, 2020, with early adoption permitted. The Company would apply this guidance to applicable impairment tests after the adoption date. The Company is currently evaluating the effect of this update on its consolidated financial statements.

In May 2017, the FASB issued Accounting Standards Update 2017-09, Compensation - Stock Compensation. This update provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. This update is effective for fiscal years beginning after December 15, 2017. Early adoption is permitted. The Company is currently evaluating the effect of this update on its consolidated financial statements.

In August 2017, the FASB issued Accounting Standards Update 2017-12, Derivatives and Hedging, which amends the hedge accounting recognition and presentation requirements in ASC 815. The Board’s objectives in issuing this update are to (1) improve the transparency and understandability of information about an entity’s risk management activities by better aligning the entity’s financial reporting for hedging relationships with those risk management activities and (2) simplify the application of hedge accounting. This update is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. The Company is currently evaluating the effect of this update on its consolidated financial statements.

3. Inventories

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

	December 30, 2017	July 1, 2017
Finished goods	$14,450	$12,244
Work-in-process	22,115	20,596
Raw materials and supplies	72,308	68,750
	$108,873	$101,590

4. Long-Term Debt

On September 3, 2014, the Company entered into a five-year term loan in the amount of $35.0 million used to acquire all of the outstanding shares of CDR Manufacturing, Inc. (dba Ayrshire Electronics). The term loan requires quarterly payments of $1.25 million through June 15, 2019, with a final payment of the remaining outstanding balance on August 31, 2019. The Company had an outstanding balance of $18.8 million and $21.3 million under the term loan as of December 30, 2017 and July 1, 2017, respectively.

On August 6, 2015, the Company entered into a First Amendment to the amended and restated credit agreement extending the limit on our line of credit facility to $45.0 million as evidenced by the Second Replacement Revolving Note. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes. The line of credit is secured by substantially all of the assets of the Company and matures on August 31, 2019 at which time all outstanding balances are payable. As of December 30, 2017, the Company had an outstanding balance under the credit facility of $15.6 million, $0.4 million in outstanding letters of credit and $29.0 million available for future borrowings. As of July 1, 2017, the Company had an outstanding balance under the credit facility of $18.3 million, $0.4 million in outstanding letters of credit and $26.3 million available for future borrowings.

On December 28, 2016, the Company entered into an equipment term loan agreement in the amount of $3.9 million in order to further invest in production equipment. The equipment term loan is collateralized by production equipment. Under this loan agreement, equal quarterly payments of approximately $0.2 million commenced on March 31, 2017 and will continue through the maturity of the equipment term loan on June 30, 2021. Amortization of the debt issuance costs is reported as interest expense on the consolidated income statement. As of December 30, 2017, the Company had an outstanding balance of $3.0 million. As of July 1, 2017, the Company had an outstanding balance of $3.5 million. The Company has available an additional $2.1 million which can be borrowed in the future under this agreement.

Borrowings under the revolving line of credit, term loan and equipment term loan bear interest at either a “Base Rate” or a “Fixed Rate,” as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 1.75%, LIBOR plus 2.00%, or LIBOR plus 2.25% depending on the level of the Company’s trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The interest rates on outstanding debt as of December 30, 2017 range from 3.57% - 4.50% compared to 3.22% - 4.25% as of July 1, 2017.

Debt maturities as of December 30, 2017 for the next five years and thereafter are as follows (in thousands):

Fiscal Years Ending	Amount
2018 [1]	$2,935
2019	5,871
2020	27,754
2021	871
Total debt	$37,431
Unamortized debt issuance costs	$(105)
Long-term debt, net of debt issuance costs	$37,326

(1) Represents scheduled payments for the remaining six-month period ending June 30, 2018.

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

5. Trade Accounts Receivable Purchase Programs

Sale Programs

The Company utilizes an Account Purchase Agreement with Wells Fargo Bank, N.A. (“WFB”) which allows the Company to sell and assign to WFB and WFB may purchase from the Company the accounts receivable of certain Company customers in a maximum aggregate amount outstanding of $20.0 million. This agreement may be cancelled at any time by either party. The Company also has an Account Purchase Agreement with Orbian Financial Services (“Orbian”). This agreement allows the Company to sell accounts receivable of certain customers to Orbian and the agreement may be cancelled at any time by either party.

Total accounts receivables sold during the six months ended December 30, 2017 and December 31, 2016 was approximately $55.4 million and $38.9 million, respectively. Accounts receivables sold and not yet collected were $2.3 million and $1.6 million as of December 30, 2017 and July 1, 2017, respectively. The receivables that were sold were removed from the condensed consolidated balance sheets and the cash received is reflected as cash provided by operating activities in the condensed consolidated statements of cash flows.

6. Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act (“Tax Act”) was signed into law. The Tax Act reduced Federal corporate tax rates effective January 1, 2018 and changed certain other provisions. Effective tax rates for the quarter and the six months ended December 30, 2017 are blended rates reflecting the estimated benefit of two quarters of Federal tax rate reductions for fiscal year 2018. These benefits were offset by a discrete expense of $1.1 million due to the revaluation of our U.S. net deferred tax assets, an adjustment relating to foreign exchange, and required adjustments associated with the transition from a global to a territorial tax system (discussed further below). This discrete adjustment increased the Company’s income tax provisions for the quarter and six months ended December 30, 2017.

The Tax Act changed the U.S. tax system from a global to a territorial model. Under the Tax Act, a deemed one-time repatriation of all accumulated earnings and profits (AE&P) in Mexico and China occurred on December 31, 2017. For purposes of calculating the toll tax associated with this deemed repatriation, AE&P pools are stratified into two asset categories, subjected to certain allowable deductions and then the net amounts are subjected to the toll tax (15.5% for cash/cash equivalents and 8% for illiquid assets). Management has previously relied upon estimates of AE&P and the related tax pools in Mexico and China in order to calculate the amount of foreign earnings that may potentially be repatriated and the resulting potential U.S. tax liability (see further discussion below). Management will undertake a formal study of the AE&P and tax pools in both Mexico and China during the third and fourth quarters of fiscal year 2018 in order to more accurately calculate the toll tax liability. At this time, management does not believe the toll tax liability will be material to the financial statements after consideration of existing foreign tax credit carryforwards. However, the ability to utilize these foreign tax credits against the toll tax liability is still unclear under the Tax Act as written; we anticipate future guidance from the U.S. Treasury regarding this matter as well as other specifics associated with the toll tax calculation. As such, there may be future discrete adjustments associated with the toll tax because of the lack of clarity regarding the utilization of foreign tax credits. Additional discrete future adjustments may also arise due to potential true-ups that result from the formal AE&P and tax pool studies, as well as other potentially unforeseen tax implications associated with future U.S. Treasury guidance.

Because of the shift to a territorial system of taxation in the U.S., the Company recognized a discrete benefit of approximately $2.1 million during the second quarter related to reversing its previously recognized estimated liability associated with estimated future repatriations from Mexico and China. In future years, because of the toll tax on AE&P described above, repatriations of cash will generally be tax-free in the U.S. However, withholding taxes in China and Mexico may still apply to any such future repatriations. Management has not changed its indefinite investment assertions with regards to the portion of AE&P in each jurisdiction that may be repatriated in the future. Accordingly, management estimates that future repatriations of cash from China may result in approximately $0.8 million of withholding tax. There would be no offsetting foreign tax credits in the U.S. and as such, this potential liability is a direct cost associated with actual repatriations. Accordingly, management recognized a $0.8 million deferred tax liability during the second quarter related to this future potential liability.

A similar analysis was conducted with anticipated future repatriations in Mexico. Under Mexican tax law, any previously taxed earnings from before 2014 (“CUFIN”) are not subject to withholding when monies are repatriated to another country. Based on management’s estimated future repatriations from Mexico and based on the estimated AE&P in Mexico as of December 31, 2013, no withholding tax liability has been recognized as of December 30, 2017. If in the future, estimated future repatriations exceed CUFIN, the Company will be required to recognize a withholding tax as a deferred tax liability at that time. Similar to China, this withholding would not be creditable and would be a direct cost associated with the actual repatriation.

The Company expects to repatriate a portion of its foreign earnings based on increased net sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company currently expects to repatriate approximately $13.3 million of foreign earnings in the future. As noted above, any future repatriations of cash to the U.S. from Mexico and/or China will be tax-free in the U.S. effective January 1, 2018. However, management still must track future anticipated repatriations in order to estimate future withholding tax liabilities as applicable in each jurisdiction. See the above paragraph for further discussion of this matter. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed assets purchases and improvements in foreign locations.

During the second quarter of fiscal year 2017, the Company signed a unilateral advance pricing agreement (APA) with the Large Taxpayer Division of Mexico's Servicio de Administración Tributaria (SAT) under an elective framework that has been agreed to by the U.S. and Mexican authorities. The APA is part of a larger program affecting hundreds of U.S. companies with maquiladora operations in Mexico. The general impact of the APA is to increase margins between the maquiladora and U.S. parent company, shifting profits to Mexico from the U.S. The APA was finalized during the fourth quarter of fiscal 2017; the overall impact to the financial statements was not material.

The Company has available approximately $7.7 million of gross federal research and development tax credits as of December 30, 2017. ASC 740 requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. Accordingly, as of December 30, 2017, the Company has recorded $4.0 million of unrecognized tax benefits associated with these federal tax credits, resulting in a net deferred tax benefit of approximately $3.7 million.

7. Earnings Per Share

The following tables present a reconciliation of the denominator in the basic and diluted EPS calculation and the number of antidilutive common share awards that were not included in the diluted earnings per share calculation. These antidilutive securities occur when equity awards outstanding have an option price greater than the average market price for the period.

	Three Months Ended (in thousands, except per share information)	
	December 30, 2017	December 31, 2016
Net income (loss)	$ (224)	$ 1,528
Weighted average shares outstanding—basic	10,760	10,758
Effect of dilutive common stock awards	—	210
Weighted average shares outstanding—diluted	10,760	10,968
Net income (loss) per share—basic	$ (0.02)	$ 0.14
Net income (loss) per share—diluted	$ (0.02)	$ 0.14
Antidilutive SARs not included in diluted earnings per share	1,105	892

	Six Months Ended (in thousands, except per share information)	
	December 30, 2017	December 31, 2016
Net income	$ 208	$ 3,320
Weighted average shares outstanding—basic	10,760	10,753
Effect of dilutive common stock awards	—	166
Weighted average shares outstanding—diluted	10,760	10,919
Net income per share—basic	$ 0.02	$ 0.31
Net income per share—diluted	$ 0.02	$ 0.30
Antidilutive SARs not included in diluted earnings per share	1,105	892

8. Share-based Compensation

The Company's incentive plan provides for equity and liability awards to employees and non-employee directors in the form of stock options, stock appreciation rights (SARs), restricted stock, restricted stock units, stock awards, stock units, performance shares, performance units, and other stock-based or cash-based awards. Compensation cost is recognized on a straight-line basis over the requisite employee service period, which is generally the vesting period, and is recorded as employee compensation expense in cost of goods sold, research, development and engineering, and selling, general and administrative expenses. Share-based compensation is recognized only for those awards that are expected to vest, with forfeitures estimated at the date of grant based on historical experience and future expectations.
In addition to service conditions, SARs contain a performance condition. The additional performance condition is based upon the achievement of Return on Invested Capital (ROIC) goals relative to a peer group. All awards with performance conditions are evaluated quarterly to determine the likelihood that performance metrics will be achieved during the performance period. These awards are charged to compensation expense over the requisite service period based on the number of shares expected to vest. The SARs cliff vest after a three-year period from date of grant and expire five years from date of grant.
The grant date fair value for the awards granted below were estimated using the Black Scholes option valuation method:

	July 28, 2017	October 28, 2016	July 26, 2016
SARs Granted	272,500	10,000	242,500
Strike Price	$ 7.26	$ 8.04	$ 8.18
Fair Value	$ 1.89	$ 2.30	$ 2.42

Total share-based compensation expense recognized during the three months ended December 30, 2017 and December 31, 2016 was approximately $147,000 and $158,000, respectively. Total share-based compensation expense recognized during the six months ended December 30, 2017 and December 31, 2016 was approximately $251,000 and $355,000, respectively. As of December 30, 2017, total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately $0.8 million. This expense is expected to be recognized over a weighted average period of 1.88 years.
No SARs were exercised during the three or six months ended December 30, 2017. During the three months ended December 31, 2016, there were 15,000 SARs exercised with an immaterial amount of intrinsic value. During the six months ended December 31, 2016, there were 117,000 SARs exercised with approximately $367,000 of intrinsic value.

9. Commitments and Contingencies

Litigation and Other Matters

The Company is party to certain lawsuits or claims in the ordinary course of business. During the second quarter of fiscal year 2017, the Company commenced the arbitration process with a former customer related to approximately $9 million in inventory purchased and approximately $1 million in outstanding accounts receivables that we believe should be reimbursed by this former customer based on the terms of the manufacturing agreement. The Company is also pursuing reimbursement for certain cancellation fees and other carrying costs already expensed, but believed to be contractually due from the former customer. The Company is actively working through the arbitration process and expects further clarity on the resolution of this matter, whether through negotiations or a scheduled hearing by the end of the third quarter fiscal year 2018. The Company has not accrued for any potential gains or losses related to this claim and legal costs are being expensed as incurred. The ultimate disposition of these matters could have a material effect on our consolidated financial position, results of operations or cash flows.

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 $35,000 as of December 30, 2017 and $32,000 as of July 1, 2017, respectively.

10. Fair Value Measurements

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

The following table summarizes the fair value of assets (liabilities) of the Company's derivatives that are required to be measured on a recurring basis as of December 30, 2017 and July 1, 2017 (in thousands):

	December 30, 2017			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Interest rate swaps	$ —	$ 3	$ —	$ 3
Foreign currency forward contracts & swaps	$ —	$ 86	$ —	$ 86
Financial Liabilities:				
Interest rate swap	$ —	$ (27)	$ —	$ (27)
Foreign currency forward contracts & swaps	$ —	$ (4,589)	$ —	$ (4,589)

	July 1, 2017			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts & swaps	$ —	$ 1,010	$ —	$ 1,010
Financial Liabilities:				
Interest rate swap	$ —	$ (103)	$ —	$ (103)
Foreign currency forward contracts & swaps	$ —	$ (5,112)	$ —	$ (5,112)

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

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at December 30, 2017 and July 1, 2017, reasonably approximate their fair value. The Company's long-term debt primarily consists of a revolving line of credit, a term loan and an equipment term loan. These borrowings bear interest at either a "Base Rate" or a "Fixed Rate," as elected by the Company. Each of these rates is a variable floating rate dependent upon current market conditions and the Company's current credit risk as discussed in footnote 4.

As a result of the determinable market rates for our revolving line of credit, term loan and equipment term loan, they are classified within Level 2 of the fair value hierarchy. The discounted cash flow of the revolving line of credit is estimated to be $15.6 million and $18.3 million as of December 30, 2017 and July 1, 2017, respectively, with a carrying value that reasonably approximates the fair value. The discounted cash flow of the term loan is estimated to be $18.8 million as of December 30, 2017 and $21.3 million as of July 1, 2017, respectively, with a carrying value that reasonably approximates the fair value. The discounted cash flow of the equipment term loan is estimated to be $3.0 million as of December 30, 2017 and $3.5 million as of July 1, 2017, respectively, with a carrying value that reasonably approximates the fair value.

11. Derivative Financial Instruments

As of December 30, 2017, the Company had outstanding foreign currency forward contracts and swaps with a total notional amount of $51.3 million. The maturity dates for these contracts and swaps extend through December 2019. For the three months ended December 30, 2017, the Company entered into $7.2 million of foreign currency forward contracts and settled $11.2 million of such contracts. During the same period of the previous year, the Company entered into $6.7 million of foreign currency forward contracts and settled $5.0 million of such contracts.

For the six months ended December 30, 2017, the Company entered into foreign currency forward contracts of $7.2 million and settled $16.6 million of such contracts. During the same period of the previous year, the Company entered into foreign currency forward contracts of $6.7 million and settled $10.2 million of such contracts.

As of December 30, 2017, the aggregate notional amount of the Company's outstanding foreign currency contracts and swaps along with their unrealized gains (losses) are expected to mature as summarized below (in thousands):

Quarter Ending	Notional Contracts and Swaps in MXN	Notional Contracts and Swaps in USD	Estimated Fair Value
March 31, 2018	$ 90,812	$ 5,713	$ (1,120)
June 30, 2018	$ 95,500	$ 5,811	$ (1,055)
September 29, 2018	$ 90,443	$ 5,301	$ (867)
December 29, 2018	$ 125,328	$ 6,746	$ (703)
March 30, 2019	$ 137,944	$ 6,979	$ (433)
June 29, 2019	$ 142,947	$ 6,828	$ (152)
September 28, 2019	$ 148,468	$ 6,740	$ 86
December 28, 2019	$ 152,613	$ 7,187	$ (259)

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

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheet as of December 30, 2017 and July 1, 2017 (in thousands):

		December 30, 2017	July 1, 2017
Derivatives Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Fair Value
Foreign currency forward contracts & swaps	Other long-term assets	$ 86	$ 1,010
Foreign currency forward contracts & swaps	Other current liabilities	$ (3,745)	$ (4,226)
Foreign currency forward contracts & swaps	Other long-term liabilities	$ (844)	$ (886)
Interest rate swap	Other long-term assets	$ 3	$ —
Interest rate swap	Other current liabilities	$ (27)	$ (81)
Interest rate swap	Other long-term liabilities	$ —	$ (22)

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the three months ended December 30, 2017 and December 31, 2016, respectively (in thousands):

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of September 30, 2017	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 30, 2017
Forward contracts & swaps	Cost of sales	$ (1,715)	$ (2,669)	$ 1,412	$ (2,972)
Interest rate swap	Interest expense	(48)	8	24	(16)
Total		$ (1,763)	$ (2,661)	$ 1,436	$ (2,988)

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of October 1, 2016	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 31, 2016
Forward contracts & swaps	Cost of sales	$ (8,325)	$ (2,717)	$ 1,341	$ (9,701)
Interest rate swap	Interest expense	(248)	42	68	(138)
Total		$ (8,573)	$ (2,675)	$ 1,409	$ (9,839)

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the six months ended December 30, 2017 and December 31, 2016, respectively (in thousands):

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of July 1, 2017	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 30, 2017
Forward contracts & swaps	Cost of sales	$ (2,707)	$ (2,791)	$ 2,526	$ (2,972)
Interest rate swap	Interest expense	(68)	(1)	53	(16)
Total		$ (2,775)	$ (2,792)	$ 2,579	$ (2,988)

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of July 2, 2016	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 31, 2016
Forward contracts & swaps	Cost of sales	$ (7,245)	$ (4,906)	$ 2,450	$ (9,701)
Interest rate swap	Interest expense	(328)	41	149	(138)
Total		$ (7,573)	$ (4,865)	$ 2,599	$ (9,839)

As of December 30, 2017, the net amount of unrealized loss expected to be reclassified into earnings within the next 12 months is approximately $3.0 million. As of December 30, 2017, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

12. Goodwill and Other Intangible Assets

The Company recorded goodwill in connection with the Ayrshire and Sabre acquisitions resulting primarily from the synergies that resulted from the Company's acquisitions and the assembled workforce. The goodwill from the acquisitions is not deductible for tax purposes.

During the six months ended December 30, 2017 and December 31, 2016, no impairment was recognized. Goodwill was recorded at $10.0 million as of December 30, 2017 and July 1, 2017.

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

	December 30, 2017			
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:				
Non-Compete Agreements	3 - 5	$ 568	$ (531)	$ 37
Customer Relationships	10	4,803	(1,831)	2,972
Favorable Lease Agreements	4 - 7	2,941	(1,692)	1,249
Total		$ 8,312	$ (4,054)	$ 4,258

	July 1, 2017			
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:				
Non-Compete Agreements	3 - 5	$ 568	$ (483)	$ 85
Customer Relationships	10	4,803	(1,590)	3,213
Favorable Lease Agreements	4 - 7	2,941	(1,439)	1,502
Total		$ 8,312	$ (3,512)	$ 4,800

Amortization expense was approximately $265,000 and $282,000 for the three months ended December 30, 2017 and December 31, 2016, respectively. Amortization expense was approximately $542,000 and $564,000 for the six months ended December 30, 2017 and December 31, 2016, respectively.

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

Fiscal Years Ending	Amount
2018 (1)	531
2019	818
2020	783
2021	784
2022	531
Thereafter	811
Total amortization expense	$ 4,258

(1) Represents estimated amortization for the remaining six-month period ending June 30, 2018.

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 Corporat together with its subsidiaries, except where the context otherwise requires.

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

Overview

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

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

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

Executive Summary

As a result of the U.S. corporate tax reform in December 2017, the GAAP results for the second quarter of 2018 were impacted by discrete charges for unrepatriated overseas earnings and a write-down of certain deferred tax assets related to U.S. tax reform and an adjustment relating to foreign exchange totaling approximately $1.1 million in tax expense or $0.10 per share. In coming quarters, the Company will benefit from the tax reform through a reduction in its estimated effective tax rate from 25% to 20%.

New programs continue to ramp and we have continued to win significant new business from EMS competitors, including two new programs involving products for new and established customers in IoT for consumers and commercial applications. While changes in the U.S. corporate tax law may have caused a net loss in the second quarter, we expect to benefit by paying less taxes in the U.S. under the new law in coming periods.

Moving into the third quarter, we continue to see a strong pipeline of potential new business and our new programs continue to ramp. Recent customer wins are expected to contribute to sales growth in coming quarters.

During the third quarter, the Company anticipates charges of approximately $0.7 million for legal expenses in a binding arbitration hearing relating to roughly $10 million of purchased and paid inventory and receivables due from a former customer. In addition to the inventory at issue in the arbitration, the Company is pursuing reimbursement for certain cancellation fees and other carrying costs already expensed but believed to be contractually due from the former customer. The Company has not accrued for any outcomes related to this claim which could result in a one-time gain or loss. Legal costs are being expensed as incurred. The ultimate disposition of these matters is unknown and could have a material effect on the consolidated financial position, results of operations and cash flows.

We will also be incurring approximately $0.5 million for severance costs related to streamlining our facilities in Mexico during the third quarter as we expect that recently won new programs will require less labor content. We expect these changes to reduce our overall Mexican facility expenses by approximately 9% by our fourth quarter. Moreover, our U.S. facilities are proving to be increasingly profitable. While we are carefully managing our expenses, our investments in SMT, sheet metal and plastic molding capabilities in both Mexico and the U.S. are expected to enable planned future growth.

The concentration of our top three customers' net sales decreased to 30.6 percent of total sales in the second quarter of fiscal year 2018 from 33.8 percent in the same period of the prior fiscal year.

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

Gross profit as a percent of net sales was 7.9 percent for the second quarter of fiscal year 2018 as compared to 8.1 percent for the same quarter of the prior fiscal year. The decrease in gross profit as a percentage of net sales was due to lower net sales during the quarter.

Operating income as a percentage of net sales was 1.5 percent and 2.1 percent for the second quarter of fiscal year 2018 and the second quarter of the prior fiscal year, respectively. The decrease in operating income as a percentage of net sales was primarily driven by the decrease in net sales as discussed above.

Net loss for the second quarter of fiscal year 2018 was $0.2 million or $(0.02) per share, as compared to net income of $1.5 million or $0.14 per share for the second quarter of fiscal year 2017. The decrease in net income for the second quarter of fiscal year 2018 as compared to the same period in fiscal year 2017, was primarily attributable to $1.1 million in discrete tax expense as a result of the U.S. corporate tax reform, and a decline in net sales as discussed above.

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

For the third quarter of fiscal year 2018, the Company expects to report revenue in the range of $110 million to $115 million, and earnings in the range of break-even to $0.05 per diluted share. These expected results assume the legal fees and severance costs discussed above with an effective tax rate of 20% in the quarter. Future results will depend on actual levels of customers' orders and the timing of the startup of production of new product programs.

We maintain a strong balance sheet with a current ratio of 2.2 and a debt to equity ratio of 0.3 as of December 30, 2017. Total cash provided by operating activities as defined on our cash flow statement was $6.9 million for the six months ended December 30, 2017. We maintain sufficient liquidity for our expected future operations and had $15.6 million in borrowings on our $45.0 million revolving line of credit with Wells Fargo Bank, N.A. of which $29.0 million remained available at December 30, 2017. We believe cash flows generated from operations, our borrowing capacity, and leasing opportunities should provide adequate capital for planned growth.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

- Inactive, Obsolete, and Surplus Inventory Reserve
- Revenue Recognition
- Allowance for Doubtful Accounts
- Accrued Warranty
- Income Taxes
- Share-Based Compensation
- Impairment of Long-Lived Assets
- Derivatives and Hedging Activity
- Long-Term Incentive Compensation Accrual
- Impairment of Goodwill
- Business Combinations
- Contingent Liabilities

Please refer to the discussion of critical accounting policies in our most recent Annual Report on Form 10-K for the fiscal year ended July 1, 2017, for further details.

RESULTS OF OPERATIONS

Comparison of the Three Months Ended December 30, 2017 with the Three Months Ended December 31, 2016

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

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended December 30, 2017 as compared to the three months ended December 31, 2016. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended					
	December 30, 2017	% of net sales	December 31, 2016	% of net sales	$ change	% point change
Net sales	$111,725	100.0 %	$118,517	100.0 %	$(6,792)	— %
Cost of sales	102,925	92.1 %	108,905	91.9 %	(5,980)	0.2 %
Gross profit	8,800	7.9 %	9,612	8.1 %	(812)	(0.2)%
Research, development and engineering	1,495	1.3 %	1,603	1.4 %	(108)	(0.1)%
Selling, general and administrative	5,654	5.1 %	5,462	4.6 %	192	0.5 %
Total operating expenses	7,149	6.4 %	7,065	6.0 %	84	0.4 %
Operating income	1,651	1.5 %	2,547	2.1 %	(896)	(0.6)%
Interest expense, net	616	0.6 %	552	0.5 %	64	0.1 %
Income before income taxes	1,035	0.9 %	1,995	1.7 %	(960)	(0.8)%
Income tax provision	1,259	1.1 %	467	0.4 %	792	0.7 %
Net income (loss)	$(224)	(0.2)%	$1,528	1.3 %	$(1,752)	(1.5)%
Effective income tax rate	121.6 %		23.4 %			

Net Sales

Net sales of $111.7 million for the second quarter of fiscal year 2018 decreased by 5.7 percent as compared to net sales of $118.5 million for the second quarter of fiscal year 2017.

The $6.8 million decrease in net sales from the prior year period was driven by a decrease in demand from current customers, partially offset by an increase in net sales from new program wins.

Gross Profit

Gross profit as a percentage of net sales for the three months ended December 30, 2017 was 7.9 percent compared to 8.1 percent for the three months ended December 31, 2016. This 0.2 percentage point decrease was due to lower net sales, an increase in other certain overhead costs partially offset by a slight decrease in material related 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 $18,000 and $251,000 for obsolete inventory during the three months ended December 30, 2017 and December 31, 2016, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated net realizable value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were $1.5 million and $1.6 million during the three months ended December 30, 2017 and December 31, 2016, respectively. Total RD&E expenses as a percent of net sales were 1.3 percent during the three months ended December 30, 2017 compared to 1.4 percent during the three months ended December 31, 2016.

Total selling, general and administrative (SG&A) expenses were $5.7 million during the three months ended December 30, 2017 compared to $5.5 million during the three months ended December 31, 2016. Total SG&A expenses as a percentage of net sales were 5.1 percent during the three months ended December 30, 2017 compared to 4.6 percent during the three months ended December 31, 2016. This 0.5 percent increase in SG&A is related to an increase in legal fees and commission expense.

Interest

Interest expense was $0.6 million during the three months ended December 30, 2017 and the three months ended December 31, 2016.

Income Taxes

The effective tax rate for the three months ended December 30, 2017 was 121.6 percent compared to 23.4 percent for the three months ended December 31, 2016. The increase was primarily attributable to the impact of discrete adjustments associated with U.S. tax reform. For further information on taxes see footnote 6 of the “Notes to Consolidated Financial Statements.”

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

RESULTS OF OPERATIONS

Comparison of the Six Months Ended December 30, 2017 with the Six Months Ended December 31, 2016

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

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the six months ended December 30, 2017 as compared to the six months ended December 31, 2016. It is provided to assist in assessing differences in our overall performance (in thousands):

	Six Months Ended					
	December 30, 2017	% of net sales	December 31, 2016	% of net sales	$ change	% point change
Net sales	$220,942	100.0 %	$235,652	100.0 %	$(14,710)	— %
Cost of sales	204,297	92.5 %	216,331	91.8 %	(12,034)	0.7 %
Gross profit	16,645	7.5 %	19,321	8.2 %	(2,676)	(0.7)%
Research, development and engineering	3,005	1.4 %	3,187	1.4 %	(182)	— %
Selling, general and administrative	10,825	4.9 %	10,797	4.6 %	28	0.3 %
Total operating expenses	13,830	6.3 %	13,984	6.0 %	(154)	0.3 %
Operating income	2,815	1.3 %	5,337	2.3 %	(2,522)	(1.0)%
Interest expense, net	1,210	0.5 %	1,141	0.5 %	69	— %
Income before income taxes	1,605	0.7 %	4,196	1.8 %	(2,591)	(1.1)%
Income tax provision	1,397	0.6 %	876	0.4 %	521	0.2 %
Net income	$208	0.1 %	$3,320	1.4 %	$(3,112)	(1.3)%
Effective income tax rate	87.0 %		20.9 %			

Net Sales

Net sales of $220.9 million for the six months ended December 30, 2017 decreased by 6.2 percent as compared to net sales of $235.7 million for the six months ended December 31, 2016.

The decrease in net sales from the prior year period was primarily driven by a decrease in demand from current customers, partially offset by an increase in net sales from new program wins.

Gross Profit

Gross profit as a percentage of net sales for the six months ended December 30, 2017 was 7.5 percent compared to 8.2 percent for the six months ended December 31, 2016. This 0.7 percentage point decrease is primarily related to an increase in certain overhead costs partially offset by a decrease in material related 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 $26,000 and $306,000 for obsolete inventory during the six months ended December 30, 2017 and December 31, 2016, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were $3.0 million and $3.2 million during the six months ended December 30, 2017 and December 31, 2016, respectively. Total RD&E expenses as a percent of net sales were 1.4 percent during the six months ended December 30, 2017 compared to 1.4 percent during the six months ended December 31, 2016, respectively.

Total selling, general and administrative (SG&A) expenses were $10.8 million during the six months ended December 30, 2017 and December 31, 2016. Total SG&A expenses as a percentage of net sales were 4.9 percent during the six months ended December 30, 2017 compared to 4.6 percent during the six months ended December 31, 2016. This 0.3 percentage point increase in SG&A is related to an increase in legal fees and commission expense.

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Interest

Interest expense was $1.2 million during the six months ended December 30, 2017 compared to $1.1 million during the six months ended December 31, 2016.

Income Taxes

The effective tax rate for the six months ended December 30, 2017 was 87.0 percent compared to 20.9 percent for the same period in fiscal year 2017. The effective tax rate increased from the prior year primarily due to the recognition of certain discrete adjustments associated with U.S. tax reform. For further information on taxes see footnote 6 of the "Notes to Consolidated Financial Statements."

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

BACKLOG

On December 30, 2017, we had an order backlog of approximately $119.9 million. This compares with a backlog of approximately $133.4 million on December 31, 2016. The decrease in backlog at December 30, 2017, when compared to December 31, 2016, reflects a decrease in demand from current customers partially offset by an increase in new customers. Order backlog consists of purchase orders received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future net sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash provided by operating activities for the six months ended December 30, 2017 was $6.9 million, compared to net cash provided by operating activities of $3.1 million during the same period of the prior fiscal year.

The $6.9 million of net cash provided by operating activities for the six months ended December 30, 2017 is primarily related to a $0.2 million in net income for the period adjusted for $3.9 million of depreciation and amortization, a $7.8 million decrease in accounts receivable, a $1.0 million increase in other liabilities, and an $8.5 million increase in accounts payable partially offset by a $7.3 million increase in inventory, a $3.5 million decrease in accrued compensation and a $3.5 million increase in other assets. This compares to $3.1 million of net cash flows provided by operating activities for the six months ended December 31, 2016, which resulted primarily from $3.3 million in net income for the period adjusted for $3.4 million of depreciation and amortization as well as a decrease in inventory of $8.6 million partially offset by an increase in trade receivables of $4.8 million and a decrease in accounts payable of $7.8 million.

Accounts receivable fluctuates based on the timing of shipments, terms offered and collections that occurred during the quarter. While overall net sales are not typically seasonal in nature, we ship the majority of our product during the latter half of the quarter. In addition, accounts receivable will fluctuate based upon the amount of accounts receivable sold under our trade accounts receivable purchase programs. During the six months ended December 30, 2017 and December 31, 2016, we factored accounts receivable of $55.4 million and $38.9 million, respectively, which were removed from our Consolidated Balance Sheets. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases and negotiated supplier terms.

Investing Cash Flow

Cash used in investing activities was $1.2 million during the six months ended December 30, 2017 as compared to $4.8 million during the six months ended December 31, 2016. Our primary investing activity during the six months ended December 30, 2017 and December 31, 2016, was purchasing equipment to support increased production levels for new programs.

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 as well as our revolving line of credit facility and equipment term loan. During the six months ended December 30, 2017 and December 31, 2016, we did not enter into any sales and leaseback transactions.

Financing Cash Flow

Cash used in financing activities was $5.7 million during the six months ended December 30, 2017 as compared to cash provided by financing activities of $2.0 million in the same period of the previous fiscal year. Our primary financing activities during the six months ended December 30, 2017, were repayments on our term loans of $2.9 million and borrowings and repayments under our revolving line of credit facility. Our primary financing activities during the six months ended December 31, 2016, were repayments on our term loan of $2.5 million as well as borrowings and repayments under our revolving line of credit facility. Our credit agreement with Wells Fargo Bank N.A. provides a revolving line of credit facility of up to $45.0 million, subject to availability.

As of December 30, 2017, we were in compliance with our loan covenants and approximately $29.0 million was available under the revolving line of credit facility. As of December 31, 2016, approximately $25.7 million was available under the revolving line of credit facility.

Our cash requirements are affected by the level of current operations and new EMS programs. We believe that projected cash from operations, funds available under the revolving credit facility and leasing capabilities will be sufficient to meet our working and fixed capital requirements for the foreseeable future. As of December 30, 2017, we had approximately $0.4 million of cash held by foreign subsidiaries. If cash is to be repatriated in the future from these foreign subsidiaries, the Company would be subject to certain withholding taxes in the foreign jurisdictions. The total amount of tax payments required for the amount of foreign subsidiary cash on hand as of December 30, 2017 would approximate $24,000. We have accrued withholding taxes for expected future repatriation of foreign earnings

as discussed in footnote 6 of the “Notes to Consolidated Financial Statements.”
OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS
We have included a summary of our Contractual Obligations in our annual report on Form 10-K for the fiscal year ended July 1, 2017. There have been no material changes in contractual obligations outside the ordinary course of business since July 1, 2017.

RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

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

We may experience fluctuations in quarterly results of operations.

Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global macroeconomic environment, volatility in overall demand for our customers’ products, success of customers’ programs, timing of new programs, new product introductions or technological advances by us, our customers and our competitors, and changes in pricing policies by us, our customers, our suppliers, and our competitors. Our customer base is diverse in the markets they serve, however, decreases in demand, particularly from customers in certain industries could affect future quarterly results. Additionally, our customers could be adversely impacted by illiquidity in the credit markets which could directly impact our operating results. Component procurement, production schedules, personnel and other resource requirements are based on estimates of customer requirements. Occasionally, our customers may request accelerated production that can stress resources and reduce operating margins. Conversely, our customers may abruptly lower or cancel production which may lead to a sudden, unexpected increase in inventory or accounts receivable for which we may not be reimbursed even when under contract with customers. In addition, because many of our operating expenses are relatively fixed, a reduction in customer demand can harm our gross profit and operating results. The products which we manufacture for our customers have relatively short product lifecycles. Therefore, our business, operating results and financial condition are dependent in a significant way on our ability to obtain orders from new customers and new product programs from existing customers.

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

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

Adverse economic conditions and uncertainty in the global economy such as unstable global financial and credit markets, inflation, and recession can negatively impact our business. Unfavorable economic conditions could affect the demand for our customers’ products by triggering a reduction in orders as well as a decline in 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 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, typically require that our customers contractually agree to buy back inventory purchased within specified lead times to build their products if not used.

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

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

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

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

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

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

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

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

There is no assurance that we will be able to retain or renew our credit agreements in the future. In the event the business grows rapidly or there is uncertainty in the macroeconomic climate, additional financing resources could be necessary in the current or future fiscal years. There is no assurance that we will be able to obtain equity or debt financing at acceptable terms, or at all in the future. In addition, we have restrictive covenants with our financial institution which could impact how we manage our business. If we cannot meet our financial covenants, our borrowings could become immediately payable which could have a material adverse impact on our financial statements. For a summary of our banking arrangements, see Note 4 Long-Term Debt of the “Notes to Consolidated Financial Statements.”

Our operations may be subject to certain risks.

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

- difficulties in staffing, turnover and managing onshore and offshore operations;
- political and economic instability (including acts of terrorism, pandemics, civil unrest, forms of violence and outbreaks of war), which could impact our ability to ship, manufacture, and/or receive product;
- unexpected changes in regulatory requirements and laws;
- longer customer payment cycles and difficulty collecting accounts receivable;
- export duties, import controls and trade barriers (including quotas);
- governmental restrictions on the transfer of funds;
- burdens of complying with a wide variety of foreign laws and labor practices;
- our locations may be impacted by hurricanes, tornadoes, earthquakes, water shortages, tsunamis, floods, typhoons, fires, extreme weather conditions and other natural or man-made disasters.

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

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

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

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

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

Our future success depends in large part on the continued service of our key technical, marketing and management personnel and on our ability to continue to attract and retain qualified production employees. There can be no assurance that we will be successful in attracting and retaining such personnel, particularly in our manufacturing locales that may be experiencing high demand for similar key 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 or don't meet expected sales volumes.

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

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

Changes in demand for customer products reduce our ability to accurately estimate the future requirements of our customers. This makes it difficult to schedule production and maximize utilization of our manufacturing capacity. We must determine the levels of business that we will seek and accept from customers, set production schedules, commit to procuring inventory, and allocate personnel and resources, based on our estimates of our customers' requirements. Customers can require sudden increases and decreases in production which can put added stress on resources and reduce margins. Sudden decreases in production can lead to excess inventory on hand which may or may not be

reimbursed by our customers even when under contract.
Continued growth could further lead to capacity constraints. We may need to transfer production to other facilities, acquire new facilities, or outsource production which could negatively impact gross margin.

An adverse change in the interest rates for our borrowings could adversely affect our financial condition.
We are exposed to interest rate risk under our revolving line of credit and term loan. We currently hedge a portion of our term loan with an interest rate swap. We have not historically hedged the interest rate on our credit facility; therefore, unless we do so, significant changes in interest rates could adversely affect our results of operations. Refer to the discussion in note 4, "Long-Term Debt" to the consolidated financial statements for further details of our debt obligations. We are also exposed to interest rate risk on our factoring activities.
Compliance or the failure to comply with current and future environmental laws or regulations could cause us significant expense.
We are subject to a variety of domestic and foreign environmental regulations relating to the use, storage, and disposal of materials used in our manufacturing processes. If we fail to comply with any present or future regulations, we could be subject to future liabilities or the suspension of current manufacturing operations. In addition, such regulations could restrict our ability to expand our operations or could require us to acquire costly equipment, substitute materials, or incur other significant expenses to comply with government regulations.
Our stock price is volatile.
Holders of the common stock will suffer immediate dilution to the extent outstanding equity awards are exercised to purchase common stock. Our stock price may be subject to wide fluctuations and possible rapid increases or declines over a short time period. These fluctuations may be due to factors specific to us such as our stock's thinly traded nature, 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 growth which can place considerable additional demands upon our management team and our operational, financial and management information systems. Our ability to manage growth effectively requires us to continue to implement and improve these systems; avoid cost overruns; maintain customer, supplier and other favorable business relationships during possible transition periods; continue to develop the management skills of our managers and supervisors; and continue to train, motivate and manage our employees. Our failure to effectively manage growth could have a material adverse effect on our results of operations.

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

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

Energy price increases may negatively impact our results of operations.

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

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

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

We are involved in various legal proceedings.

In the past, we have been notified of claims relating to various matters including contractual matters, intellectual property rights or other issues arising in the ordinary course of business. In the event of such a claim, we may be required to spend a significant amount of money to defend or otherwise address the claim. The Company is currently involved in an arbitration claim with a former customer to collect a significant payment for excess inventory purchased to an existing manufacturing agreement in place at the time. Any litigation or dispute resolution, 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 effect on our business, consolidated financial conditions and results of operations.

Our levels of insurance coverage may not be sufficient for potential damages, claims or losses.
We have various forms of business and liability insurance which we believe are appropriate based on the needs of companies in our industry. As a result, not all of our potential business risks or potential losses would be covered by our insurance policies. If we sustain a significant claim or loss which is not covered by insurance, our net income could be negatively impacted.
Changes in securities laws and regulations will increase our costs and risk of noncompliance.
We are required to file as an accelerated filer. As such, we are subject to additional requirements contained in the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) and more recently the Dodd-Frank Act. The Sarbanes-Oxley and Dodd-Frank Acts required or will require changes in some of our corporate governance, securities disclosure and compliance practices. In response to the requirements of the Sarbanes-Oxley and Dodd-Frank Acts, the SEC and NASDAQ promulgated new rules and additional rulemaking is expected in the future. Compliance with these new rules and future rules has increased and may increase further our legal, financial and accounting costs as well as a potential risk of noncompliance. Absent significant changes in related rules, which we cannot assure, we anticipate some level of increased costs related to these new regulations to continue indefinitely. We also expect these developments to make it more difficult and more expensive to obtain director and officer liability insurance, and we may be forced to accept reduced coverage or incur substantially higher costs to obtain coverage. Likewise, these developments may make it more difficult for us to attract and retain qualified members of our Board of Directors or qualified management personnel. Further, the costs associated with the compliance with and implementation of procedures under these and future laws and related rules could have a material impact on our results of operations. In addition, the costs associated with noncompliance with additional securities laws and regulations could also impact our business.
We may encounter complications with acquisitions, which could potentially harm our business.
Any current or future acquisitions may require additional equity financing, which could be dilutive to our existing shareholders, or additional debt financing, which could potentially affect our credit ratings. Any downgrades in our credit ratings associated with an acquisition could adversely affect our ability to borrow by resulting in more restrictive borrowing terms. To integrate acquired businesses, we must implement our management information systems, operating systems and internal controls, and assimilate and manage the personnel of the acquired operations. The integration of acquired businesses may be further complicated by difficulties managing operations in geographically dispersed locations. The integration of acquired businesses may not be successful and could result in disruption by diverting management’s attention from the core business. In addition, the integration of acquired businesses may require that we incur significant restructuring charges or other increases in our expenses and working capital requirements, which reduce our return on invested capital.
Acquisitions may involve numerous other risks and challenges including but not limited to: potential loss of key employees and customers of the acquired companies; the potential for deficiencies in internal controls at acquired companies; lack of experience operating in the geographic market or industry sector of the acquired business; constraints on available liquidity, and exposure to unanticipated liabilities of acquired companies. These and other factors could harm our ability to achieve anticipated levels of profitability at acquired operations or realize other anticipated benefits of an acquisition, and could adversely affect our consolidated business and operating results.
Our goodwill and identifiable intangible assets could become impaired, which could reduce the value of our assets and reduce net income in the year in which the write-off occurs.
Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. The Company also ascribes value to certain identifiable intangible assets, which consists of customer relationships, non-compete agreements, and favorable leases, as a result of the acquisitions of Sabre and Ayrshire. The Company may incur impairment charges on goodwill or identifiable intangible assets if it determines that the fair values of goodwill or identifiable intangible assets are less than their current carrying values. The Company evaluates, on a regular basis, whether events or circumstances have occurred that indicate all, or a portion, of the carrying amount of goodwill may no longer be recoverable, in which case an impairment charge to earnings would become necessary. Refer to Notes 2 and 12 to the consolidated financial statements and critical accounting policies and estimates’ in management’s discussion and analysis of financial condition and results of operations for further discussion regarding

the impairment testing of goodwill and identifiable intangible assets.
A decline in general economic conditions or global equity valuations could impact the judgments and assumptions about the fair value of the Company’s businesses and the Company could be required to record impairment charges on its goodwill or other identifiable intangible assets in the future, which could impact the Company’s consolidated balance sheet, as well as the Company’s consolidated statement of operations. If the Company was required to recognize an impairment charge in the future, the charge would not impact the Company's consolidated cash flows, current liquidity, capital resources, and covenants under its existing credit facilities.

Changes in financial accounting standards may affect our reported financial condition or results of operations as well increase costs related to implementation of new standards and modifications to internal controls.

Our consolidated financial statements are prepared in conformity with accounting standards generally accepted in the United States, or U.S. GAAP. These principles are subject to amendments made primarily by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC). A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions which are completed before a change is announced. For example, significant changes to revenue recognition rules will be effective for us in fiscal 2019 and we may incur significant costs to implement this new rule. Changes to accounting rules or challenges to our interpretation or application of the rules by regulators may have a material adverse effect on our reported financial results or on the way we conduct business. In addition, the continued convergence of U.S. GAAP and International Financial Reporting Standards ("IFRS") creates uncertainty as to the financial accounting policies and practices we will need to adopt in the future.

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, term loan and equipment term loan are secured by substantially all of our assets. The interest rates applicable to our revolving credit facility, term loan and equipment term loan fluctuate with the Wells Fargo Bank, N.A. prime rate and LIBOR rates. There was outstanding $15.6 million in borrowings under our revolving credit facility, $18.8 million outstanding on our term loan and $3.0 million outstanding on our equipment term loan as of December 30, 2017. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources and Liquidity" and Note 4 – "Long-Term Debt" to the Consolidated Financial Statements for additional information regarding our revolving credit facility and term loans.

During the second quarter of fiscal year 2015, we entered into an interest rate swap contract with a notional amount of $25.0 million related to the borrowings outstanding under the term loan. As of December 30, 2017, the remaining notional amount of the interest rate swap contract was $11.5 million. Our only material interest rate risk is associated with our revolving credit facility, term loan and equipment term loan. Through the use of the interest rate swap, as described above, we fixed the basis on which we pay interest on our term loan, thus eliminating some of our interest rate risk. See Note 11 – "Derivative Financial Instruments" to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Foreign Currency Exchange Risk

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us would directly or indirectly affect our financial results. We currently use Mexican peso forward contracts and swaps to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There was outstanding $51.3 million of foreign currency forward contracts and swaps as of December 30, 2017. The fair value of these contracts and swaps was $(4.5) million. See Note 11 – "Derivative Financial Instruments" to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 4. Controls and Procedures

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company's Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of December 30, 2017, the Company's disclosure controls and procedures are effective based on that criteria.

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

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during the three months ended December 30, 2017 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. During the second quarter of fiscal year 2017, the Company commenced the arbitration process with a former customer related to amounts we believe should be reimbursed by this former customer based on the terms of the manufacturing agreement. A range for possible outcomes cannot be determined at this time. The Company has not accrued for any potential loss related to this claim and legal costs are being expensed as incurred. The ultimate disposition of these matters could have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Item 1A. Risk Factors

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

There are no material changes to the risk factors set forth in Part I Item 1A in the Company’s Annual Report on Form 10-K for the year ended July 1, 2017.

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 — Date: February 8, 2018
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Brett R. Larsen
Brett R. Larsen — Date: February 8, 2018
Executive Vice President of Administration, Chief Financial Officer and Treasurer
(Principal Financial Officer)

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