KEY TRONIC CORP
Form 10-Q
May 13, 2011
**Table of Contents**

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

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

**FOR THE PERIOD ENDED APRIL 2, 2011**

**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 ¨ No ¨

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

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

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 April 30, 2011, 10,355,523 shares of common stock, no par value (the only class of common stock), were outstanding.

Table of Contents

**KEY TRONIC CORPORATION**

**Index**



* Items are not applicable

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

Table of Contents

**PART I: FINANCIAL INFORMATION**

**Item 1: Financial Statements**

**KEY TRONIC CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(Unaudited)**

| | April 2, 2011 | July 3, 2010 |
|---|---|---|
| | (in thousands) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 629 | $ 770 |
| Trade receivables, net of allowance for doubtful accounts of $111 and $111 | 42,326 | 34,617 |
| Inventories | 45,384 | 39,775 |
| Deferred income tax asset | 3,518 | 4,420 |
| Other | 6,353 | 3,115 |
| Total current assets | 98,210 | 82,697 |
| Property, plant and equipment - net | 15,255 | 13,898 |
| Other assets: | | |
| Deferred income tax asset | 4,356 | 4,394 |
| Other | 1,499 | 653 |
| Total other assets | 5,855 | 5,047 |
| Total assets | $ 119,320 | $ 101,642 |
| Liabilities and shareholders equity | | |
| Current liabilities: | | |
| Accounts payable | $ 27,927 | $ 29,158 |
| Accrued compensation and vacation | 4,179 | 5,097 |
| Current portion of other long-term obligations | 752 | 146 |
| Other | 2,719 | 3,588 |
| Total current liabilities | 35,577 | 37,989 |
| Long-term liabilities: | | |
| Revolving loan | 13,738 | 1,554 |
| Other long-term obligations | 3,591 | 2,682 |
| Total long-term liabilities | 17,329 | 4,236 |
| Total liabilities | 52,906 | 42,225 |
| Commitments and contingencies (Note 7) | | |
| Shareholders equity: | | |
| Common stock, no par value (in thousands) - shares authorized 25,000; issued and outstanding 10,356 and 10,264 shares, respectively | 41,149 | 40,126 |

| | | |
|---|---|---|
| Retained earnings | 23,732 | 19,533 |
| Accumulated other comprehensive income (loss) | 1,533 | (242) |
| Total shareholders equity | 66,414 | 59,417 |
| Total liabilities and shareholders equity | $ 119,320 | $ 101,642 |

See accompanying notes to consolidated financial statements.

**Table of Contents**

**KEY TRONIC CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**(Unaudited)**

| **(in thousands, except per share amounts)** | **Three Months Ended** | | **Nine Months Ended** | |
|---|---|---|---|---|
| | **April 2, 2011** | **April 3, 2010** | **April 2, 2011** | **April 3, 2010** |
| Net sales | $ 63,424 | $ 51,697 | $ 187,802 | $ 137,756 |
| Cost of sales | 59,195 | 46,455 | 172,157 | 125,129 |
| Gross profit on sales | 4,229 | 5,242 | 15,645 | 12,627 |
| Research, development and engineering expenses | 919 | 796 | 2,794 | 2,063 |
| Selling, general and administrative expenses | 2,373 | 2,216 | 7,575 | 6,225 |
| Income from operations | 937 | 2,230 | 5,276 | 4,339 |
| Interest expense | 172 | 13 | 319 | 77 |
| Income before income taxes | 765 | 2,217 | 4,957 | 4,262 |
| Income tax provision (benefit) | 41 | (2,197) | 758 | (2,117) |
| Net income | $ 724 | $ 4,414 | $ 4,199 | $ 6,379 |
| Net income per share Basic | $ 0.07 | $ 0.44 | $ 0.41 | $ 0.63 |
| Weighted average shares outstanding Basic | 10,353 | 10,126 | 10,332 | 10,094 |
| Net income per share Diluted | $ 0.07 | $ 0.43 | $ 0.40 | $ 0.63 |
| Weighted average shares outstanding Diluted | 10,436 | 10,254 | 10,420 | 10,148 |

See accompanying notes to consolidated financial statements.

**Table of Contents**

**KEY TRONIC CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

| | Nine Months Ended | |
|---|---|---|
| | April 2, 2011 | April 3, 2010 |
| | (in thousands) | |
| Cash flows from operating activities: | | |
| Net income | $ 4,199 | $ 6,379 |
| Adjustments to reconcile net income to cash (used in) provided by operating activities: | | |
| Depreciation and amortization | 1,640 | 1,214 |
| Accretion of deferred gain on sale of building | (39) | (58) |
| Provision for obsolete inventory | 210 | 1,441 |
| Provision for warranty | 139 | 29 |
| Provision for doubtful accounts | 15 | |
| (Gain) loss on disposal of assets | (12) | 3 |
| Share-based compensation expense | 378 | |
| Deferred income taxes | 589 | (1,841) |
| Changes in operating assets and liabilities: | | |
| Trade receivables | (7,724) | (2,211) |
| Inventories | (5,819) | (5,152) |
| Other assets | (2,316) | (1,889) |
| Accounts payable | (1,231) | 7,960 |
| Accrued compensation and vacation | (918) | 1,298 |
| Other liabilities | (449) | 475 |
| Cash (used in) provided by operating activities | (11,338) | 7,648 |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (3,595) | (1,542) |
| Proceeds from sale of fixed assets | 15 | 7 |
| Proceeds from life insurance | 113 | |
| Cash used in investing activities | (3,467) | (1,535) |
| Cash flows from financing activities: | | |
| Payment of financing costs | (50) | (50) |
| Proceeds from long term debt | 2,244 | |
| Principal payments on long term debt | (84) | (151) |
| Decrease in restricted cash | | 124 |
| Borrowings under revolving credit agreement | 82,791 | 9,763 |
| Repayment of revolving credit agreement | (70,607) | (12,175) |
| Proceeds from exercise of stock options | 370 | 257 |
| Cash provided by (used in) financing activities | 14,664 | (2,232) |
| Net (decrease) increase in cash and cash equivalents | (141) | 3,881 |
| Cash and cash equivalents, beginning of period | 770 | 729 |
| Cash and cash equivalents, end of period | $ 629 | $ 4,610 |
| Supplemental cash flow information: | | |

| | | | | |
|---|---|---|---|---|
| Interest payments | $ | 422 | $ | 98 |
| Income tax payments, net of refunds | $ | 355 | $ | 173 |

See accompanying notes to consolidated financial statements.

Table of Contents

**KEY TRONIC CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

The condensed 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 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 3, 2010.

The Company s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three month periods ended April 2, 2011 and April 3, 2010 were 13 week and 14 week periods, respectively. The nine months ended April 2, 2011 and April 3, 2010 were 39 week and 40 week periods, respectively. Fiscal year 2011 will end on July 2, 2011 which is a 52 week year, whereas fiscal year 2010 which ended on July 3, 2010, was a 53 week year.

**2. Significant Accounting Policies**

***Other Comprehensive Income***

| | Three Months Ended | |
|---|---|---|
| | **April 2, 2011** | **April 3, 2010** |
| | (in thousands) | |
| Net income | $ 724 | $ 4,414 |
| Other comprehensive income: | | |
| Unrealized gain on foreign exchange contracts | 692 | 350 |
| Comprehensive income | $ 1,416 | $ 4,764 |

| | Nine Months Ended | |
|---|---|---|
| | **April 2, 2011** | **April 3, 2010** |
| | (in thousands) | |
| Net income | $ 4,199 | $ 6,379 |
| Other comprehensive income: | | |
| Unrealized gain on foreign exchange contracts | 1,775 | 97 |
| Comprehensive income | $ 5,974 | $ 6,476 |

Other comprehensive income for the three and nine months ended April 2, 2011 is reflected net of tax of approximately $0.3 million and $0.9 million, respectively. Other comprehensive income for both the three and nine months ended April 3, 2010 is reflected net of tax of approximately $0.5 million.

Table of Contents

*Income Taxes*

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

*Earnings Per Common Share*

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

*Share-based Compensation*

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

Total share-based compensation expense recognized during the three and nine months ended April 2, 2011 and April 3, 2010 was as follows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | **April 2, 2011** | **April 3, 2010** |
| Stock Appreciation Rights | $ 122 | $ |

| | Nine Months Ended | |
|---|---|---|
| | **April 2, 2011** | **April 3, 2010** |
| Stock Appreciation Rights | $ 378 | $ |

On October 21, 2010, the Company obtained shareholder approval of the 2010 Incentive Plan at the Annual Shareholder Meeting. As a result, the Company made a decision to amend the 522,000 SARs granted during the fourth quarter of fiscal 2010 by replacing the cash-settlement feature with a net-share-settlement feature. As a result of the change the awards were reclassified from liability awards to equity awards effective October 21, 2010 at a weighted average fair value of $2.89. No incremental compensation cost resulted from the change. As of April 2, 2011 total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately $1.0 million. This expense is expected to be recognized over a weighted average period of 2.1 years.

Options to purchase 7,000 and 77,500 shares of our common stock were exercised during the three months ended April 2, 2011 and April 3, 2010, respectively, with an immaterial amount of intrinsic value for both periods presented. Options to purchase 91,133 and 101,666 shares of our common stock were exercised during the nine months ended April 2, 2011 and April 3, 2010, respectively, with an immaterial amount of intrinsic value for both periods presented.

Table of Contents

***Recently Issued Accounting Standards***

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-06, *Improving Disclosures about Fair Value Measurements*. This ASU updates guidance related to fair value measurements and disclosures, and requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and to describe the reasons for the transfers. In addition, in the reconciliation for fair value measurements using significant unobservable inputs, or Level 3, a reporting entity should disclose separately information about purchases, sales, issuances and settlements (that is, on a gross basis rather than one net number). The updated guidance also requires that an entity should provide fair value measurement disclosures for each class of assets and liabilities and disclosures about the valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements for Level 2 and Level 3 fair value measurements. The updated guidance is effective for interim or annual financial reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. We have adopted the provisions of ASU 2010-06 which did not have a material impact on our results of operations or financial position.

**3. Inventories**

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

| | April 2, 2011 | July 3, 2010 |
|---|---|---|
| Finished goods | $ 5,321 | $ 4,492 |
| Work-in-process | 4,891 | 4,095 |
| Raw materials and supplies | 35,172 | 31,188 |
| | $ 45,384 | $ 39,775 |

**4. Long-Term Debt**

On October 15, 2010, the Company entered into an amended credit agreement with Wells Fargo Bank, N.A. thereby increasing the revolving line of credit for up to $30 million and extending the term of the credit agreement to October 15, 2013. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a Base Rate or a Fixed Rate , as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of the Company s trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The revolving line of credit is secured by substantially all of the assets of the Company.

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

As of April 2, 2011, the Company had availability to borrow an additional $16.3 million under the revolving line of credit. The outstanding balance under the revolving line of credit was $13.7 million as of April 2, 2011 and the rate of interest being paid on the outstanding balance was in the range of 2.48% - 3.25%. The outstanding balance under the revolving line of credit as of July 3, 2010 was $1.6 million.

Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of long-term debt reasonably approximates their carrying values.

Table of Contents

**5. Income Taxes**

The Company had domestic income tax loss carryforwards (NOLs) of approximately $25.1 million at July 3, 2010. In accordance with FASB ASC Topic 740, *Accounting for Income Taxes* (ASC 740), management assessed the Company s recent operating levels and estimated future taxable income and determined there was not a need for a valuation allowance. A valuation allowance against deferred tax assets is required if it is more likely than not that the deferred tax assets will not be realized. Management determined during fiscal year 2010 that based on the Company s increased profitability and estimated repatriation from foreign subsidiaries that it was likely that the NOLs will be fully utilized prior to their expiration.

Management expects to repatriate a portion of its foreign undistributed earnings based on increased sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company repatriated approximately $1.7 million from its Mexican operations during the quarter ended April 2, 2011. The Company expects to repatriate globally approximately $11.3 million in the future. As such, as earnings are recognized in the United States, the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax have been recorded as part of deferred taxes as of April 2, 2011. All other existing unremitted foreign earnings are expected to remain permanently reinvested in planned fixed assets purchases in foreign locations.

The Company has wholly owned foreign subsidiaries in Mexico that apply certain tax credits related to production assets that currently offset all of the income tax liabilities under general Mexican income tax law. However, the Company is subject to Impuesto Empresarial a Tasa Unica (IETU), a Mexican business flat tax. The Company anticipates that it will be taxable under IETU for the foreseeable future. Therefore its deferred taxes of its Mexican operations have been accounted under the IETU tax basis. The effect of IETU and an associated presidential decree has been included in the effective tax rate as of April 2, 2011.

The Company is required to pay taxes in China on its statutory foreign profits. Its subsidiary in China began having statutory profits during the current fiscal year. The Company released its valuation allowance on its Chinese tax net operating loss carryforwards in the second quarter of fiscal 2011 as it became likely that they will be fully utilized in the future.

During fiscal year 2011 the three and nine months ended effective tax rate was impacted by foreign versus U.S. tax rates, the release of the valuation allowances on the Company s China operations, as well as current year U.S tax credits. During fiscal year 2010 the three and nine months ended effective tax rate was impacted by the release of the valuation allowances on the Company s domestic operations and foreign versus U.S. tax rates.

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. The Company has not recorded any income tax expense or benefit for uncertain tax positions and does not anticipate any adjustments over the next 12 months.

**6. Earnings Per Share**

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

| | Three Months Ended (in thousands, except per share information) | |
|---|---|---|
| | **April 2, 2011** | **April 3, 2010** |
| Net income | $ 724 | $ 4,414 |
| Weighted average shares outstanding - basic | 10,353 | 10,126 |
| Effect of dilutive common stock options | 83 | 128 |
| Weighted average shares outstanding - diluted | 10,436 | 10,254 |

| | | | | |
|---|---|---|---|---|
| Earnings per share - basic | $ | 0.07 | $ | 0.44 |
| Earnings per share - diluted | $ | 0.07 | $ | 0.43 |
| Antidilutive options not included in diluted earnings per share | | 541 | | 38 |

Table of Contents

| | Nine Months Ended (in thousands, except per share information) | |
|---|---|---|
| | April 2, 2011 | April 3, 2010 |
| Net income | $ 4,199 | $ 6,379 |
| Weighted average shares outstanding - basic | 10,332 | 10,094 |
| Effect of dilutive common stock options | 88 | 54 |
| Weighted average shares outstanding - diluted | 10,420 | 10,148 |
| Earnings per share - basic | $ 0.41 | $ 0.63 |
| Earnings per share - diluted | $ 0.40 | $ 0.63 |
| Antidilutive options not included in diluted earnings per share | 541 | 180 |

**7. Commitments and Contingencies**

Purchase Commitments

The Company had no material firm commitments to contractors and suppliers for capital expenditures at April 2, 2011.

Leases

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

Warranties

The Company provides warranties on certain product sales. Allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from management s estimates, adjustments to recognize additional cost of sales may be required in future periods. The Company s warranty reserve was approximately $48,000 and $24,000 as of April 2, 2011 and July 3, 2010, respectively.

**8. Fair Value Measurements**

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

The following table summarizes the Company s financial assets and liabilities (only those required to be measured at fair value on a recurring basis) at fair value as of April 2, 2011 and July 3, 2010 (in thousands):

| | April 2, 2011 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total Fair Value |
| **Financial Assets:** | | | | |
| Foreign currency forward contracts | $ | $ 2,323 | $ | $ 2,323 |

Table of Contents

| | July 3, 2010 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total Fair Value |
| **Financial Assets:** | | | | |
| Foreign currency forward contracts | $ | $ 416 | $ | $ 416 |
| **Financial Liabilities:** | | | | |
| Foreign currency forward contracts | $ | $ (777) | $ | $ (777) |

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

**9. Derivative Financial Instruments**

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

The Company transacts business in Mexico and is subject to the risk of foreign currency exchange rate fluctuations. The Company enters into foreign currency forward contracts to manage the foreign currency fluctuations for Mexican peso denominated payroll, utility, tax, and accounts payable expenses. The foreign currency forward contracts have terms that did not have any ineffectiveness to the underlying transactions being hedged.

As of April 2, 2011, the Company had outstanding foreign currency forward contracts with a total notional amount of $32.4 million. These contract maturity dates extend through March 2013. The Company has not entered into any additional foreign currency forward contracts subsequent to April 2, 2011.

**Table of Contents**

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of April 2, 2011 and July 3, 2010 (in thousands):

| Derivatives Designated as Hedging Instruments | Balance Sheet Location | April 2, 2011 Fair Value | July 3, 2010 Fair Value |
|---|---|---|---|
| Foreign currency forward contracts | Other current assets | $ 1,395 | $ 416 |
| Foreign currency forward contracts | Other long-term assets | $ 928 | $ |
| Foreign currency forward contracts | Other long-term liabilities | $ | $ (777) |

The following tables summarize the gain on derivative instruments on the Consolidated Statements of Income for the three and nine months ended April 2, 2011 (in thousands):

| Derivatives Designated as Hedging Instruments | AOCI Balance as of January 1, 2011 | Effective Portion Recorded In AOCI | Effective Portion Reclassified From AOCI Into Cost of Sales | AOCI Balance as of April 2, 2011 |
|---|---|---|---|---|
| Settled foreign currency forward contracts for the three months ended April 2, 2011 | $ 217 | $ 226 | $ (443) | $ |
| Unsettled foreign currency forward contracts | 624 | 909 | | 1,533 |
| Total | $ 841 | $ 1,135 | $ (443) | $ 1,533 |

| Derivatives Designated as Hedging Instruments | AOCI Balance as of July 3, 2010 | Effective Portion Recorded In AOCI | Effective Portion Reclassified From AOCI Into Cost of Sales | AOCI Balance as of April 2, 2011 |
|---|---|---|---|---|
| Settled foreign currency forward contracts for the nine months ended April 2, 2011 | $ 225 | $ 740 | $ (965) | $ |
| Unsettled foreign currency forward contracts | (467) | 2,000 | | 1,533 |
| Total | $ (242) | $ 2,740 | $ (965) | $ 1,533 |

The Company does not enter into derivative instruments for trading or speculative purposes. The Company s counterparties to the foreign currency forward contracts are major banking institutions. These institutions do not require collateral for the contracts and the Company believes that the risk of the counterparties failing to meet their contractual obligations is remote. As of April 2, 2011, the amount of existing gains, net of tax, expected to be reclassified into earnings within the next 12 months is approximately $0.9 million.

As of April 2, 2011, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

Table of Contents

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

**FORWARD-LOOKING STATEMENTS**

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

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

**Overview**

KeyTronicEMS is a leader in electronic manufacturing services and solutions to original equipment manufacturers of a broad range of products. We provide engineering services, worldwide procurement and distribution, materials management, world-class manufacturing and assembly services, in-house testing, and expertise in providing customer service. Our international production capability provides our customers with benefits of improved supply-chain management, reduced inventories, lower transportation costs, and reduced product fulfillment time. We continue to make investments in all of our operating facilities to give us the production capacity and logistical advantages to continue to win new business. The following information should be read in conjunction with the consolidated financial statements included herein and with Item 1A, Risk Factors.

Our mission is to provide our customers with superior manufacturing and engineering services at a lower total cost than our competitors for high quality production, and create long-term mutually beneficial business relationships.

**Executive Summary**

Our net sales of $63.4 million for the three months ended April 2, 2011 increased by 22.7 percent as compared to net sales of $51.7 million for the three months ended April 3, 2010. The increase in net sales was primarily driven by an increase in revenues related to new programs for both new and longstanding customers, offset by a net decline related to decreased demand from certain current customer programs. We believe that we are well positioned in the EMS industry to win new business in coming periods and profitably grow our revenue as the economy recovers.

The concentration of our largest customers increased during the third quarter of fiscal year 2011 with the top five customers sales accounting for 64.1 percent of total sales in the third quarter of fiscal 2011 compared to 52.2 percent in same period of the prior year, primarily due to an increase in the number of product programs of the top five customers from the prior year. We also experienced a change in the composition of our top five customers during the third quarter of fiscal 2011 as compared to the same period of the prior year, which we believe further demonstrates our ability to continue to diversify our growing revenue base. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies and computer accessories. The total number of our customers also continued to increase during the third quarter of fiscal year 2011.

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

**Table of Contents**

Gross profit as a percent of sales was 6.7 percent for the three months ended April 2, 2011 as compared to 10.1 percent for same three month period of the prior fiscal year. The decrease in gross profit as a percentage of net sales was primarily due to increased material costs in the product mix and start-up costs for new programs and to a lesser extent, increased freight costs.

Operating income as a percentage of sales for the three months ended April 2, 2011 was 1.5 percent compared to 4.3 percent for the three months ended April 3, 2010. The decrease in operating income as a percentage of sales was due to a decline in gross margin, partially offset by successfully controlling operating expenses.

Net income for the three months ended April 2, 2011 was $0.7 million or $0.07 per diluted share, as compared to $4.4 million or $0.43 per diluted share for the three months ended April 3, 2010. The decrease in net income as a percent of sales for the three months ended April 2, 2011 as compared to the same period in fiscal year 2010 was primarily due to an approximate 3.4 percentage point decline in our gross margin.

We maintain a strong balance sheet with a current ratio of 2.76 and a long-term debt to equity ratio of 0.24. Total cash used in operating activities as defined on our cash flow statement was $11.3 million during the nine months ended April 2, 2011. We maintain sufficient liquidity for our expected future operations and had $13.7 million in borrowings on our $30.0 million revolving line of credit with Wells Fargo, N.A. of which $16.3 million remained available at April 2, 2011. We believe cash flow generated from operations, our borrowing capacity, and equipment lease financing 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. 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 3, 2010, for further details.

- Inactive, Obsolete, and Surplus Inventory Reserve
- Allowance for Doubtful Accounts
- Accrued Warranty
- Income Taxes
- Stock-Based Compensation
- Impairment of Long-Lived Assets
- Derivatives and Hedging Activity

**RESULTS OF OPERATIONS**

***Comparison of the Three Months Ended April 2, 2011 with the Three Months Ended April 3, 2010***

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

Table of Contents

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended April 2, 2011 as compared to the three months ended April 3, 2010. It is provided to assist in assessing differences in our overall performance (in thousands):

| | Three Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | April 2, 2011 | % of net sales | April 3, 2010 | % of net sales | $ change | % change |
| Net sales | $ 63,424 | 100.0% | $ 51,697 | 100.0% | $ 11,727 | 22.7% |
| Cost of sales | 59,195 | 93.3 | 46,455 | 89.9 | 12,740 | 27.4 |
| Gross profit | 4,229 | 6.7 | 5,242 | 10.1 | (1,013) | (19.3) |
| Operating expenses: | | | | | | |
| Research, development and engineering | 919 | 1.4 | 796 | 1.5 | 123 | 15.5 |
| Selling, general and administrative | 2,373 | 3.7 | 2,216 | 4.3 | 157 | 7.1 |
| Total operating expenses | 3,292 | 5.2 | 3,012 | 5.8 | 280 | 9.3 |
| Operating income | 937 | 1.5 | 2,230 | 4.3 | (1,293) | (58.0) |
| Interest expense, net | 172 | 0.3 | 13 | 0.0 | 159 | 1,223.1 |
| Income before income taxes | 765 | 1.2 | 2,217 | 4.3 | (1,452) | (65.5) |
| Income tax provision (benefit) | 41 | 0.1 | (2,197) | 4.2 | (2,238) | * |
| Net income | $ 724 | 1.1% | $ 4,414 | 8.5% | $ (3,690) | (83.6)% |
| Effective income tax rate | 5.4% | | (99.1)% | | | |

* Changes from negative to positive are not considered meaningful.

***Net Sales***

The increase in net sales from prior year was primarily driven by an approximate $22.3 million increase in revenues related to new programs for both new and longstanding customers. This was partially offset by a $7.8 million net decline related to decreased demand from certain current customer programs and by the negative impact of program losses of approximately $2.8 million.

In the third quarter of fiscal 2011, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business in the fourth quarter of our fiscal year, driven by increased production levels of new programs for both new and longstanding customers. Sales in the fourth quarter of fiscal year 2011 are expected to be in the range of $61 million to $65 million. Future results will depend on actual levels of customers orders, the timing of the start up of production of new product programs and the potential impact of industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

***Gross Profit***

Gross profit as a percentage of sales for the third quarter of fiscal year 2011 was 6.7 percent compared to 10.1 percent for the third quarter of fiscal year 2010. This 3.4 percentage point decrease is primarily related to a 7.4 percentage point increase in material costs, as a percent of sales, resulting from higher material content in certain new customer programs, partially offset by a 2.6 percentage point improvement in leveraging of certain overhead costs, and a 1.4 percentage point improvement related to other cost of sales. The level of gross margin is impacted by product mix, timing of the start up of new programs, facility utilization, 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 $58,000 for obsolete inventory for the third quarter of fiscal year 2011 as compared to a $16,000 provision for obsolete inventory for the third quarter of fiscal year 2010. 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.

Table of Contents

***Operating Expenses***

Total selling, general and administrative (SG&A) expenses were $2.4 million and $2.2 million during the third quarters of fiscal years 2011 and 2010, respectively. This $0.2 million increase in SG&A during the third quarter of fiscal year 2011 as compared with the third quarter of fiscal 2010 is primarily related to a $0.2 million increase in professional fees.

Total research, development, and engineering (RD&E) expenses were $0.9 million and $0.8 million during the third quarters of fiscal years 2011 and 2010, respectively. This increase is primarily related to $0.1 million increase in labor costs.

***Interest***

Interest expense increased to $172,000 in the third quarter of fiscal year 2011 from $13,000 in the third quarter of fiscal year 2010. The increase in interest expense in the third quarter of fiscal year 2011 compared to the same period of fiscal year 2010 is primarily due to an increase in the average outstanding revolving line of credit balance and to a lesser extent the expense incurred due to an increase in other long term debt.

***Income Taxes***

The effective tax rate for the third quarter of fiscal year 2011 was 5.4 percent compared to (99.1) percent for the same period in fiscal 2010. The effective tax rate for the third quarter of fiscal year 2011 includes benefits related to federal research tax credits and from releasing the valuation allowance related to our operations in China. The negative effective tax rate for the same fiscal period in 2010 was primarily related to the benefit of releasing the valuation allowance related to domestic operations. For further information on taxes see footnote 5 of the Notes to Consolidated Financial Statements .

Our judgments regarding deferred tax assets and liabilities may change due to changes in market conditions, changes in foreign investment requirements, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance 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 Nine Months Ended April 2, 2011 with the Nine Months Ended April 3, 2010***

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 nine months ended April 2, 2011 as compared to the nine months ended April 3, 2010. It is provided to assist in assessing differences in our overall performance (in thousands):

| | Nine Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | **April 2, 2011** | **% of net sales** | **April 3, 2010** | **% of net sales** | **$ change** | **% change** |
| Net sales | $ 187,802 | 100.0% | $ 137,756 | 100.0% | $ 50,046 | 36.3% |
| Cost of sales | 172,157 | 91.7 | 125,129 | 90.8 | 47,028 | 37.6 |
| Gross profit | 15,645 | 8.3 | 12,627 | 9.2 | 3,018 | 23.9 |
| Operating expenses: | | | | | | |
| Research, development and engineering | 2,794 | 1.5 | 2,063 | 1.5 | 731 | 35.4 |
| Selling, general and administrative | 7,575 | 4.0 | 6,225 | 4.5 | 1,350 | 21.7 |
| Total operating expenses | 10,369 | 5.5 | 8,288 | 6.0 | 2,081 | 25.1 |
| Operating income | 5,276 | 2.8 | 4,339 | 3.2 | 937 | 21.6 |
| Interest expense, net | 319 | 0.2 | 77 | 0.1 | 242 | 314.3 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Income before income taxes | 4,957 | 2.6 | 4,262 | 3.1 | 695 | 16.3 |
| Income tax provision (benefit) | 758 | 0.4 | (2,117) | 1.5 | 2,875 | * |
| Net income | $ 4,199 | 2.2% | $ 6,379 | 4.6% | $ (2,180) | (34.2)% |
| Effective income tax rate | 15.3% | | (49.7)% | | | |

* Changes from negative to positive are not considered meaningful.

16

***Net Sales***

The increase in net sales from prior year was primarily driven by an approximate $56.9 million increase in revenues related to new programs for both new and longstanding customers. This was partially offset by a $4.0 million net decline related to decreased demand from certain current customer programs and by the negative impact of program losses of approximately $3.2 million and to a lesser extent the negative impact resulting from industry-wide shortages in the global supply chain.

In the first nine months of fiscal 2011, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business in the fourth quarter of our fiscal year, driven by increased production levels of new programs for both new and longstanding customers. Sales in the fourth quarter of fiscal year 2011 are expected to be in the range of $61 million to $65 million. Future results will depend on actual levels of customers orders, the timing of the start up of production of new product programs and the potential impact of industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

***Gross Profit***

Gross profit as a percentage of sales for the first nine months of fiscal year 2011 was 8.3 percent compared to 9.2 percent for the first nine months of fiscal year 2010. This 0.9 percentage point decrease is primarily related to a 7.1 percentage point increase in material costs, as a percent of sales, resulting from higher material content in certain new customer programs, partially offset by a 4.9 percentage point improvement in leveraging of certain overhead costs, and a 1.3 percentage point improvement related to other cost of sales. The level of gross margin is impacted by product mix, timing of the start up of new programs, facility utilization, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $0.2 million for obsolete inventory for the first nine months of fiscal year 2011 as compared to a $1.4 million provision for obsolete inventory for the same period in the prior year. The prior year provision was primarily related to the cancellation of a certain customer program due to the insolvency of the customer. 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 selling general and administrative (SG&A) expenses were $7.6 million and $6.2 million during the first nine months of fiscal years 2011 and 2010, respectively. This $1.4 million increase in SG&A during the first nine months of fiscal year 2011 as compared with the first nine months of fiscal 2010 is primarily related to a $0.6 million increase in outside services and professional fees, a $0.2 million increase in stock based compensation expense, and $0.1 million increases in both labor costs and commission costs. The remaining $0.5 million increase is related to increases in certain administrative overhead costs.

Total research, development, and engineering (RD&E) expenses were $2.8 million and $2.1 million during the first nine months of fiscal years 2011 and 2010, respectively. This $0.7 million increase is primarily related to an approximate $0.7 million increase in labor costs.

**Table of Contents**

***Interest***

Interest expense increased to $0.3 million in the first nine months of fiscal year 2011 from $0.1 million in the first nine months of fiscal year 2010. The increase in interest expense in the first nine months of fiscal year 2011 compared to the same period of fiscal year 2010 is primarily due to an increase in the average outstanding revolving line of credit balance and to a lesser extent the expense incurred due to an increase in other long term debt.

***Income Taxes***

The effective tax rate for the first nine months of fiscal year 2011 was 15.3 percent compared to (49.7) percent for the same period in fiscal 2010. The effective tax rate for the first nine months of fiscal year 2011 includes benefits related to federal research tax credits and from releasing the valuation allowance related to our operations in China. The negative effective tax rate for the same fiscal period in 2010 was primarily related the benefit of releasing the valuation allowance related to domestic operations. For further information on taxes see footnote 5 of the Notes to Consolidated Financial Statements .

Our judgments regarding deferred tax assets and liabilities may change due to changes in market conditions, changes in foreign investment requirements, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance 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 April 2, 2011, we had an order backlog of approximately $46.2 million. This compares with a backlog of approximately $49.9 million on April 3, 2010. Order backlog consists of purchase orders received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future sales.

**CAPITAL RESOURCES AND LIQUIDITY**

Operating Cash Flow

Net cash used in operating activities for the nine months ended April 2, 2011 was $11.3 million, compared to net cash provided by operating activities of $7.6 million during the same period of the prior fiscal year.

On a comparative year-to year basis, the $18.9 million decrease in cash flows provided by operating activities during the nine months ended April 2, 2011 as compared with the nine months ended April 3, 2010 resulted primarily from a $5.8 million increase in inventory, a $7.7 million increase in trade receivables, and a $1.2 million decrease in accounts payable during the nine months ended April 2, 2011. During the nine months ended April 3, 2010, the year over year difference consisted primarily of an $8.0 million increase in accounts payable offset by a $5.2 million increase in inventory and a $2.2 million increase in accounts receivable.

The increase in inventory during the nine months ended April 2, 2011 was attributable to our anticipated growth in production levels for a number of new programs. The increase in inventory during the nine months ended April 3, 2010 was attributable to new customer programs and increasing lead times on certain electronic components which led to some scheduled shipments not being shipped by the end of the quarter. We purchase inventory based on customer forecasts and orders and expected lead times, and when those forecasts cannot be met or changes are made to lead times, inventory can increase. The increase in trade receivables during the nine months ended April 2, 2011 and April 3, 2010 was primarily related to the increase in sales that occurred during the third quarters of their respective fiscal years that had not yet been collected. The decrease in accounts payable during the nine months ended April 2, 2011 was primarily driven by the timing of purchases and cash payments. The increase in accounts payable during the nine months ended April 3, 2010 was primarily driven by the increase in inventory and extending payment terms. Accounts payable fluctuates with changes in inventory levels and negotiated supplier terms.

**Table of Contents**

Investing Cash Flow

During the first nine months of fiscal year 2011, we paid $3.6 million for capital expenditures compared to $1.5 million in the same period of the previous fiscal year. Our capital expenditures primarily consist of purchases of manufacturing equipment to support our production facilities and to a lesser extent leasehold improvements at our corporate headquarters. We also use leases to acquire equipment. Operating leases are often utilized when potential technical obsolescence and funding requirement advantages outweigh the benefits of equipment ownership. Capital expenditures and periodic lease payments are expected to be financed with internally generated funds.

Financing Cash Flow

Net cash provided by financing activities for the nine months ended April 2, 2011 was $14.7 million, compared to net cash used in financing activities of $2.2 million during the same period of the prior fiscal year. Our primary financing activity during the first nine months of fiscal year 2011 related to borrowing and repayment under our revolving line of credit, which totaled net borrowings of $12.2 million. Additionally, cash provided by financing activities included $2.2 million of proceeds related to the financing of certain equipment and leasehold improvement purchases during the third quarter of fiscal 2011, offset by capital lease payments of approximately $0.1 million. Our primary financing activity during the first nine months of fiscal year 2010 was related to borrowings and repayments under our revolving line of credit, which totaled net repayments of $2.4 million.

As of April 2, 2011, we were in compliance with our loan covenants and approximately $16.3 million was available under the revolving line of credit.

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 line of credit and leasing capabilities will be sufficient to meet our working and fixed capital requirements for the foreseeable future.

**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 3, 2010. There have been no material changes in contractual obligations outside the ordinary course of business since July 3, 2010.

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

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

Potential Fluctuations in Quarterly Results

Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global macroeconomic environment, volatility in overall demand for our customers products, success of customers programs, timing of new programs, new product introductions or technological advances by us, our customers and our competitors, and changes in pricing policies by us, our customers, our suppliers, and our competitors. Our customer base is diverse in the markets they serve, however, decreases in demand, particularly from customers that supply the banking, consumer products, and gambling industries, could affect future quarterly results. Additionally, our customers could be impacted by the illiquidity of the credit markets which could directly impact our operating results.

Component procurement, production schedules, personnel and other resource requirements are based on estimates of customer requirements. Occasionally, our customers may request accelerated production that can stress resources and reduce operating margins. In addition, because many of our operating expenses are relatively fixed, a reduction in customer demand can harm our gross profit and operating results. The products which we manufacture for our customers have relatively short product lifecycles. Therefore, our business, operating results and financial condition are dependent in 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, the valuation allowance on deferred tax assets, impairment of long-lived assets, long-term incentive compensation accrual, and the provision for warranty costs.

19

**Table of Contents**

Economic Conditions

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

Credit Markets

The current illiquidity and financial instability in the credit markets could adversely impact lenders and potentially limit the ability of our suppliers and customers to borrow. This may affect their ability to fulfill their obligations to us and have an adverse effect on our financial results.

Dependence on Suppliers

We are dependent on many suppliers, including sole source suppliers, to provide key components and raw materials used in manufacturing customers products. Recently, we have seen supply shortages in certain electronic components. This can result in longer lead times and the inability to meet our customers request for flexible production and extended shipment dates. Additionally, force majeure issues in Japan have caused supply constraints from some suppliers; the full effect of the earthquake is still to be determined. 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.

Concentration of Credit Risk

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.

Competition

The EMS industry is intensely competitive. 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 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.

Concentration of Major Customers

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

The loss of one or more of our major customers, or the reduction, delay or cancellation of orders from such customers, due to economic conditions or other forces, could materially and adversely affect our business, operating results and financial condition. Specifically, some of our major customers provide products to the banking and gambling industries which have been adversely affected by the unfavorable economic environment. The contraction in demand from our customers in these industries could continue to impact our customer orders and continue to have a negative impact on our operations over the next several fiscal quarters. 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.

20

**Table of Contents**

Foreign Manufacturing Operations and Currencies

Most of the products manufactured by us are produced at our facilities located in Mexico and China. These international operations may be subject to a number of risks, including:

- difficulties in staffing and managing foreign operations;
- political and economic instability (including acts of terrorism, civil unrest, forms of violence and outbreaks of war), which could impact our ability to ship and/or receive product;
- unexpected changes in regulatory requirements and laws;
- longer customer payment cycles and difficulty collecting accounts receivable;
- export duties, import controls and trade barriers (including quotas);
- governmental restrictions on the transfer of funds;
- burdens of complying with a wide variety of foreign laws and labor practices;
- fluctuations in currency exchange rates, which could affect component costs, local payroll, utility and other expenses; and
- inability to utilize net operating losses incurred by our foreign operations to reduce our U.S. income taxes;
- our foreign locations may be impacted by hurricanes, earthquakes, water shortages, tsunamis, floods, typhoons, fires, extreme weather conditions and other natural or manmade 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 holidays or other incentives are not extended, are repealed, or we no longer qualify for such programs, our taxes may increase, which would reduce our net income.

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us could directly or indirectly affect our financial results. Future currency fluctuations are dependent upon a number of factors and cannot be easily predicted. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. However, unexpected expenses could occur from future fluctuations in exchange rates.

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

Dependence on Key Personnel

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

New Program, New Product, and New Customer Risk

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, 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.

**Table of Contents**

Interest Rate Risk

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

Compliance with Current and Future Environmental Regulation

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.

Dilution and Stock Price Volatility

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

Disclosure and Internal Controls

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.

Managing Growth

Our business is experiencing rapid growth which can place considerable additional demands upon our management team and our operational, financial and management information systems. Our ability to manage growth effectively requires us to continue to implement and improve these systems; avoid cost overruns; maintain customer, supplier and other favorable business relationships during possible transition periods; continue to develop the management skills of our managers and supervisors; and continue to train, motivate and manage our employees. Our failure to effectively manage growth could have a material adverse effect on our results of operations.

Manufacturing Process

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 cancelled 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. In addition, these defects may result in liability claims against us or expose us to liability to pay for the recall of a product. Even 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.

Table of Contents

Energy Prices

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.

**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 line of credit is secured by substantially all of our assets. The interest rates applicable to our revolving line of credit fluctuate with the Wells Fargo Bank prime rate and LIBOR rates. There was outstanding $13.7 million in borrowings under our revolving line of credit as of April 2, 2011, and the range of interest being paid on the outstanding balance was 2.48% - 3.25%. See Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity and Note 4 Long-Term Debt to the Consolidated Financial Statements for additional information regarding our revolving line of credit.

**Foreign Currency Exchange Risk**

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us would directly or indirectly affect our financial results. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There was outstanding $32.4 million of foreign currency forward contracts as of April 2, 2011. The fair value of these contracts was $2.3 million. See Note 9 Derivative Financial Instruments to the Consolidated Financial Statements for additional information regarding our derivative instruments.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company s Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of April 2, 2011, the Company s disclosure controls and procedures are effective based on that criteria.

**Changes in Internal Control over Financial Reporting**

There have been no significant changes in our internal controls over financial reporting during our third quarter ended April 2, 2011 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)).

Table of Contents

**PART II. OTHER INFORMATION:**

**Item 1. Legal Proceedings**

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

Item 1A. Risk Factors

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

There are no material changes to the risk factors set forth in Part I Item 1A in the Company s Annual Report on Form 10-K for the year ended July 3, 2010.

Item 4. Removed and Reserved

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)

**Table of Contents**

## 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<br>**Craig D. Gates**<br>**President and Chief Executive Officer**<br>**(Principal Executive Officer)** | Date: May 13, 2011 |
| /s/ Ronald F. Klawitter<br>**Ronald F. Klawitter**<br>**Executive Vice President of Administration, Chief Financial Officer and Treasurer**<br>**(Principal Financial Officer)** | Date: May 13, 2011 |