

Kimball Electronics, Inc.
Form 10-Q
February 08, 2018

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2017

OR

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

For the transition period from _____ to _____

Commission File Number 001-36454

KIMBALL ELECTRONICS, INC.

(Exact name of registrant as specified in its charter)

Indiana 35-2047713

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

1205 Kimball Boulevard, Jasper, Indiana 47546

(Address of principal executive offices) (Zip Code)

(812) 634-4000

Registrant's telephone number, including area code

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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, 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

Non-accelerated filer Smaller reporting company

(Do not check if a 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.

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

The number of shares outstanding of the Registrant's common stock as of January 26, 2018 was 26,694,649 shares.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

KIMBALL ELECTRONICS, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Amounts in Thousands, Except for Share Data)

| | (Unaudited) | |
|--|----------------------|------------------|
| | December 31, 2017 | June 30, 2017 |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 35,638 | \$44,555 |
| Receivables, net of allowances of \$315 and \$284, respectively | 173,663 | 169,785 |
| Inventories | 179,862 | 144,606 |
| Prepaid expenses and other current assets | 26,248 | 29,219 |
| Total current assets | 415,411 | 388,165 |
| Property and Equipment, net of accumulated depreciation of \$192,887 and \$180,028, respectively | 140,978 | 137,549 |
| Goodwill | 6,191 | 6,191 |
| Other Intangible Assets, net of accumulated amortization of \$26,889 and \$26,392, respectively | 4,700 | 4,581 |
| Other Assets | 17,246 | 18,458 |
| Total Assets | \$ 584,526 | \$554,944 |
| LIABILITIES AND SHARE OWNERS' EQUITY | | |
| Current Liabilities: | | |
| Borrowings under credit facilities | \$ 11,000 | \$10,000 |
| Accounts payable | 178,366 | 154,619 |
| Accrued expenses | 29,578 | 34,630 |
| Total current liabilities | 218,944 | 199,249 |
| Other Liabilities: | | |
| Long-term income taxes payable | 11,786 | — |
| Other long-term liabilities | 12,720 | 13,423 |
| Total other liabilities | 24,506 | 13,423 |
| Share Owners' Equity: | | |
| Preferred stock-no par value | | |
| Shares authorized: 15,000,000 | — | — |
| Shares issued: None | | |
| Common stock-no par value | | |
| Shares authorized: 150,000,000 | — | — |
| Shares issued: 29,430,000 | | |
| Additional paid-in capital | 301,441 | 302,483 |
| Retained earnings | 82,804 | 82,671 |
| Accumulated other comprehensive loss | (5,098 |) (9,084) |
| Treasury stock, at cost: | | |
| Shares: 2,735,000 and 2,592,000, respectively | (38,071 |) (33,798) |
| Total Share Owners' Equity | 341,076 | 342,272 |
| Total Liabilities and Share Owners' Equity | \$ 584,526 | \$554,944 |

See Notes to Condensed Consolidated Financial Statements.

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KIMBALL ELECTRONICS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Amounts in Thousands, Except for Per Share Data)

| (Unaudited) | Three Months Ended | | Six Months Ended | |
|--|--------------------|-----------|------------------|-----------|
| | December 31 | | December 31 | |
| | 2017 | 2016 | 2017 | 2016 |
| Net Sales | \$258,151 | \$230,265 | \$511,355 | \$456,716 |
| Cost of Sales | 237,189 | 209,712 | 470,903 | 417,841 |
| Gross Profit | 20,962 | 20,553 | 40,452 | 38,875 |
| Selling and Administrative Expenses | 10,769 | 8,312 | 20,669 | 17,817 |
| Other General Income | — | — | — | (4,005) |
| Operating Income | 10,193 | 12,241 | 19,783 | 25,063 |
| Other Income (Expense): | | | | |
| Interest income | 18 | 14 | 36 | 37 |
| Interest expense | (113) | (60) | (229) | (99) |
| Non-operating income (expense), net | 488 | (968) | 1,831 | (189) |
| Other income (expense), net | 393 | (1,014) | 1,638 | (251) |
| Income Before Taxes on Income | 10,586 | 11,227 | 21,421 | 24,812 |
| Provision for Income Taxes | 18,933 | 3,415 | 21,288 | 6,878 |
| Net Income (Loss) | \$(8,347) | \$7,812 | \$133 | \$17,934 |
| Earnings (Loss) Per Share of Common Stock: | | | | |
| Basic | \$(0.31) | \$0.29 | \$— | \$0.65 |
| Diluted | \$(0.31) | \$0.28 | \$— | \$0.65 |
| Average Number of Shares Outstanding: | | | | |
| Basic | 26,765 | 27,350 | 26,812 | 27,714 |
| Diluted | 26,765 | 27,455 | 27,007 | 27,775 |

See Notes to Condensed Consolidated Financial Statements.

KIMBALL ELECTRONICS, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (Amounts in Thousands)

| (Unaudited) | Three Months Ended December 31, 2017 | | | Three Months Ended December 31, 2016 | | |
|---|---|--------|---------------|---|---------|---------------|
| | Pre-tax | Tax | Net of Tax | Pre-tax | Tax | Net of Tax |
| Net income (loss) | | | \$ (8,347) | | | \$ 7,812 |
| Other comprehensive income (loss): | | | | | | |
| Foreign currency translation adjustments | \$ 1,648 | \$— | \$ 1,648 | \$ (5,328) | \$— | \$ (5,328) |
| Postemployment severance actuarial change | 118 | (43) | 75 | (45) | 17 | (28) |
| Derivative gain (loss) | (445) | 278 | (167) | (82) | 187 | 105 |
| Reclassification to (earnings) loss: | | | | | | |
| Derivatives | 494 | (73) | 421 | 617 | (216) | 401 |
| Amortization of actuarial change | (85) | 32 | (53) | (78) | 29 | (49) |
| Other comprehensive income (loss) | \$ 1,730 | \$ 194 | \$ 1,924 | \$ (4,916) | \$ 17 | \$ (4,899) |
| Total comprehensive income (loss) | | | \$ (6,423) | | | \$ 2,913 |
| | | | | | | |
| (Unaudited) | Six Months Ended December 31, 2017 | | | Six Months Ended December 31, 2016 | | |
| | Pre-tax | Tax | Net of Tax | Pre-tax | Tax | Net of Tax |
| Net income | | | \$ 133 | | | \$ 17,934 |
| Other comprehensive income (loss): | | | | | | |
| Foreign currency translation adjustments | \$ 4,862 | \$— | \$ 4,862 | \$ (4,518) | \$— | \$ (4,518) |
| Postemployment severance actuarial change | 264 | (97) | 167 | 312 | (117) | 195 |
| Derivative gain (loss) | (2,042) | 597 | (1,445) | (266) | 328 | 62 |
| Reclassification to (earnings) loss: | | | | | | |
| Derivatives | 504 | 1 | 505 | 896 | (321) | 575 |
| Amortization of actuarial change | (165) | 62 | (103) | (174) | 65 | (109) |
| Other comprehensive income (loss) | \$ 3,423 | \$ 563 | \$ 3,986 | \$ (3,750) | \$ (45) | \$ (3,795) |
| Total comprehensive income | | | \$ 4,119 | | | \$ 14,139 |

See Notes to Condensed Consolidated Financial Statements.

KIMBALL ELECTRONICS, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Amounts in Thousands)

| (Unaudited) | Six Months Ended | |
|---|------------------|-----------|
| | 2017 | 2016 |
| Cash Flows From Operating Activities: | | |
| Net income | \$133 | \$17,934 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 12,755 | 11,429 |
| Gain on sales of assets | (17) | (39) |
| Deferred income tax and other deferred charges | 3,061 | (1,617) |
| Stock-based compensation | 2,443 | 1,941 |
| Bargain purchase gain | — | (925) |
| Other, net | (53) | (41) |
| Change in operating assets and liabilities: | | |
| Receivables | (2,524) | (8,650) |
| Inventories | (33,874) | (5,158) |
| Prepaid expenses and other current assets | 1,727 | 1,099 |
| Accounts payable | 22,381 | 9,468 |
| Accrued expenses and taxes payable | 5,369 | 650 |
| Net cash provided by operating activities | 11,401 | 26,091 |
| Cash Flows From Investing Activities: | | |
| Capital expenditures | (14,708) | (19,057) |
| Proceeds from sales of assets | 107 | 191 |
| Payments for acquisitions, net of cash acquired | — | (2,138) |
| Purchases of capitalized software | (126) | (677) |
| Other, net | 10 | (7) |
| Net cash used for investing activities | (14,717) | (21,688) |
| Cash Flows From Financing Activities: | | |
| Proceeds from credit facilities | — | 4,000 |
| Payments on credit facilities | — | (4,000) |
| Net change in revolving credit facilities | 1,000 | — |
| Repurchases of common stock | (6,460) | (14,323) |
| Repurchase of employee shares for tax withholding | (1,508) | (709) |
| Net cash used for financing activities | (6,968) | (15,032) |
| Effect of Exchange Rate Change on Cash and Cash Equivalents | 1,367 | (1,369) |
| Net Decrease in Cash and Cash Equivalents | (8,917) | (11,998) |
| Cash and Cash Equivalents at Beginning of Period | 44,555 | 54,738 |
| Cash and Cash Equivalents at End of Period | \$35,638 | \$42,740 |
| Supplemental Disclosure of Cash Flow Information | | |
| Cash paid during the period for: | | |
| Income taxes | \$8,795 | \$1,959 |
| Interest expense | \$120 | \$83 |

See Notes to Condensed Consolidated Financial Statements.

KIMBALL ELECTRONICS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Business Description and Summary of Significant Accounting Policies

Business Description:

Kimball Electronics, Inc. (also referred to herein as “Kimball Electronics,” the “Company,” “we,” “us,” or “our”) is a global contract electronic manufacturing services (“EMS”) company that specializes in producing durable electronics for the automotive, medical, industrial, and public safety end markets. We offer a package of value that begins with our core competency of producing “durable electronics” and includes our set of robust processes and procedures that help us ensure that we deliver the highest levels of quality, reliability, and service throughout the entire life cycle of our customers’ products. We have been producing safety critical electronic assemblies for our automotive customers for over 30 years. We are well recognized by customers and industry trade publications for our excellent quality, reliability, and innovative service.

Basis of Presentation:

The Condensed Consolidated Financial Statements presented herein reflect the consolidated financial position as of December 31, 2017 and June 30, 2017, results of operations for the three and six months ended December 31, 2017 and 2016, and cash flows for the six months ended December 31, 2017 and 2016. The financial data presented herein is unaudited and should be read in conjunction with the annual Consolidated Financial Statements as of and for the year ended June 30, 2017 and related notes thereto included in our Annual Report on Form 10-K. As such, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) have been condensed or omitted, although we believe that the disclosures are adequate to make the information presented not misleading. Intercompany transactions and balances have been eliminated. Management believes the financial statements include all adjustments (consisting only of normal recurring adjustments) considered necessary to present fairly the financial statements for the interim periods. The results of operations for the interim periods shown in this report are not necessarily indicative of results for any future interim period or for the entire fiscal year.

Notes Receivable and Trade Accounts Receivable:

Notes receivable and trade accounts receivable are recorded per the terms of the agreement or sale, and accrued interest is recognized when earned. We determine on a case-by-case basis the cessation of accruing interest, the resumption of accruing interest, the method of recording payments received on nonaccrual receivables, and the delinquency status for our limited number of notes receivable.

In the ordinary course of business, customers periodically negotiate extended payment terms on trade accounts receivable. Customary terms require payment within 30 to 45 days, with any terms beyond 45 days being considered extended payment terms. We may utilize accounts receivable factoring arrangements with third-party financial institutions in order to extend terms for the customer without negatively impacting our cash flow. These arrangements in all cases do not contain recourse provisions which would obligate us in the event of our customers’ failure to pay. Receivables are considered sold when they are transferred beyond the reach of Kimball Electronics and its creditors, the purchaser has the right to pledge or exchange the receivables, and we have surrendered control over the transferred receivables. In the six months ended December 31, 2017 and 2016, we sold, without recourse, \$81.2 million and \$72.2 million of accounts receivable, respectively. Factoring fees were not material.

The Company’s China operation, in limited circumstances, may receive banker’s acceptance drafts from customers as payment for their trade accounts receivable. The banker’s acceptance drafts are non-interest bearing and primarily mature within six months from the origination date. The Company has the ability to sell the drafts at a discount or transfer the drafts in settlement of current accounts payable prior to the scheduled maturity date. These drafts, which totaled \$4.3 million at December 31, 2017 and \$5.3 million at June 30, 2017, are reflected in Receivables on the Condensed Consolidated Balance Sheets until the banker’s drafts are sold at a discount, transferred in settlement of current accounts payable, or cash is received at maturity. Banker’s acceptance drafts sold at a discount or transferred in settlement of current accounts payable during the six months ended December 31, 2017 and 2016 were \$1.9 million and \$4.2 million, respectively. See Note 4 - Commitments and Contingent Liabilities of Notes to Condensed

Consolidated Financial Statements for more information on banker's acceptance drafts.

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Other General Income:

Other General Income in the six months ended December 31, 2016 included \$4.0 million of pre-tax income resulting from a payment received related to a class action lawsuit in which Kimball Electronics was a class member. The lawsuit alleged that certain suppliers to the EMS industry conspired over a number of years to raise and fix the prices of electronic components, resulting in overcharges to purchasers of those components. No Other General Income was recorded in the six months ended December 31, 2017.

Non-operating Income (Expense), net:

Non-operating income (expense), net includes the impact of such items as foreign currency rate movements and related derivative gain or loss, fair value adjustments on supplemental employee retirement plan (“SERP”) investments, bank charges, and other miscellaneous non-operating income and expense items that are not directly related to operations. The bargain purchase gain on acquisition relates to the acquisition of Aircom Manufacturing, Inc. during the six months ended December 31, 2016 and resulted from the estimated fair values of the assets acquired and liabilities recorded being greater than the consideration paid. For more information on the bargain purchase gain, refer to our Annual Report on Form 10-K for the year ended June 30, 2017. The gain (loss) on SERP investments is offset by a change in the SERP liability that is recognized in Selling and Administrative Expenses.

Components of Non-operating income (expense), net:

| | Three Months Ended December 31 | | Six Months Ended December 31 | |
|--|--------------------------------------|-----------|------------------------------------|-----------|
| (Amounts in Thousands) | 2017 | 2016 | 2017 | 2016 |
| Foreign currency/derivative gain (loss) | \$333 | \$(1,185) | \$1,394 | \$(1,470) |
| Gain (loss) on supplemental employee retirement plan investments | 282 | (1) | 585 | 259 |
| Bargain purchase gain on acquisition | — | — | — | 925 |
| Other | (127) | 218 | (148) | 97 |
| Non-operating income (expense), net | \$488 | \$(968) | \$1,831 | \$(189) |

Income Taxes:

In determining the quarterly provision for income taxes, we use an estimated annual effective tax rate which is based on expected annual income, statutory tax rates, and available tax planning opportunities in the various jurisdictions in which we operate. Unusual or infrequently occurring items are separately recognized in the quarter in which they occur.

The U.S. Tax Cuts and Jobs Act (“Tax Reform”) was enacted into law on December 22, 2017. Tax Reform makes broad and complex changes to the U.S. tax code, for which complete guidance has not yet been issued. Tax Reform will affect our current fiscal year ending June 30, 2018, including, but not limited to, (i) reducing the U.S. corporate statutory tax rate, (ii) requiring a one-time transition tax on certain unremitted earnings of foreign subsidiaries that is payable over an eight-year period, (iii) eliminating U.S. federal income taxes on dividends from foreign subsidiaries, and (iv) bonus depreciation that will allow for full expensing of qualifying property. Tax Reform reduces the U.S. corporate statutory tax rate from 35% to 21%. For our fiscal year ending June 30, 2018, we will have a blended corporate tax rate of 28.1%, which is based on the applicable tax rates before and after Tax Reform and the number of days in the year.

The Company was able to make reasonable estimates of certain effects and, therefore, recorded provisional adjustments including the revaluation of its net deferred tax assets at the new applicable rates as of December 31, 2017, and the one-time deemed repatriation tax on accumulated unremitted foreign earnings. Approximately \$3.8 million of additional tax expense was recorded for the revaluation of the net deferred tax assets. The Company recorded approximately \$12.8 million of tax expense for the deemed repatriation tax, of which \$11.8 million of the tax payable was recorded in Long-term income taxes payable on the Condensed Consolidated Balance Sheet. The one-time deemed repatriation tax is based on 15.5% of the accumulated unremitted foreign earnings held in foreign cash and other liquid assets and 8.0% of the residual accumulated unremitted foreign earnings. Both the revaluation of the net deferred tax assets and the deemed repatriation tax were treated as discrete items and were recognized in Provision for Income Taxes on the Condensed Consolidated Statements of Income for the three and six months ended

December 31, 2017. The Company considers these provisional recorded amounts to be reasonable estimates as of December 31, 2017, and these amounts could be affected by additional information and other analysis related to Tax Reform. As a result, these amounts could be adjusted during the measurement period ending December 2018.

Tax Reform also subjects U.S. corporations to tax on Global Intangible Low-Taxed Income (“GILTI”), which imposes tax on foreign earnings in excess of a deemed return on tangible assets. Due to the complexity of the new GILTI tax rules, the Company is continuing to evaluate this provision for which no provisional amounts have been recorded in the Company’s Condensed Consolidated Financial Statements. An accounting policy election can be made to either record deferred taxes related to GILTI or to record the related taxes in the period in which they occur. The Company has not yet elected an accounting policy related to GILTI and will only do so after completion of further evaluation and analysis. The provisions related to GILTI are subject to adjustment during the measurement period ending December 2018.

The Company entered into a Tax Matters Agreement with Kimball International, Inc. (our “former Parent”) that governs the Company’s rights and obligations after the spin-off from former Parent on October 31, 2014 with respect to tax liabilities and benefits, tax attributes, tax contests, and other tax sharing regarding income taxes, other tax matters, and related tax returns. The Company will continue to have joint and several liabilities with former Parent with the IRS and certain U.S. state tax authorities for U.S. federal income and state taxes for the taxable periods in which the Company was a part of former Parent’s consolidated group. The tax matters agreement specifies the portion, if any, of this liability for which the Company bears responsibility, and former Parent has agreed to indemnify the Company against any amounts for which the Company is not responsible. As of both December 31, 2017 and June 30, 2017, the Company has a receivable from Kimball International recorded for \$0.6 million, of which \$0.5 million is a long-term receivable, and was recorded in Other Assets on the Condensed Consolidated Balance Sheets, relating to benefits from domestic research and development tax credits.

“Emerging Growth Company” Reporting Requirements:

The Company qualifies as an “emerging growth company” as defined in the Jumpstart Our Business Startups Act (the “JOBS Act”). For as long as a company is deemed to be an “emerging growth company,” it may take advantage of specified reduced reporting and other regulatory requirements that are generally unavailable to other public companies. Among other things, we are not required to provide an auditor attestation report on the assessment of the internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”).

Section 107 of the JOBS Act also provides that an “emerging growth company” can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. We have elected to take advantage of this extended transition period. Our financial statements may therefore not be comparable to those of companies that comply with such new or revised accounting standards.

We would cease to be an “emerging growth company” upon the earliest of:

- the last day of the fiscal year following the fifth anniversary of the date of the first sale of our common stock pursuant to an effective registration statement filed under the Securities Act, or June 30, 2020;
- the last day of the fiscal year in which our total annual gross revenues exceed \$1.07 billion;
- the date on which we have, during the previous three-year period, issued more than \$1 billion in non-convertible debt securities; or
- the date on which we become a “large accelerated filer,” as defined in Rule 12b-2 under the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), which would occur if the market value of our common stock held by non-affiliates exceeds \$700 million as of the last day of our most recently completed second fiscal quarter.

We continue to monitor our status as an “emerging growth company” and are currently preparing, and expect to be ready, to comply with the additional reporting and regulatory requirements that will be applicable to us when we cease to qualify as an “emerging growth company.”

New Accounting Standards:

In August 2017, the Financial Accounting Standards Board (“FASB”) issued guidance on accounting for derivatives and hedging activities. The objective of this guidance is to better align a company’s risk management activities and financial reporting for hedging relationships, simplify the hedge accounting requirements, and improve the disclosures of hedging arrangements. For public companies, the guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For as long as we remain an “emerging growth company” the new guidance will be effective for our fiscal year 2020 annual financial statements and for interim statements

beginning in fiscal year 2021. Early adoption is permitted. We are currently evaluating the impact of the adoption of this guidance on our consolidated financial statements.

In March 2016, the FASB issued guidance on accounting for share-based payment transactions. The objective of this guidance is to simplify certain aspects of the accounting for share-based payment transactions, including the treatment of excess income tax benefits and deficiencies, allowing an election to account for forfeitures as they occur, and classification of excess tax benefits on the statement of cash flows. For public companies, the guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted in any interim or annual period. The Company adopted this guidance effective July 1, 2017. There was no impact on the Company's financial statements upon the initial adoption as there were no tax benefits that were not previously recognized because the related tax deduction had not reduced taxes payable, and therefore no cumulative-effect adjustment to the Company's beginning retained earnings was required. The Company has elected to reverse the compensation cost of any forfeited awards when they occur and will classify the cash flows related to excess tax benefits for share-based payment arrangements as cash flows from operating activities on a prospective basis. The new guidance requires prospective application of the tax effects of differences recognized on or after the effective date between the deduction for an award for tax purposes and the compensation costs of that award recognized for financial reporting purposes. As a result, during the six months ended December 31, 2017, the Company recorded a discrete income tax adjustment related to the excess tax benefit on performance shares granted of \$0.6 million in Provision for Income Taxes on the Condensed Consolidated Statements of Income, or \$0.02 per diluted share. Due to including the income tax effects from excess tax benefits in the provision for income taxes, the effects of the excess tax benefits are no longer included in the calculation of diluted shares outstanding, which generally will result in an increase in the number of diluted shares outstanding. The Company adopted this change in the method of calculating diluted shares outstanding on a prospective basis.

In February 2016, the FASB issued guidance on leases. The new guidance requires lessees to recognize assets and liabilities on the balance sheet for the rights and obligations created by those leases with terms of more than 12 months. Under the current guidance, only capital leases are recognized on the balance sheet. The new guidance requires additional qualitative and quantitative disclosures. For public companies, the guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For as long as we remain an "emerging growth company" the new guidance will be effective for our fiscal year 2020 annual financial statements and for interim statements beginning in fiscal year 2021. Early application is permitted. We are currently evaluating the impact of the adoption of this guidance on our consolidated financial statements.

In November 2015, the FASB issued guidance on the balance sheet classification of deferred taxes. Under the current guidance, deferred tax liabilities and assets must be separated into current and noncurrent amounts in a classified statement of financial position. The new guidance requires deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The new guidance does not change the requirement that deferred tax liabilities and assets of a tax-paying component of an entity to be offset and presented as a single amount. For public companies, the guidance is effective for financial statements issued for annual periods beginning after December 15, 2016, including interim periods within those annual periods. For as long as we remain an "emerging growth company" the guidance is effective for our fiscal year 2019 annual financial statements and interim periods within our fiscal year 2020 financial statements, with earlier application permitted as of the beginning of an interim or annual reporting period. The guidance offers two acceptable adoption methods: (i) retrospective adoption to all periods presented; or (ii) prospective adoption to all deferred tax liabilities and assets. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations, or cash flows.

In July 2015, the FASB issued guidance on Simplifying the Measurement of Inventory. The guidance amends the subsequent measurement of inventory from the lower of cost or market to the lower of cost and net realizable value. Under the current guidance, market value could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. Within the scope of the new guidance, an entity should measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. For public companies, the guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For as long as we remain an "emerging growth company" the guidance is effective for our fiscal year 2018 annual financial statements and for interim statements beginning in fiscal year 2019. Early application is permitted as of the

beginning of an interim or annual reporting period. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations, or cash flows.

In May 2014, the FASB issued guidance on the recognition of revenue from contracts with customers. The core principle of the guidance is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration which the company expects to receive in exchange for those goods or services. To achieve this core principle, the guidance provides a five-step analysis of transactions to determine when and how revenue is recognized. The guidance addresses several areas including transfer of control, contracts with multiple performance obligations, and costs to

obtain and fulfill contracts. The guidance also requires additional disclosure about the nature, amount, timing, and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. In August 2015, the FASB issued additional guidance deferring the effective date for one year while allowing entities the option to adopt one year early. For public companies, the guidance is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that annual reporting period. For as long as we remain an “emerging growth company” the guidance will be effective for our fiscal year 2020 annual financial statements and for interim periods beginning in fiscal year 2021. The Company continues to evaluate the impact the adoption of this new standard will have on its consolidated financial statements; however, it anticipates, for the majority of its contracts for manufacturing services, it will change from a point-in-time recognition method upon transfer of title to an over-time model based on the progress of completing customer orders. We believe the adoption of the standard will have a material effect on the Company’s consolidated financial statements primarily from the recognition of contract assets for unbilled receivables and a corresponding reduction in inventories. Under the guidance there are two acceptable adoption methods: (i) retrospective adoption to each prior reporting period presented with the option to elect certain practical expedients; or (ii) adoption with the cumulative effect of initially applying the guidance recognized at the date of initial application and providing certain additional disclosures. We have not yet finalized our selection of a transition method for adoption.

Note 2. Inventories

Inventories are valued using the lower of first-in, first-out (“FIFO”) cost or market value. Inventory components were as follows:

| (Amounts in Thousands) | December 31, 2017 | June 30, 2017 |
|------------------------|----------------------|------------------|
| Finished products | \$ 27,526 | \$ 18,916 |
| Work-in-process | 14,980 | 15,480 |
| Raw materials | 137,356 | 110,210 |
| Total inventory | \$ 179,862 | \$ 144,606 |

Note 3. Accumulated Other Comprehensive Income (Loss)

During the six months ended December 31, 2017 and 2016, the changes in the balances of each component of Accumulated Other Comprehensive Income (Loss), net of tax, were as follows:

Accumulated Other Comprehensive Income (Loss)

| (Amounts in Thousands) | Foreign Currency Translation Adjustments | Derivative Gain (Loss) | Post Employment Benefits Net Actuarial Gain | Accumulated Other Comprehensive Income (Loss) |
|--|---|------------------------------|---|--|
| Balance at June 30, 2017 | \$ (6,876) | \$ (2,788) | \$ 580 | \$ (9,084) |
| Other comprehensive income (loss) before reclassifications | 4,862 | (1,445) | 167 | 3,584 |
| Reclassification to (earnings) loss | — | 505 | (103) | 402 |
| Net current-period other comprehensive income (loss) | 4,862 | (940) | 64 | 3,986 |
| Balance at December 31, 2017 | \$ (2,014) | \$ (3,728) | \$ 644 | \$ (5,098) |
| Balance at June 30, 2016 | \$ (9,653) | \$ (3,137) | \$ 600 | \$ (12,190) |
| Other comprehensive income (loss) before reclassifications | (4,518) | 62 | 195 | (4,261) |
| Reclassification to (earnings) loss | — | 575 | (109) | 466 |
| Net current-period other comprehensive income (loss) | (4,518) | 637 | 86 | (3,795) |
| Balance at December 31, 2016 | \$ (14,171) | \$ (2,500) | \$ 686 | \$ (15,985) |

The following reclassifications were made from Accumulated Other Comprehensive Income (Loss) to the Condensed Consolidated Statements of Income:

| Reclassifications from Accumulated Other Comprehensive Income (Loss) | Three Months Ended | | Six Months Ended | | Affected Line Item in the Condensed Consolidated Statements of Income |
|--|--------------------|------------------|------------------|------------------|---|
| | December 31 2017 | December 31 2016 | December 31 2017 | December 31 2016 | |
| (Amounts in Thousands) | | | | | |
| Derivative gain (loss) ⁽¹⁾ | \$(494) | \$(611) | \$(504) | \$(890) | Cost of Sales |
| | — | (6) | — | (6) | Non-operating income (expense), net |
| | 73 | 216 | (1) | 321 | Benefit (Provision) for Income Taxes |
| | \$(421) | \$(401) | \$(505) | \$(575) | Net of Tax |
| Postemployment Benefits: | | | | | |
| Amortization of actuarial gain ⁽²⁾ | \$47 | \$45 | \$92 | \$101 | Cost of Sales |
| | 38 | 33 | 73 | 73 | Selling and Administrative Expenses |
| | (32) | (29) | (62) | (65) | Provision for Income Taxes |
| | \$53 | \$49 | \$103 | \$109 | Net of Tax |
| Total reclassifications for the period | \$(368) | \$(352) | \$(402) | \$(466) | Net of Tax |

Amounts in parentheses indicate reductions to income.

(1) See Note 6 - Derivative Instruments of Notes to Condensed Consolidated Financial Statements for further information on derivative instruments.

(2) See Note 8 - Postemployment Benefits of Notes to Condensed Consolidated Financial Statements for further information on postemployment benefit plans.

Note 4. Commitments and Contingent Liabilities

Standby letters of credit may be issued to third-party suppliers and insurance institutions and can only be drawn upon in the event of the Company's failure to pay its obligations to a beneficiary. As of December 31, 2017, we had a maximum financial exposure from unused standby letters of credit totaling \$0.4 million. We don't expect circumstances to arise that would require us to perform under any of these arrangements and believe that the resolution of any claims that might arise in the future, either individually or in the aggregate, would not materially affect our condensed consolidated financial statements. Accordingly, no liability has been recorded as of December 31, 2017 with respect to the standby letters of credit. The Company also may enter into commercial letters of credit to facilitate payments to vendors and from customers.

The Company's China operation, in limited circumstances, receives banker's acceptance drafts from customers as settlement for their trade accounts receivable. We in turn may transfer the acceptance drafts to a supplier of ours in settlement of current accounts payable. These drafts contain certain recourse provisions afforded to the transferee under laws of The People's Republic of China. If a transferee were to exercise its available recourse rights, our China operation would be required to satisfy the obligation with the transferee and the draft would revert back to our China operation. At December 31, 2017, the drafts transferred and outstanding totaled \$1.4 million. No transferee has exercised their recourse rights against us. For additional information on banker's acceptance drafts, see Note 1 - Business Description and Summary of Significant Accounting Policies of Notes to Condensed Consolidated Financial Statements.

We maintain a provision for limited warranty repair or replacement of products manufactured and sold, which has been established in specific manufacturing contract agreements. We estimate product warranty liability at the time of sale based on historical repair or replacement cost trends in conjunction with the length of the warranty offered. Management refines the warranty liability periodically based on changes in historical cost trends and in certain cases where specific warranty issues become known.

Changes in the product warranty accrual for the six months ended December 31, 2017 and 2016 were as follows:

| (Amounts in Thousands) | Six Months Ended December 31 | |
|--|------------------------------------|--------|
| | 2017 | 2016 |
| Product warranty liability at the beginning of the period | \$593 | \$605 |
| Additions to warranty accrual (including changes in estimates) | 186 | 263 |
| Settlements made (in cash or in kind) | (79) | (256) |
| Product warranty liability at the end of the period | \$700 | \$612 |

Note 5. Fair Value

The Company categorizes assets and liabilities measured at fair value into three levels based upon the assumptions (inputs) used to price the assets or liabilities. Level 1 provides the most reliable measure of fair value, whereas level 3 generally requires significant management judgment. The three levels are defined as follows:

Level 1: Unadjusted quoted prices in active markets for identical assets and liabilities.

Level 2: Observable inputs other than those included in level 1. For example, quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets or liabilities in inactive markets.

Level 3: Unobservable inputs reflecting management's own assumptions about the inputs used in pricing the asset or liability.

Our policy is to recognize transfers between these levels as of the end of each quarterly reporting period. There were no transfers between these levels during the six months ended December 31, 2017. There were also no changes in the inputs or valuation techniques used to measure fair values during the six months ended December 31, 2017. For more information on inputs and fair valuation techniques used, refer to our Annual Report on Form 10-K for the year ended June 30, 2017.

Recurring Fair Value Measurements:

As of December 31, 2017 and June 30, 2017, the fair values of financial assets and liabilities that are measured at fair value on a recurring basis using the market approach are categorized as follows:

| (Amounts in Thousands) | December 31, 2017 | | |
|--|-------------------|----------|-----------|
| | Level 1 | Level 2 | Total |
| Assets | | | |
| Cash equivalents | \$ 1,092 | \$ — | \$ 1,092 |
| Derivatives: foreign exchange contracts | — | 921 | 921 |
| Trading securities: mutual funds held in nonqualified SERP | 8,487 | — | 8,487 |
| Total assets at fair value | \$ 9,579 | \$ 921 | \$ 10,500 |
| Liabilities | | | |
| Derivatives: foreign exchange contracts | \$ — | \$ 4,053 | \$ 4,053 |
| Total liabilities at fair value | \$ — | \$ 4,053 | \$ 4,053 |

| (Amounts in Thousands) | June 30, 2017 | | |
|--|---------------|----------|-----------|
| | Level 1 | Level 2 | Total |
| Assets | | | |
| Cash equivalents | \$ 1,087 | \$ — | \$ 1,087 |
| Derivatives: foreign exchange contracts | — | 1,810 | 1,810 |
| Trading securities: mutual funds held in nonqualified SERP | 7,607 | — | 7,607 |
| Total assets at fair value | \$ 8,694 | \$ 1,810 | \$ 10,504 |
| Liabilities | | | |
| Derivatives: foreign exchange contracts | \$ — | \$ 2,928 | \$ 2,928 |
| Total liabilities at fair value | \$ — | \$ 2,928 | \$ 2,928 |

We had no level 3 assets or liabilities measured at fair value during the six months ended December 31, 2017.

Nonqualified supplemental employee retirement plan (“SERP”) assets consist primarily of equity funds, balanced funds, a bond fund, and a money market fund. The SERP investment assets are offset by a SERP liability which represents Kimball Electronics’ obligation to distribute SERP funds to participants. See Note 7 - Investments of Notes to Condensed Consolidated Financial Statements for further information regarding the SERP.

Financial Instruments Not Carried At Fair Value:

Financial instruments that are not reflected in the Condensed Consolidated Balance Sheets at fair value that have carrying amounts which approximate fair value include notes receivable and borrowings under credit facilities. There were no changes to the inputs and valuation techniques used to assess the fair value of these financial instruments during the six months ended December 31, 2017. For more information on inputs and fair valuation techniques used, refer to our Annual Report on Form 10-K for the year ended June 30, 2017.

The carrying value of our cash deposit accounts, trade accounts receivable, and trade accounts payable approximates fair value due to the relatively short maturity and immaterial non-performance risk.

Note 6. Derivative Instruments

Foreign Exchange Contracts:

We operate internationally and are therefore exposed to foreign currency exchange rate fluctuations in the normal course of business. Our primary means of managing this exposure is to utilize natural hedges, such as aligning currencies used in the supply chain with the sale currency. To the extent natural hedging techniques do not fully offset currency risk, we use derivative instruments with the objective of reducing the residual exposure to certain foreign currency rate movements. Factors considered in the decision to hedge an underlying market exposure include the materiality of the risk, the volatility of the market, the duration of the hedge, the degree to which the underlying exposure is committed to, and the availability, effectiveness, and cost of derivative instruments. Derivative instruments are only utilized for risk management purposes and are not used for speculative or trading purposes. We use forward contracts designated as cash flow hedges to protect against foreign currency exchange rate risks inherent in forecasted transactions denominated in a foreign currency. Foreign exchange contracts are also used to hedge against foreign currency exchange rate risks related to intercompany balances denominated in currencies other than the functional currencies. As of December 31, 2017, we had outstanding foreign exchange contracts to hedge currencies against the U.S. dollar in the aggregate notional amount of \$29.7 million and to hedge currencies against the Euro in the aggregate notional amount of 78.0 million Euro. The notional amounts are indicators of the volume of derivative activities but may not be indicators of the potential gain or loss on the derivatives.

In limited cases due to unexpected changes in forecasted transactions, cash flow hedges may cease to meet the criteria to be designated as cash flow hedges. Depending on the type of exposure hedged, we may either purchase a derivative contract in the opposite position of the undesignated hedge or may retain the hedge until it matures if the hedge continues to provide an adequate offset in earnings against the currency revaluation impact of foreign currency denominated liabilities.

The fair value of outstanding derivative instruments is recognized on the balance sheet as a derivative asset or liability. When derivatives are settled with the counterparty, the derivative asset or liability is relieved and cash flow is impacted for the net settlement. For derivative instruments that meet the criteria of hedging instruments under FASB guidance, the effective portions of the gain or loss on the derivative instrument are initially recorded net of related tax effect in Accumulated Other Comprehensive Income (Loss), a component of Share Owners' Equity, and are subsequently reclassified into earnings in the period or periods during which the hedged transaction is recognized in earnings. The ineffective portion of the derivative gain or loss is reported in Non-operating income (expense), net on the Condensed Consolidated Statements of Income immediately. The gain or loss associated with derivative instruments that are not designated as hedging instruments or that cease to meet the criteria for hedging under FASB guidance is also reported in Non-operating income (expense), net on the Condensed Consolidated Statements of Income immediately.

Based on fair values as of December 31, 2017, we estimate that approximately \$1.7 million of pre-tax derivative loss deferred in Accumulated Other Comprehensive Loss will be reclassified into earnings, along with the earnings effects of related forecasted transactions, within the next 12 months. Losses on foreign exchange contracts are generally offset by gains in operating income in the income statement when the underlying hedged transaction is recognized in earnings. Because gains or losses on foreign exchange contracts fluctuate partially based on currency spot rates, the future effect on earnings of the cash flow hedges alone is not determinable, but in conjunction with the underlying hedged transactions, the result is expected to be a decline in currency risk. The maximum length of time we had hedged our exposure to the variability in future cash flows was 12 months as of both December 31, 2017 and June 30, 2017.

See Note 5 - Fair Value of Notes to Condensed Consolidated Financial Statements for further information regarding the fair value of derivative assets and liabilities and the Condensed Consolidated Statements of Comprehensive Income for the changes in deferred derivative gains and losses. Information on the location and amounts of derivative fair values in the Condensed Consolidated Balance Sheets and derivative gains and losses in the Condensed Consolidated Statements of Income are presented below.

Fair Value of Derivative Instruments on the Condensed Consolidated Balance Sheets

| Asset Derivatives | | Liability Derivatives | | | |
|--|---|------------------------------------|----------|------------------------------------|-------------------|
| (Amounts in Thousands) Balance Sheet Location | | Fair Value As of December 31, 2017 | | Fair Value As of December 31, 2017 | |
| Derivatives Designated as Hedging Instruments: | | | | | |
| Foreign exchange contracts | Prepaid expenses and other current assets | \$ 909 | \$ 1,810 | Accrued expenses | \$ 2,737 \$ 2,009 |
| Derivatives Not Designated as Hedging Instruments: | | | | | |
| Foreign exchange contracts | Prepaid expenses and other current assets | 12 | — | Accrued expenses | 1,316 919 |
| Total derivatives | | \$ 921 | \$ 1,810 | | \$ 4,053 \$ 2,928 |

The Effect of Derivative Instruments on Other Comprehensive Income (Loss)

| (Amounts in Thousands) | Three Months Ended December 31 | | Six Months Ended December 31 | |
|--|--------------------------------|--------|------------------------------|---------|
| | 2017 | 2016 | 2017 | 2016 |
| Amount of Pre-Tax Gain or (Loss) Recognized in Other Comprehensive Income (Loss) (OCI) on Derivatives (Effective Portion): | | | | |
| Foreign exchange contracts | \$(445) | \$(82) | \$(2,042) | \$(266) |

The Effect of Derivative Instruments on Condensed Consolidated Statements of Income

| (Amounts in Thousands) | Location of Gain or (Loss) | Three Months Ended December 31 | | Six Months Ended December 31 | |
|---|--------------------------------|--------------------------------|-----------|------------------------------|-----------|
| | | 2017 | 2016 | 2017 | 2016 |
| Derivatives in Cash Flow Hedging Relationships | | | | | |
| Amount of Pre-Tax Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion): | | | | | |
| Foreign exchange contracts | Cost of Sales | \$ (494) | \$ (611) | \$ (504) | \$ (890) |
| Foreign exchange contracts | Non-operating income (expense) | — | (6) | — | (6) |
| Total | | \$ (494) | \$ (617) | \$ (504) | \$ (896) |

Derivatives Not Designated as Hedging Instruments

Amount of Pre-Tax Gain or (Loss) Recognized in Income on Derivatives:

| | | | | | |
|---|--------------------------------|-----------|----------|-------------|----------|
| Foreign exchange contracts | Non-operating income (expense) | \$ (263) | \$ 1,885 | \$ (1,081) | \$ 1,662 |
| Total Derivative Pre-Tax Gain (Loss) Recognized in Income | | \$ (757) | \$ 1,268 | \$ (1,585) | \$ 766 |

Note 7. Investments

The Company maintains a self-directed supplemental employee retirement plan (“SERP”) for executive and other key employees. The Company SERP utilizes a rabbi trust, and therefore assets in the SERP portfolio are subject to creditor claims in the event of bankruptcy. The Company recognizes SERP investment assets on the balance sheet at current fair value. A SERP liability of the same amount is recorded on the balance sheet representing an obligation to distribute SERP funds to participants. The SERP investment assets are classified as trading, and accordingly, realized and unrealized gains and losses are recognized in income in the other income (expense) category. Adjustments made to revalue the SERP liability are also recognized in income as selling and administrative expenses and offset valuation adjustments on SERP investment assets. The change in net unrealized holding gains (losses) for the six months ended December 31, 2017 and 2016 was, in thousands, \$480 and \$(186), respectively.

SERP asset and liability balances applicable to Kimball Electronics participants were as follows:

| (Amounts in Thousands) | December 31, June 30, | |
|---|-----------------------|----------|
| | 2017 | 2017 |
| SERP investments - current asset | \$ 286 | \$ 258 |
| SERP investments - other long-term asset | 8,201 | 7,349 |
| Total SERP investments | \$ 8,487 | \$ 7,607 |
| | | |
| SERP obligation - current liability | \$ 286 | \$ 258 |
| SERP obligation - other long-term liability | 8,201 | 7,349 |
| Total SERP obligation | \$ 8,487 | \$ 7,607 |

Note 8. Postemployment Benefits

The Company maintains severance plans for all domestic employees. These plans provide severance benefits to eligible employees meeting the plans’ qualifications, primarily involuntary termination without cause. There are no statutory requirements for us to contribute to the plans, nor do employees contribute to the plans. The plans hold no assets. Benefits are paid using available cash on hand when eligible employees meet plan qualifications for payment. Benefits are based upon an employee’s years of service and accumulate up to certain limits specified in the plans and include both salary and an allowance for medical benefits. The net periodic postemployment benefit costs were not material for the three and six months ended December 31, 2017 and 2016. Unusual or non-recurring severance actions are not estimable using actuarial methods and are expensed in accordance with the applicable U.S. GAAP.

Note 9. Stock Compensation Plans

The Company maintains a stock compensation plan, the Kimball Electronics, Inc. 2014 Stock Option and Incentive Plan (the “Plan”), which allows for the issuance of up to 4.5 million shares and may be awarded in the form of incentive stock options, stock appreciation rights, restricted shares, unrestricted shares, restricted share units, or performance shares and performance units. The Plan is a ten-year plan with no further awards allowed to be made under the Plan after October 1, 2024. The Company also maintains a nonqualified deferred compensation plan, the Kimball Electronics, Inc. Non-Employee Directors Stock Compensation Deferral Plan (the “Deferral Plan”), which allows Non-Employee Directors of the Company’s Board of Directors (the “Board”) to elect to defer all, or a portion of, their retainer fees in stock until retirement or termination from the Board or death. The Deferral Plan allows for issuance of up to 1.0 million shares of the Company’s common stock. For more information on the Plan and the Deferral Plan, refer to our Annual Report on Form 10-K for the year ended June 30, 2017.

During the first six months of fiscal year 2018, the following stock compensation was awarded under the Plan and the Deferral Plan.

| Stock Compensation Awarded | Quarter Awarded | Shares/Units | Grant Date Fair Value (2) |
|---|-----------------|--------------|------------------------------|
| Long-Term Performance Shares ⁽¹⁾ | 1st Quarter | 205,821 | \$18.30 |
| Unrestricted shares (Director compensation) ⁽³⁾ | 2nd Quarter | 7,694 | \$20.15 |
| Deferred share units (Director compensation) ⁽⁴⁾ | 2nd Quarter | 12,159 | \$20.15 |

(1) Long-term performance shares were awarded to officers and other key employees. Payouts will be based upon a combination of a bonus percentage attainment component calculated under the Company's profit sharing incentive bonus plan, adjusted to a three-year average bonus percentage, and a growth attainment component, which is the Company's growth in sales revenue based on comparison of its three-year compounded annual growth rate ("CAGR") with the Electronics Manufacturing Services Industry's three-year CAGR. The long-term performance shares awarded are based on three successive annual performance measurement periods, with each annual tranche having a grant date when economic profit tiers are established and approved by the Compensation and Governance Committee of the Board near the beginning of the applicable fiscal year and a vesting date shortly after the end of each annual period. The number of shares issued will be less than the maximum shares issuable if one or both of the above-mentioned incentive metric maximum thresholds are not obtained.

(2) The grant date fair value is based on the stock price at the date of the award and for long-term performance shares is applicable to the first tranche only.

(3) Unrestricted shares which were awarded to non-employee members of the Company's Board of Directors as compensation for the portion of director's annual retainer fees as a result of the directors' election to be paid in unrestricted shares in lieu of cash payment or deferred share units. Director's fees are expensed over the period that directors earn the compensation. Unrestricted shares do not have vesting periods, holding periods, restrictions on sales, or other restrictions.

(4) Deferred share units were awarded to non-employee members of the Company's Board of Directors as compensation for the portion of director's annual retainer fees as a result of directors' elections to receive deferred share units in lieu of cash payment or unrestricted shares. Director's fees are expensed over the period that directors earn the compensation. Deferred share units are participating securities and are payable in common stock upon a Director's retirement or termination from the Board or death.

Note 10. Share Owners' Equity

On October 21, 2015, the Company's Board of Directors (the "Board") authorized an 18-month stock repurchase plan (the "Plan") allowing a repurchase of up to \$20 million worth of common stock. On September 29, 2016, the Board extended the Plan to allow the repurchase of up to an additional \$20 million worth of common stock with no expiration date. On August 23, 2017, the Board increased the Plan to allow the repurchase of up to an additional \$20 million worth of common stock with no expiration date. This latest increase brings the total authorized stock repurchases under the Plan to \$60 million. Purchases may be made under various programs, including in open-market transactions, block transactions on or off an exchange, or in privately negotiated transactions, all in accordance with applicable securities laws and regulations. The Plan may be suspended or discontinued at any time.

During the six months ended December 31, 2017, the Company repurchased \$6.3 million of common stock at an average price of \$19.45 which was recorded as Treasury stock, at cost in the Condensed Consolidated Balance Sheets. Since the inception of the Plan, the Company has repurchased \$41.4 million of common stock under the Plan at an average cost of \$13.65 per share.

Note 11. Earnings Per Share

Basic and diluted earnings per share were calculated as follows under the two-class method:

| (Amounts in thousands, except per share data) | Three Months | | Six Months | |
|--|--------------|---------|-------------|----------|
| | Ended | | Ended | |
| | December 31 | | December 31 | |
| | 2017 | 2016 | 2017 | 2016 |
| Basic and Diluted Earnings Per Share: | | | | |
| Net Income (Loss) | \$(8,347) | \$7,812 | \$133 | \$17,934 |
| Less: Net Income allocated to participating securities | — | 3 | — | 4 |
| Net Income (Loss) allocated to common Share Owners | \$(8,347) | \$7,809 | \$133 | \$17,930 |

| | | | | |
|---|--------|--------|--------|--------|
| Basic weighted average common shares outstanding | 26,765 | 27,350 | 26,812 | 27,714 |
| Dilutive effect of average outstanding performance shares | — | 102 | 191 | 58 |
| Dilutive effect of average outstanding deferred stock units | — | 3 | 4 | 3 |
| Dilutive weighted average shares outstanding | 26,765 | 27,455 | 27,007 | 27,775 |

Earnings (Loss) Per Share of Common Stock:

| | | | | |
|---------|-----------|--------|-----|--------|
| Basic | \$(0.31) | \$0.29 | \$— | \$0.65 |
| Diluted | \$(0.31) | \$0.28 | \$— | \$0.65 |

For the three months ended December 31, 2017, all outstanding stock compensation awards were antidilutive, as a result of the net loss recognized for the period, and were excluded from the dilutive calculation, including 290,000 average outstanding performance shares and 15,000 average outstanding unvested deferred stock units. The net loss in the three months ended December 31, 2017 was not allocated to participating securities as the holders have no requirements to fund losses. For the six months ended December 31, 2017 and for the three and six months ended December 31, 2016, all outstanding stock compensation awards were dilutive and were included in the dilutive calculation.

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

"Emerging Growth Company" Status

The Condensed Consolidated Financial Statements are prepared in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") and reflect the financial position, results of operations, and cash flows of Kimball Electronics. Kimball Electronics qualifies as an "emerging growth company" as defined in the Jumpstart Our Business Startups Act (the "JOBS Act"). For as long as a company is deemed to be an "emerging growth company," it may take advantage of specified reduced reporting and other regulatory requirements that are generally unavailable to other public companies. The JOBS Act also provides that an "emerging growth company" can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. We have elected to take advantage of this extended transition period. Our financial statements may therefore not be comparable to those of companies that comply with such new or revised accounting standards. See Note 1 - Business Description and Summary of Significant Accounting Policies of Notes to Condensed Consolidated Financial Statements for more information on "emerging growth company" reduced reporting requirements and when we would cease to be an "emerging growth company." We continue to monitor our status as an "emerging growth company" and are currently preparing, and expect to be ready, to comply with the additional reporting and regulatory requirements that will be applicable to us when we cease to qualify as an "emerging growth company."

Business Overview

We are a global contract electronic manufacturing services (“EMS”) company that specializes in producing durable electronics for the automotive, medical, industrial, and public safety markets. Our manufacturing services, including engineering and supply chain support, utilize common production and support capabilities globally. We are well recognized by our customers and the EMS industry for our excellent quality, reliability, and innovative service, and we were named the 2016 EMS Company of the Year by CIRCUITS ASSEMBLY, a leading brand and technical publication for electronics manufacturers worldwide.

A significant business challenge that we face as an independent publicly traded company is maintaining our profit margins while we look to accelerate revenue growth. The EMS industry is very competitive. As a mid-sized player in the EMS market, we can expect to be challenged by the agility and flexibility of the smaller, regional players and we can expect to be challenged by the scale and price competitiveness of the larger, global players.

We enjoy a unique market position between these extremes which allows us to compete with the larger scale players for high-volume projects, but also maintain our competitive position in the generally lower volume durable electronics market space. We expect to continue to effectively operate in this market space. Price increases are uncommon in the market as production efficiencies and material pricing advantages for most projects drive costs and prices down over the life of the projects. This characteristic of the contract electronics marketplace is expected to continue.

Key economic indicators currently point toward continued strengthening in the overall economy. However, uncertainties still exist and may pose a threat to our future growth as they have the tendency to cause disruption in business strategy, execution, and timing in many of the markets in which we compete.

The 2017 edition of The Worldwide Electronics Manufacturing Services Market, a comprehensive study on the worldwide EMS market published by New Venture Research (“NVR”), provided worldwide forecast trends through 2021. NVR projects worldwide electronics assembly value to grow at a compound annual growth rate (“CAGR”) of 4.2% over the next five years, with the automotive, medical, and industrial markets projected to grow at a CAGR of 5.7%, 4.3%, and 4.5%, respectively.

Our overall expectation for the EMS market is that of moderate growth, but with mixed demand. Over the last three fiscal years, our CAGR was approximately 7.9%, and our goal is to grow at a CAGR of 8% over the three-year period ending June 30, 2020. Our focus is on the four key vertical markets of automotive, medical, industrial, and public safety.

The automotive end market has improved from both new product introductions and increased demand on existing products, and it continues to benefit from the trend of increasing electronic content that is placed in automobiles. The industrial market is showing improvement with increased end market demand for smart metering and climate control products. We saw a decline in the public safety market in the current quarter compared to the same quarter in fiscal year 2017 as improvement from new product introductions only partially offset a decline in demand of existing products. In the medical market, demonstrated growth across our customer base was largely the result of new program launches as overall market demand remains stable. We continue to monitor the current economic environment and its potential impact on our customers.

We invest in capital expenditures prudently for projects in support of both organic growth and potential acquisitions that would enhance our capabilities and diversification while providing an opportunity for growth and improved profitability. For example, the acquisitions of Medivative Technologies, LLC (“Medivative”) and Aircom Manufacturing, Inc. (“Aircom”) within the last two fiscal years provide capabilities that will enhance our medical end market as well as support our mechanical assembly needs in all four key vertical markets. We have a strong focus on cost control and closely monitor market changes and our liquidity in order to proactively adjust our operating costs and discretionary capital spending as needed. Managing working capital in conjunction with fluctuating demand levels is likewise key. In addition, a long-standing component of our profit sharing incentive bonus plan is that it is linked to our financial performance which results in varying amounts of compensation expense as profits change.

We continue to maintain a strong balance sheet, which included no long-term debt and Share Owners’ equity of \$341 million at December 31, 2017. Our short-term liquidity available, represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled \$95.5 million at December 31, 2017.

In addition to the above discussion related to the current market conditions, management currently considers the following events, trends, and uncertainties to be most important to understanding our financial condition and operating performance:

Due to the contract and project nature of the EMS industry, fluctuation in the demand for our products and variation in the gross margin on those projects is inherent to our business. Effective management of manufacturing capacity is, and will continue to be, critical to our success.

The nature of the EMS industry is such that the start-up of new customers and new programs to replace expiring programs occurs frequently. While our agreements with customers generally do not have a definitive term and thus could be canceled at any time with little or no notice, we generally realize relatively few cancellations prior to the end of the product's life cycle. We attribute this to our focus on long-term customer relationships, meeting customer expectations, required capital investment, and product qualification cycle times. As such, our ability to continue contractual relationships with our customers, including our principal customers, is not certain. New customers and program start-ups generally cause losses early in the life of a program, which are generally recovered as the program becomes established and matures. Risk factors within our business include, but are not limited to, general economic and market conditions, customer order delays, globalization, foreign currency exchange rate fluctuations, rapid technological changes, component availability, supplier and customer financial stability, the contract nature of this industry, the concentration of sales to large customers, and the potential for customers to choose a dual sourcing strategy or to in-source a greater portion of their electronics manufacturing. The continuing success of our business is dependent upon our ability to replace expiring customers/programs with new customers/programs. We monitor our success in this area by tracking the number of customers and the percentage of our net sales generated from them by years of service as depicted in the table below. While variation in the size of program award makes it difficult to directly correlate this data to our sales trends, we believe it does provide useful information regarding our customer loyalty and new business growth. Additional risk factors that could have an effect on our performance are located within the "Risk Factors" section of our Annual Report on Form 10-K for the year ended June 30, 2017.

| | Six Months Ended December 31 | |
|------------------------|------------------------------------|-------|
| Customer Service Years | 2017 | 2016 |
| More than 10 Years | | |
| % of Net Sales | 55 % | 55 % |
| # of Customers | 27 | 27 |
| 5 to 10 Years | | |
| % of Net Sales | 34 % | 40 % |
| # of Customers | 19 | 24 |
| Less than 5 Years | | |
| % of Net Sales | 11 % | 5 % |
| # of Customers | 30 | 33 |
| Total | | |
| % of Net Sales | 100 % | 100 % |
| # of Customers | 76 | 84 |

Globalization continues to reshape not only the industries in which we operate but also our key customers, suppliers, and competitors.

- Employees throughout our business operations are an integral part of our ability to compete successfully, and the stability of the management team is critical to long-term Share Owner value. Our talent management and succession planning processes help to maintain stability in management.

Certain preceding statements could be considered forward-looking statements under the Private Securities Litigation Reform Act of 1995 and are subject to certain risks and uncertainties including, but not limited to, successful integration of acquisitions and new operations, adverse changes in the global economic conditions, the geopolitical environment, loss of key customers or suppliers, or similar unforeseen events. Additional information on risks is

contained in our Annual Report on Form 10-K for the year ended June 30, 2017.

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Financial Overview

| (Amounts in Millions, Except for Per Share Data) | At or for the Three Months Ended December 31 | | | | | |
|--|--|----------------------|--|---------|----------------------|-------------|
| | 2017 | as a | | 2016 | as a | |
| | | % of Net Sales | | | % of Net Sales | % Change |
| Net Sales | \$258.2 | | | \$230.3 | 12 | % |
| Gross Profit | \$21.0 | 8.1 % | | \$20.6 | 8.9 % | 2 % |
| Selling and Administrative Expenses | \$10.8 | 4.2 % | | \$8.3 | 3.6 % | 30 % |
| Operating Income | \$10.2 | 3.9 % | | \$12.2 | 5.3 % | (17) % |
| Provision for Income Taxes | \$18.9 | | | \$3.4 | | 454 % |
| Net Income (Loss) | \$(8.3) | | | \$7.8 | | (207) % |
| Diluted Earnings per Share | \$(0.31) | | | \$0.28 | | |
| Open Orders | \$241.7 | | | \$189.9 | 27 | % |

| (Amounts in Millions, Except for Per Share Data) | For the Six Months Ended December 31 | | | | | |
|--|---|----------------------|--|---------|----------------------|-------------|
| | 2017 | as a | | 2016 | as a | |
| | | % of Net Sales | | | % of Net Sales | % Change |
| Net Sales | \$511.4 | | | \$456.7 | 12 | % |
| Gross Profit | \$40.5 | 7.9 % | | \$38.9 | 8.5 % | 4 % |
| Selling and Administrative Expenses | \$20.7 | 4.0 % | | \$17.8 | 3.9 % | 16 % |
| Other General Income | \$— | | | \$4.0 | | |
| Operating Income | \$19.8 | 3.9 % | | \$25.1 | 5.5 % | (21) % |
| Provision for Income Taxes | \$21.3 | | | \$6.9 | | 210 % |
| Net Income | \$0.1 | | | \$17.9 | | (99) % |
| Diluted Earnings per Share | \$— | | | \$0.65 | | |

| (Amounts in Millions) | Three Months Ended December 31 | | | Six Months Ended December 31 | | |
|-----------------------|--------------------------------------|---------|-------------|------------------------------------|---------|-------------|
| | 2017 | 2016 | % Change | 2017 | 2016 | % Change |
| | | | | | | |
| Automotive | \$116.4 | \$96.3 | 21 % | \$218.4 | \$188.5 | 16 % |
| Medical | 72.9 | 63.4 | 15 % | 149.1 | 128.4 | 16 % |
| Industrial | 52.0 | 48.4 | 7 % | 106.8 | 99.9 | 7 % |
| Public Safety | 13.8 | 15.8 | (13) % | 31.0 | 29.0 | 7 % |
| Other | 3.1 | 6.4 | (52) % | 6.1 | 10.9 | (44) % |
| Total Net Sales | \$258.2 | \$230.3 | 12 % | \$511.4 | \$456.7 | 12 % |

Second quarter and year-to-date fiscal year 2018 consolidated net sales increased compared to the second quarter and year-to-date period of fiscal year 2017 primarily due to the ramp-up of new product introductions, an overall increase in demand, and the favorable effect of foreign exchange fluctuations on sales. Sales to customers in the automotive market, medical market, and industrial market increased in the second quarter of fiscal year 2018 over the second quarter of fiscal year 2017, more than offsetting the decrease in sales to customers in the public safety market. All four of our vertical markets experienced sales growth in the year-to-date period of fiscal year 2018 when compared to the

year-to-date period of fiscal year 2017.

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Sales to customers in the automotive market experienced double-digit sales growth in the second quarter and year-to-date period of fiscal year 2018 compared to the second quarter and year-to-date period of fiscal year 2017 as demand in North America and Europe increased, more than offsetting a decrease in demand in China. The increase in the automotive market demand over the prior fiscal year second quarter and year-to-date was driven by new product introductions and increased demand from existing customers. Sales to customers in the medical market experienced double-digit sales growth in the second quarter and year-to-date period of fiscal year 2018 compared to the second quarter and year-to-date period of fiscal year 2017 primarily due to new product introductions and increased demand for existing products. Sales to customers in the industrial market increased in the second quarter and year-to-date period of fiscal year 2018 compared to the second quarter and year-to-date period of fiscal year 2017 primarily due to new product launches related to smart metering in addition to increased end market demand for climate control products, which these increases were somewhat offset by lower demand in other existing products. Sales to customers in the public safety market declined in the second quarter of fiscal year 2018 compared to the second quarter of fiscal year 2017 due to lower overall demand; however, sales to customers in the public safety market increased in the first half of fiscal year 2018 compared to the first half of the prior fiscal year due to new product awards and increased demand for existing products.

A significant amount of sales to Philips, ZF, and Nexteer Automotive accounted for the following portions of our net sales:

| | Three Months Ended | | Six Months Ended | |
|--------------------|--------------------|------|------------------|------|
| | December 31 | | December 31 | |
| | 2017 | 2016 | 2017 | 2016 |
| Philips | 13% | 14% | 14% | 14% |
| ZF | 14% | 11% | 14% | 11% |
| Nexteer Automotive | 13% | 13% | 12% | 12% |

Open orders were up 27% as of December 31, 2017 compared to December 31, 2016 as open orders in three of our four vertical markets increased, with the largest increase occurring from the automotive market. Open orders are the aggregate sales price of production pursuant to unfulfilled customer orders, which may be canceled by the customer subject to contractual termination provisions. Substantially all of the open orders as of December 31, 2017 are expected to be filled within the next twelve months. Open orders at a point in time may not be indicative of future sales trends due to the contract nature of our business.

Second quarter and year-to-date period fiscal year 2018 gross profit as a percent of net sales declined when compared to the second quarter and year-to-date period of fiscal year 2017, in large part due to the impact on yields and higher costs associated with the support of new product introductions, higher domestic healthcare costs, and unfavorable product mix.

Selling and administrative expenses increased as a percent of net sales and in absolute dollars in the second quarter of fiscal year 2018 when compared to the second quarter of fiscal year 2017. The current quarter selling and administrative expenses increased in part from higher stock-based compensation. In addition, higher salary and related payroll costs, which were largely due to an increase in the number of employees, and higher expense from the supplemental employee retirement plan (“SERP”) contributed to the increase in selling and administrative expenses. The SERP expense is a result of the revaluation of the SERP liability and is offset by the revaluation to fair value of the SERP investments recorded in Other Income (Expense).

For the first half of fiscal year 2018, selling and administrative expenses increased in absolute dollars from the first half of fiscal year 2017 primarily from higher salary and related payroll costs, which were largely due to an increase in the number of employees, and higher stock-based compensation, in addition to the higher expense from the supplemental employee retirement plan (“SERP”). The selling and administrative expenses as a percent of net sales increased slightly in the first half of fiscal year 2018 compared to the first half of fiscal year 2017.

Other General Income in the first six months of fiscal year 2017 included \$4.0 million of pre-tax income resulting from a payment received related to the settlement of a class action lawsuit in which Kimball Electronics was a class member. The lawsuit alleged that certain suppliers to the EMS industry conspired over a number of years to raise and fix the prices of electronic components, resulting in overcharges to purchasers of those components. No Other General Income was recorded during the first six months of fiscal year 2018.

Other Income (Expense) consisted of the following:

| (Amounts in Thousands) | Three Months Ended | | Six Months Ended | |
|---|--------------------|-------------------|-------------------|-------------------|
| | December 31, 2017 | December 31, 2016 | December 31, 2017 | December 31, 2016 |
| Interest income | \$18 | \$14 | \$36 | \$37 |
| Interest expense | (113) | (60) | (229) | (99) |
| Foreign currency/derivative gain (loss) | 333 | (1,185) | 1,394 | (1,470) |
| Gain (loss) on supplemental employee retirement plan (“SERP”) investments | 282 | (1) | 585 | 259 |
| Bargain purchase gain on acquisition | — | — | — | 925 |
| Other | (127) | 218 | (148) | 97 |
| Other income (expense), net | \$393 | \$(1,014) | \$1,638 | \$(251) |

The revaluation to fair value of the SERP investments recorded in Other Income (Expense) is offset by the revaluation of the SERP liability recorded in Selling and Administrative Expenses, and thus there is no effect on net income. The foreign currency/derivative gain (loss) resulted from net foreign currency exchange rate movements during the period. The bargain purchase gain on acquisition for the first six months of fiscal year 2017 resulted from the Aircom acquisition as the consideration paid for Aircom was less than the estimated fair values of the assets acquired and liabilities assumed.

Our income before income taxes and effective tax rate were comprised of the following U.S. and foreign components:

| (Amounts in Thousands) | For the Six Months Ended | | | |
|------------------------|--------------------------|--------------------|---------------------|--------------------|
| | December 31, 2017 | | December 31, 2016 | |
| | Income Before Taxes | Effective Tax Rate | Income Before Taxes | Effective Tax Rate |
| United States | \$3,308 | 515.0 % | \$5,722 | 29.3 % |
| Foreign | 18,113 | 23.5 % | 19,090 | 27.2 % |
| Total | \$21,421 | 99.4 % | \$24,812 | 27.7 % |

In December 2017, the U.S. Tax Cuts and Jobs Act (“Tax Reform”) was enacted into law by the United States which lowered the U.S. corporate statutory tax rate from 35% to 21%. For fiscal year companies with a June 30 year end, the blended federal statutory tax rate for the current fiscal year ending June 30, 2018 is 28.1%. Due to the enactment of Tax Reform, we revalued our net deferred tax assets at the new applicable rates as of December 31, 2017, and we estimated and recorded tax on the one-time deemed repatriation on our accumulated unremitted foreign earnings during the second quarter of fiscal year 2018. While we expect the lower U.S. corporate statutory tax rate will lower our consolidated effective tax rate and have a favorable impact on our net income in the future, Tax Reform did have a significant unfavorable impact to our effective tax rate and our net income for the first half of fiscal year 2018.

When compared to the statutory rate, the domestic effective tax rate and the consolidated effective tax rate for the first six months of fiscal year 2018 were unfavorably impacted by Tax Reform as we recorded income tax expense of approximately \$12.8 million for the deemed repatriation tax and income tax expense of approximately \$3.8 million for the revaluation of our net deferred tax assets, which were both treated as discrete items and were recognized in Provision for Income Taxes on the Condensed Consolidated Statements of Income for the three and six months ended December 31, 2017. The Company considers these provisional recorded amounts to be reasonable estimates as of December 31, 2017. As a result, these amounts could be adjusted during the measurement period ending December 2018. Items partially offsetting the unfavorable impact from Tax Reform on the effective tax rate included the discrete income tax adjustment related to the excess tax benefit on stock-based compensation granted during the six months ended December 31, 2017, which was recognized in accordance with the new accounting standard for share-based payment transactions, and the high mix of earnings in foreign jurisdictions that have generally lower statutory rates than the United States. See [Note 1 - Business Description and Summary of Significant Accounting Policies](#) of Notes to Condensed Consolidated Financial Statements for additional information on Tax Reform and the adoption of the

new accounting standard for share-based payment transactions.

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The effective tax rate for the first six months of fiscal year 2017 was favorably impacted by a high mix of earnings in foreign jurisdictions and an adjustment for domestic tax credits. Also impacting the effective tax rate for the first six months of the prior fiscal year was the \$0.9 million bargain purchase gain from the Aircom acquisition, which was treated as a discrete item and excluded from the calculation of the estimated annual effective tax rate.

Comparing the balance sheet as of December 31, 2017 to June 30, 2017, inventory increased \$35.3 million primarily to support increased production volumes and open orders in addition to the implementation of an inventory management program for one of our largest customers in the medical market. Accounts payable increased \$23.7 million largely from the increased inventory purchases to support increased production volumes. Long-term income taxes payable has a balance of \$11.8 million at December 31, 2017 for the long-term portion of the deemed repatriation tax that is allowed to be paid over an eight-year period. See [Note 1 - Business Description and Summary of Significant Accounting Policies](#) of Notes to Condensed Consolidated Financial Statements for additional information on the deemed repatriation tax and Tax Reform.

Liquidity and Capital Resources

Working capital at December 31, 2017 was \$196.5 million compared to working capital of \$188.9 million at June 30, 2017. The current ratio was 1.9 at both December 31, 2017 and June 30, 2017. Our short-term liquidity available, represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled \$95.5 million at December 31, 2017 and \$104.8 million at June 30, 2017.

Cash Conversion Days (“CCD”) are calculated as the sum of Days Sales Outstanding (“DSO”) plus Production Days Supply on Hand (“PDSOH”) less Accounts Payable Days (“APD”). CCD is a metric used to measure the efficiency of managing working capital. CCD for the quarter ended December 31, 2017 was 60 days, which was unchanged from the quarter ended June 30, 2017 and increased from the quarter ended December 31, 2016. The following table summarizes our CCD for the quarterly periods indicated.

| | Three Months Ended | | |
|-------|--------------------|---------------|-------------------|
| | December 31, 2017 | June 30, 2017 | December 31, 2016 |
| DSO | 62 | 62 | 64 |
| PDSOH | 66 | 59 | 60 |
| APD | 68 | 61 | 65 |
| CCD | 60 | 60 | 59 |

We define DSO as the average of monthly trade accounts and notes receivable divided by an average day’s net sales, PDSOH as the average of monthly gross inventory divided by an average day’s cost of sales, and APD as the average of monthly accounts payable divided by an average day’s cost of sales.

Cash Flows

The following table reflects the major categories of cash flows for the first six months of fiscal years 2018 and 2017.

| (Amounts in thousands) | Six Months Ended | |
|---|------------------|------------|
| | December 31 | |
| | 2017 | 2016 |
| Net cash provided by operating activities | \$11,401 | \$26,091 |
| Net cash used for investing activities | \$(14,717) | \$(21,688) |
| Net cash used for financing activities | \$(6,968) | \$(15,032) |

Cash Flows from Operating Activities

Net cash provided by operating activities for the first six months of fiscal year 2018 was primarily driven by adjustments to net income for non-cash items, including the adjustment for income tax expense resulting from Tax Reform reflected in Deferred income tax and other deferred charges and Accrued expenses and taxes payable on the Condensed Consolidated Statement of Cash Flows, partially offset by the remaining changes in working capital balances. Net cash provided by operating activities for the first six months of fiscal year 2017 was primarily driven by net income adjusted for non-cash items and included \$4.0 million of cash proceeds related to the settlement of a class action lawsuit. Changes in operating assets and liabilities used \$6.9 million of cash in the first six months of fiscal year 2018 and \$2.6 million of cash in the first six months of fiscal year 2017.

The cash used of \$6.9 million from changes in operating assets and liabilities in the first six months of fiscal year 2018 is largely due to an increase in inventory, which used cash of \$33.9 million primarily to support increased production volumes and open orders in addition to the implementation of an inventory management program for one of our largest customers in the medical market. Partially offsetting this usage was an increase in accounts payable, which provided cash of \$22.4 million largely resulting from the increased inventory purchases to support increased production volumes. Accrued expenses and taxes payable provided cash of \$5.4 million primarily from the increase in income taxes payable related to the deemed repatriation tax net of income taxes paid, which was partially offset by a reduction in other accrued expenses.

For the usage of \$2.6 million cash from changes in working capital balances in the first six months of fiscal year 2017, large fluctuations were in our accounts receivable, inventory, and accounts payable. An increase in accounts receivable used cash of \$8.7 million which primarily resulted from increased sales volumes. An increase in inventory used cash of \$5.2 million primarily to support increased open orders and production volumes. Partially offsetting these usages was an increase in accounts payable which provided cash of \$9.5 million largely resulting from the increased inventory purchases and APD.

Cash Flows from Investing Activities

For the first six months of fiscal years 2018 and 2017, net cash used for investing activities was \$14.7 million and \$21.7 million, respectively. During the first six months of fiscal year 2018, we reinvested \$14.8 million into capital investments for the future primarily for machinery and equipment for capacity purposes and to support new business awards. During the first six months of fiscal year 2017, we reinvested \$19.7 million into capital investments for the future with the largest expenditures to support new business awards, capacity purposes, and for the purchase of the previously leased facility that housed the former Medivative operation. Also during the first six months of fiscal year 2017, we invested \$2.1 million, net of cash received, to acquire certain assets and assumed certain liabilities of Aircom Manufacturing, Inc.

Cash Flows from Financing Activities

For the first six months of fiscal year 2018, net cash used for financing activities resulted from repurchases of our common stock under an authorized stock repurchase plan and the remittance of tax withholdings on share-based payments, partially offset by the increased borrowings on our primary credit facility for domestic cash needs. For the first six months of fiscal year 2017, net cash used for financing activities resulted from repurchases of our common stock under an authorized stock repurchase plan and for the remittance of tax withholdings on share-based payments.

Credit Facilities

The Company maintains a U.S. primary credit facility (the “primary facility”) that has a maturity date of October 31, 2019 and allows for up to \$50 million in borrowings, with an option to increase the amount available for borrowing to \$75 million at the Company’s request, subject to participating banks’ consent.

The proceeds of the revolving credit loans are to be used for general corporate purposes of the Company including potential acquisitions and stock repurchases. A portion of the credit facility, not to exceed \$15 million of the principal amount, will be available for the issuance of letters of credit. A commitment fee on the unused portion of the principal amount of the credit facility is payable at a rate that ranges from 20.0 to 25.0 basis points per annum as determined by the Company’s ratio of consolidated total indebtedness to adjusted consolidated EBITDA. The interest rate on borrowings is dependent on the type of borrowings.

At December 31, 2017, we had \$11.0 million in short-term borrowings under the primary facility and \$0.4 million in letters of credit against the primary facility. At June 30, 2017, we had \$10.0 million in short-term borrowings under the primary facility and \$0.4 million in letters of credit against the primary facility. The short-term borrowings under the primary facility were used for domestic cash needs.

The Company’s financial covenants under the primary credit facility require:

- a ratio of consolidated total indebtedness minus unencumbered U.S. cash on hand in the United States in excess of \$15 million to adjusted consolidated EBITDA, determined as of the end of each of its fiscal quarters for the then most recently ended four fiscal quarters, to not be greater than 3.0 to 1.0, and
- a fixed charge coverage ratio, determined as of the end of each of its fiscal quarters for the then most recently ended four fiscal quarters, to not be less than 1.10 to 1.00.

We were in compliance with the financial covenants during the six-month period ended December 31, 2017.

Kimball Electronics has foreign credit facilities available to satisfy short-term cash needs at specific foreign locations rather than funding from intercompany sources. As of December 31, 2017, we maintained a Thailand overdraft credit facility which allows for borrowings up to 90 million Thai Baht (approximately \$2.8 million at December 31, 2017 exchange rates). We had no borrowings under this foreign credit facility as of December 31, 2017 or June 30, 2017. We also maintained a credit facility for our China operation, which allows for borrowings up to \$7.5 million that can be drawn in either U.S. dollars or China Renminbi. We had no borrowings outstanding under this foreign credit facility as of December 31, 2017 or June 30, 2017. During fiscal year 2017, we established an uncommitted revolving credit facility for our Netherlands subsidiary, which allows for borrowings of up to 9.2 million Euro (approximately \$11.0 million at December 31, 2017 exchange rates) that can be drawn in Euro, U.S. dollars, or other optional currency. We had no borrowings outstanding under this foreign credit facility as of December 31, 2017 or June 30, 2017. These foreign credit facilities can be canceled at any time by either the bank or us.

Factoring Arrangements

The Company may utilize accounts receivable factoring arrangements with third-party financial institutions in order to extend terms for the customer without negatively impacting our cash flow. These arrangements in all cases do not contain recourse provisions which would obligate us in the event of our customers’ failure to pay. Receivables are considered sold when they are transferred beyond the reach of Kimball Electronics and its creditors, the purchaser has the right to pledge or exchange the receivables, and we have surrendered control over the transferred receivables. In the six months ended December 31, 2017 and 2016, we sold, without recourse, \$81.2 million and \$72.2 million of accounts receivable, respectively.

Future Liquidity

We believe our principal sources of liquidity from available funds on hand, cash generated from operations, and the availability of borrowing under our credit facilities will be sufficient to meet our working capital and other operating needs for at least the next 12 months. The ability to borrow in USD equivalent under all of our credit facilities totaled \$59.9 million at December 31, 2017. We expect to continue to invest in capital expenditures prudently, particularly for projects, including potential acquisitions, that would enhance our capabilities and diversification while providing an opportunity for growth and higher profits. As part of this plan to enhance our capabilities and diversification, we acquired certain assets and assumed certain liabilities of Medivative Technologies, LLC and Aircom Manufacturing, Inc. within the past two fiscal years. These acquisitions were financed with available liquidity.

We are growing our business in Europe through the expansion of our manufacturing capabilities in the region. We completed the construction of our greenfield facility in Romania in fiscal year 2016 and have begun operations. Capacity at this facility will continue to ramp up in fiscal year 2018.

At December 31, 2017, our capital expenditure commitments were approximately \$9 million, consisting primarily of commitments for capacity purposes in anticipation of future growth, including new program wins, and improvements to our facilities. We anticipate our funds on hand and funds provided by operations will be sufficient to fund these capital expenditures.

At December 31, 2017, our foreign operations held cash totaling \$33.8 million. Tax Reform imposed a one-time deemed repatriation tax on accumulated unremitted foreign earnings of 15.5% for the accumulated unremitted foreign earnings held in foreign cash and other liquid assets and 8.0% of the residual accumulated unremitted foreign earnings. The Company estimated and recorded approximately \$12.8 million for the deemed repatriation tax, of which approximately \$1.0 million of the tax payable will be paid in the next 12 months with the remaining balance to be paid over an eight-year period. The Company expects to pay this tax payable with available liquidity. Most of these accumulated unremitted foreign earnings have been invested in active non-U.S. business operations, and we intend to only repatriate a small amount of these earnings to the United States in a tax-free manner. Our intent is to permanently reinvest the remaining funds outside of the United States, and our current plans do not demonstrate a need to repatriate these funds to our U.S. operations. However, if the remaining funds were repatriated, a portion of the funds remitted would be subject to applicable non-U.S. income and withholding taxes. See Note 1 - Business Description and Summary of Significant Accounting Policies of Notes to Condensed Consolidated Financial Statements for additional information on the deemed repatriation tax and Tax Reform.

On October 21, 2015, the Company's Board of Directors approved a resolution to authorize an 18-month stock repurchase plan (the "Plan") to allow the repurchase of up to \$20 million of common stock. Then on September 29, 2016, the Board extended the Plan to allow the repurchase of up to an additional \$20 million worth of common stock with no expiration date. On August 23, 2017, the Board increased the Plan to allow the repurchase of up to an additional \$20 million worth of common stock with no expiration date. This latest increase brings the total authorized stock repurchases under the Plan to \$60 million. The Plan may be suspended or discontinued at any time. The extent to which the Company repurchases its shares, and the timing of such repurchases, will depend upon a variety of factors, including market conditions, regulatory requirements, and other corporate considerations, as determined by the Company's management team. The Company expects to finance the purchases with existing liquidity. The Company has repurchased \$41.4 million of common stock under the Plan through December 31, 2017.

Our ability to generate cash from operations to meet our liquidity obligations could be adversely affected in the future by factors such as general economic and market conditions, lack of availability of raw material components in the supply chain, a decline in demand for our services, loss of key contract customers, unsuccessful integration of acquisitions and new operations, the ability of Kimball Electronics to generate profits, and other unforeseen circumstances. In particular, should demand for our customers' products and, in turn, our services decrease significantly over the next 12 months, the available cash provided by operations could be adversely impacted.

The preceding statements include forward-looking statements under the Private Securities Litigation Reform Act of 1995. Certain factors could cause actual results to differ materially from forward-looking statements.

Fair Value

During the second quarter of fiscal year 2018, no level 1 or level 2 financial instruments were affected by a lack of market liquidity. For level 1 financial assets, readily available market pricing was used to value the financial instruments. Our foreign currency derivative assets and liabilities, which were classified as level 2, were independently valued using observable market inputs such as forward interest rate yield curves, current spot rates, and time value calculations. To verify the reasonableness of the independently determined fair values, these derivative fair values were compared to fair values calculated by the counterparty banks. Our own credit risk and counterparty credit risk had an immaterial impact on the valuation of the foreign currency derivatives. See Note 5 - Fair Value of Notes to Condensed Consolidated Financial Statements for additional information.

Contractual Obligations

There have been no material changes outside the ordinary course of business to Kimball Electronics' summary of contractual obligations under the caption, "Contractual Obligations" in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended June 30, 2017.

Off-Balance Sheet Arrangements

In limited circumstances, we receive banker's acceptance drafts from customers in our China operation. In turn, we may transfer the acceptance drafts to a supplier in settlement of current accounts payable. These drafts contain certain recourse provisions afforded to the transferee under laws of The People's Republic of China, and if exercised, our China operation would be required to satisfy the obligation with the transferee and the draft would revert back to our China operation. At December 31, 2017, the drafts transferred and outstanding totaled \$1.4 million. No transferee has exercised their recourse rights against us.

We also have standby letters of credit and operating leases entered into in the normal course of business. These arrangements do not have a material current effect and are not reasonably likely to have a material future effect on our financial condition, results of operations, liquidity, capital expenditures, or capital resources.

See Note 1 - Business Description and Summary of Significant Accounting Policies of Notes to Condensed Consolidated Financial Statements for more information on the banker's acceptance drafts and Note 4 - Commitments and Contingent Liabilities of Notes to Condensed Consolidated Financial Statements for more information on standby letters of credit. We do not have material exposures to trading activities of non-exchange traded contracts.

The preceding statements are forward-looking statements under the Private Securities Litigation Reform Act of 1995. Certain factors could cause actual results to differ materially from forward-looking statements.

Critical Accounting Policies

Kimball Electronics' Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America. These principles require the use of estimates and assumptions that affect amounts reported and disclosed in the Condensed Consolidated Financial Statements and related notes. Actual results could differ from these estimates and assumptions. Management uses its best judgment in the assumptions used to value these estimates, which are based on current facts and circumstances, prior experience, and other assumptions that are believed to be reasonable. For further information regarding our critical accounting policies, refer to "Note 1 - Business Description and Summary of Significant Accounting Policies" of Notes to Consolidated Financial Statements and "Critical Accounting Policies" in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended June 30, 2017.

New Accounting Standards

See Note 1 - Business Description and Summary of Significant Accounting Policies of Notes to Condensed Consolidated Financial Statements for information regarding New Accounting Standards.

Forward-Looking Statements

Certain statements contained within this document are considered forward-looking under the Private Securities Litigation Reform Act of 1995. The statements may be identified by the use of words such as “believes,” “anticipates,” “expects,” “intends,” “plans,” “projects,” “estimates,” “forecasts,” “seeks,” “likely,” “future,” “may,” “might,” “should,” “would,” “could,” and “may.” These forward-looking statements are subject to risks and uncertainties including, but not limited to, successful integration of acquisitions and new operations, adverse changes in the global economic conditions, the geopolitical environment, significant reductions in volumes and order patterns from key contract customers, loss of key customers or suppliers within specific industries, financial stability of key customers and suppliers, availability or cost of raw materials and components, increased competitive pricing pressures reflecting excess industry capacities, foreign exchange fluctuations, changes in the regulatory environment, or similar unforeseen events. Additional cautionary statements regarding other risk factors that could have an effect on the future performance of Kimball Electronics are contained in our Annual Report on Form 10-K for the year ended June 30, 2017.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Exchange Rate Risk: Kimball Electronics operates internationally and thus is subject to potentially adverse movements in foreign currency rate changes. Our risk management strategy includes the use of derivative financial instruments to hedge certain foreign currency exposures. Derivatives are used only to manage underlying exposures and are not used in a speculative manner. Further information on derivative financial instruments is provided in Note 6 - Derivative Instruments of Notes to Condensed Consolidated Financial Statements. We estimate that a hypothetical 10% adverse change in foreign currency exchange rates relative to non-functional currency balances of monetary instruments, to the extent not hedged by derivative instruments, would not have a material impact on profitability over an entire year.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

We maintain controls and procedures designed to ensure that information required to be disclosed in the reports that are filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation of those controls and procedures performed as of December 31, 2017, our Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective.

(b) Changes in internal control over financial reporting.

There have been no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2017 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We may, from time to time, be involved in legal proceedings arising in the normal course of business. Other than proceedings incidental to our business, we are not a party to, nor is any of our property the subject of, any material pending legal proceedings and no such proceedings are, to our knowledge, threatened against us.

Item 1A. Risk Factors

We are subject to various risks and uncertainties in the course of our business. A comprehensive disclosure of risk factors related to Kimball Electronics can be found in our Annual Report on Form 10-K. There have been no material changes to the risk factors disclosed in our Form 10-K for the year ended June 30, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table contains information about our purchases of equity securities during the three months ended December 31, 2017.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plan ⁽¹⁾⁽²⁾⁽³⁾ |
|--------------------------------------|----------------------------------|------------------------------|---|--|
| October 1, 2017 - October 31, 2017 | — | \$ — | — | \$21,628,975 |
| November 1, 2017 - November 30, 2017 | 122,971 | \$ 19.68 | 122,971 | \$19,208,640 |
| December 1, 2017 - December 31, 2017 | 28,938 | \$ 20.73 | 28,938 | \$18,608,701 |
| Total | 151,909 | \$ 19.88 | 151,909 | |

(1) On October 21, 2015, our Board of Directors (the “Board”) approved an 18-month stock repurchase plan (the “Plan”), authorizing the repurchase of up to \$20 million worth of our common stock.

(2) On September 29, 2016, the Board extended the Plan to allow the repurchase of up to an additional \$20 million worth of common stock with no expiration date.

(3) On August 23, 2017, the Board approved another extension of the Plan to allow the repurchase of an additional \$20 million worth of common stock with no expiration date, which brings the total amount of stock repurchases authorized under the Plan to \$60 million.

Item 6. Exhibits

Exhibits (numbered in accordance with Item 601 of Regulation S-K)

- 3.1 Amended and Restated Articles of Incorporation of the Company (Incorporated by reference to Exhibit 3.1 to the Company's Form 8-K/A filed October 23, 2014, File No. 001-36454)
- 3.2 Amended and Restated By-laws of the Company (Incorporated by reference to Exhibit 3.2 to the Company's Form 8-K filed November 13, 2017, File No. 001-36454)
- 31.1+ Certification filed by Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2+ Certification filed by Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1+^ Certification furnished by the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2+^ Certification furnished by the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 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

+ Filed herewith

^ In accordance with Item 601(b)(32)(ii) of Regulation S-K, the certifications furnished in Exhibit 32.1 and 32.2 will not be deemed "filed" for purposes of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

SIGNATURES

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

KIMBALL ELECTRONICS, INC.

By: /s/ DONALD D. CHARRON

Donald D. Charron
Chairman of the Board,
Chief Executive Officer
February 8, 2018

By: /s/ MICHAEL K. SERGESKETTER

Michael K. Sergesketter
Vice President,
Chief Financial Officer
February 8, 2018

Kimball Electronics, Inc.

Exhibit Index

| Exhibit No. | Description |
|----------------------|--|
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| 31.2 ⁺ | <u>Certification filed by Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
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