KEY TRONIC CORP
Form 10-Q
February 11, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE PERIOD ENDED JANUARY 1, 2011**

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE PERIOD FROM ______ TO ______.**

Commission File Number 0-11559

KEY TRONIC CORPORATION

(Exact name of registrant as specified in its charter)

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

N. 4424 Sullivan Road

Spokane Valley, Washington 99216

(509) 928-8000

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

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

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

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

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

As of January 29, 2011, 10,348,523 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

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

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PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	January 1, 2011	July 3, 2010
	(in thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 1,637	$ 770
Trade receivables, net allowance for doubtful accounts of $126 and $111	37,754	34,617
Inventories	46,588	39,775
Deferred income tax asset	3,748	4,420
Other	6,221	3,115
Total current assets	95,948	82,697
Property, plant and equipment - net	14,967	13,898
Other assets:		
Deferred income tax asset	4,356	4,394
Other	993	653
Total other assets	5,349	5,047
Total assets	$ 116,264	$ 101,642
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 25,010	$ 29,158
Accrued compensation and vacation	4,117	5,097
Current portion of other long-term obligations	72	146
Other	2,599	3,588
Total current liabilities	31,798	37,989
Long-term liabilities:		
Revolving loan	17,781	1,554
Other long-term obligations	1,830	2,682
Total long-term liabilities	19,611	4,236
Total liabilities	51,409	42,225
Commitments and contingencies (Note 7)		

Shareholders equity:		
Common stock, no par value (in thousands) - shares authorized 25,000; issued and outstanding 10,349 and 10,264 shares, respectively	41,006	40,126
Retained earnings	23,008	19,533
Accumulated other comprehensive income (loss)	841	(242)
Total shareholders equity	64,855	59,417
Total liabilities and shareholders equity	$ 116,264	$ 101,642

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended	
	January 1, 2011	December 26, 2009
	(in thousands, except per share amounts)	
Net sales	$ 61,038	$ 44,750
Cost of sales	55,592	40,040
Gross profit on sales	5,446	4,710
Operating expenses:		
Research, development and engineering	961	704
Selling, general and administrative	2,770	2,273
Total operating expenses	3,731	2,977
Operating income	1,715	1,733
Interest expense	75	19
Income before income tax (benefit) provision	1,640	1,714
Income tax (benefit) provision	(93)	44
Net income	$ 1,733	$ 1,670
Earnings per share basic	$ 0.17	$ 0.17
Weighted average shares outstanding - basic	10,345	10,087
Earnings per share diluted	$ 0.17	$ 0.17
Weighted average shares outstanding - diluted	10,448	10,110

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Six Months Ended	
	January 1, 2011	**December 26, 2009**
	(in thousands, except per share amounts)	
Net sales	$ 124,378	$ 86,059
Cost of sales	112,962	78,674
Gross profit on sales	11,416	7,385
Operating expenses:		
Research, development and engineering	1,875	1,267
Selling, general and administrative	5,202	4,009
Total operating expenses	7,077	5,276
Operating income	4,339	2,109
Interest expense	147	64
Income before income tax provision	4,192	2,045
Income tax provision	717	80
Net income	$ 3,475	$ 1,965
Earnings per share basic	$ 0.34	$ 0.19
Weighted average shares outstanding - basic	10,321	10,076
Earnings per share diluted	$ 0.33	$ 0.19
Weighted average shares outstanding - diluted	10,420	10,094

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended	
	January 1, 2011	December 26, 2009
	(in thousands)	
Cash flows from operating activities:		
Net income	$ 3,475	$ 1,965
Adjustments to reconcile net income to cash (used in) provided by operating activities:		
Depreciation and amortization	1,082	819
Accretion of deferred gain on sale of building	(39)	(39)
Provision for obsolete inventory	152	1,425
Provision for warranty	75	16
Provision for doubtful accounts	15	
(Gain) loss on disposal of assets	(13)	9
Share-based compensation expense	256	
Deferred income taxes	621	
Changes in operating assets and liabilities:		
Trade receivables	(3,152)	(1,330)
Inventories	(6,965)	1,960
Other assets	(2,683)	(310)
Accounts payable	(4,148)	4,588
Accrued compensation and vacation	(980)	447
Other liabilities	(711)	523
Cash (used in) provided by operating activities	(13,015)	10,073
Cash flows from investing activities:		
Purchase of property and equipment	(2,772)	(1,170)
Proceeds from sale of fixed assets	15	
Proceeds from life insurance	113	
Cash used in investing activities	(2,644)	(1,170)
Cash flows from financing activities:		
Payment of financing costs	(50)	(50)
Repayment of long term debt		(114)
Decrease in restricted cash		124
Borrowings under revolving credit agreement	60,779	9,763
Repayment of revolving credit agreement	(44,552)	(12,175)
Proceeds from exercise of stock options	349	37
Cash provided by (used in) financing activities	16,526	(2,415)
Net increase in cash and cash equivalents	867	6,488
Cash and cash equivalents, beginning of period	770	729
Cash and cash equivalents, end of period	$ 1,637	$ 7,217

Supplemental cash flow information:				
Interest payments	$	227	$	82
Income tax payments, net of refunds	$	276	$	64

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The condensed consolidated financial statements included herein have been prepared by Key Tronic Corporation and subsidiaries (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in our annual consolidated financial statements have been condensed or omitted. The year-end condensed consolidated balance sheet information was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The financial statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period. The results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes included in the Company s Annual Report on Form 10-K for the fiscal year ended July 3, 2010.

The Company s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three and six month periods ended January 1, 2011 and December 26, 2009 were 13 week and 26 week periods, respectively. Fiscal year 2011 will end on July 2, 2011 which is a 52 week year, whereas fiscal year 2010 which ended on July 3, 2010, was a 53 week year.

2. Significant Accounting Policies

Other Comprehensive Income

	Three Months Ended	
	January 1, 2011	December 26, 2009
	(in thousands)	
Net income	$ 1,733	$ 1,670
Other comprehensive income:		
Unrealized gain on foreign exchange contracts	410	776
Comprehensive income	$ 2,143	$ 2,446

	Six Months Ended	
	January 1, 2011	December 26, 2009
	(in thousands)	
Net income	$ 3,475	$ 1,965
Other comprehensive income:		
Unrealized gain on foreign exchange contracts	1,083	507
Comprehensive income	$ 4,558	$ 2,472

Other comprehensive income for the three and six months ended January 1, 2011 is reflected net of tax of approximately $221,000 and $572,000, respectively.

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Income Taxes

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

Earnings Per Common Share

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

Fair Value of Financial Instruments

The carrying values of financial instruments reflected on the balance sheets at January 1, 2011 and July 3, 2010, reasonably approximate their fair value. Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of long-term debt is estimated to be $17.8 million and $1.6 million, respectively, as of January 1, 2011 and July 3, 2010, which approximates the carrying values.

Share-based Compensation

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

Total share-based compensation expense recognized during the three and six months ended January 1, 2011 and December 26, 2009 was as follows (in thousands):

	Three Months Ended	
	January 1, 2011	**December 26, 2009**
Stock Appreciation Rights	$ 114	$

	Six Months Ended	
	January 1, 2011	**December 26, 2009**
Stock Appreciation Rights	$ 256	$

On October 21, 2010, the Company obtained shareholder approval of the 2010 Incentive Plan at the Annual Shareholder Meeting. As a result, the Company made a decision to amend the remaining 522,000 SARs granted during the fourth quarter of fiscal 2010 by replacing the cash-settlement feature with a net-share-settlement feature. As a result of the change the awards were reclassified from liability awards to equity awards effective October 21, 2010 at a weighted average fair value of $2.89. No incremental compensation cost resulted from the change. As of January 1, 2011 total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately $1.2 million. This expense is expected to be recognized over a weighted average period of 2.4 years.

Options to purchase 18,334 and 20,833 shares of our common stock were exercised during the three months ended January 1, 2011 and December 26, 2009, respectively, with an immaterial amount of intrinsic value for both periods presented. Options to purchase 84,133 and

24,166 shares of our common stock were exercised during the six months ended January 1, 2011 and December 26, 2009, respectively, with an immaterial amount of intrinsic value for both periods presented.

Recently Issued Accounting Standards

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

3. Inventories

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

	January 1, 2011	July 3, 2010
Finished goods	$ 5,775	$ 4,492
Work-in-process	4,711	4,095
Raw materials and supplies	36,102	31,188
	$ 46,588	$ 39,775

4. Long-Term Debt

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

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

As of January 1, 2011, the Company had availability to borrow an additional $12.2 million under the Wells Fargo line of credit. The outstanding balance under the credit facility was $17.8 million as of January 1, 2011 and the rate of interest being paid on the outstanding balance was in the range of 2.48% - 3.25%. There was no outstanding balance under the credit facility as of December 26, 2009.

5. Income Taxes

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

Management expects to repatriate a portion of its foreign undistributed earnings based on increased sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company expects to repatriate approximately $15.0 million in the future. As such, as earnings are recognized in the United States, the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax have been recorded as part of deferred taxes as of January 1, 2011. All other unremitted foreign earnings are expected to remain permanently reinvested in planned fixed assets purchases in foreign locations.

The Company has wholly owned foreign subsidiaries in Mexico that apply certain tax credits related to production assets that currently offset all of the income tax liabilities under general Mexican income tax law. However, the Company is subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The Company anticipates that it will be taxable under IETU for the foreseeable future. Therefore its deferred taxes of its Mexican operations have been accounted under the IETU tax basis. The effect of IETU and an associated presidential decree has been included in the effective tax rate as of January 1, 2011.

The Company is required to pay taxes in China on its statutory foreign profits. Its subsidiary in China began having statutory profits during the quarter ended January 1, 2011. The Company released its valuation allowance on its Chinese tax net operating loss carryforwards as it became likely that they will be fully utilized in the future.

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

	Three Months Ended	
	January 1, 2011	**December 26, 2009**
Federal income tax expense at statutory rate	$ 558	$ 583
Effect of foreign vs. domestic taxes	(551)	(49)
Change in valuation allowance	(13)	(447)
Other	(87)	(43)
Income tax provision	$ (93)	$ 44

	Six Months Ended	
	January 1, 2011	**December 26, 2009**
Federal income tax expense at statutory rate	$ 1,425	$ 946
Effect of foreign vs. domestic taxes	(542)	(66)
Change in valuation allowance	(13)	(714)
Other	(167)	(86)
Income tax provision	$ 703	$ 80

FASB ASC Topic 740, *Accounting for Income Taxes*, requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. The Company has not recorded any income tax expense or benefit for uncertain tax positions and does not anticipate any adjustments over the next 12 months.

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6. Earnings Per Share

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

	Three Months Ended (in thousands, except per share information)	
	January 1, 2011	December 26, 2009
Net income	$ 1,733	$ 1,670
Weighted average shares outstanding - basic	10,345	10,087
Effect of dilutive common stock options	103	23
Weighted average shares outstanding - diluted	10,448	10,110
Earnings per share - basic	$ 0.17	$ 0.17
Earnings per share - diluted	$ 0.17	$ 0.17
Antidilutive options not included in diluted earnings per share	541	445

	Six Months Ended (in thousands, except per share information)	
	January 1, 2011	December 26, 2009
Net income	$ 3,475	$ 1,965
Weighted average shares outstanding - basic	10,321	10,076
Effect of dilutive common stock options	99	18
Weighted average shares outstanding - diluted	10,420	10,094
Earnings per share - basic	$ 0.34	$ 0.19
Earnings per share - diluted	$ 0.33	$ 0.19
Antidilutive options not included in diluted earnings per share	541	445

7. Commitments and Contingencies

Purchase Commitments

The Company had no material firm commitments to contractors and suppliers for capital expenditures at January 1, 2011. The Company allowed an option to purchase an additional manufacturing facility in Juarez, Mexico to expire.

Leases

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

Warranties

The Company provides warranties on certain product sales. Allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from management s estimates, adjustments

to recognize additional cost of sales may be required in future periods. The Company s warranty reserve was approximately $48,000 and $25,000 as of January 1, 2011 and July 3, 2010, respectively.

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8. Fair Value Measurements

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

The following table summarizes the Company s financial assets and liabilities (only those required to be measured at fair value on a recurring basis) at fair value as of January 1, 2011 and July 3, 2010 (in thousands):

	January 1, 2011			
	Level 1	**Level 2**	**Level 3**	**Total Fair Value**
Financial Assets:				
Foreign currency forward contracts	$	$ 1,294	$	$ 1,294

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

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

9. Derivative Financial Instruments

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

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

As of January 1, 2011, the Company had outstanding foreign currency forward contracts with a total notional amount of $30.1 million. These contract maturity dates extend through November 2012. Subsequent to January 1, 2011, the Company entered into an additional $5.9 million foreign currency forward contracts that extended the hedge position through March 2013.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of January 1, 2011 and July 3, 2010 (in thousands):

Derivatives Designated as Hedging Instruments	**Balance Sheet Location**	**January 1, 2011 Fair Value**	**July 3, 2010 Fair Value**
Foreign currency forward contracts	Other current assets	$ 847	$ 416
Foreign currency forward contracts	Other long-term assets	$ 447	$

Foreign currency forward contracts	Other long-term liabilities	$	$ (777)

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The following tables summarize the gain on derivative instruments on the Consolidated Statements of Income for the three and six months ended January 1, 2011 (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of October 2, 2010	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of January 1, 2011
Settled foreign currency forward contracts for the three months ended January 1, 2011	$ 107	$ 139	$ (246)	$
Unsettled foreign currency forward contracts	324	517		841
Total	$ 431	$ 656	$ (246)	$ 841

Derivatives Designated as Hedging Instruments	AOCI Balance as of July 3, 2010	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of January 1, 2011
Settled foreign currency forward contracts for the six months ended January 1, 2011	$ 173	$ 349	$ (522)	$
Unsettled foreign currency forward contracts	(415)	1,256		841
Total	$ (242)	$ 1,605	$ (522)	$ 841

The Company does not enter into derivative instruments for trading or speculative purposes. The Company s counterparties to the foreign currency forward contracts are major banking institutions. These institutions do not require collateral for the contracts and the Company believes that the risk of the counterparties failing to meet their contractual obligations is remote. As of January 1, 2011, the amount of existing gains, net of tax, expected to be reclassified into earnings within the next 12 months is approximately $550,000.

As of January 1, 2011, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

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

FORWARD-LOOKING STATEMENTS

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

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

Overview

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

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

Executive Summary

Our net sales of $61.0 million for the three months ended January 1, 2011 increased by 36.4 percent as compared to net sales of $44.8 million for the three months ended December 26, 2009. The increase in net sales was primarily driven by an increase in revenues related to new programs for both new and longstanding customers and to a lesser extent a net improvement related to increased demand from current customer programs. Net sales were negatively impacted by industry-wide shortages in the global supply chain to a lesser extent than previous quarters. We believe that we are well positioned in the EMS industry to win new business in coming periods and profitably grow our revenue as the economy recovers.

The concentration of our largest customers decreased during the second quarter of fiscal year 2011 with the top five customers sales decreasing to 56.2 percent of total sales in the second quarter of fiscal 2011 from 62.6 percent in same period of the prior year. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies and computer accessories. The total number of our customers continued to increase during the second quarter of fiscal year 2011.

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

Gross profit as a percent of sales was 8.9 percent for the three months ended January 1, 2011 as compared to 10.5 percent for same three month period of the prior fiscal year. The decrease in gross profit as a percentage of net sales was primarily due to our product mix and start-up costs for new programs. We incurred an increase in material costs as a percentage of sales, partially offset by higher sales, and increased leverage of certain overhead costs, as a percent of sales.

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Operating income as a percentage of sales for the three months ended January 1, 2011 was 2.8 percent compared to 3.9 percent for the three months ended December 26, 2009. The decrease in operating income as a percentage of sales was due to a decline in gross margin, partially offset with our continued success in controlling operating expenses as selling general and administrative expenses decreased approximately 0.6 percentage points as a percent of net sales when compared to the second quarter of fiscal 2010.

Net income for the three months ended January 1, 2011 was $1.7 million or $0.17 per diluted share, as compared to $1.7 million or $0.17 per diluted share for the three months ended December 26, 2009. The decrease in net income as a percent of sales for three months ended January 1, 2011 as compared to the same period in fiscal year 2010 was primarily due to an approximate 1.6 percentage point decline in our gross margin.

We maintain a strong balance sheet with a current ratio of 3.02 and a long-term debt to equity ratio of 0.27. Total cash used in operating activities as defined on our cash flow statement was $13.0 million during the six months ended January 1, 2011. We maintain sufficient liquidity for our expected future operations and had $17.8 million in borrowings on our $30.0 million revolving line of credit with Wells Fargo, N.A. of which $12.2 million remained available at January 1, 2011. We believe cash flow generated from operations, our borrowing capacity, and equipment lease financing should provide adequate capital for planned growth.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

The accounting policies and estimates listed below are those that we believe are the most critical to our consolidated financial condition and results of operations. They are also the accounting policies that typically require our most difficult, subjective and complex judgments and estimates, often for matters that are inherently uncertain. Please refer to the discussion of critical accounting policies in our most recent Annual Report on Form 10-K for the fiscal year ended July 3, 2010, for further details.

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