KEY TRONIC CORP
Form 10-Q
May 08, 2014

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

FORM 10-Q

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x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE PERIOD ENDED MARCH 29, 2014
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE PERIOD FROM TO .
Commission File Number 0-11559

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of April 25, 2014, 10,539,503 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

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

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

	March 29, 2014	June 29, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$2,241	$10,819
Trade receivables, net of allowances of $37 and $40, respectively	52,637	47,009
Inventories	46,086	44,664
Deferred income tax asset	1,516	1,767
Other	9,464	7,508
Total current assets	111,944	111,767
Property, plant and equipment—net	21,188	17,911
Other assets:		
Deferred income tax asset	3,052	3,179
Other	1,914	2,273
Goodwill	1,740	—
Other intangible assets	2,138	—
Total other assets	8,844	5,452
Total assets	$141,976	$135,130
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$28,540	$26,400
Accrued compensation and vacation	6,297	7,413
Current portion of other long-term obligations	—	576
Other	5,021	3,551
Total current liabilities	39,858	37,940
Long-term liabilities:		
Deferred income tax liability	—	1,585
Other long-term obligations	564	1,445
Total long-term liabilities	564	3,030
Total liabilities	40,422	40,970
Commitments and contingencies (Note 8)		
Shareholders’ equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,533 and 10,502 shares, respectively	44,015	43,369
Retained earnings	55,711	49,478
Accumulated other comprehensive income	1,828	1,313
Total shareholders’ equity	101,554	94,160
Total liabilities and shareholders’ equity	$141,976	$135,130

See accompanying notes to consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	March 29, 2014	March 30, 2013	March 29, 2014	March 30, 2013
Net sales	$77,043	$84,343	$233,267	$276,418
Cost of sales	70,436	76,483	213,088	249,587
Gross profit	6,607	7,860	20,179	26,831
Research, development and engineering expenses	1,414	1,329	4,181	3,804
Selling, general and administrative expenses	2,985	2,938	8,964	8,406
Total operating expenses	4,399	4,267	13,145	12,210
Operating income	2,208	3,593	7,034	14,621
Interest expense, net	12	38	50	246
Income before income taxes	2,196	3,555	6,984	14,375
Income tax provision	782	692	751	4,189
Net income	$1,414	$2,863	$6,233	$10,186
Net income per share — Basic	$0.13	$0.27	$0.59	$0.97
Weighted average shares outstanding — Basic	10,533	10,489	10,523	10,488
Net income per share — Diluted	$0.13	$0.26	$0.57	$0.94
Weighted average shares outstanding — Diluted	10,926	10,931	10,920	10,888

See accompanying notes to consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	March 29, 2014	March 30, 2013	March 29, 2014	March 30, 2013
Comprehensive income:				
Net income	$1,414	$2,863	$6,233	$10,186
Other comprehensive income:				
Unrealized gain on foreign exchange contracts, net of tax	203	2,458	515	3,481
Comprehensive income	$1,617	$5,321	$6,748	$13,667

Other comprehensive income for the three months ended March 29, 2014 and March 30, 2013 is reflected net of tax expense of approximately $0.1 million and $1.3 million, respectively. Other comprehensive income for the nine months ended March 29, 2014 and March 30, 2013 is reflected net of tax expense of approximately $0.3 million and $1.8 million, respectively.

See accompanying notes to consolidated financial statements.

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

	Nine Months Ended	
	March 29, 2014	March 30, 2013
Operating activities:		
Net income	$6,233	$10,186
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	2,792	1,955
Excess tax benefit from exercise of stock options	(113)	(103)
Provision for obsolete inventory	227	422
Provision for warranty	19	16
Provision for doubtful accounts	37	62
Loss on disposal of assets	10	27
Share-based compensation expense	483	647
Deferred income taxes	(1,532)	1,495
Changes in operating assets and liabilities:		
Trade receivables	(5,665)	12,212
Inventories	(872)	10,274
Other assets	(1,411)	(2,199)
Accounts payable	2,140	(15,741)
Accrued compensation and vacation	(1,116)	460
Other liabilities	1,120	1,127
Cash provided by operating activities	2,352	20,840
Investing activities:		
Payment for acquisition	(6,027)	—
Proceeds from life insurance	—	144
Purchase of property and equipment	(4,467)	(2,768)
Cash used in investing activities	(10,494)	(2,624)
Financing activities:		
Payment of financing costs	(23)	(75)
Principal payments on capital lease obligations	(576)	(542)
Borrowings under revolving credit agreement	—	66,528
Repayment of revolving credit agreement	—	(81,539)
Excess tax benefit from exercise of stock options	113	103
Proceeds from exercise of stock options	50	9
Cash used in financing activities	(436)	(15,516)
Net (decrease) increase in cash and cash equivalents	(8,578)	2,700
Cash and cash equivalents, beginning of period	10,819	502
Cash and cash equivalents, end of period	$2,241	$3,202
Supplemental cash flow information:		
Interest payments	$56	$289
Income tax payments, net of refunds	$1,850	$1,781

See accompanying notes to consolidated financial statements.

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

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balances, June 29, 2013	10,502	$43,369	$49,478	$ 1,313	$94,160
Net income	—	—	6,233	—	6,233
Unrealized gain on foreign exchange contracts, net	—	—	—	515	515
Exercise of stock options	31	50	—	—	50
Share-based compensation	—	483	—	—	483
Tax benefit from exercise of stock options	—	113	—	—	113
Balances, March 29, 2014	10,533	$44,015	$55,711	$ 1,828	$101,554

See accompanying notes to consolidated financial statements.

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

1. Basis of Presentation

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

The Company’s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three and nine month periods ended March 29, 2014 and March 30, 2013 were 13 week and 39 week periods, respectively. Fiscal year 2014 will end on June 28, 2014 which is a 52 week year, and fiscal year 2013 which ended on June 29, 2013, was also a 52 week year.

2. Significant Accounting Policies

Earnings Per Common Share

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

Derivative Instruments and Hedging Activities

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

The Company 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 majority of foreign currency fluctuations for Mexican peso denominated payroll, utility, tax, and accounts payable expenses. The foreign currency forward contracts have terms that are matched to the underlying transactions being hedged. As a result, these transactions fully offset the hedged risk and no ineffectiveness has been recorded.

The Company's foreign currency forward contracts potentially expose the Company to credit risk to the extent the counterparties may be unable to meet the terms of the agreement. The Company minimizes such risk by seeking high quality counterparties. 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. The Company does not enter into derivative instruments for trading or speculative purposes.

Income Taxes

We compute our interim income tax provision through the use of an estimated annual effective tax rate (ETR) applied to year-to-date operating results and specific events that are discretely recognized as they occur. In determining the estimated annual ETR, we analyze various factors, including projections of our annual earnings, taxing jurisdictions in which the earnings will be generated, the impact of state and local income taxes, our ability to use tax credits and net operating loss carryforwards, and available tax planning alternatives. Discrete items, including the effect of changes in tax laws, tax rates, and certain circumstances with respect to valuation allowances or other unusual or non-recurring tax adjustments, are reflected in the period in which they occur as an addition to, or reduction from, the income tax provision, rather than included in the estimated annual ETR. Refer to Note 5 for further discussions.

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

We utilize a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments based on new assessments and changes in estimates and which may not accurately forecast actual outcomes. Our policy is to recognize interest and penalties related to the underpayment of income taxes as a component of income tax expense. To date, we have not incurred charges for interest or penalties in relation to the underpayment of income taxes. The tax years 1998 through the present remain open to examination by the major U.S. taxing jurisdictions to which we are subject.

Recently Issued Accounting Standards

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

3. Inventories

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

	March 29, 2014	June 29, 2013
Finished goods	$5,789	$7,097
Work-in-process	5,583	5,098
Raw materials and supplies	34,714	32,469
	$46,086	$44,664

4. Long-Term Debt

On October 15, 2010, the Company entered into an amended credit agreement with Wells Fargo Bank, N.A. thereby increasing its revolving line of credit facility for up to $30.0 million. On November 8, 2013, the Company entered into a third amendment to the credit agreement extending the term to October 15, 2018. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a “Base Rate” or a “Fixed Rate”, as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 1.75%, LIBOR plus 2.00%, or LIBOR plus 2.25% depending on the level of the Company’s trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The revolving line of credit is secured by substantially all of the assets of the Company.

The Company must comply with certain financial covenants, including a cash flow leverage ratio and an asset coverage 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 March 29, 2014, the Company had availability to borrow $30.0 million under the line of credit. The company did not have an outstanding balance on the line of credit as of March 29, 2014 or June 29, 2013.

5. Income Taxes

The Company expects to repatriate a portion of its foreign earnings based on increased sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company currently expects to repatriate approximately $9.9 million of foreign earnings in the future. As such, these earnings would be recognized in the United States, and the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax of expected repatriation of foreign earnings have been recorded as part of deferred taxes as of March 29, 2014. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed assets purchases and improvements in foreign locations.

Mexican tax reform was signed into law in December 2013 creating a discrete benefit of approximately $1.5 million that was recognized during the second quarter as a result of a change in applicable tax regimes. In recent years, the Company had been subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). However, effective January 1, 2014, IETU was repealed as part of a larger reform of the Mexican tax system. The Company is now subject to the general Mexican tax regime (ISR). The effective tax rate for the nine months ended March 29, 2014 is based on the anticipated annualized effects of both the IETU and ISR regimes for fiscal year 2014.

The Company has available approximately $5.0 million of gross federal research and development tax credits as of March 29, 2014. ASC 740 requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. Accordingly, as of March 29, 2014, the Company has recorded $3.1 million to date of gross unrecognized tax benefits associated with these federal tax credits, resulting in a net deferred tax benefit of approximately $1.9 million.

6. Earnings Per Share

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

	Three Months Ended (in thousands, except per share information)	
	March 29, 2014	March 30, 2013
Net income	$ 1,414	$ 2,863
Weighted average shares outstanding—basic	10,533	10,489
Effect of dilutive common stock options	393	442
Weighted average shares outstanding—diluted	10,926	10,931
Earnings per share—basic	$ 0.13	$ 0.27
Earnings per share—diluted	$ 0.13	$ 0.26
Antidilutive options not included in diluted earnings per share	208	—

	Nine Months Ended (in thousands, except per share information)	
	March 29, 2014	March 30, 2013
Net income	$ 6,233	$ 10,186
Weighted average shares outstanding—basic	10,523	10,488
Effect of dilutive common stock options	397	400
Weighted average shares outstanding—diluted	10,920	10,888
Earnings per share—basic	$ 0.59	$ 0.97
Earnings per share—diluted	$ 0.57	$ 0.94
Antidilutive options not included in diluted earnings per share	208	—

7. Share-based Compensation

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

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

The grant date fair value for the awards granted below were estimated using the Black Scholes option valuation method:

	July 31, 2013	July 25, 2012	January 26, 2012	July 27, 2011
SARs Granted	213,166	210,666	32,000	184,666
Strike Price	$11.34	$7.44	$ 6.30	$4.40
Fair Value	$4.67	$3.71	$ 3.08	$2.20

Total share-based compensation expense recognized during the three months ended March 29, 2014 and March 30, 2013 was approximately $148,000 and $222,000, respectively. Total share-based compensation expense recognized during the nine months ended March 29, 2014 and March 30, 2013 was approximately $483,000 and $647,000, respectively. As of March 29, 2014 total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately $1.1 million. This expense is expected to be recognized over a

weighted average period of 1.95 years.

No options to purchase shares of common stock or SARs were exercised during the three months ended March 29, 2014 or the three months ended March 30, 2013. During the nine months ended March 29, 2014, 19,930 options to purchase shares of common stock were exercised and 30,000 SARs were exercised, with an intrinsic value of approximately $0.3 million. Options to purchase 7,500 shares of common stock were exercised during the nine months ended March 30, 2013, with an immaterial amount of intrinsic value.

8. Commitments and Contingencies

Purchase Commitments

The Company had no material firm commitments to contractors or suppliers for capital expenditures as of March 29, 2014.

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 $8,000 and $9,000 as of March 29, 2014 and June 29, 2013, respectively.

9. Fair Value Measurements

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

The following table summarizes the fair value of assets/(liabilities) of the Company's derivatives that are required to be measured on a recurring basis as of March 29, 2014 and June 29, 2013 (in thousands):

	March 29, 2014			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$—	$2,833	$—	$2,833
Financial Liabilities:				
Foreign currency forward contracts	$—	$(59)	$—	$(59)

	June 29, 2013			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$—	$2,429	$—	$2,429
Financial Liabilities:				
Foreign currency forward contracts	$—	$(434)	$—	$(434)

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

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at March 29, 2014 and June 29, 2013, reasonably approximate their fair value.

10. Derivative Financial Instruments

As of March 29, 2014, the Company had outstanding foreign currency forward contracts with a total notional amount of $67.4 million. The maturity dates for these contracts extend through June 2017. For the three months ended March 29, 2014, the Company entered into foreign currency forward contracts of $5.0 million and settled $5.7 million of such contracts. For the three months ended March 30, 2013, the Company entered into $10.9 million of foreign currency forward contracts and settled $5.8 million of such contracts.

For the nine months ended March 29, 2014, the Company entered into forward contracts of $15.2 million and settled $17.6 million of such contracts. During the same period of the previous year, the Company entered into foreign currency forward contracts of $21.5 million and settled $17.0 million of such contracts.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheet as of March 29, 2014 and June 29, 2013 (in thousands):

		March 29, 2014	June 29, 2013
Derivatives Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Fair Value
Foreign currency forward contracts	Other current assets	$2,020	$760
Foreign currency forward contracts	Other long-term assets	$813	$1,669
Foreign currency forward contracts	Other current liabilities	$—	$(145)
Foreign currency forward contracts	Other long-term liabilities	$(59)	$(289)

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the three months ended March 29, 2014 and March 30, 2013, respectively (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of December 28, 2013	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 29, 2014
Settled foreign currency forward contracts for the three months ended March 29, 2014	$110	$11	$ (121)	$—
Unsettled foreign currency forward contracts	1,515	313	—	1,828
Total	$1,625	$324	$ (121)	$1,828

Derivatives Designated as Hedging Instruments	AOCI Balance as of December 29, 2012	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 30, 2013
Settled foreign currency forward contracts for the three months ended March 30, 2013	$(9)	$184	$ (175)	$—
Unsettled foreign currency forward contracts	373	2,449	—	2,822
Total	$364	$2,633	$ (175)	$2,822

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the nine months ended March 29, 2014 and March 30, 2013, respectively (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of June 29, 2013	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 29, 2014
Settled foreign currency forward contracts for the nine months ended March 29, 2014	$85	$124	$ (209)	$—
Unsettled foreign currency forward contracts	1,228	600	—	1,828
Total	$1,313	$724	$ (209)	$1,828

Derivatives Designated as Hedging Instruments	AOCI Balance as of June 30, 2012	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 30, 2013
Settled foreign currency forward contracts for the nine months ended March 30, 2013	$(162)	$675	$ (513)	$—
Unsettled foreign currency forward contracts	(497)	3,319	—	2,822
Total	$(659)	$3,994	$ (513)	$2,822

The Company does not enter into derivative instruments for trading or speculative purposes. The Company's counterparties to the foreign currency forward contracts are major financial institutions. These institutions do not require collateral for the contracts and the Company believes that the risk of the counterparties failing to meet their contractual obligations is remote. As of March 29, 2014, the net amount of unrealized gain expected to be reclassified into earnings within the next 12 months is approximately $1.4 million. As of March 29, 2014, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

11. Acquisition

On July 1, 2013, the Company acquired substantially all of the assets of Sabre Assembly & Manufacturing Co. of Texas ("Sabre"), a sheet metal fabrication company with facilities located in Juarez, Mexico. The acquisition of Sabre enables the Company to offer metal fabrication directly to its customers, in combination with plastic molding, PCB assembly, complete product assembly, design engineering and testing engineering services. Under the terms of the transaction, the assets acquired included manufacturing equipment, inventory, customer relationships and non-compete agreements with key employees. No debt or liabilities were assumed. The total cash payment of $6.0 million was funded through existing cash. The Company incurred approximately $50,000 of costs related to due diligence and closing this acquisition.

The following table summarizes the fair values of the assets acquired as of the date of acquisition (in thousands):

	Fair Values At July 1, 2013
Current Assets	$777
Fixed Assets	1,168
Non-Compete Agreements	372
Customer Relationships	1,970
Goodwill	1,740
Fair value of assets acquired	$6,027

The Sabre acquisition is accounted for using the acquisition method of accounting whereby the total purchase price is allocated to tangible and intangible assets and liabilities based on their fair values on the date of acquisition. The Company determines the purchase price allocations on the acquisition based on estimates of the fair values of the assets acquired. Goodwill recorded in connection with the above acquisition is primarily attributable to the synergies expected to arise after the Company's acquisition of the business and the assembled workforce of the acquired business. The goodwill is not amortized for financial accounting purposes but is deductible for tax purposes over a

15-year period. The intangibles related to non-compete agreements and customer relationships will be amortized using the straight-line method over five and ten years, respectively. The carrying values of goodwill and intangibles reasonably approximate their fair values as of March 29, 2014.

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

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

Overview

KeyTronicEMS is a leader in electronic manufacturing services 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 unparalleled 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, capabilities and logistical advantages to continue to win new business. The following information should be read in conjunction with the consolidated financial statements included herein and with Part II Item 1A, Risk Factors included as part of this filling.

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

Executive Summary

During the third quarter of fiscal year 2014, many of our new programs continued to ramp up. We expect to see sequential growth during the fourth quarter of fiscal year 2014, as growing revenue from new customers and new programs should offset and then exceed the demand reductions in recent periods by our two largest customers.

Net sales of $77.0 million for the third quarter of fiscal year 2014 decreased by 8.7 percent as compared to net sales of $84.3 million for the third quarter of fiscal year 2013. The decrease in net sales was primarily driven by the overall decrease in demand related to current customer programs, which includes the large customers discussed above. This decrease in net sales was partially offset by the positive impact of new customer programs and the revenue generated from the acquisition of Sabre. We believe that we are well positioned in the electronic manufacturing services (EMS) industry to win new business in coming periods and profitably grow our revenue as the economy recovers and new programs ramp into full production.

The concentration of our top three customers' sales decreased to 54.2 percent of total sales in the third quarter of fiscal year 2014 from 55.3 percent in the same period of the prior fiscal year. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies, computer accessories, electronic whiteboards, medical, educational, irrigation, automotive, transportation management, robotics, RFID, power supply, off-road vehicle equipment, fitness equipment, HVAC controls, and consumer products. At the end of the third quarter of fiscal year 2014, we were generating revenue from 192 separate programs compared to 177 programs at the end of the third quarter of fiscal year 2013. Some of these new programs represent small annual sales while others have multi-million-dollar potential.

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

Gross profit as a percent of sales was 8.6 percent for the third quarter of fiscal year 2014 as compared to 9.3 percent for the same quarter of the prior fiscal year. The decrease in gross profit as a percentage of net sales was primarily due to less absorption of fixed expenses resulting from a decrease in revenue.

Operating income as a percentage of sales for the third quarter of fiscal year 2014 was 2.9 percent compared to 4.3 percent for the same quarter of the prior fiscal year. The decrease in operating income as a percentage of net sales was primarily due to a decrease in gross margin and a slight increase in headcount in program management and engineering to support new program wins and anticipated future growth.

Net income for the third quarter of fiscal year 2014 was $1.4 million or $0.13 per diluted share, as compared to $2.9 million or $0.26 per diluted share for the third quarter of fiscal year 2013. The decrease in net income for the third quarter of fiscal year 2014 as compared to the same period in fiscal year 2013, is the result of a decrease in demand from some of our large, longstanding customers as well as an increase in certain overhead costs as a percentage of net sales, partially offset by a decrease in material-related costs as a percentage of net sales which is discussed in further detail in the "Results of Operations" section.

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

For the fourth quarter of fiscal year 2014, the Company expects to report revenue in the range of $78 million to $85 million. Future results will depend on actual levels of customers' orders, the timing of the startup of production of new product programs and the impact of the industry-wide shortages in the global supply chain.

We maintain a strong balance sheet with a current ratio of 2.8 and currently have no bank debt. Total cash provided by operating activities as defined on our cash flow statement was $2.4 million during the third quarter of fiscal year 2014. We maintain sufficient liquidity for our expected future operations. We did not have an outstanding balance on our revolving line of credit with Wells Fargo Bank, N.A. as of March 29, 2014. As a result, $30.0 million remained available to borrow as of March 29, 2014. We believe cash flow generated from operations, our borrowing capacity, and leasing opportunities should provide adequate capital for planned growth.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

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

Please refer to the discussion of critical accounting policies in our most recent Annual Report on Form 10-K for the fiscal year ended June 29, 2013, for further details.

RESULTS OF OPERATIONS

Comparison of the Three Months Ended March 29, 2014 with the Three Months Ended March 30, 2013

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

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended March 29, 2014 as compared to the three months ended March 30, 2013. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended							
	March 29, 2014	% of net sales	March 30, 2013	% of net sales	$ change	% point change		
Net sales	$77,043	100.0 %	$84,343	100.0 %	$(7,300)	—	%	
Cost of sales	70,436	91.4 %	76,483	90.7 %	(6,047)	0.7	%	
Gross profit	6,607	8.6 %	7,860	9.3 %	(1,253)	(0.7)	%	
Research, development and engineering	1,414	1.8 %	1,329	1.6 %	85	0.2	%	
Selling, general and administrative	2,985	3.9 %	2,938	3.5 %	47	0.4	%	
Total operating expenses	4,399	5.7 %	4,267	5.1 %	132	0.6	%	
Operating income	2,208	2.9 %	3,593	4.3 %	(1,385)	(1.4)	%	
Interest expense, net	12	— %	38	— %	(26)	—	%	
Income before income taxes	2,196	2.9 %	3,555	4.2 %	(1,359)	(1.3)	%	
Income tax provision	782	1.0 %	692	0.8 %	90	0.2	%	
Net income	$1,414	1.8 %	$2,863	3.4 %	$(1,449)	(1.6)	%	
Effective income tax rate	35.6 %		19.5 %					

Net Sales

The decrease in net sales from the prior year period was primarily driven by an approximate $13.6 million decrease in revenues related to decreased demand from current customer programs, partially offset by a $6.3 million increase in revenues related to new program wins and the revenue generated from the acquisition of Sabre.

During the three months ended March 29, 2014, we continue to see a robust pipeline of potential new business and have further diversified our future revenue base during the third quarter by winning two new programs from new customers involving consumer products and fitness equipment. Furthermore, our continued integration of Sabre Manufacturing into our operations is allowing us to begin rapidly expanding our sheet metal fabrication business across our customer base.

Gross Profit

Gross profit as a percentage of sales for the three months ended March 29, 2014 was 8.6 percent compared to 9.3 percent for the three months ended March 30, 2013. This 0.7 percentage point decrease is primarily related to a 3.8 percentage point increase in certain overhead costs, partially offset by a 3.1 percentage point decrease in material-related costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $56,000 and $67,000 for obsolete inventory during the three months ended March 29, 2014 and March 30, 2013, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were $1.4 million and $1.3 million during the three months ended March 29, 2014 and March 30, 2013, respectively. Total RD&E expenses as a percent of net sales were 1.8 percent and 1.6 percent during the three months ended March 29, 2014 and March 30, 2013, respectively. This 0.2 percentage point increase in RD&E as a percentage of net sales is primarily related to a slight increase in headcount in program management and engineering to support new program wins and anticipated future growth coupled with the decline in revenue.

Total selling, general and administrative (SG&A) expenses were $3.0 million during the three months ended March 29, 2014 compared to $2.9 million during the three months ended March 30, 2013. Total SG&A expenses as a percentage of net sales were 3.9 percent during the three months ended March 29, 2014 compared to 3.5 percent during the three months ended March 30, 2013. This 0.4 percentage point increase in SG&A is primarily related to the decrease in net sales, an increase in labor related expenses, and to a lesser extent an increase in other overhead costs.

Total operating expenses were $4.4 million or 5.7 percent of net sales for the three months ended March 29, 2014 and $4.3 million or 5.1 percent of net sales for the three months ended March 30, 2013. The 0.6 percentage point increase in operating expenses as a percentage of net sales is primarily related to the decrease in net sales, an increase in labor related expenses, and to a lesser extent an increase in other overhead costs.

Interest

Interest expense decreased to $12,000 during the three months ended March 29, 2014 from $38,000 during the three months ended March 30, 2013. The decrease in interest expense is primarily related to a decrease in the average balance outstanding on our line of credit and to a lesser extent paying down existing capital leases.

Income Taxes

The effective tax rate for the three months ended March 29, 2014 was 35.6 percent compared to 19.5 percent for the same period in fiscal year 2013. The effective tax rate increased from the prior year primarily due to a discrete benefit recognized during the third quarter of fiscal year 2013 related to federal R&D tax credits. For further information on taxes see footnote 5 of the “Notes to Consolidated Financial Statements."

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

RESULTS OF OPERATIONS

Comparison of the Nine Months Ended March 29, 2014 with the Nine Months Ended March 30, 2013

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

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the nine months ended March 29, 2014 as compared to the nine months ended March 30, 2013. It is provided to assist in assessing differences in our overall performance (in thousands):

	Nine Months Ended								
	March 29, 2014	% of net sales		March 30, 2013	% of net sales		$ change	% point change	
Net sales	$233,267	100.0	%	$276,418	100.0	%	$(43,151)	—	%
Cost of sales	213,088	91.3	%	249,587	90.3	%	(36,499)	1.0	%
Gross profit	20,179	8.7	%	26,831	9.7	%	(6,652)	(1.0)	%
Research, development and engineering	4,181	1.8	%	3,804	1.4	%	377	0.4	%
Selling, general and administrative	8,964	3.8	%	8,406	3.0	%	558	0.8	%
Total operating expenses	13,145	5.6	%	12,210	4.4	%	935	1.2	%
Operating income	7,034	3.0	%	14,621	5.3	%	(7,587)	(2.3)	%
Interest expense, net	50	—	%	246	0.1	%	(196)	(0.1)	%
Income before income taxes	6,984	3.0	%	14,375	5.2	%	(7,391)	(2.2)	%
Income tax provision	751	0.3	%	4,189	1.5	%	(3,438)	(1.2)	%
Net income	$6,233	2.7	%	$10,186	3.7	%	$(3,953)	(1.0)	%
Effective income tax rate	10.8 %			29.1 %					

Net Sales

The decrease in net sales from the prior year period was primarily driven by an approximate $51.1 million decrease in revenues related to decreased demand from current customer programs, an approximate $5.2 million decrease in revenues related to program losses, partially offset by a $13.1 million increase in revenues related to new program wins and the revenue generated from the acquisition of Sabre.

During the nine months ended March 29, 2014, we continue to see a robust pipeline of potential new business and have further diversified our future revenue base during the third quarter by winning two new programs from new customers involving consumer products and fitness equipment. Furthermore, our continued integration of Sabre Manufacturing into our operations is allowing us to begin rapidly expanding our sheet metal fabrication business across our customer base.

Gross Profit

Gross profit as a percentage of sales for the nine months ended March 29, 2014 was 8.7 percent compared to 9.7 percent for the nine months ended March 30, 2013. This 1.0 percentage point decrease is primarily related to a 5.4 percentage point increase in certain overhead costs, partially offset by a 4.4 percentage point decrease in material-related costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $227,000 and $422,000 for obsolete inventory during the nine months ended March 29, 2014 and March 30, 2013, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were $4.2 million and $3.8 million during the nine months ended March 29, 2014 and March 30, 2013, respectively. Total RD&E expenses as a percent of net sales were 1.8 percent and 1.4 percent during the nine months ended March 29, 2014 and March 30, 2013, respectively. This 0.4 percentage point increase in RD&E as a percentage of net sales is primarily related to a slight increase in headcount in program management and engineering to support new program wins and anticipated future growth coupled with the decline in revenue.

Total selling, general and administrative (SG&A) expenses were $9.0 million during the nine months ended March 29, 2014 compared to $8.4 million during the nine months ended March 30, 2013. Total SG&A expenses as a percentage of net sales were 3.8 percent during the nine months ended March 29, 2014 compared to 3.0 percent during the nine months ended March 30, 2013. This 0.8 percentage point increase in SG&A is primarily related to the decrease in net sales, an increase in labor related expenses, and to a lesser extent an increase in other overhead costs. In addition, SG&A expenses for the nine months ended March 30, 2013, included a positive impact of a non-recurring adjustment of approximately $0.5 million related to the reversal of a deferred compensation liability.

Total operating expenses were $13.1 million or 5.6 percent of net sales for the nine months ended March 29, 2014 and $12.2 million or 4.4 percent of net sales for the nine months ended March 30, 2013. The 1.2 percentage point increase in operating expenses as a percentage of net sales is primarily related to the decrease in net sales, an increase in labor related expenses and to a lesser extent an increase in other overhead costs.

Interest

Interest expense decreased to $50,000 during the nine months ended March 29, 2014 from $246,000 during the nine months ended March 30, 2013. The decrease in interest expense is primarily related to a decrease in the average balance outstanding on our line of credit and to a lesser extent paying down existing capital leases.

Income Taxes

The effective tax rate for the nine months ended March 29, 2014 was 10.8 percent compared to 29.1 percent for the same period in fiscal year 2013. The effective tax rate decreased from the prior year primarily due to a $1.5 million discrete benefit recorded during the second quarter of fiscal year 2014 related to the repeal of the IETU tax regime in Mexico. For further information on taxes see footnote 5 of the “Notes to Consolidated Financial Statements."

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

BACKLOG

On March 29, 2014, we had an order backlog of approximately $64.6 million. This compares with a backlog of approximately $64.2 million on March 30, 2013. Order backlog consists of purchase orders received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash provided by operating activities for the nine months ended March 29, 2014 was $2.4 million, compared to net cash provided by operating activities of $20.8 million during the same period of the prior fiscal year.

This $18.4 million year-over-year decrease in cash provided by operating activities is primarily related to a $0.9 million increase in inventory and a $5.7 million increase in accounts receivable offset by a $2.1 million increase in accounts payable during the nine months ended March 29, 2014. This compares to $20.8 million of cash flows provided by operating activities during the nine months ended March 30, 2013, which resulted primarily from a $10.3 million decrease in inventory and a $12.2 million decrease in accounts receivable offset by a $15.7 million decrease in accounts payable. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts receivable fluctuates based on the timing of shipments, terms offered and collections that occurred during the quarter. While overall sales are not typically seasonal in nature,

we ship the majority of our product during the latter half of the quarter. During the nine months ended March 29, 2014, accounts receivable increased due to the change in the product mix of sales in the latter half of the quarter compared to the same period of the prior fiscal year. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases and negotiated supplier terms.

Investing Cash Flow

Cash used in investing activities was $10.5 million during the nine months ended March 29, 2014 as compared to $2.6 million during the nine months ended March 30, 2013. Our primary investing activity during the nine months ended March 29, 2014, was the acquisition of Sabre as discussed in further detail in footnote 11 of the "Notes to Consolidated Financial Statements." In addition, investing cash flows consist of capital expenditures to purchase sheet metal and plastic injection molding equipment to support production.

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

Financing Cash Flow

Cash used in financing activities was $0.4 million during the nine months ended March 29, 2014 as compared to $15.5 million in the same period of the previous fiscal year. Our primary financing activity during the nine months ended March 29, 2014, was principal payments on our capital lease obligations. Our primary financing activity during the nine months ended March 30, 2013, was borrowing and repayment under our revolving line of credit facility. Our credit agreement with Wells Fargo Bank N.A. provides a revolving line of credit facility of up to $30.0 million, subject to availability. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a “Base Rate” or a “Fixed Rate”, as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month LIBOR plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 1.75%, LIBOR plus 2.00%, or LIBOR plus 2.25% depending on the level of our trailing four quarters EBITDA.

As of March 29, 2014, we were in compliance with our loan covenants and approximately $30.0 million was available under the revolving line of credit facility. The Company did not have an outstanding balance under the credit facility as of March 29, 2014.

Our cash requirements are affected by the level of current operations and new EMS programs. We believe that projected cash from operations, funds available under the revolving credit facility and leasing capabilities will be sufficient to meet our working and fixed capital requirements for the foreseeable future. As of March 29, 2014, we had approximately $0.6 million of cash held by foreign subsidiaries. If cash is to be repatriated in the future from these foreign subsidiaries, the Company could be subject to additional income taxes payable in the U.S. The total amount of tax payments required for the amount of foreign subsidiary cash on hand as of March 29, 2014 would approximate $57,000. We have accrued for expected future repatriation of foreign earnings as discussed in footnote 5 of the "Notes to Consolidated Financial Statements."

CONTRACTUAL OBLIGATIONS

We have included a summary of our Contractual Obligations in our annual report on Form 10-K for the fiscal year ended June 29, 2013. There have been no material changes in contractual obligations outside the ordinary course of business since June 29, 2013.

RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

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

We may experience fluctuations in quarterly results of operations.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

There is no assurance that we will be able to retain or renew our credit agreements in the future. In the event the business grows rapidly or the uncertain macroeconomic climate continues, additional financing resources could be necessary in the current or future fiscal years. There is no assurance that we will be able to obtain equity or debt financing at acceptable terms, or at all in the future. For a summary of our banking arrangements, see Note 4 Long-Term Debt of the “Notes to Consolidated Financial Statements.”

Our international operations may be subject to certain risks.

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

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

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

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

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

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

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

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

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

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

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

We are exposed to interest rate risk under our revolving line of credit with interest rates based on various levels of margin added to published prime rate and LIBOR rates depending on the calculation of a certain financial covenant. We have not historically hedged the interest rate on our credit facility, therefore, significant changes in interest rates could adversely affect our results of operations.

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

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

Our stock price is volatile.

Holders of the common stock will suffer immediate dilution to the extent outstanding equity awards are exercised to purchase common stock. Our stock price may be subject to wide fluctuations and possible rapid increases or declines

over a short time period. These fluctuations may be due to factors specific to us such as variations in quarterly operating results or changes in earnings estimates, or to factors relating to the EMS industry or to the securities markets in general, which, in recent years, have experienced significant price fluctuations. These fluctuations often have been unrelated to the operating performance of the specific companies whose stocks are traded.

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

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

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

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

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

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

Energy price increases may negatively impact our results of operations.

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

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

We rely on information technology networks and systems to process, transmit and store electronic information. In particular, we depend on our information technology infrastructure for a variety of functions, including worldwide

financial reporting, inventory management, procurement, invoicing and email communications. Any of these systems may be susceptible to outages due to fire, floods, power loss, telecommunications failures, terrorist attacks and similar events. Despite the implementation of network security measures, our systems and those of third parties on which we rely may also be vulnerable to computer viruses, break-ins and similar disruptions. If we or our vendors are unable to prevent such outages and breaches, our operations could be disrupted.

We are involved in various legal proceedings.

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

Increases in our own market capitalization and changes in securities laws and regulations will increase our costs and risk of noncompliance.

As a result of our increased market capitalization as of the end of our second quarter of fiscal year 2013, we are required to file as an accelerated filer. As such, we are subject to additional requirements contained in the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) and more recently the Dodd-Frank Act. The Sarbanes-Oxley and Dodd-Frank Acts required or will require changes in some of our corporate governance, securities disclosure and compliance practices. In response to the requirements of the Sarbanes-Oxley and Dodd-Frank Acts, the SEC and NASDAQ promulgated new rules and additional rulemaking is expected in the future. As part of the Dodd-Frank Act, the SEC requires that certain companies will be subject to due diligence, disclosure and reporting requirements for manufacturing products that include components containing certain conflict minerals.

Compliance with these new rules and future rules has increased and may increase further our legal, financial and accounting costs as well as a potential risk of noncompliance. In addition, these new rules and future rules may result in a decrease in the supply of such minerals, an increase in their cost and/or a disruption to our supply chain. Absent significant changes in related rules, which we cannot assure, we anticipate some level of increased costs related to these new regulations to continue indefinitely. Further, the costs associated with the compliance with and implementation of procedures under these and future laws and related rules could have a material impact on our results of operations. In addition, the costs associated with noncompliance with additional securities laws and regulations could also impact our business.

We may encounter complications with acquisitions, which could potentially harm our business.

Any current or future acquisitions may require additional equity financing, which could be dilutive to our existing shareholders, or additional debt financing, which could potentially affect our credit ratings. Any downgrades in our credit ratings associated with an acquisition could adversely affect our ability to borrow by resulting in more restrictive borrowing terms. To integrate acquired businesses, we must implement our management information systems, operating systems and internal controls, and assimilate and manage the personnel of the acquired operations. The integration of acquired businesses may be further complicated by difficulties managing operations in geographically dispersed locations. The integration of acquired businesses may not be successful and could result in disruption by diverting management's attention from the core business. In addition, the integration of acquired businesses may require that we incur significant restructuring charges or other increases in our expenses and working capital requirements, which reduce our return on invested capital.

Acquisitions may involve numerous other risks and challenges including but not limited to: potential loss of key employees and customers of the acquired companies; the potential for deficiencies in internal controls at acquired companies; lack of experience operating in the geographic market or industry sector of the acquired business; and exposure to unanticipated liabilities of acquired companies. These and other factors could harm our ability to achieve anticipated levels of profitability at acquired operations or realize other anticipated benefits of an acquisition, and could adversely affect our consolidated business and operating results.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

We are subject to the risk of fluctuating interest rates in the normal course of business. Our major market risk relates to our secured debt. Our revolving credit facility is secured by substantially all of our assets. The interest rates applicable to our revolving credit facility fluctuate with the Wells Fargo Bank, N.A. prime rate and LIBOR rates. The company did not have an outstanding balance on the line of credit as of March 29, 2014. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources and Liquidity” and Note

4 – “Long-Term Debt” to the Consolidated Financial Statements for additional information regarding our revolving credit facility.

Foreign Currency Exchange Risk

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us would directly or indirectly affect our financial results. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There was outstanding $67.4 million of foreign currency forward contracts as of March 29, 2014. The fair value of these contracts was $2.8 million. See Note 9 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 4. Controls and Procedures

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company’s Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of March 29, 2014, the Company’s disclosure controls and procedures are effective based on that criteria.

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

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during three months ended March 29, 2014 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)).

PART II. OTHER INFORMATION:

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

There are no material changes to the risk factors set forth in Part I Item 1A in the Company’s Annual Report on Form 10-K for the year ended June 29, 2013.

Item 6. Exhibits

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

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

SIGNATURES

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

KEY TRONIC CORPORATION

/s/ CRAIG D. GATES
Craig D. Gates — Date: May 8, 2014
President and Chief Executive Officer
(Principal Executive Officer)

/s/ RONALD F. KLAWITTER
Ronald F. Klawitter — Date: May 8, 2014
Executive Vice President of Administration, Chief Financial Officer and Treasurer
(Principal Financial Officer)