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

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OR

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

Commission File Number 0-11559

KEY TRONIC CORPORATION

(Exact name of registrant as specified in its charter)

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

N. 4424 Sullivan Road

Spokane Valley, Washington 99216

(509) 928-8000

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

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

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

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

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

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

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* Items are not applicable

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

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PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

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

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

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

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

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

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

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

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

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

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

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

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

2. Significant Accounting Policies

Other Comprehensive Income

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

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

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

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Income Taxes

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

Earnings Per Common Share

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

Fair Value of Financial Instruments

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

Share-based Compensation

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

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

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

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

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

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

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

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Recently Issued Accounting Standards

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

3. Inventories

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

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

4. Long-Term Debt

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

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

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

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5. Income Taxes

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

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

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

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

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

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

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

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

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6. Earnings Per Share

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

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

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

7. Commitments and Contingencies

Purchase Commitments

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

Leases

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

Warranties

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

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

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8. Fair Value Measurements

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

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

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

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

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

9. Derivative Financial Instruments

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

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

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

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

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

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

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

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

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

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

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

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

FORWARD-LOOKING STATEMENTS

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

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

Overview

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

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

Executive Summary

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

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

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

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

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

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

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

Inactive, Obsolete, and Surplus Inventory Reserve

Allowance for Doubtful Accounts

Accrued Warranty

Income Taxes

Stock-Based Compensation

Impairment of Long-Lived Assets

Derivatives and Hedging Activity

RESULTS OF OPERATIONS

Comparison of the Three Months Ended January 1, 2011 with the Three Months Ended December 26, 2009

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

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The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended January 1, 2011 as compared to the three months ended December 26, 2009. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended					
	January 1, 2011	% of net sales	December 26, 2009	% of net sales	$ change	% change
Net sales	$ 61,038	100.0%	$ 44,750	100.0%	$ 16,288	36.4%
Cost of sales	55,592	91.1	40,040	89.5	15,552	38.8
Gross profit	5,446	8.9	4,710	10.5	736	15.6
Operating expenses:						
Research, development and engineering	961	1.6	704	1.6	257	36.5
Selling, general and administrative	2,770	4.5	2,273	5.1	497	21.9
Total operating expenses	3,731	6.1	2,977	6.7	754	25.3
Operating income	1,715	2.8	1,733	3.9	(18)	(1.0)
Interest expense, net	75	0.1	19	0.1	56	294.7
Income before income taxes	1,640	2.7	1,714	3.8	(74)	(4.3)
Income (benefit) tax provision	(93)	(0.1)	44	0.1	(137)	*
Net income	$ 1,733	2.8%	$ 1,670	3.7%	$ 63	3.8%
Effective income tax rate	(5.7)%		2.6%			

* Changes from negative to positive are not considered meaningful.

Net Sales

The increase in net sales from prior year was primarily driven by an approximate $14.7 million increase in revenues related to new programs for both new and longstanding customers and to a lesser extent a $2.6 million net improvement related to increased demand from current customer programs, partially offset by the negative impact of program losses of approximately $1.0 million.

In the second quarter of fiscal 2011, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and expect modest growth in the second half of our fiscal year, driven by increased production levels of new programs for both new and longstanding customers. Sales in the third quarter of fiscal year 2011 are expected to be in the range of $60 million to $62 million and net sales for the full year are expected to be in the range of $250 million to $260 million. Future results will depend on actual levels of customers orders, the timing of the start up of production of new product programs and the impact of the industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Gross Profit

Gross profit as a percentage of sales for the second quarter of fiscal year 2011 was 8.9 percent compared to 10.5 percent for the second quarter of fiscal year 2010. This 1.6 percentage point decrease is primarily related to an 8.0 percentage point increase in material costs, as a percent of sales, resulting from higher material content in certain new product offerings, partially offset by a 3.1 percentage point improvement in leveraging of certain overhead costs, and a 3.3 percentage point improvement related to other cost of sales. The level of gross margin is impacted by product mix, timing of the start up of new programs, facility utilization, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $72,000 for obsolete inventory for the second quarter of fiscal year 2011 as compared to a $1.4 million provision for obsolete inventory for the second quarter of fiscal year 2010. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated 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.

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Operating Expenses

Total selling general and administrative (SG&A) expenses were $2.8 million and $2.3 million during the second quarters of fiscal years 2011 and 2010, respectively. This $0.5 million increase in SG&A during the second quarter of fiscal year 2011 as compared with the second quarter of fiscal 2010 is primarily related to a $0.2 million increase in professional fees, a $0.1 million increase in China related SG&A costs, and a $0.1 million increase in labor costs.

Total research, development, and engineering (RD&E) expenses were $1.0 million and $0.7 million during the second quarters of fiscal years 2011 and 2010, respectively. This increase is primarily related to $0.3 million increase in labor costs.

Total operating expenses were $3.7 million in the second quarter of fiscal year 2011 and $3.0 million in the second quarter of fiscal year 2010. The difference is mainly attributable to the increases in SG&A expenses and RD&E expenses discussed above. Operating expenses as a percentage of sales decreased to 6.1 percent in the second quarter of fiscal year 2011 from 6.7 percent in the second quarter of fiscal year 2010.

Interest

Interest expense increased to $75,000 in the second quarter of fiscal year 2011 from $19,000 in the second quarter of fiscal year 2010. The increases in interest expense in the second quarter of fiscal year 2011 compared to the same period of fiscal year 2010 is due to an increase in the average outstanding revolving credit facility balance.

Income Taxes

The effective tax rate for the second quarter of fiscal year 2011 was (5.7) percent compared to 2.6 percent for the same period in fiscal 2010. The decreased effective tax rate is primarily attributable to the release of the valuation allowance on net operating loss carryforwards (NOLs) in China during the second quarter of fiscal year 2011. The effective tax rate for the same fiscal period in 2010 was primarily related only to earnings of foreign subsidiaries since there was a valuation allowance related to the domestic operations. For further information on taxes see footnote 5 of the Notes to Consolidated Financial Statements .

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

RESULTS OF OPERATIONS

Comparison of the Six Months Ended January 1, 2011 with the Six Months Ended December 26, 2009

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

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the six months ended January 1, 2011 as compared to the six months ended December 26, 2009. It is provided to assist in assessing differences in our overall performance (in thousands):

	Six Months Ended					
	January 1, 2011	% of net sales	December 26, 2009	% of net sales	$ change	% change
Net sales	$ 124,378	100.0%	$ 86,059	100.0%	$ 38,319	44.5%
Cost of sales	112,962	90.8	78,674	91.4	34,288	43.6
Gross profit	11,416	9.2	7,385	8.6	4,031	54.6
Operating expenses:						
Research, development and engineering	1,875	1.5	1,267	1.5	608	48.0
Selling, general and administrative	5,202	4.2	4,009	4.7	1,193	29.8

Total operating expenses	7,077	5.7	5,276	6.1	1,801	34.1
Operating income	4,339	3.5	2,109	2.5	2,230	105.7
Interest expense, net	147	0.1	64	0.1	83	129.7
Income before income taxes	4,192	3.4	2,045	2..4	2,147	105.0
Income tax provision	717	0.6	80	0.1	637	796.3
Net income	$ 3,475	2.8%	$ 1,965	2.3%	$ 1,510	76.8%
Effective income tax rate	17.1%		3.9%			

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Net Sales

The increase in net sales from prior year was primarily driven by an approximate $34.6 million increase in revenues related to new programs for both new and longstanding customers and to a lesser extent a $4.1 million net improvement related to increased demand from current customer programs, partially offset by the negative impact of program losses of approximately $0.4 million.

In the first six months of fiscal 2011, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and expect modest growth in the second half of our fiscal year, driven by increased production levels of new programs for both new and longstanding customers. Sales in the third quarter of fiscal year 2011 are expected to be in the range of $60 million to $62 million and net sales for the full year are expected to be in the range of $250 million to $260 million. Future results will depend on actual levels of customers orders, the timing of the start up of production of new product programs and the impact of the industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Gross Profit

Gross profit as a percentage of sales for the first six months of fiscal year 2011 was 9.2 percent compared to 8.6 percent for the first six months of fiscal year 2010. This 0.6 percentage point increase is primarily related to a 6.3 percentage point improvement in leveraging of certain overhead costs and a 1.4 percentage point improvement related to other cost of sales, partially offset by a 7.1 percentage point increase in material costs, as a percent of sales, resulting from higher material content in certain new product offerings. The level of gross margin is impacted by product mix, timing of the start up of new programs, facility utilization, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $152,000 for obsolete inventory for the first six months of fiscal year 2011 as compared to a $1.4 million provision for obsolete inventory for the same period in the prior year. 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 selling general and administrative (SG&A) expenses were $5.2 million and $4.0 million during the first six months of fiscal years 2011 and 2010, respectively. This $1.2 million increase in SG&A during the first six months of fiscal year 2011 as compared with the first six months of fiscal 2010 is primarily related to a $0.5 million increase in professional fees, a $0.2 million increase in incentive compensation, a $0.2 million increase in China SG&A costs, a $0.2 million increase on other SG&A costs, and a $0.1 million increase in labor costs.

Total research, development, and engineering (RD&E) expenses were $1.9 million and $1.3 million during the first six months of fiscal years 2011 and 2010, respectively. This $0.6 million increase is primarily related to $0.5 million and $0.1 million increases in labor costs and incentive compensation costs, respectively.

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Total operating expenses were $7.1 million in the first six months of fiscal year 2011 and $5.3 million in the first six months of fiscal year 2010. The difference is mainly attributable to the increases in SG&A expenses and RD&E expenses discussed above. Operating expenses as a percentage of sales decreased to 5.7 percent in the first six months of fiscal year 2011 from 6.1 percent in the first six months of fiscal year 2010.

Interest

Interest expense increased to $147,000 in the first six months of fiscal year 2011 from $64,000 in the first six months of fiscal year 2010. The increases in interest expense in the first six months of fiscal year 2011 compared to the same period of fiscal year 2010 is due to an increase in the average outstanding revolving credit facility balance.

Income Taxes

The effective tax rate for the first quarter of fiscal year 2011 was 17.1 percent compared to 3.9 percent for the same period in fiscal 2010. The increased effective tax rate is primarily attributable to the release of the valuation allowance during the fiscal year ended July 3, 2010. The effective tax rate for the same fiscal period in 2010 was primarily related only to earnings of foreign subsidiaries since there was a valuation allowance related to the domestic operations. For further information on taxes see footnote 5 of the Notes to Consolidated Financial Statements .

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

Backlog

On January 1, 2011, we had an order backlog of approximately $37.9 million. This compares with a backlog of approximately $33.6 million on December 26, 2009. The increase in backlog at January 1, 2011, when compared to December 26, 2009, reflects an increase in expected revenue during the remainder of fiscal year 2011. Order backlog consists of purchase orders received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash used in operating activities for the six months ended January 1, 2011 was $13.0 million, compared to net cash provided by operating activities of $10.1 million during the same period of the prior fiscal year.

On a comparative year-to year basis, the $23.1 million decrease in cash flows provided by operating activities during the six months ended January 1, 2011 as compared with the six months ended December 26, 2009 resulted primarily from a $7.0 million increase in inventory, a $4.1 million decrease in accounts payable, and a $3.2 million increase in trade receivables during the six months ended January 1, 2011. During the six months ended December 26, 2009 inventory decreased $2.0 million and accounts payable increased $4.6 million. The increase in inventory during the six months ended January 1, 2011 was attributable to our anticipated growth in production levels for a number of new programs and orders we could not ship due to the industry wide electronic components supply constraints. The decrease in inventory during the six months ended December 26, 2009 was attributable to a reduction of finished goods. The decrease in accounts payable during the six months ended January 1, 2011 was primarily driven by the timing of purchases and cash payments and to a lesser extent taking advantage of certain early payment discounts. The increase in accounts payable during the six months ended December 26, 2009 was also primarily driven by the timing of purchases and cash payments. Accounts payable fluctuates with changes in inventory levels and negotiated supplier terms. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change the amount of inventory may also fluctuate.

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Investing Cash Flow

During the first six months of fiscal year 2011, we paid $2.8 million for capital expenditures compared to $1.2 million in the same period of the previous fiscal year. Our capital expenditures primarily consist of purchases of manufacturing equipment to support our production facilities and to a lesser extent leasehold improvements at our corporate headquarters. We also use leases to acquire equipment. Operating leases are often utilized when potential technical obsolescence and funding requirement advantages outweigh the benefits of equipment ownership. Capital expenditures and periodic lease payments are expected to be financed with internally generated funds.

Financing Cash Flow

Net cash provided by financing activities for the six months ended January 1, 2011 was $16.5 million, compared to net cash used in financing activities of $2.4 million during the same period of the prior fiscal year. Our primary financing activity during the first six months of fiscal year 2011 and 2010 was borrowing and repayment under our revolving line of credit facility, which totaled net borrowings of $16.2 million for the six months ended January 1, 2011 as compared with net repayments of $2.5 million for the same period in the previous year.

As of January 1, 2011, we were in compliance with our loan covenants and approximately $12.2 million was available under the revolving line of credit facility.

Our cash requirements are affected by the level of current operations and new EMS programs. We believe that projected cash from operations, funds available under the revolving credit facility and leasing capabilities will be sufficient to meet our working and fixed capital requirements for the foreseeable future.

CONTRACTUAL OBLIGATIONS

We have included a summary of our Contractual Obligations in our annual report on Form 10-K for the fiscal year ended July 3, 2010. There have been no other material changes in contractual obligations outside the ordinary course of business since July 3, 2010.

RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

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

Potential Fluctuations in Quarterly Results

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

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

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

Economic Conditions

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

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Credit Markets

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

Dependence on Suppliers

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

Concentration of Credit Risk

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

Competition

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

Concentration of Major Customers

At present, our customer base is concentrated and could become more or less concentrated. Our largest EMS customer accounted for 18% of net sales in fiscal year 2010. This same customer accounted for 6% of sales in 2009 and 0% in 2008. For the fiscal years ended 2010, 2009, and 2008, the five largest customers accounted for 57%, 52%, and 68% of total sales, respectively. There can be no assurance that our principal customers will continue to purchase products from us at current levels. Moreover, we typically do not enter into long-term volume purchase contracts with our customers, and our customers have certain rights to extend or delay the shipment of their orders. We, however, require that our customers contractually agree to buy back inventory purchased within specified lead times to build their products if not used.

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

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Foreign Manufacturing Operations

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

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

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

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

Dependence on Key Personnel

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

Technological Change and New Product Risk

The markets for our customers products is characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and relatively 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.

Interest Rate Risk

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

Compliance with Current and Future Environmental Regulation

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

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Foreign Currency Fluctuations

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

Dilution and Stock Price Volatility

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

Disclosure and Internal Controls

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

Managing Growth

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

Manufacturing Process

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

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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 JP Morgan Chase Bank prime rate and LIBOR rates. There was outstanding $17.8 million in borrowings under our revolving credit facility as of January 1, 2011, and the range of interest being paid on the outstanding balance was 2.48% - 3.25%. See Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity and Note 4 Long-Term Debt to the Consolidated Financial Statements for additional information regarding our revolving 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 $30.1 million of foreign currency forward contracts as of January 1, 2011. The fair value of these contracts was $1.3 million. See Note 9 Derivative Financial Instruments to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company s Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of January 1, 2011, the Company s disclosure controls and procedures are effective based on that criteria.

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during our second quarter ended January 1, 2011 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting (as defined in Exchange Act Rules 13a 15(f) and 15d 15(f)).

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PART II. OTHER INFORMATION:

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

Item 4. Removed and Reserved

Item 6. Exhibits

(31.1) Certification of Chief Executive Officer (Exchange Act Rules 13(a)-14 and 15(d)-14)

(31.2) Certification of Chief Financial Officer (Exchange Act Rules 13(a)-14 and 15(d)-14)

(32.1) Certification of Chief Executive Officer (18 U.S.C. 1350)

(32.2) Certification of Chief Financial Officer (18 U.S.C. 1350)

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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
President and Chief Executive Officer
(Principal Executive Officer)

Date: February 11, 2011

/s/ Ronald F. Klawitter
Ronald F. Klawitter
Executive Vice President of Administration, Chief Financial

Officer and Treasurer
(Principal Financial Officer)

Date: February 11, 2011