KEY TRONIC CORP
Form 10-Q
November 05, 2015

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 SEPTEMBER 26, 2015
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 October 23, 2015, 10,710,606 shares of common stock, no par value (the only class of common stock), were outstanding.

KEY TRONIC CORPORATION
Index

* Items are not applicable

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

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

	September 26, 2015	June 27, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$140	$372
Trade receivables, net of allowance for doubtful accounts of $229 and $97	73,761	72,852
Inventories	100,800	91,594
Deferred income tax asset	6,245	6,643
Other	15,515	13,646
Total current assets	196,461	185,107
Property, plant and equipment, net	26,898	26,974
Other assets:		
Deferred income tax asset	2,637	80
Goodwill	9,957	9,957
Other intangible assets, net	6,774	7,055
Other	1,573	1,621
Total other assets	20,941	18,713
Total assets	$244,300	$230,794
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$74,957	$61,528
Accrued compensation and vacation	7,456	9,467
Current portion of debt	5,000	5,000
Other	13,239	10,794
Total current liabilities	100,652	86,789
Long-term liabilities:		
Term loan	25,000	26,250
Revolving loan	12,131	11,631
Deferred income tax liability	—	501
Other long-term obligations	7,401	4,855
Total long-term liabilities	44,532	43,237
Total liabilities	145,184	130,026
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,707 and 10,706 shares, respectively	44,647	44,136
Retained earnings	62,212	61,395
Accumulated other comprehensive loss	(7,743)	(4,763)
Total shareholders' equity	99,116	100,768
Total liabilities and shareholders' equity	$244,300	$230,794

See accompanying notes to consolidated financial statements.

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

	Three Months Ended	
	September 26, 2015	September 27, 2014
Net sales	$126,209	$86,342
Cost of sales	117,290	82,104
Gross profit	8,919	4,238
Research, development and engineering expenses	1,556	1,336
Selling, general and administrative expenses	5,583	4,607
Total operating expenses	7,139	5,943
Operating income (loss)	1,780	(1,705)
Interest expense, net	533	189
Income (loss) before income taxes	1,247	(1,894)
Income tax provision (benefit)	430	(371)
Net income (loss)	$817	$(1,523)
Net income (loss) per share — Basic	$0.08	$(0.14)
Weighted average shares outstanding — Basic	10,706	10,548
Net income (loss) per share — Diluted	$0.07	$(0.14)
Weighted average shares outstanding — Diluted	11,391	10,548

See accompanying notes to consolidated financial statements.

4

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

	Three Months Ended	
	September 26, 2015	September 27, 2014
Comprehensive loss:		
Net income (loss)	$817	$(1,523)
Other comprehensive loss:		
Unrealized loss on hedging instruments, net of tax	(2,980)	(1,736)
Comprehensive loss	$(2,163)	$(3,259)

Other comprehensive loss for the three months ended September 26, 2015 and September 27, 2014 is reflected net of tax benefit of approximately $(1.5) million and $(1.0) million, respectively.
See accompanying notes to consolidated financial statements.

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

	Three Months Ended	
	September 26, 2015	September 27, 2014
Operating activities:		
Net income (loss)	$817	$(1,523)
Adjustments to reconcile net income (loss) to cash provided by operating activities:		
Depreciation and amortization	1,516	1,269
Excess tax benefit from share-based compensation	(325)	—
Provision for obsolete inventory	405	118
(Recovery of) provision for warranty	(22)	14
(Recovery of) provision for doubtful accounts	(4)	74
Gain on disposal of assets	—	(6)
Share-based compensation expense	189	165
Deferred income taxes	(1,127)	1,815
Changes in operating assets and liabilities, net of acquisition:		
Trade receivables	(905)	(3,911)
Inventories	(9,611)	2,589
Other assets	(1,904)	(3,303)
Accounts payable	13,429	5,450
Accrued compensation and vacation	(2,011)	(2,052)
Other liabilities	847	(2,837)
Cash provided by (used in) operating activities	1,294	(2,138)
Investing activities:		
Payment for acquisition, net of cash acquired	—	(47,763)
Purchase of property and equipment	(3,512)	(2,248)
Proceeds from sale of fixed assets	2,439	2,195
Cash used in investing activities	(1,073)	(47,816)
Financing activities:		
Payment of financing costs	(28)	(11)
Proceeds from issuance of long term debt	—	35,000
Repayments of long term debt	(1,250)	—
Borrowings under revolving credit agreement	50,721	39,552
Repayment of revolving credit agreement	(50,221)	(21,618)
Proceeds from accounts receivable purchase agreement	—	1,147
Payments towards accounts receivable purchase agreement	—	(8,969)
Excess tax benefit from share-based compensation	325	—
Proceeds from exercise of stock options	—	17
Cash (used in) provided by financing activities	(453)	45,118
Net decrease in cash and cash equivalents	(232)	(4,836)
Cash and cash equivalents, beginning of period	372	5,803
Cash and cash equivalents, end of period	$140	$967
Supplemental cash flow information:		
Interest payments	$491	$286
Income tax payments, net of refunds	$552	$198

See accompanying notes to consolidated financial statements.

6

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

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balances, June 27, 2015	10,706	$44,136	$61,395	$ (4,763)	$100,768
Net income	—	—	817	—	817
Unrealized loss on hedging instruments, net	—	—	—	(2,980)	(2,980)
Exercise of stock appreciation rights	3	—	—	—	—
Shares withheld for taxes	(2)	(3)	—	—	(3)
Share-based compensation	—	189	—	—	189
Excess tax benefit from share-based compensation	—	325	—	—	325
Balances, September 26, 2015	10,707	$44,647	$62,212	$ (7,743)	$99,116

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 27, 2015.
The Company’s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three month periods ended September 26, 2015 and September 27, 2014 were 13 week periods, respectively. Fiscal year 2016 will end on July 2, 2016 which is a 53 week year. Fiscal year 2015 which ended on June 27, 2015, was a 52 week year.

2. Significant Accounting Policies

Earnings Per Common Share

Basic earnings per common share (EPS) is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted EPS is computed by dividing net income (loss) 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 and an interest rate swap 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 uses derivatives to manage the variability of foreign currency fluctuations of expenses in our Mexico facilities and interest rate risk associated with certain borrowings under the Company’s debt arrangement. The foreign currency forward contracts and interest rate swaps 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 and interest rate swaps 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 and interest rate swaps 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 6 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.

Impairment of Goodwill and Other Intangible Assets

The Company records intangible assets that are acquired individually or with a group of other assets in the financial statements at acquisition. In accordance with ASC 350, Goodwill and Other Intangible Assets, goodwill and intangible assets acquired in a business combination and determined to have an indefinite useful life are not amortized but are required to be reviewed for impairment at least annually or when events or circumstances indicate that carrying value may exceed fair value. The Company’s acquired intangible assets are subject to amortization over their estimated useful lives and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an intangible asset may not be recoverable.

Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09 (ASU 2014-09), Revenue from Contracts with Customers. The guidance in this Update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under current guidance. This may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. In August 2015, the FASB issued an amendment to defer the effective date of ASU 2014-09 for all entities by one year. This Update is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016. Companies have the option of using either a full or modified retrospective approach in applying this standard. The Company is in the process of assessing the impact of ASU 2014-09 on its consolidated financial statements.

In August 2014, the FASB issued Accounting Standards Update 2014-15 (ASU 2014-15), Presentation of Financial Statements - Going Concern. The guidance in this Update applies to all entities. The amendments require management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the amendments (1) provide a definition of the term substantial doubt, (2) require an evaluation every reporting period including interim periods, (3) provide principles for considering the mitigating effect of management's plans, (4) require certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) require an express statement and other disclosures when substantial doubt is not alleviated, and (6) require an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The amendments of ASU 2014-15, when adopted, are not expected to have a material impact on the Company's consolidated financial statements.

In April 2015, the FASB issued Accounting Standards Update 2015-03 (ASU 2015-03), Simplifying the Presentation of Debt Issuance Costs. The guidance in this Update changes the presentation of debt issuance costs in financial statements. Under the new guidance, an entity presents such costs in the balance sheet as a direct deduction from the related debt liability rather than as an asset. Amortization of the costs is reported as interest expense. This guidance is effective for the Company beginning in the first quarter of fiscal year 2017 and early adoption is permitted in an interim period with any adjustments reflected as of the beginning of the fiscal year that includes that interim period. The guidance is not expected to have a significant impact to the Company's consolidated financial statements.

In July 2015, the FASB issued final guidance that simplifies the subsequent measurement of inventory for which cost is determined by methods other than last-in first-out ("LIFO") and the retail inventory method. For inventory within the scope of the new guidance, entities will be required to compare the cost of inventory to only one measure, its net realizable value, and not the three measures required by the existing guidance. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The new guidance should not change how entities initially measure the cost of inventory. The guidance will be effective for the Company in the fiscal year beginning July 3, 2017. Early adoption is permitted. We have not yet determined the impact this new guidance may have on our financial statements.

In September 2015, the FASB issued Accounting Standards Update 2015-16 (ASU 2015-16), Simplifying the Accounting for Measurement-Period Adjustments. The amendments in this Update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this Update require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. We are currently evaluating the impact of adopting this new guidance on our consolidated financial statements.

3. Inventories

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

	September 26, 2015	June 27, 2015
Finished goods	$10,245	$8,019
Work-in-process	17,777	15,220
Raw materials and supplies	72,778	68,355
	$100,800	$91,594