

KEY TRONIC CORP
Form 10-Q
February 09, 2017

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

FORM 10-Q

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

FOR THE PERIOD ENDED DECEMBER 31, 2016

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 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 Smaller reporting company

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

As of January 27, 2017, 10,759,680 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

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

PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands)

	December 31, 2016	July 2, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	\$1,280	\$1,018
Trade receivables, net of allowance for doubtful accounts of \$134 and \$135	66,444	61,678
Inventories	98,106	107,006
Other	10,892	11,757
Total current assets	176,722	181,459
Property, plant and equipment, net	29,938	27,925
Other assets:		
Deferred income tax asset	11,050	8,982
Goodwill	9,957	9,957
Other intangible assets, net	5,364	5,928
Other	1,471	1,673
Total other assets	27,842	26,540
Total assets	\$234,502	\$235,924
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$51,178	\$58,967
Accrued compensation and vacation	7,695	9,571
Current portion of debt	5,841	5,000
Other	14,292	10,572
Total current liabilities	79,006	84,110
Long-term liabilities:		
Term loans	21,693	21,250
Revolving loan	18,930	18,073
Other long-term obligations	7,998	6,909
Total long-term liabilities	48,621	46,232
Total liabilities	127,627	130,342
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,758 and 10,725 shares, respectively	45,466	45,227
Retained earnings	71,248	67,928
Accumulated other comprehensive loss	(9,839)	(7,573)
Total shareholders' equity	106,875	105,582
Total liabilities and shareholders' equity	\$234,502	\$235,924
See accompanying notes to consolidated financial statements.		

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited, in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	December	December	December	December
	31, 2016	26, 2015	31, 2016	26, 2015
Net sales	\$ 118,517	\$ 116,403	\$ 235,652	\$ 242,612
Cost of sales	108,905	107,293	216,331	224,583
Gross profit	9,612	9,110	19,321	18,029
Research, development and engineering expenses	1,603	1,506	3,187	3,062
Selling, general and administrative expenses	5,462	5,201	10,797	10,784
Total operating expenses	7,065	6,707	13,984	13,846
Operating income	2,547	2,403	5,337	4,183
Interest expense, net	552	521	1,141	1,054
Income before income taxes	1,995	1,882	4,196	3,129
Income tax provision	467	95	876	525
Net income	\$ 1,528	\$ 1,787	\$ 3,320	\$ 2,604
Net income per share — Basic	\$0.14	\$0.17	\$0.31	\$0.24
Weighted average shares outstanding — Basic	10,758	10,710	10,753	10,708
Net income per share — Diluted	\$0.14	\$0.16	\$0.30	\$0.23
Weighted average shares outstanding — Diluted	10,968	11,418	10,919	11,279

See accompanying notes to consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	December	December	December	December
	31, 2016	26, 2015	31, 2016	26, 2015
Comprehensive income:				
Net income	\$ 1,528	\$ 1,787	\$3,320	\$ 2,604
Other comprehensive income:				
Unrealized (loss) gain on hedging instruments, net of tax	(1,266)	687	(2,266)	(2,293)
Comprehensive income	\$ 262	\$ 2,474	\$ 1,054	\$ 311

Other comprehensive income for the three months ended December 31, 2016 and December 26, 2015, is reflected net of tax (benefit) provision of approximately \$(0.7) million and \$0.4 million, respectively. Other comprehensive income for the six months ended December 31, 2016 and December 26, 2015, is reflected net of tax benefit of approximately \$(1.2) million for both periods.

See accompanying notes to consolidated financial statements.

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

	Six Months Ended	
	December 31, 2016	December 26, 2015
Operating activities:		
Net income	\$3,320	\$ 2,604
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	3,430	3,034
Excess tax benefit from share-based compensation	—	(402)
Provision for obsolete inventory	306	515
Provision for warranty	63	40
Recovery of doubtful accounts	(1)	(19)
Loss on disposal of assets	109	—
Share-based compensation expense	355	426
Deferred income taxes	(900)	(2,227)
Changes in operating assets and liabilities:		
Trade receivables	(4,765)	12,031
Inventories	8,594	(6,830)
Other assets	836	(756)
Accounts payable	(7,789)	(4,689)
Accrued compensation and vacation	(1,876)	(2,085)
Other liabilities	1,448	1,665
Cash provided by operating activities	3,130	3,307
Investing activities:		
Purchase of property and equipment	(4,936)	(7,544)
Proceeds from sale of fixed assets	101	6,183
Cash used in investing activities	(4,835)	(1,361)
Financing activities:		
Payment of financing costs	(193)	(56)
Proceeds from issuance of long term debt	3,919	—
Repayments of long term debt	(2,500)	(2,500)
Borrowings under revolving credit agreement	79,260	101,397
Repayments of revolving credit agreement	(78,403)	(100,368)
Excess tax benefit from share-based compensation	—	402
Tax withholding from exercise of share-based compensation	(116)	—
Cash provided by (used in) financing activities	1,967	(1,125)
Net increase cash and cash equivalents	262	821
Cash and cash equivalents, beginning of period	1,018	372
Cash and cash equivalents, end of period	\$1,280	\$ 1,193
Supplemental cash flow information:		
Interest payments	\$1,127	\$ 1,032
Income tax payments, net of refunds	\$418	\$ 836
See accompanying notes to consolidated financial statements.		

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

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balances, July 2, 2016	10,725	\$45,227	\$67,928	\$ (7,573)	\$ 105,582
Net income	—	—	3,320	—	3,320
Unrealized loss on hedging instruments, net	—	—	—	(2,266)	(2,266)
Exercise of stock appreciation rights	46	—	—	—	—
Shares withheld for taxes	(13)	(116)	—	—	(116)
Share-based compensation	—	355	—	—	355
Balances, December 31, 2016	10,758	\$45,466	\$71,248	\$ (9,839)	\$ 106,875

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 July 2, 2016. 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 December 31, 2016 and December 26, 2015 were 13 and 26 week periods, respectively. Fiscal year 2017 will end on July 1, 2017, which is a 52 week year. Fiscal year 2016 which ended on July 2, 2016, was a 53 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, foreign currency swaps 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 term loan arrangement. The foreign currency forward contracts, foreign currency swaps and interest rate swap 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, foreign currency swaps and interest rate swap potentially expose the Company to credit risk to the extent the counterparty may be unable to meet the terms of the agreement. The Company minimizes such risk by seeking high quality counterparty. The Company's counterparty to the foreign currency forward contracts, foreign currency swaps and interest rate swap are major banking institutions. These institutions do not require collateral for the contracts, and the Company believes that the risk of the counterparty 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 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 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. 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 annual goodwill impairment analysis is performed as of the first day of the fourth quarter. 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 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 fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted. The Company adopted this guidance during the current quarter and it had no impact on our financial statements.

In February 2016, the FASB issued Accounting Standards Update 2016-02 (ASU 2016-02), Leases which supersedes ASC 840 Leases and creates a new topic, ASC 842 Leases. This update requires lessees to recognize a lease asset and a lease liability for all leases, including operating leases, with a term greater than 12 months on its balance sheet. The update also expands the required quantitative and qualitative disclosures surrounding leases. This update is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years, with earlier adoption permitted. This update will be applied using a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is currently evaluating the effect of this update on its consolidated financial statements.

In March 2016, the FASB issued Accounting Standards Update 2016-09 (ASU 2016-09), Improvements to Employee Share-Based Payment Accounting. This update simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This update is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with earlier adoption permitted. The Company prospectively adopted this ASU during the first quarter of fiscal year 2017. As a result, excess tax benefits are recorded in income tax expense instead of a component of shareholders' equity and excess tax benefits are no longer broken out on the consolidated statement of cash flows beginning in fiscal year 2017.

In August 2016, the FASB issued Accounting Standards Update 2016-15 (ASU 2016-15), Classification of Certain Cash Receipts and Cash Payments. This update provides guidance on how to record eight specific cash flow issues. This update is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted and a retrospective transition method to each period should be presented. The Company early adopted this guidance during the current quarter and it had no impact on our condensed consolidated financial statements.

3. Inventories

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

	December 31, 2016	July 2, 2016
Finished goods	\$ 13,005	\$ 13,384
Work-in-process	17,609	18,988
Raw materials and supplies	67,492	74,634
	\$ 98,106	\$ 107,006

4. Long-Term Debt

On September 3, 2014, the Company entered into a five-year term loan in the amount of \$35.0 million used to acquire all of the outstanding shares of CDR Manufacturing, Inc. (dba Ayrshire Electronics). The term loan requires quarterly payments of \$1.25 million through June 15, 2019 with a final payment of the remaining outstanding balance on August 31, 2019. The Company had an outstanding balance of \$23.8 million and \$26.3 million under the term loan as of December 31, 2016 and July 2, 2016, respectively.

On August 6, 2015, the Company entered into a First Amendment to the amended and restated credit agreement extending the limit on our line of credit facility to \$45.0 million as evidenced by the Second Replacement Revolving Note. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes. The line of credit is secured by substantially all of the assets of the Company and matures on August 31, 2019 at which time all outstanding balances are payable. As of December 31, 2016, the Company had an outstanding balance under the credit facility of \$18.9 million, \$0.4 million in outstanding letters of credit and \$25.7 million available for future borrowings. As of July 2, 2016, the Company had an outstanding balance under the credit facility of \$18.1 million, \$0.4 million in outstanding letters of credit and \$26.5 million available for future borrowings.

On December 28, 2016, the Company entered into an equipment term loan agreement in the amount of \$3.9 million in order to further invest in production equipment. The equipment term loan is collateralized by production equipment. Under this loan agreement, equal quarterly payments of approximately \$0.2 million will commence on March 31,

2017 and will continue through the maturity of the equipment term loan on June 30, 2021. The Company has available an additional \$2.1 million which can be borrowed in the future under this agreement.

Borrowings under the revolving line of credit, term loan and equipment term loan bear interest at either a “Base Rate” or a “Fixed Rate,” as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 1.75%, LIBOR plus 2.00%, or LIBOR plus 2.25% depending on the level of the Company’s trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The interest rates on outstanding debt as of December 31, 2016 range from 2.66% - 3.75% compared to 2.45% - 3.50% as of July 2, 2016.

Debt maturities as of December 31, 2016 for the next five years and thereafter are as follows (in thousands):

Fiscal Years Ending	Amount
2017 ⁽¹⁾	\$2,935
2018	5,871
2019	5,871
2020	31,051
2021	871
Total debt	\$46,599
Unamortized debt issuance costs	\$(135)
Long-term debt, net of debt issuance costs	\$46,464

(1) Represents scheduled payments for the remaining six-month period ending July 1, 2017.

The Company must comply with certain financial covenants, including a cash flow leverage ratio, an asset coverage ratio, and a fixed charge coverage ratio. The credit agreement requires the Company to maintain a minimum profit threshold, limits the maximum capital lease expenditures and restricts the Company from declaring or paying dividends in cash or stock without prior bank approval. The Company is in compliance with all financial covenants for all periods presented.

5. Trade Accounts Receivable Purchase Programs

Sale Programs

The Company utilizes an Account Purchase Agreement with Wells Fargo Bank, N.A. (“WFB”) which allows the Company to sell and assign to WFB and WFB may purchase from the Company the accounts receivable of certain Company customers in a maximum aggregate amount outstanding of \$20.0 million. The initial term of the agreement is set to mature in June 2017 and there are successive 12 month renewal periods available. The Company also has an Account Purchase Agreement with Orbian Financial Services (“Orbian”). This agreement allows the Company to sell accounts receivable of certain customers to Orbian and the agreement may be cancelled at any time by either party. Total accounts receivables sold during the six months ended December 31, 2016 and December 26, 2015 was approximately \$38.9 million and \$34.8 million, respectively. Accounts receivables sold and not yet collected were \$2.0 million and \$1.7 million as of December 31, 2016 and July 2, 2016, respectively. The receivables that were sold were removed from the condensed consolidated balance sheets and the cash received is reflected as cash provided by operating activities in the condensed consolidated statements of cash flows.

6. Income Taxes

The Company expects to repatriate a portion of its foreign earnings based on increased net sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company currently expects to repatriate approximately \$14.2 million of foreign earnings in the future. As such, these earnings would be recognized in the United States, and the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax of expected repatriation of foreign earnings have been recorded as part of deferred taxes as of December 31, 2016. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed assets purchases and improvements in foreign locations.

During the second quarter of fiscal year 2017, the Company signed a unilateral advance pricing agreement (APA) with the Large Taxpayer Division of Mexico’s Servicio de Administración Tributaria (SAT) under an elective framework that has been agreed to by the U.S. and Mexican authorities. The APA is part of a larger program affecting hundreds of U.S. companies with maquiladora operations in Mexico. The general impact of the APA is to increase margins between the maquiladora and U.S. parent company, shifting profits to Mexico from the U.S.

As a result of the APA, the Company anticipates that it will have an increased tax liability in Mexico of approximately \$0.4 million related to the calendar years 2014-2016. However, the increased costs to the U.S. will result in a reduced tax liability of approximately \$0.4 million in the U.S. during fiscal year 2017. The overall net impact of the APA is therefore estimated to not be material to the Company's consolidated financial results. The estimated increased liabilities in Mexico and related offsetting tax benefit in the U.S. have been recorded during the second quarter of fiscal year 2017. Currently, the Company anticipates that the APA will be finalized late in the third quarter of fiscal year 2017.

Further, the resulting impact of the APA resulted in approximately \$1.8 million of additional earnings being recognized in Mexico. The Company is currently reevaluating its repatriation assumptions but at this time, it is assumed that the amounts previously deemed permanently reinvested in Mexico may be sufficient to sustain future capital needs and growth in Mexico. As such, the entire \$1.8 million is expected to be repatriated in the future. The Company has available approximately \$7.1 million of gross federal research and development tax credits as of December 31, 2016. ASC 740 requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. Accordingly, as of December 31, 2016, the Company has recorded \$3.8 million of unrecognized tax benefits associated with these federal tax credits, resulting in a net deferred tax benefit of approximately \$3.3 million.

7. Earnings Per Share

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

	Three Months Ended	
	(in thousands, except per share information)	
	December 31, 2016	December 26, 2015
Net income	\$ 1,528	\$ 1,787
Weighted average shares outstanding—basic	10,758	10,710
Effect of dilutive common stock awards	210	708
Weighted average shares outstanding—diluted	10,968	11,418
Net income per share—basic	\$ 0.14	\$ 0.17
Net income per share—diluted	\$ 0.14	\$ 0.16
Antidilutive SARs not included in diluted earnings per share	892	456
	Six Months Ended	
	(in thousands, except per share information)	
	December 31, 2016	December 26, 2015
Net income	\$ 3,320	\$ 2,604
Weighted average shares outstanding—basic	10,753	10,708
Effect of dilutive common stock awards	166	571
Weighted average shares outstanding—diluted	10,919	11,279
Earnings per share—basic	\$ 0.31	\$ 0.24
Earnings per share—diluted	\$ 0.30	\$ 0.23
Antidilutive SARs not included in diluted earnings per share	892	456

8. Share-based Compensation

The Company's incentive plan provides for equity and liability awards to employees and non-employee directors in the form of stock options, stock appreciation rights (SARs), restricted stock, restricted stock units, stock awards, stock units, performance shares, performance units, and other stock-based or cash-based awards. Compensation cost is recognized on a straight-line basis over the requisite employee service period, which is generally the vesting period, and is recorded as employee compensation expense in cost of goods sold, research, development and engineering, and selling, general and administrative expenses. Share-based compensation is recognized only for those awards that are expected to vest, with forfeitures estimated at the date of grant based on historical experience and future expectations. In addition to service conditions, SARs contain a performance condition. The additional performance condition is based upon the achievement of Return on Invested Capital (ROIC) goals relative to a peer group. All awards with performance conditions are evaluated quarterly to determine the likelihood that performance metrics will be achieved during the performance period. These awards are charged to compensation expense over the requisite service period based on the number of shares expected to vest. The SARs cliff vest after a three-year period from date of grant and expire five years from date of grant.

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

	October 28, 2016	July 26, 2016	July 29, 2015
SARs Granted	10,000	242,500	248,166
Strike Price	\$ 8.04	\$ 8.18	\$ 10.26
Fair Value	\$ 2.30	\$ 2.42	\$ 3.65

Total share-based compensation expense recognized during the three months ended December 31, 2016 and December 26, 2015 was approximately \$158,000 and \$237,000, respectively. Total share-based compensation expense recognized during the six months ended December 31, 2016 and December 26, 2015 was approximately \$355,000 and \$426,000, respectively. As of December 31, 2016, total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately \$1.1 million. This expense is expected to be recognized over a weighted average period of 1.92 years.

SARs exercised during the three months ended December 31, 2016 and December 26, 2015 were 15,000 and 10,000, respectively, with an immaterial amount of intrinsic value. SARs exercised during the six months ended December 31, 2016 and December 26, 2015 were 117,000 and 13,333, respectively. There was approximately \$367,000 of intrinsic value for SARs exercised during the six months ended December 31, 2016, compared to an immaterial amount during the six months ended December 26, 2015.

9. Commitments and Contingencies

Litigation and Other Matters

The Company is party to certain lawsuits or claims in the ordinary course of business. During the second quarter of fiscal year 2017, the Company commenced the arbitration process with a former customer and certain vendors related to amounts we believe should be reimbursed by this former customer based on the terms of the manufacturing agreement. A range for possible outcomes cannot be determined at this time. The Company has not accrued for any potential loss related to this claim and legal costs are being expensed as incurred. The ultimate disposition of these matters could have a material adverse effect on our consolidated financial position, results of operations or cash flows.

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 \$50,000 and \$30,000 as of December 31, 2016 and July 2, 2016, respectively.

10. Fair Value Measurements

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

The following table summarizes the fair value of assets (liabilities) of the Company's derivatives that are required to be measured on a recurring basis as of December 31, 2016 and July 2, 2016 (in thousands):

	December 31, 2016			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Liabilities:				
Interest rate swap	\$—	\$(208)	\$—	\$(208)
Foreign currency forward contracts & swaps	\$—	\$(14,699)	\$—	\$(14,699)
	July 2, 2016			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts & swaps	\$—	\$136	\$—	\$136
Financial Liabilities:				
Interest rate swap	\$—	\$(498)	\$—	\$(498)
Foreign currency forward contracts & swaps	\$—	\$(11,112)	\$—	\$(11,112)

The Company currently has forward contracts and swaps to hedge known future cash outflows for expenses denominated in the Mexican peso and an interest rate swap to mitigate risk associated with certain borrowings under the Company's debt arrangement. 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 loss, as they qualify for hedge accounting.

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at December 31, 2016 and July 2, 2016, reasonably approximate their fair value. The Company's long-term debt primarily consists of a revolving line of credit, a term loan and an equipment term loan. Borrowings under the revolving line of credit bear interest at either a "Base Rate" or a "Fixed Rate," as elected by the Company. Each of these rates is a variable floating rate dependent upon current market conditions and the Company's current credit risk as discussed in footnote 4.

As a result of the determinable market rate for our revolving line of credit, term loan and equipment term loan, they are classified within Level 2 of the fair value hierarchy. The discounted cash flow of the revolving line of credit is estimated to be \$18.9 million and \$18.1 million as of December 31, 2016 and July 2, 2016, respectively, with a carrying value that reasonably approximates the fair value. The discounted cash flow of the term loan is estimated to be \$23.8 million as of December 31, 2016 and \$26.3 million as of July 2, 2016, respectively, with a carrying value that reasonably approximates the fair value. The discounted cash flow of the equipment term loan is estimated to be \$3.9 million as of December 31, 2016, with a carrying value that reasonably approximates the fair value. As of July 2, 2016, the Company did not have a balance under the equipment term loan.

11. Derivative Financial Instruments

As of December 31, 2016, the Company had outstanding foreign currency forward contracts and swaps with a total notional amount of \$65.9 million. The maturity dates for these contracts and swaps extend through September 2019. For the three months ended December 31, 2016, the Company entered into foreign currency forward contracts of \$6.7 million and settled \$5.0 million of such contracts. During the same period of the previous year, the Company did not enter into any foreign currency forward contracts and settled \$5.2 million of such contracts.

For the six months ended December 31, 2016, the Company entered into foreign currency forward contracts of \$6.7 million and settled \$10.2 million of such contracts. During the same period of the previous year, the Company entered into foreign currency forward contracts of \$12.0 million and settled \$10.6 million of such contracts.

On October 1, 2014, the Company entered into an interest rate swap contract with an effective date of September 1, 2015 and a termination date of September 3, 2019, with a notional amount of \$25.0 million related to the borrowings outstanding under the term loan. This interest rate swap pays the Company variable interest at the one month LIBOR rate, and the Company pays the counter party a fixed interest rate. The fixed interest rate for the contract is 1.97% that replaces the one month LIBOR rate component of our contractual interest to be paid to WFB as part of our term loan. Based on the terms of the interest rate swap contract and the underlying borrowings outstanding under the term loan, the interest rate contract was determined to be effective, and thus qualifies as a cash flow hedge.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheet as of December 31, 2016 and July 2, 2016 (in thousands):

Derivatives Designated as Hedging Instruments	Balance Sheet Location	December 31, 2016	July 2, 2016
		Fair Value	Fair Value
Foreign currency forward contracts & swaps	Other long-term assets	\$ —	\$ 136
Foreign currency forward contracts & swaps	Other current liabilities	\$(7,045)	\$(4,670)
Foreign currency forward contracts & swaps	Other long-term liabilities	\$(7,654)	\$(6,442)
Interest rate swap	Other current liabilities	\$(161)	\$(264)
Interest rate swap	Other long-term liabilities	\$(47)	\$(234)

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the three months ended December 31, 2016 and December 26, 2015, respectively (in thousands):

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of October 1, 2016	Effective Portion Recorded in AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 31, 2016
Forward contracts & swaps	Cost of sales	\$(8,325)	\$(2,717)	\$ 1,341	\$(9,701)
Interest rate swap	Interest expense	(248)	42	68	(138)
Total		\$(8,573)	\$(2,675)	\$ 1,409	\$(9,839)

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of September 26, 2015	Effective Portion Recorded in AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 26, 2015
Forward contracts & swaps	Cost of sales	\$(7,336)	\$(357)	\$ 924	\$(6,769)
Interest rate swap	Interest expense	(407)	5	115	(287)
Total		\$(7,743)	\$(352)	\$ 1,039	\$(7,056)

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the six months ended December 31, 2016 and December 26, 2015, respectively (in thousands):

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of July 2, 2016	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 31, 2016
Forward contracts & swaps	Cost of sales	\$ (7,245)	\$ (4,906)	\$ 2,450	\$ (9,701)
Interest rate swap	Interest expense	(328)	41	149	(138)
Total		\$ (7,573)	\$ (4,865)	\$ 2,599	\$ (9,839)

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of June 27, 2015	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of December 26, 2015
Forward contracts & swaps	Cost of sales	\$ (4,487)	\$ (3,890)	\$ 1,608	\$ (6,769)
Interest rate swap	Interest expense	(276)	(126)	115	(287)
Total		\$ (4,763)	\$ (4,016)	\$ 1,723	\$ (7,056)

As of December 31, 2016, the net amount of unrealized loss expected to be reclassified into earnings within the next 12 months is approximately \$4.8 million. As of December 31, 2016, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

12. Goodwill and Other Intangible Assets

The Company recorded goodwill in connection with the Ayrshire and Sabre acquisitions resulting primarily from the synergies that resulted from the Company's acquisitions and the assembled workforce. The goodwill from the acquisitions is not deductible for tax purposes.

During the six months ended December 31, 2016 and December 26, 2015, no impairment was recognized. Goodwill was recorded at \$10.0 million as of December 31, 2016 and July 2, 2016.

The components of acquired intangible assets are as follows (in thousands):

		December 31, 2016		
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:				
Non-Compete Agreements	3 - 5	\$ 568	\$ (413)	\$ 155
Customer Relationships	10	4,803	(1,350)	3,453
Favorable Lease Agreements	4 - 7	2,941	(1,185)	1,756
Total		\$ 8,312	\$ (2,948)	\$ 5,364
		July 2, 2016		
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:				
Non-Compete Agreements	3 - 5	\$ 568	\$ (343)	\$ 225
Customer Relationships	10	4,803	(1,110)	3,693
Favorable Lease Agreements	4 - 7	2,941	(931)	2,010
Total		\$ 8,312	\$ (2,384)	\$ 5,928

Amortization expense was approximately \$282,000 for both the three months ended December 31, 2016 and December 26, 2015. Amortization expense was approximately \$564,000 for both the six months ended December 31, 2016 and December 26, 2015.

Aggregate amortization expense relative to existing intangible assets by fiscal year is currently estimated to be as follows (in thousands):

Fiscal Years Ending	Amount
2017 ⁽¹⁾	\$ 564
2018	1,073
2019	818
2020	783
2021	784
Thereafter	1,342
Total amortization expense	\$ 5,364

(1) Represents estimated amortization for the remaining six-month period ending July 1, 2017.

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 (EMS) and solutions to original equipment manufacturers of a broad range of products including consumer products, communications, medical, defense, automotive, electronics, gaming, industrial and computer markets. We provide engineering services, worldwide procurement and distribution, materials management, world-class manufacturing and assembly services, in-house testing, and unparalleled customer service. Our combined capabilities and vertical integration are proving to be a desirable offering to our expanded customer base.

Our international production capability provides our customers with benefits of improved supply-chain management, reduced inventories, lower transportation costs, and reduced product fulfillment time. We continue to make investments in all of our operating facilities to give us the production capacity, capabilities and logistical advantages to continue to win new business. The following information should be read in conjunction with the consolidated financial statements included herein and with Part II Item 1A, Risk Factors included as part of this filing.

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

Acquisitions

On September 3, 2014, we completed the acquisition of all the outstanding shares of CDR Manufacturing, Inc. (dba Ayrshire Electronics), which added five locations (four in North America and one in Mexico). This acquisition expanded our printed circuit board assembly capacity, total revenue, and added to and diversified our customer base with the addition of many new multi-national companies. Subsequent to the acquisition, the Reynosa, Mexico operations were transferred to the Company’s existing Juarez, Mexico facilities. During the second quarter of fiscal year 2017, we closed the Harrodsburg, Kentucky facility in order to improve operating efficiencies. The remaining programs from the Kentucky facility have been transferred to other facilities.

Executive Summary

During the second quarter of fiscal year 2017, our new programs continued to ramp, more than offsetting a modest slowdown in demand from a few longstanding customers, which is consistent with EMS industry-wide experience. At the same time, we captured significant new business from other EMS competitors, including established programs that may begin generating revenue before the end of fiscal year 2017. We recently won new programs involving inventory automation systems and commercial lighting. Moving into the third quarter, we continue to see a robust pipeline of potential new business and our new programs continue to ramp, effectively offsetting softening sales demand in some current programs. In preparation for future growth, we continue to invest in expanding our SMT, sheet metal and plastic molding capabilities.

The concentration of our top three customers’ net sales increased to 33.8 percent of total sales in the second quarter of fiscal year 2017 from 30.5 percent in the same period of the prior fiscal year.

Net 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 net sales to our significant customers and most contracts with customers are not firm long-term purchase commitments. We seek to maintain flexibility in production capacity by employing skilled temporary and short-term labor and by utilizing short-term leases on equipment and manufacturing facilities. In addition, our capacity and core competencies for printed circuit board assemblies, precision molding, sheet metal fabrication, tool making, assembly, and engineering can be applied to a wide variety of products.

Gross profit as a percent of net sales was 8.1 percent for the second quarter of fiscal year 2017 as compared to 7.8 percent for the same quarter of the prior fiscal year. The increase in gross profit as a percentage of net sales was due to a decrease in certain material related costs in the current period which were partially offset by an increase in overhead costs as a percentage of net sales.

Operating income as a percentage of net sales was 2.1 percent for both the second quarter of fiscal year 2017 and the second quarter of the prior fiscal year.

Net income for the second quarter of fiscal year 2017 was \$1.5 million or \$0.14 per share, as compared to net income of \$1.8 million or \$0.16 per share for the second quarter of fiscal year 2016. The decrease in net income for the second quarter of fiscal year 2017 as compared to the same period in fiscal year 2016 was primarily attributable to a reduction in income tax expense during the prior year comparable quarter due to the recognition of certain federal R&D credits which became available to the Company as a result of the PATH Act being signed into law during December 2015.

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

For the third quarter of fiscal year 2017, the Company expects to report revenue in the range of \$115 million to \$120 million, and earnings in the range of \$0.11 to \$0.16 per diluted share. These expected results assume an effective tax rate of 20%. Future results will depend on actual levels of customers' orders and the timing of the startup of production of new product programs.

We maintain a strong balance sheet with a current ratio of 2.2 and a debt to equity ratio of 0.4 as of December 31, 2016. Total cash provided by operating activities as defined on our cash flow statement was \$3.1 million for the six months ended December 31, 2016. We maintain sufficient liquidity for our expected future operations and had \$18.9 million in borrowings on our \$45.0 million revolving line of credit with Wells Fargo Bank, N.A. of which \$25.7 million remained available at December 31, 2016. We believe cash flows generated from operations, our borrowing capacity, and leasing opportunities should provide adequate capital for planned growth.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

Inactive, Obsolete, and Surplus Inventory Reserve

Revenue Recognition

Allowance for Doubtful Accounts

Accrued Warranty

Income Taxes

Share-Based Compensation

Impairment of Long-Lived Assets

Derivatives and Hedging Activity

Long-Term Incentive Compensation Accrual

Impairment of Goodwill

Business Combinations

Contingent Liabilities

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 2, 2016, for further details.

RESULTS OF OPERATIONS

Comparison of the Three Months Ended December 31, 2016 with the Three Months Ended December 26, 2015
The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes.

The following table sets forth certain information regarding the components of our condensed consolidated statements of income for the three months ended December 31, 2016 as compared to the three months ended December 26, 2015. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended		Three Months Ended		\$ change	% point change
	December 31, 2016	% of net sales	December 26, 2015	% of net sales		
Net sales	\$118,517	100.0 %	\$116,403	100.0 %	\$2,114	— %
Cost of sales	108,905	91.9 %	107,293	92.2 %	1,612	(0.3)%
Gross profit	9,612	8.1 %	9,110	7.8 %	502	0.3 %
Research, development and engineering	1,603	1.4 %	1,506	1.3 %	97	0.1 %
Selling, general and administrative	5,462	4.6 %	5,201	4.4 %	261	0.2 %
Total operating expenses	7,065	6.0 %	6,707	5.7 %	358	0.3 %
Operating income	2,547	2.1 %	2,403	2.1 %	144	— %
Interest expense, net	552	0.4 %	521	0.5 %	31	(0.1)%
Income before income taxes	1,995	1.7 %	1,882	1.6 %	113	0.1 %
Income tax provision	467	0.4 %	95	0.1 %	372	0.3 %
Net income	\$1,528	1.3 %	\$1,787	1.5 %	\$(259)	(0.2)%
Effective income tax rate	23.4 %		5.0 %			

Net Sales

Net sales of \$118.5 million for the second quarter of fiscal year 2017 increased by 1.8 percent as compared to net sales of \$116.4 million for the second quarter of fiscal year 2016.

The \$2.1 million increase in net sales from the prior year period was driven by new program wins, partially offset by a decrease in net sales from the former longstanding customer which has been discussed in prior quarters.

Gross Profit

Gross profit as a percentage of net sales for the three months ended December 31, 2016 was 8.1 percent compared to 7.8 percent for the three months ended December 26, 2015. This 0.3 percentage point increase was due to a decrease in material related costs partially offset by an increase in certain overhead costs as a percentage of net sales. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter. Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately \$251,000 and \$110,000 for obsolete inventory during the three months ended December 31, 2016 and December 26, 2015, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated net realizable value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were \$1.6 million and \$1.5 million during the three months ended December 31, 2016 and December 26, 2015, respectively. Total RD&E expenses as a percent of net sales were 1.4 percent and 1.3 percent during the three months ended December 31, 2016 and December 26, 2015, respectively. This 0.1 percent increase in RD&E as a percentage of net sales is due to an increase in personnel costs during the three months ended December 31, 2016.

Total selling, general and administrative (SG&A) expenses were \$5.5 million during the three months ended December 31, 2016 compared to \$5.2 million during the three months ended December 26, 2015. Total SG&A expenses as a percentage of net sales were 4.6 percent during the three months ended December 31, 2016 compared to 4.4 percent during the three months ended December 26, 2015. This 0.2 percent increase as a percentage of net sales is primarily attributable to an increase in personnel costs during three months ended December 31, 2016.

Interest

Interest expense increased to \$552,000 during the three months ended December 31, 2016 from \$521,000 during the three months ended December 26, 2015. The increase in interest expense is primarily related to an increase in the average balance outstanding on our line of credit that was primarily used to fund capital expenditures in our facilities.

Income Taxes

The effective tax rate for the three months ended December 31, 2016 was 23.4 percent compared to 5.0 percent for the three months ended December 26, 2015. The increase is primarily attributable to the discrete benefit recognized in the prior year quarter associated with federal research and development tax credits.

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

RESULTS OF OPERATIONS

Comparison of the Six Months Ended December 31, 2016 with the Six Months Ended December 26, 2015

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 December 31, 2016 as compared to the six months ended December 26, 2015. It is provided to assist in assessing differences in our overall performance (in thousands):

	Six Months Ended					
	December 31, 2016	% of net sales	December 26, 2015	% of net sales	\$ change	% point change
Net sales	\$235,652	100.0 %	\$242,612	100.0 %	\$(6,960)	— %
Cost of sales	216,331	91.8 %	224,583	92.6 %	(8,252)	(0.8) %
Gross profit	19,321	8.2 %	18,029	7.4 %	1,292	0.8 %
Research, development and engineering	3,187	1.3 %	3,062	1.3 %	125	— %
Selling, general and administrative	10,797	4.6 %	10,784	4.4 %	13	0.2 %
Total operating expenses	13,984	5.9 %	13,846	5.7 %	138	0.2 %
Operating income	5,337	2.3 %	4,183	1.7 %	1,154	0.6 %
Interest expense, net	1,141	0.5 %	1,054	0.4 %	87	0.1 %
Income before income taxes	4,196	1.8 %	3,129	1.3 %	1,067	0.5 %
Income tax provision	876	0.4 %	525	0.2 %	351	0.2 %
Net income	\$3,320	1.4 %	\$2,604	1.1 %	\$716	0.3 %
Effective income tax rate	20.9 %		16.8 %			

Net Sales

Net sales of \$235.7 million for the six months ended December 31, 2016 decreased by 2.9 percent as compared to net sales of \$242.6 million for the six months ended December 26, 2015.

The decrease in net sales from the prior year period was primarily driven by a decrease in net sales from the former longstanding customer which has been discussed in prior quarters, partially offset by an increase in new program wins and an increase in demand from current customers.

Gross Profit

Gross profit as a percentage of net sales for the six months ended December 31, 2016 was 8.2 percent compared to 7.4 percent for the six months ended December 26, 2015. This 0.8 percentage point increase is primarily related to a decrease in material related costs partially offset by an increase in certain overhead costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately \$306,000 and \$515,000 for obsolete inventory during the six months ended December 31, 2016 and December 26, 2015, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were \$3.2 million and \$3.1 million during the six months ended December 31, 2016 and December 26, 2015, respectively. Total RD&E expenses as a percent of net sales were 1.3 percent during the six months ended December 31, 2016 and December 26, 2015, respectively.

Total selling, general and administrative (SG&A) expenses were \$10.8 million during the six months ended December 31, 2016 and December 26, 2015, respectively. Total SG&A expenses as a percentage of net sales were 4.6 percent during the six months ended December 31, 2016 compared to 4.4 percent during the six months ended December 26, 2015. This 0.2 percentage point increase in SG&A is primarily related to a decrease in revenue during the six months ended December 31, 2016.

Interest

Interest expense was \$1.1 million during the six months ended December 31, 2016 and December 26, 2015, respectively.

Income Taxes

The effective tax rate for the six months ended December 31, 2016 was 20.9 percent compared to 16.8 percent for the same period in fiscal year 2016. The effective tax rate increased from the prior year primarily due to the recognition of certain federal R&D credits during the second quarter of fiscal 2016 which became available to the Company as a result of PATH Act of 2015 being signed into law by the President during December 2015. For further information on taxes see footnote 6 of the "Notes to Consolidated Financial Statements."

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

BACKLOG

On December 31, 2016, we had an order backlog of approximately \$133.4 million. This compares with a backlog of approximately \$123.3 million on December 26, 2015. The increase in backlog at December 31, 2016, when compared to December 26, 2015, reflects an increase in new customers partially offset by a decrease in demand. 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 net sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash provided by operating activities for the six months ended December 31, 2016 was \$3.1 million, compared to net cash provided by operating activities of \$3.3 million during the same period of the prior fiscal year.

The \$3.1 million of net cash provided by operating activities for the six months ended December 31, 2016 is primarily related to \$3.3 million in net income for the period adjusted for \$3.4 million of depreciation and amortization as well as a decrease in inventory of \$8.6 million partially offset by an increase in trade receivables of \$4.8 million and a decrease in accounts payable of \$7.8 million. This compares to \$3.3 million of net cash flows provided by operating activities for the six months ended December 26, 2015, which resulted primarily from net income of \$2.6 million adjusted for \$3.0 million of depreciation and amortization and a \$12.0 million decrease in trade receivables, partially offset by a \$6.8 million increase in inventory, a \$4.7 million decrease in accounts payable, and a \$2.1 million decrease in accrued compensation and vacation.

Accounts receivable fluctuates based on the timing of shipments, terms offered and collections that occurred during the quarter. While overall net sales are not typically seasonal in nature, we ship the majority of our product during the latter half of the quarter. In addition, accounts receivable will fluctuate based upon the amount of accounts receivable sold under our trade accounts receivable purchase programs. During the six months ended December 31, 2016 and December 26, 2015, we factored accounts receivable of \$38.9 million and \$34.8 million, respectively, which were removed from our Consolidated Balance Sheets. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases and negotiated supplier terms.

Investing Cash Flow

Cash used in investing activities was \$4.8 million during the six months ended December 31, 2016 as compared to \$1.4 million during the six months ended December 26, 2015. Our primary investing activity during the six months ended December 31, 2016 was purchasing equipment to support increased production levels for new programs. Our primary investing activities during the six months ended December 26, 2015 was the purchase of equipment to support increased production levels for new programs as well as the sale and leaseback of equipment.

Operating and capital leases are often utilized when potential technical obsolescence and funding requirement advantages outweigh the benefits of equipment ownership. Capital expenditures and periodic lease payments are expected to be financed with internally generated funds as well as our revolving line of credit facility and equipment term loan. During the six months ended December 31, 2016, we did not enter into any sales and leaseback transactions. During the same period of the prior year we received \$6.2 million of cash from a sale and leaseback transaction.

Financing Cash Flow

Cash provided by financing activities was \$2.0 million during the six months ended December 31, 2016 as compared to cash used in financing activities of \$1.1 million in the same period of the previous fiscal year. Our primary financing activities during the six months ended December 31, 2016 was the funding of a \$3.9 million equipment term loan, repayments on our term loan of \$2.5 million and borrowings and repayments under our revolving line of credit facility. Our primary financing activities during the six months ended December 26, 2015 were repayments on our term loan of \$2.5 million as well as borrowings and repayments under our revolving line of credit facility. Our credit agreement with Wells Fargo Bank N.A. provides a revolving line of credit facility of up to \$45.0 million, subject to availability.

As of December 31, 2016, we were in compliance with our loan covenants and approximately \$25.7 million was available under the revolving line of credit facility. As of December 26, 2015, approximately \$31.9 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. As of December 31, 2016, we had approximately \$1.3 million of cash held by foreign subsidiaries. If cash is to be repatriated in the future from these foreign subsidiaries, the Company could be subject to additional income taxes payable in the U.S. The total

amount of tax payments required for the amount of foreign subsidiary cash on hand as of December 31, 2016 would approximate \$130,000. We have accrued for expected future repatriation of foreign earnings as discussed in footnote 6 of the “Notes to Consolidated Financial Statements.”

OFF-BALANCE SHEET ARRANGEMENTS AND 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 2, 2016. There have been no material changes in contractual obligations outside the ordinary course of business since July 2, 2016.

RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

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

We may experience fluctuations in quarterly results of operations.

Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global macroeconomic environment, volatility in overall demand for our customers’ products, success of customers’ programs, timing of new programs, new product introductions or technological advances by us, our customers and our competitors, and changes in pricing policies by us, our customers, our suppliers, and our competitors. Our customer base is diverse in the markets they serve, however, decreases in demand 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. Conversely, our customers may abruptly lower or cancel production which may lead to a sudden, unexpected increase in inventory or accounts receivable for which we may not be reimbursed even when under contract with our customers. In addition, because many of our operating expenses are relatively fixed, a reduction in customer demand can harm our gross profit and operating results. The products which we manufacture for our customers have relatively short product lifecycles. Therefore, our business, operating results and financial condition are dependent in a significant way on our ability to obtain orders from new customers and new product programs from existing customers.

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

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

Adverse economic conditions and uncertainty in the global economy such as unstable global financial and credit markets, inflation and recession can negatively impact our business. Unfavorable economic conditions could affect the demand for our customers’ products by triggering a reduction in orders as well as a decline in forecasts which could adversely affect our net sales in future periods. Additionally, the financial strength of our customers and suppliers and their ability to obtain and rely on credit financing may affect their ability to fulfill their obligations to us and have an adverse effect on our financial results.

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

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

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

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

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

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

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

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

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

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

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

Our operations may be subject to certain risks.

We manufacture product in facilities located in Mexico, China and the United States. These operations may be subject to a number of risks, including:

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

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

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.

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Fluctuations in foreign currency exchange rates could increase our operating costs.

We have manufacturing operations located in Mexico and China. A significant portion of our operations are denominated in the Mexican peso and the Chinese currency, the renminbi (“RMB”). Currency exchange rates fluctuate daily as a result of a number of factors, including changes in a country’s political and economic policies. Volatility in the currencies of our entities and the United States dollar could seriously harm our business, operating results and financial condition. The primary impact of currency exchange fluctuations is on the cash, receivables, payables and expenses of our operating entities. As part of our hedging strategy, we currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. We currently do not hedge expenses denominated in RMB. Unexpected losses could occur from increases in the value of these currencies relative to the United States dollar.

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

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

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

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

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

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

Customers may change production timing and demand schedules which makes it difficult for us to schedule production and capital expenditures and to maximize the efficiency of our manufacturing capacity.

Changes in demand for customer products reduce our ability to accurately estimate the future requirements of our customers. This makes it difficult to schedule production and maximize utilization of our manufacturing capacity. We must determine the levels of business that we will seek and accept from customers, set production schedules, commit to procuring inventory, and allocate personnel and resources, based on our estimates of our customers’ requirements. Customers can require sudden increases and decreases in production which can put added stress on resources and reduce margins. Sudden decreases in production can lead to excess inventory on hand which may or may not be reimbursed by our customers even when under contract.

Continued growth could further lead to capacity constraints. We may need to transfer production to other facilities, acquire new facilities, or outsource production which could negatively impact gross margin.

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

We are exposed to interest rate risk under our revolving line of credit and term loan. We currently hedge a portion of our term loan with an interest rate swap. We have not historically hedged the interest rate on our credit facility;

therefore, unless we do so, significant changes in interest rates could adversely affect our results of operations. Refer to the discussion in note 4, “Long-Term Debt” to the consolidated financial statements for further details of our debt obligations. We are also exposed to interest rate risk on our factoring activities.

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

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

Our stock price is volatile.

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

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

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

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

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

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

We manufacture and design products to our customers' specifications, and, in some cases, our manufacturing processes and facilities may need to comply with applicable statutory and regulatory requirements. For example, medical devices that we manufacture or design, as well as the facilities and manufacturing processes that we use to produce them, are regulated by the Food and Drug Administration and non-U.S. counterparts of this agency. In addition, our customers' products and the manufacturing processes that we use to produce them often are highly complex. As a result, products that we manufacture may at times contain manufacturing or design defects, and our manufacturing processes may be subject to errors or not be in compliance with applicable statutory and regulatory requirements.

Defects in the products we manufacture or design, whether caused by a design, manufacturing or component failure or error, or deficiencies in our manufacturing processes, may result in delayed shipments to customers or reduced or canceled customer orders. If these defects or deficiencies are significant, our business reputation may also be damaged. The failure of the products that we manufacture or our manufacturing processes and facilities to comply with applicable statutory and regulatory requirements may subject us to legal fines or penalties and, in some cases, require us to shut down or incur considerable expense to correct a manufacturing process or facility. Our customers are required to indemnify us against liability associated with designing products to meet their specifications. However, if our customers are responsible for the defects, they may not, or may not have resources to, assume responsibility for

any costs or liabilities arising from these defects, which could expose us to additional liability claims.

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Energy price increases may negatively impact our results of operations.

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

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

We rely on information technology networks and systems to process, transmit and store electronic information. In particular, we depend on our information technology infrastructure for a variety of functions, including worldwide financial reporting, inventory management, procurement, invoicing and email communications. Any of these systems may be susceptible to outages due to fire, floods, power loss, telecommunications failures, terrorist attacks and similar events. Despite the implementation of network security measures, our systems and those of third parties on which we rely may also be vulnerable to computer viruses, break-ins and similar disruptions. If we or our vendors are unable to prevent such outages and breaches, our operations could be disrupted.

We are involved in various legal proceedings.

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

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

As a result of our increased market capitalization as of the end of our second quarter of fiscal year 2013, we are required to file as an accelerated filer. As such, we are subject to additional requirements contained in the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) and more recently the Dodd-Frank Act. The Sarbanes-Oxley and Dodd-Frank Acts required or will require changes in some of our corporate governance, securities disclosure and compliance practices. In response to the requirements of the Sarbanes-Oxley and Dodd-Frank Acts, the SEC and NASDAQ promulgated new rules and additional rulemaking is expected in the future. Compliance with these new rules and future rules has increased and may increase further our legal, financial and accounting costs as well as a potential risk of noncompliance. Absent significant changes in related rules, which we cannot assure, we anticipate some level of increased costs related to these new regulations to continue indefinitely. We also expect these developments to make it more difficult and more expensive to obtain director and officer liability insurance, and we may be forced to accept reduced coverage or incur substantially higher costs to obtain coverage. Likewise, these developments may make it more difficult for us to attract and retain qualified members of our Board of Directors or qualified management personnel. Further, the costs associated with the compliance with and implementation of procedures under these and future laws and related rules could have a material impact on our results of operations. In addition, the costs associated with noncompliance with additional securities laws and regulations could also impact our business.

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

Any current or future acquisitions may require additional equity financing, which could be dilutive to our existing shareholders, or additional debt financing, which could potentially affect our credit ratings. Any downgrades in our credit ratings associated with an acquisition could adversely affect our ability to borrow by resulting in more restrictive borrowing terms. To integrate acquired businesses, we must implement our management information systems, operating systems and internal controls, and assimilate and manage the personnel of the acquired operations. The integration of acquired businesses may be further complicated by difficulties managing operations in

geographically dispersed locations. The integration of acquired businesses may not be successful and could result in disruption by diverting management's attention from the core business. In addition, the integration of acquired businesses may require that we incur significant restructuring charges or other increases in our expenses and working capital requirements, which reduce our return on invested capital.

Acquisitions may involve numerous other risks and challenges including but not limited to: potential loss of key employees and customers of the acquired companies; the potential for deficiencies in internal controls at acquired companies; lack of experience operating in the geographic market or industry sector of the acquired business; constraints on available liquidity, and exposure to unanticipated liabilities of acquired companies. These and other factors could harm our ability to achieve anticipated levels of profitability at acquired operations or realize other anticipated benefits of an acquisition, and could adversely affect our consolidated business and operating results. Our goodwill and identifiable intangible assets could become impaired, which could reduce the value of our assets and reduce net income in the year in which the write-off occurs.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. The Company also ascribes value to certain identifiable intangible assets, which consists of customer relationships, non-compete agreements, and favorable leases, as a result of the acquisitions of Sabre and Ayrshire. The Company may incur impairment charges on goodwill or identifiable intangible assets if it determines that the fair values of goodwill or identifiable intangible assets are less than their current carrying values. The Company evaluates, on a regular basis, whether events or circumstances have occurred that indicate all, or a portion, of the carrying amount of goodwill may no longer be recoverable, in which case an impairment charge to earnings would become necessary. Refer to Notes 2 and 12 to the consolidated financial statements and 'critical accounting policies and estimates' in management's discussion and analysis of financial condition and results of operations for further discussion regarding the impairment testing of goodwill and identifiable intangible assets.

A decline in general economic conditions or global equity valuations could impact the judgments and assumptions about the fair value of the Company's businesses and the Company could be required to record impairment charges on its goodwill or other identifiable intangible assets in the future, which could impact the Company's consolidated balance sheet, as well as the Company's consolidated statement of operations. If the Company was required to recognize an impairment charge in the future, the charge would not impact the Company's consolidated cash flows, current liquidity, capital resources, and covenants under its existing credit facilities.

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, term loan and equipment term loan are secured by substantially all of our assets. The interest rates applicable to our revolving credit facility, term loan and equipment term loan fluctuate with the Wells Fargo Bank, N.A. prime rate and LIBOR rates. There was outstanding \$18.9 million in borrowings under our revolving credit facility, \$23.8 million outstanding on our term loan and \$3.9 million outstanding on our equipment term loan as of December 31, 2016. 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 and term loans.

During the second quarter of fiscal year 2015, we entered into an interest rate swap contract with a notional amount of \$25.0 million related to the borrowings outstanding under the term loan. As of December 31, 2016, the remaining notional amount of the interest rate swap contract was \$17.5 million. Our only material interest rate risk is associated with our revolving credit facility, term loan and equipment term loan. Through the use of the interest rate swap, as described above, we fixed the basis on which we pay interest on our term loan, thus eliminating some of our interest rate risk. See Note 11 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

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 and swaps to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There was outstanding \$65.9 million of foreign currency forward contracts and swaps as of December 31, 2016. The fair value of these contracts and swaps was \$(14.7) million. See Note 11 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 4. Controls and Procedures

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company’s Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of December 31, 2016, the Company’s disclosure controls and procedures are effective based on that criteria.

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

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during the three months ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)).

PART II. OTHER INFORMATION:

Item 1. Legal Proceedings

We are involved in various legal actions arising in the ordinary course of business. During the second quarter of fiscal year 2017, the Company commenced the arbitration process with a former customer and certain vendors related to amounts we believe should be reimbursed by this former customer based on the terms of the manufacturing agreement. A range for possible outcomes cannot be determined at this time. The Company has not accrued for any potential loss related to this claim and legal costs are being expensed as incurred. The ultimate disposition of these matters could 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 2, 2016.

Item 6. Exhibits

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

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

SIGNATURES

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

KEY TRONIC CORPORATION

/s/ CRAIG D. GATES

Craig D. Gates

President and Chief Executive Officer

(Principal Executive Officer)

Date: February 9, 2017

/s/ Brett R. Larsen

Brett R. Larsen

Executive Vice President of Administration, Chief Financial Officer and Treasurer

(Principal Financial Officer)

Date: February 9, 2017