

KMG CHEMICALS INC
Form 10-Q
March 12, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(One)

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

For the quarterly period ended January 31, 2014

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____.

Commission file number: 001-35577

KMG CHEMICALS, INC.

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

75-2640529
(I.R.S. Employer
Identification No.)

9555 West Sam Houston Parkway South,

Suite 600 Houston, Texas
(Address of principal executive offices)

77099
(Zip Code)

(713) 600-3800

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 for 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 Regulation 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

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 March 12, 2014, there were 11,620,626 shares of the registrant's common stock outstanding.

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Table of Contents**ITEM 1. FINANCIAL STATEMENTS****KMG CHEMICALS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except for share and per share amounts)**

	January 31, 2014 (Unaudited)	July 31, 2013
Assets		
Current assets		
Cash and cash equivalents	\$ 14,960	\$ 13,949
Accounts receivable		
Trade, net of allowances of \$250 at January 31, 2014 and \$224 at July 31, 2013	39,560	41,935
Other	3,366	4,210
Inventories, net	52,120	53,387
Current deferred tax assets	620	1,400
Prepaid expenses and other	2,053	3,955
Total current assets	112,679	118,836
Property, plant and equipment, net	96,390	96,688
Deferred tax assets	984	1,069
Goodwill	11,105	10,929
Intangible assets, net	29,006	29,261
Restricted cash	1,000	1,000
Other assets, net	4,376	4,232
Total assets	\$ 255,540	\$ 262,015
Liabilities and stockholders equity		
Current liabilities		
Accounts payable	\$ 30,200	\$ 35,492
Accrued liabilities	15,465	10,351
Current maturities of long-term debt	20,000	
Total current liabilities	65,665	45,843
Long-term debt, net of current maturities	59,000	85,000
Deferred tax liabilities	9,297	11,462
Other long-term liabilities	2,458	2,470
Total liabilities	136,420	144,775

Commitments and contingencies

Stockholders' equity

Preferred stock, \$0.01 par value, 10,000,000 shares authorized, none issued		
Common stock, \$0.01 par value, 40,000,000 shares authorized, 11,614,246 shares issued and outstanding at January 31, 2014 and 11,522,321 shares issued and outstanding at July 31, 2013	116	115
Additional paid-in capital	28,151	26,689
Accumulated other comprehensive loss		(2,504)
Retained earnings	90,853	92,940
Total stockholders' equity	119,120	117,240
Total liabilities and stockholders' equity	\$ 255,540	\$ 262,015

See accompanying notes to condensed consolidated financial statements.

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KMG CHEMICALS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(UNAUDITED)

(In thousands, except for per share amounts)

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
Net sales	\$ 84,253	\$ 56,959	\$ 177,813	\$ 122,295
Cost of sales	59,063	41,238	127,056	86,486
Gross profit	25,190	15,721	50,757	35,809
Distribution expenses	12,892	5,922	25,004	12,975
Selling, general and administrative expenses	9,870	6,603	20,270	12,534
Restructuring charges	4,031		4,031	
Operating income (loss)	(1,603)	3,196	1,452	10,300
Other income (expense)				
Interest expense, net	(661)	(395)	(1,324)	(806)
Other, net	(120)	(76)	(435)	(126)
Total other expense, net	(781)	(471)	(1,759)	(932)
Income (loss) from continuing operations before income taxes	(2,384)	2,725	(307)	9,368
Provision for income taxes	(360)	(1,070)	(1,085)	(3,505)
Income (loss) from continuing operations	(2,744)	1,655	(1,392)	5,863
Discontinued operations				
Loss from discontinued operations, before income taxes		(52)		(154)
Income tax benefit		15		51
Loss from discontinued operations		(37)		(103)
Net income (loss)	\$ (2,744)	\$ 1,618	\$ (1,392)	\$ 5,760
Earnings per share				
Basic				
Income (loss) from continuing operations	\$ (0.24)	\$ 0.14	\$ (0.12)	\$ 0.51

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Loss from discontinued operations					(0.01)
Net income (loss)	\$	(0.24)	\$	0.14	\$ (0.12) \$ 0.50
Diluted					
Income (loss) from continuing operations	\$	(0.24)	\$	0.14	\$ (0.12) \$ 0.51
Loss from discontinued operations					(0.01)
Net income (loss)	\$	(0.24)	\$	0.14	\$ (0.12) \$ 0.50
Weighted average shares outstanding					
Basic		11,613		11,480	11,594 11,458
Diluted		11,613		11,578	11,594 11,571

See accompanying notes to condensed consolidated financial statements.

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KMG CHEMICALS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(UNAUDITED)

(In thousands)

	Three Months Ended		Six Months Ended	
	January 31,		January 31,	
	2014	2013	2014	2013
Net income (loss)	\$ (2,744)	\$ 1,618	\$ (1,392)	\$ 5,760
Other comprehensive income				
Foreign currency translation gain	364	895	2,504	1,967
Total other comprehensive income	364	895	2,504	1,967
Total comprehensive income (loss)	\$ (2,380)	\$ 2,513	\$ 1,112	\$ 7,727

See accompanying notes to condensed consolidated financial statements.

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KMG CHEMICALS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(In thousands)

	Six Months Ended	
	January 31,	
	2014	2013
Cash flows from operating activities		
Net income (loss)	\$ (1,392)	\$ 5,760
Adjustments to reconcile net income (loss) to net cash provided by operating activities		
Depreciation and amortization	7,011	3,504
Non-cash restructuring charges	771	
Amortization of loan costs included in interest expense	30	31
Stock-based compensation expense	1,434	297
Bad debt expense	130	77
Allowance for excess and obsolete inventory	38	(301)
Loss on disposal of property	63	9
Loss on sale of animal health business		57
Deferred income taxes	940	(5)
Tax benefit from stock-based awards	(328)	(436)
Changes in operating assets and liabilities		
Accounts receivable trade	2,578	4,437
Accounts receivable other	140	(2,617)
Inventories	1,733	(1,687)
Other current and noncurrent assets	1,812	791
Accounts payable	(5,817)	(742)
Accrued liabilities and other	2,633	(559)
Net cash provided by operating activities	11,776	8,616
Cash flows from investing activities		
Additions to property, plant and equipment	(5,307)	(2,772)
Disposals of property, plant and equipment	17	
Net cash used in investing activities	(5,290)	(2,772)
Cash flows from financing activities		
Net payments under revolving credit agreement	(6,000)	(2,000)
Proceeds from exercise of stock options		70
Tax benefit from stock-based awards	328	436
Payment of dividends	(695)	(687)

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Net cash used in financing activities	(6,367)	(2,181)
Effect of exchange rate changes of cash	892	191
Net increase in cash and cash equivalents	1,011	3,854
Cash and cash equivalents at beginning of period	13,949	1,633
Cash and cash equivalents at end of period	\$ 14,960	\$ 5,487
Supplemental disclosures of cash flow information		
Cash paid for interest	\$ 1,304	\$ 777
Cash paid for income taxes	\$ 382	\$ 4,403
Supplemental disclosure of non-cash investing activities		
Purchase of property, plant and equipment through accounts payable	\$ 682	\$
See accompanying notes to condensed consolidated financial statements.		

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The consolidated balance sheet as of July 31, 2013, which has been derived from audited consolidated financial statements, and the unaudited condensed consolidated financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those requirements, certain footnotes or other financial information that are normally required by generally accepted accounting principles in the United States of America (GAAP) have been condensed or omitted. The Company believes that the disclosures made are adequate to make the information not misleading and in the opinion of management reflect all adjustments, including those of a normal recurring nature, that are necessary for a fair presentation of financial position and results of operations for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of results of operations to be expected for the full year. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended July 31, 2013.

These condensed consolidated financial statements are prepared using certain estimates by management and include the accounts of KMG Chemicals, Inc. and its subsidiaries (collectively, the Company). All significant intercompany balances and transactions have been eliminated in consolidation.

2. Acquisitions

On May 31, 2013, the Company completed the acquisition of the ultra pure chemicals (UPC) business subsidiaries of OM Group, with facilities located in the United States, the United Kingdom, France and Singapore. The purchase price was \$62.6 million. The subsidiaries sell high purity and ultra purity, wet process chemicals to the semiconductor industry.

The following table summarizes the acquired assets and assumed liabilities and the preliminary acquisition accounting for the fair value of the assets and liabilities recognized in the consolidated balance sheets at the acquisition date (in thousands):

Cash	\$ 689
Accounts receivable	14,698
Inventory	11,047
Other current assets	1,963
Property, plant and equipment	28,939
Intangible assets:	
Value of product qualifications	12,800
Non-compete agreement	1,900
Transition services	154
Total intangible assets	14,854

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Total assets acquired	\$ 72,190
Current liabilities	\$ 11,401
Other long-term liabilities	5,326
Total liabilities assumed	16,727
Net assets acquired	\$ 55,463

The Company recognized goodwill associated with the acquisition which represented the value of the assembled workforce and expected synergies from combining operations. The goodwill recognized in the Company's consolidated balance sheets is as follows (in thousands):

Carrying value at July 31, 2013	\$ 7,150
Foreign currency translation adjustment	176
Carrying value at January 31, 2014	\$ 7,326

Table of Contents**3. Earnings Per Share**

Basic earnings per share have been computed by dividing net income by the weighted average shares outstanding. Diluted earnings per share have been computed by dividing net income by the weighted average shares outstanding plus potentially dilutive common shares. The following table presents information necessary to calculate basic and diluted earnings per share for periods indicated:

	Three Months Ended		Six Months Ended	
	January 31,	January 31,	January 31,	January 31,
	2014	2013	2014	2013
	(Amounts in thousands, except per share data)			
Income (loss) from continuing operations	\$ (2,744)	\$ 1,655	\$ (1,392)	\$ 5,863
Loss from discontinued operations		(37)		(103)
Net income (loss)	\$ (2,744)	\$ 1,618	\$ (1,392)	\$ 5,760
Weighted average shares outstanding-basic	11,613	11,480	11,594	11,458
Dilutive effect of options and stock awards		98		113
Weighted average shares outstanding-diluted	11,613	11,578	11,594	11,571
Basic earnings per share				
Basic earnings per share from continuing operations	\$ (0.24)	\$ 0.14	\$ (0.12)	\$ 0.51
Basic earnings per share on loss from discontinued operations				(0.01)
Basic earnings per share	\$ (0.24)	\$ 0.14	\$ (0.12)	\$ 0.50
Diluted earnings per share				
Diluted earnings per share from continuing operations	\$ (0.24)	\$ 0.14	\$ (0.12)	\$ 0.51
Diluted earnings per share on loss from discontinued operations				(0.01)
Diluted earnings per share	\$ (0.24)	\$ 0.14	\$ (0.12)	\$ 0.50

Outstanding stock-based awards are not included in the computation of diluted earnings per share under the treasury stock method, if including them would be anti-dilutive. There were an average of approximately 30,000 shares and 21,000 shares of potentially dilutive securities not included in the computation of diluted earnings per share for the three and six months ended January 31, 2014, and there were an average of 3,700 shares and 1,900 shares of potentially dilutive shares not included in the computation of diluted earnings per share for the three and six months ended January 31, 2013. Potentially dilutive shares are not included in the computation of diluted weighted average shares outstanding due to a loss from continuing operations for the three and six months ended January 31, 2014.

4. Inventories

Inventories are summarized in the following table (in thousands):

	January 31, 2014	July 31, 2013
Raw materials	\$ 8,293	\$ 8,003
Work in process	1,458	1,382
Supplies	1,666	1,730
Finished products	40,936	42,452
Less: reserve for inventory obsolescence	(233)	(180)
Inventories, net	\$ 52,120	\$ 53,387

Table of Contents**5. Property, Plant and Equipment**

Property, plant and equipment and related accumulated depreciation and amortization are summarized as follows (in thousands):

	January 31, 2014	July 31, 2013
Land	\$ 15,898	\$ 15,620
Buildings and improvements	42,478	41,273
Equipment	73,510	66,807
Leasehold improvements	143	143
	132,029	123,843
Less: accumulated depreciation and amortization	(43,738)	(36,933)
	88,291	86,910
Construction-in-progress	8,099	9,778
Property, plant and equipment, net	\$ 96,390	\$ 96,688

6. Stock-Based Compensation

The Company has stock-based incentive plans which are described in more detail in Note 11 to the consolidated financial statements in the Company's Annual Report on Form 10-K for fiscal year 2013. The Company recognized stock-based compensation costs of approximately \$191,000 and \$116,000 for the three months and \$1.4 million and \$297,000 for the six months ended January 31, 2014 and 2013, respectively. The Company also recognized the related tax benefits of \$108,000 and \$43,000, respectively, for the three months and \$544,000 and \$109,000 for the six months ended January 31, 2014 and 2013, respectively. Stock-based compensation costs are recorded under selling, general and administrative expenses in the condensed consolidated statements of income (loss).

As of January 31, 2014, the unrecognized compensation costs related to stock-based awards was approximately \$662,000, which is expected to be recognized over a weighted-average period of 2.7 years.

A summary of stock option and stock activity is presented below.

Stock Options

A summary of activity for the six months ended January 31, 2014 is presented below. No options were granted in the first six months of fiscal years 2014 or 2013:

	Shares	Weighted- Average Exercise Price
Outstanding on August 1, 2013	58,000	\$ 4.03

Granted		
Exercised	(58,000)	4.03
Forfeited/expired		
Outstanding on January 31, 2014		

No stock options were outstanding at January 31, 2014.

There were 25,000 and 58,000 stock options exercised in the three and six months ended January 31, 2014, respectively, with an intrinsic value of \$327,000 and \$952,000, respectively. There were 80,000 options exercised in the three and six months ended January 31, 2013 with an intrinsic value of \$1.1 million.

Table of Contents**Performance Shares**

On August 1, 2013, there were 154,758 non-vested performance shares outstanding which reflected the maximum number of shares under the awards. There were no shares granted or vested under performance awards during the six months ended January 31, 2014. As of January 31, 2014, the non-vested performance-based stock awards consisted of Series 1 and Series 2 awards granted to certain executives and employees in fiscal years 2013 and 2012, as summarized below.

Date of Grant	Series Award	Maximum Award (Shares)⁽¹⁾	Grant Date Fair Value	Measurement Period Ending	Expected Percentage of Vesting	Expected Shares to Vest
Fiscal Year 2013 Awards						
12/04/2012	Series 1	58,600	\$ 18.75	07/31/2015	15%	8,790
		58,600				8,790
Fiscal Year 2012 Awards						
2/27/2012	Series 1	300	\$ 18.08	07/31/2014	10%	30
2/27/2012	Series 2	200	\$ 18.08	07/31/2014	0%	
		500				30
10/28/2011	Series 1	13,800	\$ 15.30	07/31/2014	10%	1,380
10/28/2011	Series 2	9,200	\$ 15.30	07/31/2014	0%	
		23,000				1,380
10/11/2011	Series 1	16,658	\$ 14.16	07/31/2014	10%	1,666
10/11/2011	Series 2	11,105	\$ 14.16	07/31/2014	0%	
		27,763				1,666
Total		109,863				11,866

(1) The table does not include awards of 23,242 and 12,992 in Series 1 awards (at maximum) in fiscal years 2013 and 2012, respectively, and 8,661 (at maximum) in Series 2 awards in fiscal year 2012, all of which were forfeited during the three months ended January 31, 2014.

Series 1: For the fiscal year 2013 awards, vesting is subject to performance requirements composed of certain objectives including average annual return on invested capital and annual compound growth rate in the Company's diluted earnings per share. For the fiscal year 2012 award, vesting for the Series 1 awards is subject to a performance requirement composed of certain earnings per share or revenue growth objectives and average annual return on invested capital measured across a three year period. These objectives are measured quarterly using the Company's budget, actual results and long-term projections. For each of the Series 1 awards, the expected percentage of vesting is

evaluated through January 31, 2014, and reflects the percentage of shares projected to vest for the respective awards at the end of their measurement periods.

Series 2: Vesting for the Series 2 awards is subject to performance requirements pertaining to the growth rate in the Company's basic earnings per share over a three year period. The achievement of performance requirements is measured quarterly using the Company's budget, actual results and long-term projections. For fiscal year 2012 awards, the expected percentage of vesting is evaluated through January 31, 2014, and reflects the percentage of shares projected to vest for the respective awards at the end of their measurement periods.

The weighted-average grant-date fair value of performance awards outstanding was \$17.70 and \$17.66 at January 31, 2014 and August 1, 2013, respectively.

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The table does not include performance-based Series 1 awards granted on February 25, 2014 by the Company's board of directors to Christopher T. Fraser and certain other executives and employees for an aggregate of 192,344 shares of common stock (at maximum) for fiscal year 2014. Vesting for the fiscal year 2014 Series 1 awards is subject to a performance requirement composed of certain earnings per share or revenue growth objectives and average annual return on invested capital measured across a three year period beginning August 1, 2013 and ending July 31, 2016. In addition, Mr. Fraser was granted (i) a performance-based Series 3 award for 10,000 shares of common stock (at maximum) having the same performance requirement, and (ii) a performance-based Series 1 award for 4,000 shares of common stock (at maximum) having certain personal objectives as a performance requirement, and in each case such awards vest and are measured over a one year period beginning August 1, 2013 and ending July 31, 2014. The grant date fair value of the performance-based awards for fiscal year 2014 was \$14.88. The expected percentage of vesting and the percentage of shares projected to vest for the respective awards at the end of their measurement periods will be evaluated quarterly.

Table of Contents***Time Based Shares***

A summary of activity for time-based stock awards for the six months ended January 31, 2014 is presented below:

	Shares	Weighted-Average Grant-Date Fair Value
Non-vested on August 1, 2013		
Granted ⁽¹⁾	45,508	\$ 21.12
Vested	(15,508)	19.28
Non-vested on January 31, 2014	30,000	22.07

(1) Reflects 6,380 shares, 4,000 shares and 5,128 shares granted to non-employee directors on January 31, 2014, October 31, 2013 and August 27, 2013 respectively, for service for the three months ended January 31, 2014, for the two months ended October 31, 2013 and the three months ended August 31, 2013, respectively. The shares vest on the date of grant and the Company recognizes compensation expense related to the awards over the respective service periods in accordance with GAAP. Additionally, the Company granted a time-based award for 30,000 shares to Christopher T. Fraser, when he became the Company's full-time President and CEO on September 24, 2013. These time-based shares vest in equal installments of 6,000 shares each over one, two, three, four and five years from the date of grant. Compensation expense will be recorded over the vesting period using the straight-line method. The September 24, 2013 grant date fair value was approximately \$662,000 using the Company's closing stock price of \$22.07 on the grant date.

The table does not include awards granted on February 25, 2014 to certain executives and employees of time-based awards for an aggregate of 21,600 shares of common stock (at maximum), vesting in general over one, two or three year periods from the employment of the executives or from the grant date. The grant date fair value of the shares and the performance-based awards was \$14.88.

Mr. Fraser was granted 50,000 shares upon becoming President and CEO. The shares vested on the date of grant on September 24, 2013, and the Company recognized compensation expense of the grant date fair value of \$1.1 million based on the closing stock price on that date.

The total fair value of shares vested during the six months ended January 31, 2014 and 2013 was approximately \$1.4 million and \$243,000, respectively.

The Company's board of directors granted 4,900 shares of common stock to certain employees on February 25, 2014. These shares were vested on the date of grant.

Table of Contents**7. Intangible Assets**

Intangible assets are summarized as follows (in thousands):

	Number of Years Weighted Average Amortization Period	Original Cost	January 31, 2014 Accumulated Amortization	Foreign Currency Translation Adjustment	Carrying Amount
Intangible assets subject to amortization: (range of useful life):					
Electronic chemicals-related contracts (5-8 years)	6.6	\$ 2,204	\$ (383)	\$ 47	\$ 1,868
Electronic chemicals-related trademarks and patents (10-15 years)	12.0	117	(62)		55
Electronic chemicals-value of product qualifications (5-15 years)	14.1	14,100	(1,728)	607	12,979
Total intangible assets subject to amortization	13.1	\$ 16,421	\$ (2,173)	\$ 654	14,902
Intangible assets not subject to amortization:					
Creosote product registrations					5,339
Penta product registrations					8,765
Total intangible assets not subject to amortization					14,104
Total intangible assets, net					\$ 29,006

	Number of Years Weighted Average Amortization Period	Original Cost	July 31, 2013 Accumulated Amortization	Carrying Amount
Intangible assets subject to amortization: (range of useful life):				
Electronic chemicals-related contracts (5-8 years)	6.5	\$ 2,297	\$ (253)	\$ 2,044
Electronic chemicals-related trademarks and patents (10-15 years)	12.0	117	(57)	60
Electronic chemicals-value of product qualifications (5-15 years)	14.1	14,100	(1,047)	13,053

Total intangible assets subject to amortization	13.0	\$ 16,514	\$ (1,357)	15,157
Intangible assets not subject to amortization:				
Creosote product registrations				5,339
Penta product registrations				8,765
Total intangible assets not subject to amortization				14,104
Total intangible assets, net				\$ 29,261

Intangible assets subject to amortization are amortized over their estimated useful lives. Amortization expense was approximately \$475,000 and \$73,000 for the three month periods ended January 31, 2014 and 2013, respectively, and \$962,000 and \$150,000 for the six month periods ended January 31, 2014 and 2013, respectively.

8. Dividends

Dividends of approximately \$348,000 (\$0.03 per share) and \$345,000 (\$0.03 per share) were declared and paid in the second quarter of fiscal years 2014 and 2013, respectively. Dividends of approximately \$695,000 (\$0.06 per share) and \$687,000 (\$0.06 per share) were declared and paid in the first six months of fiscal years 2014 and 2013, respectively. A dividend of \$0.03 per share was approved by the Company's board of directors on February 25, 2014 to be paid on March 21, 2014 to shareholders of record on March 10, 2014.

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The Company has two reportable segments – electronic chemicals and wood treating chemicals.

	Three Months Ended		Six Months Ended	
	January 31, 2014	January 31, 2013	January 31, 2014	January 31, 2013
	(Amounts in thousands)			
Sales				
Electronic chemicals	\$ 61,428	\$ 35,647	\$ 125,880	\$ 75,154
Wood treating chemicals	22,795	21,183	51,859	46,883
Total sales for reportable segments	\$ 84,223	\$ 56,830	\$ 177,739	\$ 122,037
Depreciation and amortization				
Electronic chemicals	\$ 3,345	\$ 1,539	\$ 6,592	\$ 3,089
Wood treating chemicals	98	105	196	212
Other	104	103	223	203
Total consolidated depreciation and amortization	\$ 3,547	\$ 1,747	\$ 7,011	\$ 3,504
Segment income from operations ⁽¹⁾				
Electronic chemicals	\$ 2,995	\$ 2,429	\$ 6,333	\$ 7,501
Wood treating chemicals	1,111	2,220	3,616	5,586
Total segment income from operations	\$ 4,106	\$ 4,649	\$ 9,949	\$ 13,087

(1) Segment income from operations includes allocated corporate overhead expenses.

Corporate overhead expenses allocated to segment income from operations for the three and six months ended January 31, 2014 and 2013 were as follows:

	Three Months Ended		Six Months Ended	
	January 31, 2014	January 31, 2013	January 31, 2014	January 31, 2013
	(Amounts in thousands)			
Electronic chemicals	\$ 2,465	\$ 1,228	\$ 4,438	\$ 2,631
Wood treating chemicals	1,070	1,087	2,130	2,232
Total corporate overhead expense allocation	\$ 3,535	\$ 2,315	\$ 6,568	\$ 4,863

A reconciliation of total segment information to consolidated amounts is as follows:

	Three Months Ended		Six Months Ended	
	January 31, 2014	January 31, 2013	January 31, 2014	January 31, 2013
	(Amounts in thousands)			
Sales				
Total sales for reportable segments	\$ 84,223	\$ 56,830	\$ 177,739	\$ 122,037
Other	30	129	74	258
Net sales	\$ 84,253	\$ 56,959	\$ 177,813	\$ 122,295
Segment income from operations				
Total segment income from operations	\$ 4,106	\$ 4,649	\$ 9,949	\$ 13,087
Other corporate expense ⁽¹⁾	(1,678)	(1,453)	(4,466)	(2,787)
Restructuring charges	(4,031)		(4,031)	
Operating income (loss)	(1,603)	3,196	1,452	10,300
Interest expense, net	(661)	(395)	(1,324)	(806)
Other expense, net	(120)	(76)	(435)	(126)
Income (loss) from continuing operations before income taxes	\$ (2,384)	\$ 2,725	\$ (307)	\$ 9,368

- (1) Other corporate expense primarily represents employee stock-based compensation expenses and those public entity expenses such as board compensation, audit expense, fees related to the listing of our stock, and expenses incurred to pursue acquisition opportunities. Other corporate expense includes \$2.1 million of other professional services and \$1.4 million of stock based compensation, for the first six months of fiscal year 2014.

Table of Contents**10. Long-Term Debt**

The Company's debt consisted of the following (in thousands):

	January 31, 2014	July 31, 2013
	(Amounts in thousands)	
Senior secured debt:		
Note purchase agreement, maturing on December 31, 2014, interest rate of 7.43%	\$ 20,000	\$ 20,000
Revolving loan facility, maturing on April 30, 2018, variable interest rates based on LIBOR plus 1.50% at January 31, 2014 and July 31, 2013	59,000	65,000
Total debt	79,000	85,000
Current maturities of long-term debt	20,000	
Long-term debt, net of current maturities	\$ 59,000	\$ 85,000

To finance the acquisition of the electronic chemicals business in December 2007, the Company entered into an amended and restated credit agreement and a note purchase agreement. The amended and restated credit agreement is now with Wells Fargo Bank, National Association, and with Bank of America, N.A. The note purchase agreement is now with The Prudential Insurance Company of America and Pruco Life Insurance Company.

Initially, the amended and restated credit agreement included a revolving loan facility and a term loan facility. The term loan was paid off in fiscal year 2012, and that aspect of the facility has been removed. The Company amended these facilities several times, most recently in April and in May 2013 to increase the amount that may be borrowed under the revolving loan up to \$110.0 million, to include an accordion feature that allows for an additional revolving loan increase of up to \$25.0 million with approval from the Company's lenders, and to extend the maturity date of the revolving loan facility to April 30, 2018, with mandatory reduction in revolving loan commitment of \$10.0 million each year from September 30, 2014 to September 30, 2017 totaling \$40.0 million. The matrix for the calculation of interest payable on the revolving loan facility and the method for the calculation of the fixed charge coverage ratio were also revised.

The revolving loan bears interest at a varying rate of LIBOR plus a margin based on our funded debt to earnings before interest, taxes, depreciation and amortization (EBITDA).

Ratio of Funded Debt to EBITDA	Margin
Equal to or greater than 2.5 to 1.0	2.25%
Equal to or greater than 2.0 to 1.0, but less than 2.5 to 1.0	2.00%
Equal to or greater than 1.5 to 1.0, but less than 2.0 to 1.0	1.75%
Less than 1.5 to 1.0	1.50%

Advances outstanding under the revolving loan bear interest at 1.71% and 1.69% as of January 31, 2014 and July 31, 2013, respectively. The amount outstanding on the revolving loan at January 31, 2014 was \$59.0 million, and an

additional \$3.5 million is reserved for outstanding letters of credit. The amount that may be borrowed under the revolving facility is limited by a covenant for funded debt to pro-forma earnings before interest, taxes and depreciation, and at January 31, 2014 that limitation restricts the Company's borrowing capacity to \$13.9 million.

The note purchase agreement is for \$20.0 million. Advances under the note purchase agreement mature on December 31, 2014, and bear interest at 7.43% per annum. Principal is payable at maturity. At January 31, 2014, \$20.0 million was outstanding under the note purchase agreement.

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Loans under the amended and restated credit agreement and the note purchase agreement are secured by the Company's assets, including inventory, accounts receivable, equipment, intangible assets, and real property. The credit facility and the note purchase agreement have restrictive covenants, including that the Company must maintain a fixed charge coverage ratio of 1.5 to 1.0 or below, a ratio of funded debt to earnings before interest, taxes and depreciation (as adjusted for extraordinary items, with lender consent) of 3.0 to 1.0 or below, and a current ratio of at least 1.5 to 1.0.

11. Income Taxes

Income tax expense for the interim periods was computed using the effective tax rate based on the application of an estimated annual effective income tax rate applied to year-to-date income before income tax expense. In determining the estimated annual effective income tax rate, we analyze various factors, including forecasts of projected annual earnings and the ability to use tax credits and net operating loss carry forwards. The overall effective income tax rate for the three and six month periods ended January 31, 2014 is (15.1%) and (353.4%), primarily due to the valuation allowances recorded against the Company's current and prior period operating losses for its Italian subsidiary, as a result of the restructuring of those operations. Excluding the Italian results, the effective tax rate on ordinary income is 31.4% and 33.4% for the three and six month periods ended January 31, 2014, respectively. For the three and six month periods ended January 31, 2013, the effective rate for continuing operations was 39.3% and 37.4%. In general, differences between the effective tax rates and the rate of 35.0%, excluding for the effect of restructuring charges and operational results in Italy, are primarily due to foreign and state income taxes, and the distribution of income between the U.S. and foreign operations.

12. Litigation and Other Contingencies

The Company is subject to contingencies, including litigation relating to environmental laws and regulations, commercial disputes and other matters. Certain of these contingencies are discussed below. The ultimate resolution of these contingencies is subject to significant uncertainty, and should the Company fail to prevail in any of them or should several of them be resolved against the Company in the same reporting period, these matters could, individually or in the aggregate, be material to the consolidated financial statements. The ultimate outcome of these matters, however, cannot be determined at this time, nor can the amount of any potential loss be reasonably estimated, and as a result except where indicated no amounts have been recorded in the Company's consolidated financial statements.

The Company records legal costs associated with loss contingencies as expenses in the period in which they are incurred.

A lawsuit was filed against the Company's wholly-owned subsidiary, KMG de Mexico, relating to the title to the land on which its facility in Matamoros is located. The plaintiffs claim that their title to the land is superior to the person from whom our subsidiary bought the land. The plaintiffs are seeking to have our subsidiary's purchase overturned, and to recover the land and certain improvements or their value. The lawsuit was initially filed in 1998 in Matamoros, Mexico under *Adolfo Cazares Rosas, et al vs. KMG de Mexico and Guillermo Villarreal*. In January 2008, the case was sent by the appeals court back to the lower court to obtain additional factual information, and on April 20, 2009 the plaintiffs were required to re-file the case in the First Civil Court in Matamoros, Tamaulipas, Mexico as *Adolfo Cazares, Luis Escudero and Juan Cue vs. KMG de Mexico and Guillermo Villarreal*. In June 2011 the lower court ruled against KMG de Mexico, and held that the plaintiffs had superior title to the land, but that verdict was overturned on appeal in May 2012, and the case will be returned to the trial court for further action. The Company intends to continue to vigorously defend KMG de Mexico.

The Company's subsidiary in Italy has filed suit in the Provincial Tax Court in Milan, Italy to contest assessments by the taxing authority in Italy pertaining to the three year period ended July 31, 2011. In the aggregate, the amount of the assessments, including interest and penalties, is 1.8 million. If all the adjustments are sustained, the additional liability for the years 2009 through 2011 would total approximately \$2.4 million, including interest and penalties through January 31, 2014 (at an exchange rate of 1.35 \$/). The Company recorded a liability for an uncertain tax position for items in the amount of \$437,000. The Company intends to vigorously pursue its position before the court, but the ultimate outcome of this litigation is subject to uncertainty.

The Company's subsidiary in Italy has filed suit in the Provincial Court in Milan, Italy to contest the assessment of additional registration tax against the Company's subsidiary in Italy based on an increased valuation of assets purchased from Air Products and Chemicals, Inc. in December 2007. The amount of the assessment, including interest and penalties through January 31, 2014, is 781,000 (or approximately \$1.1 million, at an exchange rate of 1.35 \$/). The ultimate outcome of this assessment is subject to uncertainty.

The Company is subject to federal, state, local and foreign laws and regulations and potential liabilities relating to the protection of the environment and human health and safety including, among other things, the cleanup of contaminated sites, the treatment, storage and disposal of wastes, the emission of substances into the air or waterways, and various health and safety matters. The Company expects to incur substantial costs for ongoing compliance with such laws and regulations. The Company may also face governmental or third-party claims, or otherwise incur costs, relating to cleanup of, or for injuries resulting from, contamination at sites associated with past and present operations. The Company accrues for environmental liabilities when a determination can be made that they are probable and reasonably estimable.

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13. Restructuring Events

In October 2013, the Company announced that as part of global restructuring of its electronic chemicals operations, the Fremont, California manufacturing site acquired in the acquisition from OM Group will be closed, and production shifted primarily to the Company's Hollister, California and Pueblo, Colorado facilities. In November 2013, the Company announced that it will close its manufacturing facility in Milan, Italy, and shift production to facilities in France and the United Kingdom. The Company will continue to operate the warehouse facility in Milan. Total costs related to restructuring accrued for the three and six months ended January 31, 2014 was approximately \$4.0 million. Restructuring charges in the second quarter and in the first six months of fiscal year 2014 included approximately \$2.5 million in employee costs, \$700,000 in decommissioning and environmental expense and \$800,000 in accelerated depreciation with respect to property, plant and equipment at the facilities to be closed.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

We manufacture, formulate and distribute specialty chemicals globally. We operate businesses engaged in electronic chemicals and industrial wood treating chemicals. Our electronic chemicals are sold to the semiconductor industry, where they are used primarily to clean and etch silicon wafers in the production of semiconductors. Our wood treating chemicals, pentachlorophenol (penta) and creosote are used by our industrial customers primarily to extend the useful life of utility poles and railroad crossties.

Acquisition

We completed our acquisition of the ultra pure chemicals (UPC) business subsidiaries of OM Group, Inc., in the fourth quarter of fiscal year 2013. The purchase price was \$62.6 million. The UPC subsidiaries sell high purity, wet process chemicals to the semiconductor industry.

Restructuring

In October 2013, we announced that as part of global restructuring of our electronic chemicals operations, we will close our Fremont, California manufacturing site acquired in the UPC acquisition, and shift production primarily to our Hollister, California and Pueblo, Colorado facilities. In November 2013, we announced that we will close our manufacturing facility in Milan, Italy, and shift production to our facilities in France and the United Kingdom. We will continue to operate our warehouse facility in Milan. Total costs related to restructuring accrued for the three and six months ended January 31, 2014 was approximately \$4.0 million. Restructuring charges included in the second quarter and in the first six months of fiscal year 2014 included approximately \$2.5 million in employee costs, \$700,000 in decommissioning and environmental expense and \$800,000 in accelerated depreciation with respect to property, plant and equipment at the facilities to be closed. We estimate that restructuring charges, exclusive of accelerated depreciation, will range between \$7.0 million and \$9.0 million cumulatively over fiscal years 2014 and 2015, and that accelerated depreciation with respect to the closed facilities will be approximately \$4.0 million over those two fiscal years.

Results of Operations

Three and Six Month Periods Ended January 31, 2014 compared with Three and Six Month Periods Ended January 31, 2013

Segment Net Sales

Segment data is presented for our two reportable segments for the three and six month periods ended January 31, 2014 and 2013. The segment data should be read in conjunction with our condensed consolidated financial statements and related notes thereto included elsewhere in this report.

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
	(Amounts in thousands)			
Sales				
Electronic chemicals	\$ 61,428	\$ 35,647	\$ 125,880	\$ 75,154
Wood treating chemicals	22,795	21,183	51,859	46,883
Total sales for reportable segments	\$ 84,223	\$ 56,830	\$ 177,739	\$ 122,037

Table of Contents*Net Sales*

Net sales for reportable segments increased \$27.4 million, or 48.2%, to \$84.2 million in the second quarter of fiscal year 2014 from \$56.8 million for the same period of the prior year. For the six months ended January 31, 2014, net sales for reportable segments increased \$55.7 million, or 45.7%, to \$177.7 million from \$122.0 million. For the second quarter and for the six months period ended January 31, 2014, net sales in both of our segments improved, primarily reflecting increased sales in electronic chemicals from the acquisition in May 2013 of the UPC business subsidiaries and with some growth volume of creosote sales.

In the second quarter of fiscal year 2014, the electronic chemicals segment had net sales of \$61.4 million, an increase of \$25.8 million, or 72.5%, as compared to \$35.6 million for the prior year period. For the six month periods, net sales in the electronic chemicals segment increased \$50.7 million, or 67.4%, to \$125.9 million from \$75.2 million. In both periods, sales in fiscal year 2014 increased over the prior year periods, because of the added net sales attributable to the UPC acquisition. Although production of microprocessors for personal computers is expected to grow over the next five years, production in mobility markets such as cellphones and tablets is expected to grow much more substantially. Following our UPC acquisition, we participate in the mobility market to a greater degree than in the past, while increasing our already substantial participation in the personal computer and server market.

Net sales of wood treating chemicals increased \$1.6 million, or 7.6%, to \$22.8 million in the second quarter of fiscal year 2014 as compared to \$21.2 million for the prior year period. For the six month periods, net sales in the wood treating segment increased \$5.0 million, or 10.7%, to \$51.9 million from \$46.9 million. The increase in sales in the second quarter and in the first six months of the current fiscal year over the prior year periods was due to greater volume of creosote shipments to customers that service the crosstie end markets. Although our creosote volume improved, customers continued to pre-treat railroad ties with boron solutions to increase the service life of the crosstie. This practice has the effect of reducing the amount of creosote used to treat the tie. We expect that practice will continue, as all the Class I railroads intend to purchase a portion of their ties with the borate treatment. Penta product sales declined approximately \$400,000 in the second quarter of fiscal year 2014, and declined \$1.0 million for the first six months of fiscal year 2014. In the western United States, penta sales remain strong as several utilities have increased their pole replacement programs, and demand for taller transmission poles is robust as wind farms and solar plants connect to the power grid. Sales in the southeast, however, remained weak as the cold weather impacted demand for treated poles and inhibited the ability to cut timber in the region; and unlike the prior years, the absence of a major hurricane or other severe weather limited demand for utility pole replacements.

Gross Profit

Gross profit increased by \$9.5 million, or 60.5%, to \$25.2 million in the second quarter of fiscal year 2014 from \$15.7 million in the same quarter of the prior year. For the six month period, gross profit increased \$15.0 million or 41.9%, to \$50.8 million from \$35.8 million in the prior year period. The increase in aggregate gross profit for the quarter and the six months period was due to sales attributable to the UPC acquisition. Gross profit as a percentage of sales improved to 29.9% in the second quarter of fiscal year 2014 from 27.6% in the second quarter of fiscal year 2013. The increase in consolidated gross profit in the quarterly and six month comparisons came from 98.0% and 55.2% increases, respectively, in gross profit in our electronic chemicals segment, despite 15.6% and 14.2% declines in gross profits for the comparable periods, respectively, in our wood treating chemicals business.

Our supply agreement for creosote with our European supplier expired on December 31, 2013, but since then we have purchased creosote from that source on a limited basis and continue to discuss a new supply agreement. In addition, we have made arrangements for creosote supply from alternate sources. We are continuing to pursue additional supply opportunities.

Other companies may include certain costs that we record in cost of sales as distribution expenses or selling, general and administrative expenses, and may include certain of the costs that we record in distribution expenses or selling, general and administrative expenses as a component of cost of sales, resulting in a lack of comparability between our gross profit and that reported by other companies.

Table of Contents*Distribution Expenses*

Distribution expenses were up by \$7.0 million in the second quarter of fiscal year 2014 to \$12.9 million from \$5.9 million in the prior year period, a 118.6% increase. Distribution expenses were approximately 15.3% and 10.4% of net sales for the second quarter of fiscal years 2014 and 2013, respectively. Distribution expenses for the six month periods ending January 31, 2014 and 2013 were \$25.0 million and \$13.0 million, respectively, an increase of \$12.0 million or 92.3%, in fiscal year 2014 over the prior year period. Distribution expense as percent of revenue of the six month periods ending January 31, 2014 and 2013 were 14.1% and 10.6% of net sales, respectively. Distribution expense is heavily concentrated in our electronic chemicals business and the increases in the quarterly and six month comparisons for that expense in fiscal year 2014 reflect greater volume shipments from UPC-related sales and from expenses for chemical management operations in Singapore.

Selling, General and Administrative Expenses

Selling, general, and administrative expenses increased \$3.3 million, or 50.0%, to \$9.9 million in the second quarter of fiscal year 2014 from \$6.6 million in the same quarter of fiscal year 2013. Those expenses were 11.7% and 11.6% of net sales in the second quarter of fiscal years 2014 and 2013, respectively. For the six month period, those expenses increased \$7.8 million or 62.4%, to \$20.3 million from \$12.5 million. The increase in the second quarter of fiscal year 2014 as compared to the prior year period was largely due to higher professional services and employee-related costs. For the first six months of fiscal year 2014 as compared to the prior year, selling, general and administrative expense increased primarily because of \$2.1 million in professional services, \$1.1 million of stock-based compensation expense related to our new CEO, \$430,000 of other employee related costs and \$660,000 of integration expenses for our UPC acquisition. The remainder of the increase in selling, general and administrative expenses in the second quarter and in the first six months of fiscal year 2014 is attributable to the acquired UPC business. In the second quarter and first six months of fiscal year 2013, we incurred \$740,000 and \$1.3 million, respectively, of acquisition-related expense for the UPC acquisition that we were then pursuing.

Segment Income from Operations

In the second quarter of fiscal year 2014, operating income in the electronic chemicals segment was \$3.0 million (excluding restructuring charges), an increase of \$600,000, or 25.0%, as compared to \$2.4 million for the prior year period. The improvement in the quarterly comparison was due to increased profitability in our legacy electronic chemicals business. This increase was partially offset by higher depreciation and amortization expenses of approximately \$1.8 million. For the six month period, operating income in the electronic chemicals segment decreased \$1.2 million, excluding restructuring charges, or 16.0% to \$6.3 million from \$7.5 million. The decrease in the six month comparison was due to a decline in operating profits in our legacy electronic chemicals business from lesser volume and lower margins, and from approximately \$500,000 of integration expense in the first quarter.

In our wood treating chemicals segment, operating income decreased approximately \$1.1 million, or 50.0%, to \$1.1 million in the second quarter of fiscal year 2014 as compared to \$2.2 million for the prior year period. For the six month period, operating income in the wood treating segment decreased \$2.0 million or 35.7%, to \$3.6 million from \$5.6 million. Although creosote volume was improved in the quarter and in the six month period over the prior year, we also experienced lower pricing and higher costs associated with cleaning a barge that was returned to its owner. Additionally, penta sales revenue was down \$400,000 in the quarter and \$1.0 million for the six month period as compared to the prior year, and we had higher hazardous waste disposal costs related to the penta business. We expect that penta sales in the third and fourth quarter of fiscal year 2014 will approximate sales in the prior year periods.

Other corporate expense primarily represents employee stock-based compensation expenses and those public entity expenses such as board compensation, audit expense, fees related to the listing of our stock, and expenses incurred to pursue potential acquisition opportunities.

Interest Expense, net

Interest expense was \$661,000 and \$395,000 in the second quarter of fiscal years 2014 and 2013, respectively, and was \$1.3 million and \$806,000 for the first six months of fiscal year 2014 and 2013, respectively. The increases in the periods were due to greater amounts outstanding on our revolving loan facility borrowed to consummate our UPC acquisition in May 2013.

Income Taxes

The overall effective income tax rate for the three and six month period ended January 31, 2014 was (15.1%) and (353.4%), respectively, primarily due to restructuring charges and operational results in Italy for which we will not be able to realize a tax benefit. With the consolidation of our European manufacturing facilities, it is more likely than not that our subsidiary in Italy will not generate a sufficient profit in the near future to recover the restructuring charges. The impact on our Italian subsidiary's tax provision was approximately \$1.4 million, and, was recorded in the second quarter of fiscal year 2014. Excluding the Italian results, the effective tax rate on ordinary income was 31.4% and 33.4% for the three and six months ended January 31, 2014. The effective rate for continuing operations was 39.3% and 37.4% for the three and six months ended January 31, 2013, respectively.

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Discontinued Operations

Discontinued operations reflected a loss before income taxes of \$52,000 and \$154,000 for the second quarter and first six months of fiscal year 2013, respectively. Those costs were related to the animal health business that was discontinued in March 2012, and to dismantling equipment relating to the agricultural chemicals business that was discontinued in fiscal year 2008.

Liquidity and Capital Resources

Cash Flows

For the six months ended January 31, 2014, operating cash flows were favorably impacted by an increase in accrued liabilities of \$2.6 million. Accrued liabilities increased primarily due to recognition of restructuring charges. Operating cash flows were negatively impacted by a decrease in accounts payable of \$5.8 million primarily in connection with our wood treating segment from the timing of payments for creosote purchases. Net borrowings decreased by \$6.0 million on account of payments that reduced the revolving line of credit.

Working Capital

We have a revolving line of credit of \$110.0 million under an amended and restated credit agreement. At January 31, 2014, we had \$59.0 million outstanding under the revolving facility, and an additional \$3.5 million is reserved for outstanding letters of credit, with up to an additional \$47.5 million of additional borrowing capacity. However, the amount that may be borrowed under the revolving facility is limited by a covenant for funded debt to pro-forma earnings before interest, taxes and depreciation (EBITDA), and at January 31, 2014 that limitation restricted our borrowing capacity to \$13.9 million. Management believes that our current revolving credit facility, combined with cash flows from operations, will adequately provide for our working capital needs for current operations for the next twelve months, but we will need to extend or replace \$20.0 million of indebtedness that matures on December 31, 2014. Management has begun the process of accomplishing that extension or replacement.

Long Term Debt

To finance the acquisition of the electronic chemicals business in December 2007, we entered into an amended and restated credit agreement and a note purchase agreement. The amended and restated credit agreement is now with Wells Fargo Bank, National Association, and with Bank of America, N.A. The note purchase agreement is now with The Prudential Insurance Company of America and Pruco Life Insurance Company.

Initially, the amended and restated credit agreement included a revolving loan facility and a term loan facility. The term loan was paid off in fiscal year 2012, and that aspect of the facility has been removed. We amended the facilities and the note purchase agreement several times, most recently in April and in May 2013 to increase the amount that may be borrowed under the revolving loan up to \$110.0 million, to include an accordion feature that allows for an additional revolving loan increase of up to \$25.0 million with approval from the Company's lenders, and to extend the maturity date to April 30, 2018. The matrix for the calculation of interest payable on the revolving loan facility and the method for the calculation of the fixed charge coverage ratio were also revised.

The revolving loan matures April 30, 2018, and bears interest at a varying rate of LIBOR plus a margin based on our funded debt to EBITDA ratio, as described below.

Ratio of Funded Debt to EBITDA	Margin
Equal to or greater than 2.5 to 1.0	2.25%
Equal to or greater than 2.0 to 1.0, but less than 2.5 to 1.0	2.00%
Equal to or greater than 1.5 to 1.0, but less than 2.0 to 1.0	1.75%
Less than 1.5 to 1.0	1.50%

Advances under the revolving loan bear interest at 1.71% and 1.69% as of January 31, 2014 and July 31, 2013, respectively. At January 31, 2014, \$59.0 million was outstanding on the revolving facility, and an additional \$3.5 million is reserved for outstanding letters of credit.

The note purchase agreement is for \$20.0 million. Advances under the note purchase agreement mature on December 31, 2014, and bear interest at 7.43% per annum. Principal is payable at maturity. At January 31, 2014, \$20.0 million was outstanding under the note purchase agreement.

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Loans under the amended and restated credit agreement and the note purchase agreement are secured by our assets, including stock in subsidiary inventory, accounts receivable, equipment, intangible assets and real property. The credit facility and the note have restrictive covenants, including that the Company must maintain a fixed charge coverage ratio of funded debt to EBITDA (as adjusted for extraordinary items, with lender consent) of no more than 3.0 to 1.0, and a current ratio of at least 1.5 to 1.0. On January 31, 2014, we were in compliance with all of our debt covenants.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements, such as financing or unconsolidated variable interest entities, other than operating leases.

Disclosure Regarding Forward Looking Statements

We are including the following discussion to inform our existing and potential security holders generally of some of the risks and uncertainties that can affect us and to take advantage of the safe harbor protection for forward-looking statements that applicable federal securities law affords. From time to time, our management or persons acting on our behalf make forward-looking statements to inform existing and potential security holders about our company. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, intend, plan, project, forecast, may, should, budget, goal, expect, expressions, we are making forward-looking statements. Many risks and uncertainties may impact the matters addressed in these forward-looking statements. Our forward-looking statements speak only as of the date made and we will not update forward-looking statements unless the securities laws require us to do so.

Some of the key factors which could cause our future financial results and performance to vary from those expected include:

the loss of primary customers;

the loss of key suppliers;

the integration of our UPC acquisition taking longer or being more costly than currently believed, or the failure to achieve all the planned benefits of that integration;

penta being banned or restricted as a persistent organic pollutant under the Stockholm Convention Treaty;

the implementation of a new enterprise resource planning system taking longer or being more costly than currently believed;

our ability to implement productivity improvements, cost reduction initiatives or facilities expansions;

market developments affecting, and other changes in, the demand for our products and the entry of new competitors or the introduction of new competing products;

availability or increases in the price of energy, our primary raw materials and active ingredients;

the timing of planned capital expenditures;

our ability to identify, develop or acquire, and market additional product lines and businesses necessary to implement our business strategy and our ability to finance such acquisitions and development;

the condition of the capital markets generally, which will be affected by interest rates, foreign currency fluctuations and general economic conditions;

cost and other effects of legal and administrative proceedings, settlements, investigations and claims, including environmental liabilities which may not be covered by indemnity or insurance;

the effects of weather, earthquakes, other natural disasters and terrorist attacks;

the ability to obtain registration and re-registration of our products under applicable law;

the political and economic climate in the foreign or domestic jurisdictions in which we conduct business; and

other United States or foreign regulatory or legislative developments which affect the demand for our products generally or increase the environmental compliance cost for our products or impose liabilities on the manufacturers and distributors of such products.

The information contained in this report, including the information set forth under the heading **Risk Factors**, identifies additional factors that could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions and, therefore, the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report and the exhibits and other documents incorporated herein by reference, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to certain market risks in the ordinary course of our business, arising primarily from changes in interest rates and to a lesser extent foreign currency exchange rate fluctuations. Generally we do not utilize derivative financial instruments or hedging transactions to manage that risk. Our exposure to interest rate risk and foreign currency risk is discussed in our Annual Report on Form 10-K for the fiscal year ended July 31, 2013. There has been no material change in that information.

ITEM 4. CONTROLS AND PROCEDURES

The term disclosure controls and procedures is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission. Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

There were no changes to our internal control over financial reporting during the quarterly period covered by this Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth in Note 12 to the condensed consolidated financial statements is incorporated herein by reference.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors contained in our Annual Report on Form 10-K for the fiscal year ended July 31, 2013.

ITEM 5. OTHER INFORMATION

The Nominating and Corporate Governance Committee will consider recommendations for directors made by shareholders for next annual meeting of shareholders, if such recommendations are received in writing, addressed to the chair of the committee, Mr. John C. Hunter III, in care of the Company, at 9555 W. Sam Houston Parkway S., Suite 600, Houston, Texas 77099 by July 15, 2014.

ITEM 6. EXHIBITS

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The financial statements are filed as part of this report in Part 1, Item 1. The following documents are filed as exhibits. Documents marked with an asterisk (*) are management contracts or compensatory plans, and portions of documents marked with a dagger (†) have been granted confidential treatment.

31.1	Certificates under Section 302 the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer.
31.2	Certificates under Section 302 the Sarbanes-Oxley Act of 2002 of the Chief Financial Officer.
32.1	Certificates under Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer.
32.2	Certificates under Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Financial Officer.
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

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SIGNATURES

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

KMG Chemicals, Inc.

By: /s/ Christopher T. Fraser
Christopher T. Fraser
President and Chief Executive Officer

Date: March 12, 2014

By: /s/ Malinda G. Passmore
Malinda G. Passmore
Chief Financial Officer

Date: March 12, 2014