KEY TRONIC CORP
Form 10-K
September 10, 2018

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED JUNE 30, 2018
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 (State or other jurisdiction of Incorporation or organization)	91-0849125 (I.R.S. Employer Identification No.)
N. 4424 Sullivan Road, Spokane Valley, Washington (Address of principal executive offices)	99216 (Zip Code)

(509) 928-8000
(Registrant's telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report)

Securities Registered Pursuant to Section 12(b) of the Act: None

Title of each class	Name of each exchange on which registered
Common stock, no par value	The NASDAQ Stock Market LLC

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

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 x No ¨

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

State the aggregate market value of the voting and non-voting common equity held by non affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant’s most recently completed second fiscal quarter.

As of December 30, 2017, the aggregate market value of the registrant’s common stock held by non-affiliates of the registrant was $69.5 million based on the closing price as reported on the NASDAQ.

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 10,759,680 shares of common stock were outstanding as of September 4, 2018.

Documents Incorporated by Reference:

Certain information is incorporated into Part III of this report by reference to the Proxy Statement for the registrant's 2018 annual meeting of stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Form 10-K.

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FORWARD-LOOKING STATEMENTS

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

This Annual Report on Form 10-K 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 Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

PART I

Item 1. BUSINESS

Background

Key Tronic Corporation (dba: KeyTronicEMS Co.) was organized in 1969, as a Washington corporation that locally manufactured computer keyboards. The ability to design, build and deliver a quality product led us to become a leading independent manufacturer of keyboards for computers in the United States. Our fully integrated design, tooling, and automated manufacturing capabilities enabled us to rapidly respond to customers' needs for keyboards in production quantities worldwide. We supported our sales growth through the development and purchase of international manufacturing facilities. As the computer keyboard market matured with increasing competition from other international providers, we determined that our business could no longer solely rely on keyboard sales.

After assessing market conditions and our strengths and capabilities, we shifted our focus from keyboard manufacturing to contract manufacturing for a wide range of products. Our unique strategic attributes are based on our core strengths of innovative design and engineering expertise in electronics, mechanical engineering, sheet metal fabrication and stamping, and precision plastics combined with high-quality, low cost production, and assembly on an international basis while providing exceptional customer service. These strengths have made our company a strong competitor in the electronic manufacturing services (EMS) market.

Our Industry and Strategy

The expansion of the EMS industry and our acquisitions have allowed us to continue to expand our customer base and the industries that we serve. The increase in new programs represents a growing portion of our revenue and a promising foundation for our future. In keeping with our long-term strategic objectives, we have been successfully building a more diversified customer portfolio, spanning a wider range of industries. We currently offer our customers the following services: integrated electronic and mechanical engineering, precision plastic molding, sheet metal fabrication, printed circuit board (PCB) and complete product assembly, component selection, sourcing and procurement, worldwide logistics, and new product testing and production all at competitive pricing due to our global footprint. We differentiate ourselves from others our size and larger in the EMS industry by providing vertical integration, a flexible and responsive approach to our customer's changing supply demand, and complete design engineering support.

We believe that we are well positioned in the EMS industry to continue the expansion of our customer base and achieve long-term growth. Our unique blend of multinational facilities, vertical integration, centralized management, and core strengths continue to support our growth and our customers' needs. We continue to focus on controlling operating expenses and leveraging the synergistic capabilities of our world-class facilities in the United States, Mexico, and China. This international production capability provides our customers with the benefits of improved supply-chain management, reduced inventory, lower labor costs, lower transportation costs, and reduced product fulfillment time. Given our competitive advantages and the growing pressure for new potential customers to move forward with their outsourcing strategies, we are strongly positioned to win new business in coming periods and grow our revenue and profits.

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The EMS industry is intensely competitive. Although our customer base is growing, we still have less than 1% of the potential global market and our revenue can fluctuate significantly due to reliance on a concentrated base of customers. We are planning for new customer growth in the coming quarters by securing new programs with new and existing customers, increasing our worldwide manufacturing capacity, leveraging further our design engineering capabilities and continuing to improve our manufacturing and procurement processes and capabilities. Ongoing challenges that we face include but are not limited to the following: continuing to win programs from new and existing customers, balancing capital employed, production capacity and key personnel in support of new customer programs, improving operating efficiencies, controlling costs while developing competitive pricing strategies, and successfully transitioning new program wins to full production.

Customers and Marketing

We provide a mix of manufacturing services for outsourced Original Equipment Manufacturing (OEM) products. We provide the following EMS services: product design, surface mount technologies (SMT) and pin through hole capability for printed circuit board assembly, tool making, precision plastic molding, sheet metal fabrication and painting, liquid injection molding, complex assembly, automated tape winding, prototype design and full product assembly.

Sales of the majority of our products have not historically been seasonal in nature, but may be seasonal in the future if there are changes in the types of products manufactured. Sales can, however, fluctuate significantly between quarters from changes in customers and customer demand due to the concentration of sales generated by our largest customers. For the fiscal years 2018, 2017 and 2016, the five largest customers in each year accounted for 42%, 42% and 41% of combined total net sales, respectively. We continue to diversify our customer base by adding additional programs and customers. We expect net sales to our five largest customers as a percentage of total net sales to approximate current levels going forward.

The following table represents all customers that represented 10% or more of total net sales during the last three fiscal years:

	Percentage of Net Sales by Fiscal Year		
	2018	2017	2016
Customer A	19%	18%	18%

There can be no assurance that the Company’s principal customers will continue to purchase products from the Company at current levels. Moreover, the Company typically does not enter into long-term volume purchase contracts with it’s customers, and the Company’s customers have certain rights to extend or delay the shipment of their orders. The loss of one or more of the Company’s major customers, or the reduction, delay or cancellation of orders from such customers, could materially and adversely affect the Company’s business, operating results and financial condition.

We market our products and services primarily through our direct sales department which is comprised of strategically located field sales people and distributors. We also maintain relationships with several independent sales organizations to assist in marketing our EMS product lines.

Manufacturing

We have continually made investments in developing and expanding a capital equipment base to achieve vertical integration and efficiencies in our manufacturing processes. We have invested significant capital into SMT for volume manufacturing of complex printed circuit board assemblies and in our metal shop providing precision metal stamping, fabricating, and finishing. We also design and develop tooling for injection molding and sheet metal fabrication and manufacture the majority of plastic and sheet metal parts used in the products we manufacture. Additionally, we have equipment to maintain a controlled clean environment for manufacturing processes that require a high level of precise control.

We use a variety of manual and automated assembly processes in our facilities, depending upon product complexity and degree of customization. Some examples of automated processes include component insertion, SMT, selective soldering, flexible robotic assembly, automated storage tape winding, computerized vision system quality inspection, laser turrets, automated switch and key top installation, robotic welding, automated powder coat application, and automated functional testing.

Our engineering expertise and automated manufacturing processes enable us to work closely with our customers during the design and prototype stages of production and to jointly increase productivity and reduce response time to the marketplace. We use computer-aided design techniques and software to assist in preparation of the tool design layout and component placement, to reduce tooling and production costs, improve component and product quality, and enhance turnaround time during product development.

We purchase materials and components for our products from many different suppliers, including both domestic and international sources. We develop close working relationships with our suppliers, many of whom have been supplying products to us for several years.

Research, Development, and Engineering

As part of our long-term strategy, we are committed to supporting our customers by providing research, development, and engineering services. We have recently seen an increase in the success of providing design support on existing and potential customers in differentiating ourselves. These services allow us to facilitate in optimizing new product designs, and the production processes of our customers' programs.

Research, development, and engineering (RD&E) expenses consist principally of employee related costs, third party development costs, program materials costs, depreciation, and allocated information technology and facilities costs.

Competition

The market for the products and services we provide is highly competitive. There are numerous competitors in the EMS industry, many of which have substantially more resources and are more geographically diverse than we are. Some of our competitors have similar international production capabilities, large financial resources and some have substantially greater manufacturing, research and development, and marketing resources. There is also competition from the manufacturing operations of our current and potential customers, who are continually evaluating the merits of manufacturing their products internally versus the advantages of outsourcing. We believe that we can currently compete favorably in these areas primarily on the basis of our international footprint, responsiveness, creativity, vertical production capability, quality, and cost.

Trademarks

Our name and logo are federally registered trademarks, and we believe they are valuable assets of our business. We operate under the trade name "KeyTronicEMS" to better identify our primary business concentration in contract manufacturing in the EMS industry.

Employees

We consider our employees to be our primary strength and we make considerable efforts to maintain a well-qualified workforce. Our employee benefits include bonus programs involving periodic payments to all employees based on meeting quarterly or fiscal year performance targets. We regularly provide transportation, medical services, and meals to all of our employees in foreign locations. The Company also has defined contribution plans available to U.S. employees who have attained age 21 and provide group health, life, and disability insurance plans. We also maintain share based compensation plans and other long-term incentive plans for certain employees and outside directors.

As of June 30, 2018 we had 4,701 full-time employees compared to 5,038 on July 1, 2017, and 4,947 on July 2, 2016. Since we can have significant fluctuations in product demand, we seek to maintain flexibility in our workforce by utilizing skilled temporary labor in our manufacturing facilities in addition to full-time employees.

Backlog

On July 28, 2018 our order backlog was valued at approximately $167.7 million, compared to approximately $126.9 million on July 29, 2017. The amount of backlog is not necessarily indicative of future sales but can be indicative of trends in expected future sales revenue. Due to the relationships with our customers, we will occasionally allow orders to be canceled or rescheduled and as a result it is not a meaningful indicator of future financial results. If there are canceled or rescheduled orders, we typically negotiate fees to cover the costs we have incurred. Order backlog consists of purchase orders received for products expected to be shipped approximately within the next twelve months, although shipment dates are subject to change due to design modifications, customer forecast changes, or other customer requirements.

Foreign Markets

Information concerning net sales and long-lived assets (property, plant, and equipment) by geographic areas is set forth in Note 12, "Enterprise-Wide Disclosures" of the consolidated financial statements of this Annual Report on Form 10-K and that information is incorporated herein.

Executive Officers of the Registrant

The table below sets forth the name, current age and current position of our executive officers and other significant employees:

Name	Age	Positions Held
Executive Officers		
Craig D. Gates	59	President and Chief Executive Officer
Brett R. Larsen	45	Executive Vice President of Administration, Chief Financial Officer, and Treasurer
Douglas G. Burkhardt	60	Executive Vice President of Worldwide Operations
Philip S. Hochberg	56	Executive Vice President of Business Development
David H. Knaggs	37	Vice President of Quality and Regulatory Affairs
Frank Crispigna III	57	Vice President of Supply Chain
Duane D. Mackleit	50	Vice President of Program Management
Chad T. Orebaugh	47	Vice President of Engineering

Executive Officers

CRAIG D. GATES – President and Chief Executive Officer

Mr. Gates, age 59, has been President and Chief Executive officer of the Company since April 2009. Previously, he was Executive Vice President and General Manager from August 2002 to April 2009. He served as Executive Vice President of Marketing, Engineering and Sales from July 1997 to August 2002 and served as Vice President and General Manager of New Business Development from October 1995 to July 1997. He joined the Company as Vice President of Engineering in October of 1994. From 1982 to 1991 he held various engineering and management positions within the Microswitch Division of Honeywell, Inc., in Freeport, Illinois, and from 1991 to October 1994 he served as Director of Operations, Electronics for Microswitch. Mr. Gates has a Bachelor of Science Degree in Mechanical Engineering and a Masters in Business Administration from the University of Illinois, Urbana.

BRETT R. LARSEN – Executive Vice President of Administration, Chief Financial Officer, and Treasurer

Mr. Larsen, age 45, has served as Executive Vice President of Administration, Chief Financial Officer, and Treasurer since July 2015. Previously, he was Vice President of Finance and Controller from February 2010 to July 2015. He was Chief Financial Officer of FLSmidth Spokane, Inc. from December 2008 to February 2010. From October 2005 through November 2008, Mr. Larsen served as Controller of Key Tronic Corporation. From May 2004 to October 2005, Mr. Larsen served as Manager of Financial Reporting of Key Tronic Corporation. From 2002 to May 2004, Mr. Larsen was an audit manager for the public accounting firm BDO USA, LLP. He also held various auditing and supervisory positions with Grant Thornton LLP from 1997 to 2002. Mr. Larsen has a Bachelor of Science degree in Accounting and a Masters degree in Accounting from Brigham Young University and is a Certified Public Accountant.

DOUGLAS G. BURKHARDT – Executive Vice President of Worldwide Operations

Mr. Burkhardt, age 60, has been Executive Vice President of Worldwide Operations of the Company since July 2010. Previously Mr. Burkhardt was Vice President of Worldwide Operations from July 2008 to July 2010 and Director of China Operations and Program Management from January 2006 to July 2008. Mr. Burkhardt also served as Director of Northwest and China Operations from November of 1998 to January of 2006. Mr. Burkhardt also served as Director of Customer Satisfaction from March 1997 to November 1998 and Director of Molding from September of 1995 to March of 1997. Prior to this, Mr. Burkhardt served in other various senior management positions within the Company. Mr. Burkhardt has been with the Company since May of 1989. Prior to joining Key Tronic, Mr. Burkhardt worked for House of Aluminum and Glass for 12 years where he was the plant manager.

PHILIP S. HOCHBERG – Executive Vice President of Business Development

Mr. Hochberg, age 56, has been Executive Vice President of Business Development since July 2012. Prior to this, Mr. Hochberg served as Vice President of Business Development from October 2009 through June 2012. He was Director of Business Development and Program Management from July 2008 to October 2009. Mr. Hochberg served as Director of Business Development from October 2004 to July 2008 and as Director of EMS Sales and Marketing from July 2000 to October 2004. Prior to joining Key Tronic, Mr. Hochberg worked for Quinton Instrument Company as their Director of Marketing and Product Management from 1992 to 2000. From 1988 to 1992, he was employed by SpaceLabs Medical as their Business Development Marketing Manager. Mr. Hochberg has an MBA from the

University of British Columbia, a BA in Psychology, with a minor in Business from Washington University in St. Louis.

DAVID H. KNAGGS – Vice President of Quality and Regulatory Affairs

Mr. Knaggs, age 37, has been Vice President of Quality and Regulatory Affairs since October 2016. Before joining KeyTronicEMS, Mr. Knaggs worked at Telect, Inc. from 2008 to 2016 as their Director of Engineering. Prior to that, he worked at Isothermal Systems Research as Lead Systems Engineer from 2003 to 2008. He has a Bachelor of Science degree in Mechanical Engineering with a minor in mathematics from the University of Washington.

FRANK CRISPIGNA III – Vice President of Supply Chain

Mr. Crispigna, age 57, has been Vice President of Supply Chain of the company since October 2011. Prior to this, Mr. Crispigna held a variety of Materials and Supply Chain positions at Plexus Corporation since 1997, most recently serving as the Director – Supply Chain Solutions from 2005 - 2011. He has a Masters degree in Business Administration, and a Bachelor of Business Administration Degree in Marketing from the University of Wisconsin – Oshkosh. Mr. Crispigna also is a C.P.M., and received his certification in Supply Chain Leadership from the University of Wisconsin.

DUANE D. MACKLEIT – Vice President of Program Management

Mr. Mackleit, age 50, has been Vice President of Program Management of the company since July 2012. He served as Director of Program Management from July 2008 through June 2012. From May 2006 to July 2008 he served as Principal Program Manager. Prior to that, he served as Program Manager from March 2002 to May 2006 and Associate Program Manager from August 2000 to March 2002. Mr. Mackleit has also held several other positions with Key Tronic Corporation. Mr. Mackleit has an AA in Business from Spokane Falls Community College and a BA in Business/Marketing from Eastern Washington University. He also holds a MBA from Gonzaga University.

CHAD T. OREBAUGH – Vice President of Engineering

Mr. Orebaugh, age 47, has been Vice President of Engineering since April 2017. Prior to this, Mr. Orebaugh served as Director of Engineering since May 2013. From April 2010 to May 2013, he served as Manager of Engineering. From January 2000 to April 2010 he served as Lead Mechanical Engineer. Prior to that, he served as Mechanical Engineer from October 1998 to January 2000 and Associate Mechanical Engineer since October 1997. Mr. Orebaugh holds a BA in Mechanical Engineering from Gonzaga University.

Available Information

Our principal executive offices are located at 4424 North Sullivan Road, Spokane Valley, Washington 99216, and our telephone number is (509) 928-8000. Our website is located at http://www.keytronic.com where filings of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q or current reports on Form 8-K are available after they have been filed with the Securities and Exchange Commission. The information presented on our website currently and in the future is not considered to be part of this document or any document incorporated by reference in this document.

Item 1A. RISK FACTORS
There are risks and uncertainties that could affect our business. These risks and uncertainties include but are not limited to, the risk factors described below, in Item 7A: “Quantitative and Qualitative Disclosures about Market Risk” and elsewhere in this Form 10-K.

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

We may experience fluctuations in quarterly results of operations.
Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global macroeconomic environment, volatility in overall demand for our customers’ products, success of customers’ programs, timing of new programs, new product introductions or technological advances by us, our customers and our competitors, and changes in pricing policies by us, our customers, our suppliers, and our competitors. Our customer base is diverse in the markets they serve, however, decreases in demand, particularly from customers in certain industries could affect future quarterly results. Additionally, our customers could be adversely impacted by illiquidity in 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 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 life cycles. 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, tariffs, 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 sales in future periods. Additionally, the financial strength of our customers and suppliers and their ability to obtain and rely on credit financing may affect their ability to fulfill their obligations to us and have an adverse effect on our financial results.

The majority of our sales come from a small number of customers and a decline in sales to any of these customers could adversely affect our business.
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 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 there is uncertainty in the macroeconomic climate, 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. In addition, we have restrictive covenants with our financial institution which could impact how we manage our business. If we cannot meet our financial covenants, our borrowings could become immediately payable which could have a material adverse impact on our financial statements. 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, turnover 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.

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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.

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 production employees. There can be no assurance that we will be successful in attracting and retaining such personnel, particularly in our manufacturing locales that may be experiencing high demand for similar key 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 or don’t meet expected sales volumes.

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.

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

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

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

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

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

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

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

Energy price increases may negatively impact our results of operations.

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

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

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

We are involved in various legal proceedings.

In the past, we have been notified of claims relating to various matters including contractual matters, intellectual property rights or other issues arising in the ordinary course of business. In the event of such a claim, we may be required to spend a significant amount of money to defend or otherwise address the claim. Any litigation or dispute resolution, 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.

Our levels of insurance coverage may not be sufficient for potential damages, claims or losses.

We have various forms of business and liability insurance which we believe are appropriate based on the needs of companies in our industry. As a result, not all of our potential business risks or potential losses would be covered by our insurance policies. If we sustain a significant claim or loss which is not covered by insurance, our net income could be negatively impacted.

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Changes in securities laws and regulations will increase our costs and risk of noncompliance.
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 1 and 15 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.

Changes in financial accounting standards may affect our reported financial condition or results of operations as well increase costs related to implementation of new standards and modifications to internal controls.

Our consolidated financial statements are prepared in conformity with accounting standards generally accepted in the United States, or U.S. GAAP. These principles are subject to amendments made primarily by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC). A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions which are completed before a change is announced. For example, significant changes to revenue recognition rules will be effective for us in fiscal 2019 and we may have material fluctuations in revenue from quarter to quarter once implemented. Changes to accounting rules or challenges to our interpretation or application of the rules by regulators may have a material adverse effect on our reported financial results or on the way we conduct business.

Item 1B. UNRESOLVED STAFF COMMENTS

None

Item 2. PROPERTIES AS OF DATE OF FILING

We have manufacturing and sales operations located in the United States, Mexico, and China. The table below lists the locations and square footage of our operating facilities:

Location	Approx. Sq. Ft.	Type of Interest (Leased/Owned)	Description of Use
Corinth, Mississippi	350,000	Leased	Manufacturing and warehouse
El Paso, Texas	80,000	Leased	Shipping and warehouse
Fayetteville, Arkansas (1)	175,000	Leased	Manufacturing and warehouse
Fayetteville, Arkansas (1)	105,000	Leased	Manufacturing and warehouse
Harrodsburg, Kentucky (2)	22,000	Owned	Manufacturing and warehouse
Louisville, Kentucky	2,300	Leased	Administration
Oakdale, Minnesota (3)	60,000	Leased	Manufacturing and warehouse
Spokane Valley, Washington	95,000	Leased	Sales, research, administration and manufacturing
Spokane Valley, Washington	36,000	Leased	Manufacturing
Total USA	925,300		
Juarez, Mexico	193,000	Leased	Warehouse
Juarez, Mexico	174,000	Owned	Manufacturing
Juarez, Mexico	115,000	Owned	Manufacturing and warehouse
Juarez, Mexico	103,000	Owned	Manufacturing and warehouse
Juarez, Mexico	72,000	Leased	Manufacturing
Juarez, Mexico	66,000	Owned	Manufacturing and warehouse
Juarez, Mexico	60,000	Owned	Manufacturing and warehouse
Total Mexico	783,000		
Shanghai, China	121,000	Leased	Manufacturing and warehouse
Shanghai, China	8,000	Leased	Manufacturing
Total China	129,000		
Grand Total	1,837,300		

(1) The Arkansas facility is currently in the process of moving to a smaller and more cost effective location. The move should be completed by the beginning of December 2018 and the lease on the facility with 175,000 square feet will be terminated.

(2) During fiscal year 2017, we closed the Harrodsburg, Kentucky location and transferred customer programs to other facilities in the USA. The facility is currently listed for sale. Additionally, the sale of the building in less than one year is not probable at this time. As such, the property is appropriately being reported in Property, Plant, and Equipment.

(3) Commencing on January 1, 2019, the approximate square footage for the Oakdale, Minnesota location will be increasing to approximately 102,914 square feet as we are expanding in our current building.

The geographic diversity of these locations allows us to offer services near certain of our customers and major electronics markets with the additional benefit of reduced labor costs. We consider the productive capacity of our current facilities sufficient to carry on our current business. In addition, in Juarez, Mexico one of our buildings includes adjacent vacant land that could be developed into additional manufacturing and warehouse space.

All of our facilities are ISO certified to ISO 9001:2015 standard and to Customs Trade Partnership against Terrorism (CTPAT). In addition, the Juarez, Mexico; Shanghai, China and Spokane, Washington facilities are registered/certified to IATF 16949 automotive standard, AS 9100D aviation, space and defense standard, ISO 13485:2016 medical devices, ISO 14001:2015 environmental standard, ANSI/ESD S20.20 Electrostatic Discharge Control Program, OHSAS 18001 Occupational Health and Safety standard, and SA8000 / ISO 2600 social accountability standard.

Oakdale, Minnesota is additionally registered to ISO-13485:2016 medical devices standard, AS9100C aviation, space and defense standard, and NADCAP certified. The Spokane, Washington and Juarez, Mexico facilities are additionally registered to ISO/IEC 80079-34 explosive atmospheres. Additionally, Juarez, Mexico is registered by the NSF for water products. The Oakdale, Minnesota; Corinth, Mississippi; Fayetteville, Arkansas and Spokane, Washington facilities are all registered by the U.S. State Department for International Traffic in Arms Regulations (ITAR).

Item 3. LEGAL PROCEEDINGS

We are a party to certain lawsuits or claims in the ordinary course of business. We do not believe that these proceedings, individually or in the aggregate, will have a material adverse effect on our financial position, results of operations or cash flow. Refer to Commitment and Contingencies footnote for further details on litigation in the fiscal year.

Item 4. MINE SAFETY DISCLOSURES

Not Applicable

PART II

Item 5: MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is traded on the NASDAQ Global Market, formerly the NASDAQ National Market System under the symbol "KTCC." Quarterly high and low sales prices for our common stock for fiscal years 2018 and 2017 were as follows:

	2018		2017	
	High	Low	High	Low
First Quarter	$7.40	$6.69	$8.28	$7.23
Second Quarter	7.95	6.74	8.18	7.08
Third Quarter	7.30	6.81	8.20	7.08
Fourth Quarter	8.60	6.85	8.00	6.69

High and low stock prices are based on the daily sales prices reported by the NASDAQ Stock Market. These quotations represent prices between dealers without adjustment for markups, markdowns, and commissions, and may not represent actual transactions.

Holders and Dividends

As of June 30, 2018, we had 671 shareholders of common stock on record. As a result of our credit agreement with Wells Fargo Bank, N.A. we are restricted from declaring or paying dividends in cash or stock without the Bank's prior written consent. We have not paid a cash dividend and do not anticipate payment of dividends in the foreseeable future.

Equity Compensation Plan Information

Information concerning securities authorized for issuance under our equity compensation plans is set forth in Part III, Item 12 of this Annual Report, under the caption "Securities Authorized for Issuance under Equity Compensation Plans", and that information is incorporated herein by reference.

Performance Graph

Set forth below is a line graph comparing the cumulative total shareholder return on our common stock with the cumulative total return of the NASDAQ Stock Market (U.S. & Foreign) Index and the NASDAQ Electronic Components Index in fiscal 2018.

	6/29/2013	6/28/2014	6/27/2015	7/2/2016	7/1/2017	6/30/2018
Key Tronic Corporation	100.00	103.67	103.00	71.40	68.50	73.24
NASDAQ Composite	100.00	132.45	151.00	148.88	189.66	233.12
NASDAQ Electronic Components	100.00	141.22	150.63	158.95	227.17	300.77

Item 6: SELECTED FINANCIAL DATA

The following selected data is derived from our audited consolidated financial statements and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," the consolidated financial statements and related notes, and other information included in this report.

Financial Highlights

(In thousands, except for Supplemental Data and Per Share Amounts)

	Fiscal Year Ended				
	June 30, 2018	July 1, 2017	July 2, 2016	June 27, 2015 (3)	June 28, 2014 (3)
Consolidated Statements of Operations Data:					
Net sales	$446,322	$467,797	$484,965	$433,997	$305,394
Gross profit	34,169	38,300	38,825	33,305	26,854
Gross margin percentage	7.7 %	8.2 %	8.0 %	7.7 %	8.8 %
Operating income	1,114	9,544	10,416	6,653	9,304
Operating margin percentage	0.2 %	2.0 %	2.1 %	1.5 %	3.0 %
Net income (loss)	(1,325)	5,617	6,533	4,304	7,613
Net income (loss) per share – diluted	(0.12)	0.51	0.58	0.38	0.67
Consolidated Cash Flow Data:					
Cash flows provided by operations	11,457	9,425	4,580	7,667	1,458
Capital expenditures	4,523	9,307	13,277	8,808	7,763
Consolidated Balance Sheet Data:					
Net working capital (1)	95,607	100,440	97,349	98,318	71,049
Total assets	246,528	232,840	235,924	230,794	156,660
Long-term liabilities	29,534	38,520	46,232	43,237	848
Shareholders' equity	118,081	116,567	105,582	100,768	103,645
Book value per share (2)	$10.97	$10.83	$9.84	$9.42	$9.83
Supplemental Data:					
Number of shares outstanding at year-end	10,759,680	10,759,680	10,725,349	10,706,136	10,546,750
Number of employees at year-end	4,701	5,038	4,947	4,866	3,343
Approximate square footage of operational facilities	1,837,300	1,760,000	1,828,000	1,892,000	1,139,000

(1) Net working capital is defined as total current assets less total current liabilities. Net working capital measures the portion of current assets that are financed by long term funds and is an indicator of short term financial management.

(2) Book value per share is defined as total shareholders' equity divided by the number of shares outstanding at the end of the fiscal year.

(3) Reflects the acquisition of Ayrshire on September 3, 2014 in fiscal year 2015 and Sabre on July 1, 2013 in fiscal year 2014.

Item 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

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

Executive Summary

For the fourth quarter of fiscal 2018, we saw increasing demand from a number of our longstanding customers and most of our new programs, including Skybell Technologies, continued to ramp steadily. We also continued to win significant new business from EMS competitors and from existing customers, including new programs involving medical devices, distribution services and electronic signage. At the same time, our productivity continued to be adversely impacted by industry wide shortages in key components, resulting in delays in delivery and increased costs.

Net sales of $446.3 million for fiscal year 2018 decreased by 4.6 percent as compared to net sales of $467.8 million in fiscal year 2017. The decrease in net sales was primarily driven by a decrease in demand from current customers, partially offset by an increase in new program wins.

While 2018 was a challenging year, we replaced the revenue shortfall caused by a large former customer, significantly diversified our customer base, reduced our debt by $8.0 million for the year and returned to strong sequential growth in the fourth quarter. Moving into the first quarter of fiscal year 2019, although we continue to face industry supply chain issues, we expect significant growth in revenue and earnings. In preparation, we continue to invest in new equipment and processes to be more productive in our Mexico facilities, and we are expanding and enhancing our profitable US facilities. We're optimistic about our opportunities for growth in fiscal 2019 and beyond.

For the first quarter of fiscal year 2019, the Company expects to report revenue in the range of $118 million to $122 million. Future results will depend on actual levels of customers' orders, the timing of the start-up of production of new product programs, impact of the new revenue recognition accounting policy and the potential impact of the geopolitical uncertainty. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

We continue to diversify our customer base by adding additional programs and customers. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies, computer accessories, medical, educational, irrigation, automotive, transportation management, robotics, RFID, power supply, off-road vehicle equipment, fitness equipment, HVAC controls, consumer products, home building products, material handling systems, lighting equipment and consumer security products.

Gross profit as a percent of net sales was 7.7 percent in fiscal year 2018 compared to 8.2 percent for the prior fiscal year. The decrease in gross profit as a percentage of net sales was primarily related to an increase in certain overhead costs partially offset by a decrease in material related costs. The level of gross margin is impacted by product mix, timing of the startup of new programs, facility utilization, and pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter and year to year.

Operating income as a percentage of net sales for fiscal year 2018 was 0.2 percent compared to 2.0 percent for fiscal year 2017. The decrease in operating income as a percentage of net sales was primarily due to a decrease in net revenue and a before tax one-time loss of approximately $4.5 million related to the arbitration settlement.

Net loss for fiscal year 2018 was $(1.3) million or $(0.12) per share, as compared to net income of $5.6 million or $0.52 per share for fiscal year 2017. The decrease in net income for fiscal year 2018 as compared to fiscal year 2017 was primarily driven by the decrease in net revenue as described above as well as a before tax one-time loss of approximately $4.5 million related to the arbitration settlement.

We maintain a strong balance sheet with a current ratio of 2.0 and a debt to equity ratio of 0.30. Total cash provided by operating activities as defined on our cash flow statement was $11.5 million during fiscal year 2018. We maintain sufficient liquidity for our expected future operations. As of June 30, 2018, we had $16.2 million outstanding on our revolving line of credit with Wells Fargo Bank, N.A. As a result, $28.4 million remained available to borrow as of June 30, 2018. We believe cash flow from operations, our borrowing capacity, our accounts receivable sale program, and equipment financing should provide adequate capital for planned growth over the long term.

RESULTS OF OPERATIONS

Comparison of the Fiscal Year Ended June 30, 2018 with the Fiscal Year Ended July 1, 2017

The following table sets forth for the periods indicated certain items of the consolidated statements of income expressed as a percentage of net sales. The financial information and discussion below should be read in conjunction with the consolidated financial statements and notes contained in this Annual Report.

	Fiscal Year Ended					
	June 30, 2018	% of net sales	July 1, 2017	% of net sales	$ change	% point change
Net sales	$446,322	100.0%	$467,797	100.0%	$(21,475)	—
Cost of sales	412,153	92.3	429,497	91.8	(17,344)	0.5
Gross profit	34,169	7.7	38,300	8.2	(4,131)	(0.5)
Operating expenses:						
Research, development and engineering	6,186	1.4	6,393	1.4	(207)	—
Selling, general and administrative	22,334	5.0	22,363	4.8	(29)	0.2
Loss on settlement of arbitration	4,535	1.0	—	—	4,535	1.0
Total operating expenses	33,055	7.4	28,756	6.2	4,299	1.2
Operating income	1,114	0.2	9,544	2.0	(8,430)	(1.8)
Interest expense, net	2,556	0.6	2,288	0.5	268	0.1
Income before income taxes	(1,442)	(0.3)	7,256	1.6	(8,698)	(1.9)
Income tax provision	(117)	—	1,639	0.4	(1,756)	(0.4)
Net income	$(1,325)	(0.3)%	$5,617	1.2%	$(6,942)	(1.5)
Effective income tax rate	8.1%		22.6%			

Net Sales

The decrease in net sales of $21.5 million from prior year period was primarily driven by a decrease in demand from current customers, partially offset by an increase in net sales from new program wins.

The following table shows the revenue by industry sectors as a percentage of revenue for fiscal years 2018 and 2017:

	Fiscal Year Ended	
	June 30, 2018	July 1, 2017
Industrial	42%	40%
Consumer	38	35
Gaming	7	9
Communication	4	8
Transportation	4	1
Computer and Peripheral	3	2
Printers	2	5
Total	100%	100%

We provide services to customers in a number of industries and produce a variety of products for our customers in each industry. Key Tronic does not target any particular industry, but rather seeks to find programs that strategically fit our vertical manufacturing capabilities. As we continue to diversify our customer base and win new customers, we will continue to see a change in the industry concentrations of our revenue.

Sales to foreign locations represented 26.2 percent and 22.6 percent of our total net sales in fiscal years 2018 and 2017, respectively.

Cost of Sales

Total cost of sales as a percentage of net sales was 92.3 percent and 91.8 percent in fiscal years 2018 and 2017, respectively.

Total cost of materials as a percentage of net sales was approximately 61.1 percent and 61.7 percent in fiscal years 2018 and 2017, respectively. The change from year-to-year is primarily a result of improved pricing of certain raw materials as well as a more favorable product mix.

Production and support costs as a percentage of net sales were 31.2 percent and 30.1 percent in fiscal years 2018 and 2017, respectively. The increase in fiscal year 2018 is primarily related to severance expenses related to streamlining the company’s facilities in Mexico.

We provide a reserve for obsolete and non-saleable inventories based on specific identification of inventory against current demand and recent usage. We also consider our customers' ability to pay for inventory whether or not there is a lead-time assurance agreement for a specific program. The amounts charged to expense for these inventories were approximately $31,000 and $496,000 in fiscal years 2018 and 2017, respectively.

We provide warranties on certain products we sell and estimate warranty costs based on historical experience and anticipated product returns. Warranty expense is related to workmanship claims on keyboards and EMS products. The amounts charged to expense are determined based on an estimate of warranty exposure. The net warranty expense was approximately $74,000 and $68,000 in fiscal years 2018 and 2017, respectively.

Gross Profit

Gross profit as a percentage of net sales was 7.7 percent and 8.2 percent in fiscal years 2018, and 2017, respectively. The 0.5 percentage point decrease in gross profit as a percentage of net sales during fiscal year 2018 as compared to fiscal year 2017 is primarily related to a 0.6 percentage point decrease in material related costs partially offset by a 1.1 percentage point increase in certain overhead costs.

Changes in gross profit margins reflect the impact of a number of factors that can vary from period to period, including product mix, start-up costs and efficiencies associated with new programs, product life cycles, sales volumes, capacity utilization of our resources, management of inventories, component pricing and shortages, end market demand for customers’ products, fluctuations in and timing of customer orders, and competition within the EMS industry. These and other factors can cause variations in operating results. There can be no assurance that gross margins will not decrease in future periods.

We took early pay discounts to suppliers that totaled approximately $1.7 million and $1.9 million in fiscal years 2018 and 2017, respectively. Early pay discounts will fluctuate based on our liquidity and changes in the discounts and terms offered by our suppliers.

Research, Development and Engineering

Research, development and engineering expenses (RD&E) consists principally of employee related costs, third party development costs, program materials, depreciation and allocated information technology and facilities costs. Total RD&E expenses were $6.2 million in fiscal year 2018 and $6.4 million in fiscal year 2017, respectively. Total RD&E expenses as a percent of net sales were 1.4 percent in fiscal years 2018 and 2017.

Selling, General and Administrative

Selling, general and administrative expenses (SG&A) consist principally of salaries and benefits, advertising and marketing programs, sales commissions, travel expenses, provision for doubtful accounts, facilities costs, and professional services. Total SG&A expenses were $22.3 million and $22.4 million in fiscal years 2018 and 2017, respectively. Total SG&A expenses as a percent of net sales were 5.0 percent and 4.8 percent in fiscal years 2018 and 2017, respectively. This 0.2 percentage point increase in SG&A as a percentage of net sales is primarily related to an increase in legal fees related to an effort to collect from a former customer through arbitration.

Loss on Settlement of Arbitration

We were awarded $6.7 million following the conclusion of a previously disclosed arbitration proceeding, which began in the second quarter of fiscal year 2017. This award resolved a dispute with a former customer involving approximately $9.3 million in inventory purchased and approximately $1.9 million in outstanding accounts receivables and other related fees and costs that we believed to be reimbursable. This event, including all related disposal fees, resulted in an approximately $4.5 million before tax one-time loss to fiscal year 2018. The adverse impact net of taxes on net loss was $3.4 million.

Interest Expense

We had net interest expense of $2.6 million and $2.3 million in both fiscal years 2018 and 2017. The increase in interest expense is primarily related to an increase in the average balance outstanding on our line of credit.

Income Tax Provision

We had an income tax benefit of approximately $(0.1) million during fiscal year 2018 and an income tax expense of approximately $1.6 million during fiscal year 2017. The income tax expense (benefit) recognized during both fiscal years 2018 and 2017, was primarily a function of U.S., federal, state and foreign taxes recognized at the statutory rates offset by the net benefit associated with federal research and development tax credits and changes in potential foreign tax credits. The Company also recognized the impacts of U.S. tax reform, including a provisional estimate related to mandatory repatriation, in the fiscal year ended June 30, 2018.

We continually review our requirements for liquidity domestically to fund current operations, revenue growth and to look for potential future acquisitions. We anticipate repatriating a portion of our unremitted foreign earnings. The estimated taxes and associated foreign tax credits are included in the income tax calculation. For further information on taxes please review footnote 6 of the "Notes to Consolidated Financial Statements."

International Subsidiaries

We offer customers a complete global manufacturing solution. Our facilities provide our customers the opportunity to have their products manufactured in the facility that best serves specific cost, product manufacturing and distribution needs. The locations of active foreign subsidiaries are as follows:

- Key Tronic Juarez, SA de CV owns five facilities and leases two facilities in Juarez, Mexico. These facilities include an SMT facility, an assembly and molding facility, a sheet metal fabrication facility, and assembly and warehouse facilities. This subsidiary is primarily used to support our U.S. operations.
- Key Tronic Computer Peripherals (Shanghai) Co., Ltd. leases two facilities with SMT, assembly, global purchasing and warehouse capabilities in Shanghai, China, which began operations in 1999. Its primary function is to provide EMS services for export.

Foreign sales (based on shipping instructions) from our worldwide operations, including domestic exports, were $117.1 million and $105.9 million in fiscal years 2018 and 2017, respectively. Products and manufacturing services provided by our subsidiary operations are often shipped to customers directly by the parent company.

RESULTS OF OPERATIONS

Comparison of the Fiscal Year Ended July 1, 2017 with the Fiscal Year Ended July 2, 2016

The following table sets forth for the periods indicated certain items of the consolidated statements of income expressed as a percentage of net sales. The financial information and discussion below should be read in conjunction with the consolidated financial statements and notes contained in this Annual Report.

	Fiscal Year Ended					
	July 1, 2017	% of net sales	July 2, 2016	% of net sales	$ change	% point change
Net sales	$467,797	100.0%	$484,965	100.0%	$(17,168)	—
Cost of sales	429,497	91.8	446,140	92.0	(16,643)	(0.2)
Gross profit	38,300	8.2	38,825	8.0	(525)	0.2
Operating expenses:						
Research, development and engineering	6,393	1.4	6,397	1.3	(4)	0.1
Selling, general and administrative	22,363	4.8	22,012	4.5	351	0.3
Total operating expenses	28,756	6.2	28,409	5.8	347	0.4
Operating income	9,544	2.0	10,416	2.1	(872)	(0.1)
Interest expense, net	2,288	0.5	2,265	0.5	23	—
Income before income taxes	7,256	1.6	8,151	1.7	(895)	(0.1)
Income tax provision	1,639	0.4	1,618	0.3	21	0.1
Net income	$5,617	1.2%	$6,533	1.3%	$(916)	(0.1)
Effective income tax rate	22.6%		19.9%			

Net Sales

The decrease in net sales of $17.2 million from prior year 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.

The following table shows the revenue by industry sectors as a percentage of revenue for fiscal years 2017 and 2016:

	Fiscal Year Ended	
	July 1, 2017	July 2, 2016
Industrial	40%	39%
Consumer	35	31
Gaming	9	7
Communication	8	13
Printers	5	6
Computer and Peripheral	2	1
Transportation	1	3
Total	100%	100%

We provide services to customers in a number of industries and produce a variety of products for our customers in each industry. As we continue to diversify our customer base and win new customers we may continue to see a change in the industry concentrations of our revenue.

Sales to foreign locations represented 22.6 percent and 28.3 percent of our total net sales in fiscal years 2017 and 2016, respectively.

Cost of Sales

Total cost of sales as a percentage of net sales was 91.8 percent and 92.0 percent in fiscal years 2017 and 2016, respectively.

Total cost of materials as a percentage of net sales was approximately 61.7 percent and 63.9 percent in fiscal years 2017 and 2016, respectively. The change from year-to-year is primarily a result of improved pricing of certain raw materials as well as a more favorable product mix.

Production and support costs as a percentage of net sales were 30.1 percent and 28.1 percent in fiscal years 2017 and 2016, respectively. The increase in fiscal year 2017 is primarily related absorption increasing as a percentage of sales during the fiscal year.

We provide a reserve for obsolete and non-saleable inventories based on specific identification of inventory against current demand and recent usage. We also consider our customers' ability to pay for inventory whether or not there is a lead-time assurance agreement for a specific program. The amounts charged to expense for these inventories were approximately $0.5 million and $0.8 million in fiscal years 2017 and 2016, respectively.

We provide warranties on certain products we sell and estimate warranty costs based on historical experience and anticipated product returns. Warranty expense is related to workmanship claims on keyboards and EMS products. The amounts charged to expense are determined based on an estimate of warranty exposure. The net warranty expense was approximately $68,000 and $95,000 in fiscal years 2017 and 2016, respectively.

Gross Profit

Gross profit as a percentage of net sales was 8.2 percent and 8.0 percent in fiscal years 2017, and 2016, respectively. The 0.2 percentage point increase in gross profit as a percentage of net sales during fiscal year 2017 as compared to fiscal year 2016 is primarily related to a 1.7 percentage point decrease in material related costs partially offset by a 1.5 percentage point increase in certain overhead costs. This reflects an increase in gross margin percentage year-over-year as the unprofitable manufacturing facility was closed and trimming non-profitable programs.

Changes in gross profit margins reflect the impact of a number of factors that can vary from period to period, including product mix, start-up costs and efficiencies associated with new programs, product life cycles, sales volumes, capacity utilization of our resources, management of inventories, component pricing and shortages, end market demand for customers' products, fluctuations in and timing of customer orders, and competition within the EMS industry. These and other factors can cause variations in operating results. There can be no assurance that gross margins will not decrease in future periods.

We took early pay discounts to suppliers that totaled approximately $1.9 million and $1.9 million in fiscal years 2017 and 2016, respectively. Early pay discounts will fluctuate based on our liquidity and changes in the discounts and terms offered by our suppliers.

Research, Development and Engineering

Research, development and engineering expenses (RD&E) consists principally of employee related costs, third party development costs, program materials, depreciation and allocated information technology and facilities costs. Total RD&E expenses were $6.4 million in fiscal years 2017 and 2016. Total RD&E expenses as a percent of net sales were 1.4 percent and 1.3 percent in fiscal years 2017 and 2016, respectively.

Selling, General and Administrative

Selling, general and administrative expenses (SG&A) consist principally of salaries and benefits, advertising and marketing programs, sales commissions, travel expenses, provision for doubtful accounts, facilities costs, and professional services. Total SG&A expenses were $22.4 million and $22.0 million in fiscal years 2017 and 2016, respectively. Total SG&A expenses as a percent of net sales were 4.8 percent and 4.5 percent in fiscal years 2017 and 2016, respectively. This 0.3 percentage point increase in SG&A as a percentage of net sales is primarily related to an increase in legal fees.

Interest Expense

We had net interest expense of $2.3 million in both fiscal years 2017 and 2016.

Income Tax Provision

We had an income tax expense of approximately $1.6 million during both fiscal years 2017 and 2016. The income tax expense recognized during both fiscal years 2017 and 2016, was primarily a function of U.S., federal, state and foreign taxes recognized at the statutory rates offset by the net benefit associated with federal research and development tax credits and changes in potential foreign tax credits.

We continually review our requirements for liquidity domestically to fund current operations, revenue growth and to look for potential future acquisitions. We anticipate repatriating a portion of our unremitted foreign earnings. The estimated taxes and associated foreign tax credits are included in the income tax calculation. For further information on taxes please review footnote 6 of the “Notes to Consolidated Financial Statements.”

Capital Resources and Liquidity

Operating Cash Flow

Net cash provided by operating activities for fiscal year 2018 was $11.5 million compared to net cash provided by operating activities of $9.4 million and $4.6 million in fiscal years 2017 and 2016, respectively.

The $11.5 million of net cash provided by operating activities during fiscal year 2018 is primarily related to $1.3 million of net loss, $7.8 million of depreciation and amortization, a $23.3 million increase in accounts payable, $10.6 million decrease in accounts receivable, a $0.6 million decrease in inventory, partially offset by a $4.5 million loss on arbitration. The $9.4 million of net cash provided by operating activities during fiscal year 2017 was primarily due to $5.6 million of net income, $7.2 million of depreciation and amortization and a $4.9 million decrease in inventory, partially offset by a $3.5 million increase in accounts receivable and a $5.9 million decrease in accounts payable. The $4.6 million of cash provided by operating activities during fiscal year 2016 was primarily due to $6.5 million of net income, $6.2 million of depreciation and amortization and an $11.1 million decrease in accounts receivable offset by a $16.2 million increase in inventory and a $2.6 million decrease in accounts payable.

Accounts receivable fluctuates based on the timing of shipments, terms offered and collections. In addition, accounts receivable will fluctuate based upon the amount of accounts receivable sold under our Trade Accounts Receivable Purchase Program. During fiscal years 2018, 2017 and 2016, we factored receivables of $104.7 million, $86.5 million and $78.0 million, respectively, from accounts receivable sold to financial institutions, which are not included on 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, negotiated supplier terms, and taking advantage of early pay discounts.

Investing Cash Flow

Cash flows used in investing activities were $3.5 million, $8.5 million, and $5.7 million in fiscal years 2018, 2017 and 2016, respectively. Our primary investing activity during fiscal year 2018 and 2017, was purchasing equipment to support increased production levels for new programs. Our primary investing activities during fiscal year 2016 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 and available borrowing capacities. During fiscal years 2018, 2017 and 2016, we received $1.0 million, $0.6 million and $13.3 million of cash resulting from the sale and leaseback of equipment under operating leases, respectively.

Financing Cash Flow

Cash flows used in financing activities were $8.0 million in fiscal year 2018 and $1.6 million in fiscal year 2017 as compared to cash provided by financing activities of $1.7 million in fiscal year 2016. Our primary financing activities during fiscal year 2018, were repayments on our term loans of $5.9 million as well as borrowings and repayments under our revolving line of credit facility. Our primary financing activities during fiscal year 2017 was the funding of a $3.9 million equipment term loan, repayments on our term loans of $5.4 million as well as borrowings and repayments under our revolving line of credit facility. Our primary financing activities during fiscal year 2016 were repayments on our term loan of $5.0 million as well as borrowings and repayments under our revolving line of credit facility.

As of June 30, 2018, the Company had an outstanding balance on the line of credit of $16.2 million. We had availability to borrow an additional $28.4 million under the Wells Fargo line of credit and we were in compliance with our loan covenants. 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 fixed asset financing will be sufficient to meet our working and fixed capital requirements for the foreseeable future.

As of June 30, 2018, we had approximately $0.3 million of cash held by foreign subsidiaries. Under the Tax Cuts and Jobs Act, future cash repatriations from these foreign subsidiaries are no longer subject to U.S. income taxes, but may be subject to foreign withholding taxes. See additional discussion in Footnote 6, Income Taxes. The total amount of foreign withholding taxes required to be paid for the amount of foreign subsidiary cash on hand as of June 30, 2018, would approximate $27,000. The Company also has approximately $29.5 million of foreign earnings that have not been repatriated to the U.S. Of that amount, the Company estimates that $14.3 million is to be repatriated in the future, requiring foreign withholding taxes of $0.8 million that is currently accrued in our deferred tax liabilities. The remaining $15.2 million is considered to be permanently reinvested in Mexico and China. If these amounts were required to be repatriated, we estimate it would create an additional $1.3 million in foreign withholding taxes payable.

Contractual Obligations and Commitments

In the normal course of business, we enter into contracts which obligate us to make payments in the future. The table below sets forth our significant future obligations by fiscal year:

Payments Due by Fiscal Year (in thousands)

	Total	2019	2020	2021	2022	2023	Thereafter
Term loans (1)	$18,862	$5,871	$12,120	$871	$—	$—	$ —
Wells Fargo Bank N.A. revolving loan (2)	$16,222	$—	$16,222	$—	$—	$—	$ —
Operating leases (3)	$18,500	$6,387	$3,128	$2,119	$1,385	$1,308	$ 4,173
Purchase orders (4)							

(1) The terms of the Wells Fargo Bank N.A. term loans are discussed in the consolidated financial statements at Note 4, "Long-Term Debt." Principal on the term loan is payable in equal quarterly installments of $1.25 million through June 15, 2019, with final installment of all remaining unpaid principal due on August 31, 2019. The equipment term loan is payable in equal quarterly payments of approximately $0.2 million which commenced on March 31, 2017 and will continue through the maturity of the equipment term loan on June 30, 2021.

(2) The terms of the Wells Fargo Bank N.A. revolving loan are discussed in the consolidated financial statements at Note 4, "Long-Term Debt." As of June 30, 2018, we were in compliance with our loan covenants.

(3) We maintain vertically integrated manufacturing operations in the United States, Mexico and China. We lease some of our administrative and manufacturing facilities and equipment. A complete discussion of properties can be found in Part 1, Item 2 at "Properties." Leases have proven to be an acceptable method for us to acquire new or replacement equipment and to maintain facilities with a minimum impact on our short term cash flows for operations. In addition, such operations are heavily dependent upon technically superior manufacturing equipment including molding machines in various tonnages, Surface Mount Technology (SMT) lines, sheet metal fabrication and stamping machines, clean rooms, and automated insertion, and test equipment for the various products we are capable of producing.

(4) As of June 30, 2018, we had open purchase order commitments for materials and other supplies of approximately $36.4 million. Included in the open purchase orders are various blanket orders for annual requirements. Actual needs under these blanket purchase orders fluctuate with our manufacturing levels and as such cannot be broken out between fiscal years. In addition, we have contracts with many of our customers that minimize our exposure to losses for material purchased within lead-times necessary to meet customer forecasts. Purchase orders generally can be cancelled without penalty within specified ranges that are determined in negotiations with our suppliers. These agreements depend in part on the type of materials purchased as well as the circumstances surrounding any requested cancellations.

In addition to the cash requirements presented above, we have various other accruals which are not included in the table above. For example, we owe our suppliers approximately $76.2 million for accounts payable and shipments in transit at the end of the fiscal year. We generally pay our suppliers in a range from 30 to 120 days depending on terms offered. These payments are financed by operating cash flows and our revolving line of credit.

We believe that cash flows generated from operations, factoring, leasing facilities, and funds available under the revolving credit facility will satisfy cash requirements for a period in excess of 12 months and into the foreseeable future.

Critical Accounting Policies and Estimates

Preparation of our consolidated financial statements requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenues and expenses. Note 1 to our consolidated financial statements describes the significant accounting policies used in the preparation of our consolidated financial statements. Management believes the most complex and sensitive judgments, because of their significance to our consolidated financial statements, result primarily from the need to make estimates about effects of matters that are inherently uncertain. The most significant areas involving management judgments are described below. Actual results in these areas could differ from management's estimates.

Revenue

Sales revenue from manufacturing is recognized upon shipment of the manufactured product per contractual terms. Upon shipment, title transfers and the customer assumes risks and rewards of ownership of the product. The price to the buyer is fixed or determinable and recoverability is reasonably assured. Unless specifically stated in contractual terms, there are no formal customer acceptance requirements or further obligations related to the manufacturing services; if any such requirements exist, then sales revenue is recognized at the time when such requirements are completed and such obligations are fulfilled. Revenue is recorded net of estimated returns of manufactured product based on management's analysis of historical returns.

Revenues and associated costs from engineering design, development services and tooling, which are performed under contract of short term durations, are recognized only after the completed performance of the service.

Inactive, Obsolete, and Surplus Inventory Reserve

Inventories are stated at the lower of cost or net realizable value. Cost is determined principally using the first-in, first-out (FIFO) method. We reserve for inventories that we deem inactive, obsolete or surplus. This reserve is calculated based upon the demand for the products that we produce. Demand is determined by expected sales, customer purchase orders, or customer forecasts. If expected sales do not materialize, then we would have inventory in excess of our reserves and would have to charge the excess against future earnings. In the case where we have purchased material based upon a customer's forecast or purchase orders, we are usually covered by lead-time assurance agreements or purchase orders with each customer. These contracts state that the financial liability for material purchased within agreed upon lead-time and based upon the customer's forecasts, lies with the customer. If we purchase material outside the lead-time assurance agreement and the customer's forecasts do not materialize or if we have no lead-time assurance agreement for a specific program, we would have the financial liability and may have to charge inactive, obsolete or surplus inventory against earnings. We also reserve for inventory related to specific customers covered by lead-time assurance agreements when those customers are experiencing financial difficulties or reimbursement is not reasonably assured.

Allowance for Doubtful Accounts

We value our accounts receivable net of an allowance for doubtful accounts. As of June 30, 2018, we did not have an allowance for doubtful accounts. As of July 1, 2017, the allowance for doubtful accounts was approximately $0.1 million. This allowance is based on estimates of the portion of accounts receivable that may not be collected in the future. The estimates used are based primarily on specific identification of potentially uncollectible accounts. Such accounts are identified using publicly available information in conjunction with evaluations of current payment activity. However, if any of our customers were to develop unexpected and immediate financial problems that would prevent payment of open invoices, we could incur additional and possibly material expenses that would negatively impact earnings.

Accrued Warranty

An accrual is made for expected warranty costs, with the related expense recognized in cost of goods sold. We review the adequacy of this accrual quarterly based on historical analysis and anticipated product returns and rework costs. Our warranty period for keyboards is generally longer than that for EMS products. We only warrant materials and workmanship on EMS products, and we do not warrant design defects for EMS customers.

Income Taxes

Income tax expense includes U.S. and international income taxes and a provisional estimate for U.S. taxes on undistributed earnings of foreign subsidiaries. We do not record foreign withholding taxes on undistributed earnings of international subsidiaries that are deemed to be permanently reinvested. Certain income and expenses are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes. The deferred income taxes are classified as long-term assets or liabilities. The most significant areas involving management judgments include deferred income tax assets and liabilities, uncertain tax positions, and research and development tax credits. Our estimates of the realization of the deferred tax assets related to our tax credits are based upon our estimates of future taxable income which may change.

Stock-Based Compensation

Stock-based compensation is accounted for according to Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 718, Compensation—Stock Compensation. ASC 718 requires us to expense the fair value of employee stock options, stock appreciation rights and other forms of stock-based compensation. Under the fair value recognition provisions of ASC 718, share-based compensation cost is estimated at the grant date based upon the fair value of the award and is recognized as expense ratably over the requisite service period of the award (generally the vesting period). Determining the appropriate fair value model and calculating the fair value of share-based awards requires judgment, including estimating the expected life of the share-based award, the expected stock price volatility over the expected life of the share-based award and forfeitures.

To determine the fair value of stock based awards on the date of grant we use the Black-Scholes option-pricing model. Inherent in this model are assumptions related to expected stock price volatility, option life, risk-free interest rate and dividend yield. The risk-free interest rate is a less-subjective assumption as it is based on factual data derived from public sources. We use a dividend yield of zero as we have never paid cash dividends and have no intention to pay cash dividends in the foreseeable future. The expected stock price volatility and option life assumptions require a greater level of judgment. Our expected stock-price volatility assumption is based upon the historical volatility of our stock which is obtained from public data sources. The expected life represents the weighted average period of time that share-based awards are expected to be outstanding, giving consideration to vesting schedules and historical exercise patterns. We determine the expected life assumption based upon the exercise and post-vesting behavior that has been exhibited historically, adjusted for specific factors that may influence future exercise patterns. If expected volatility or expected life were to increase, that would result in an increase in the fair value of our stock options which would result in higher compensation charges, while a decrease in volatility or the expected life would result in a lower fair value of our stock option awards resulting in lower compensation charges.

We estimate forfeitures for all of our awards based upon historical experience of stock-based pre-vesting forfeitures. We believe that our estimates are based upon outcomes that are reasonably likely to occur. If actual forfeitures are higher than our estimates it would result in lower compensation expense and to the extent the actual forfeitures are lower than our estimate we would record higher compensation expense.

Impairment of Long-Lived Assets

Long-lived assets, such as property, plant, and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge would be recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Derivatives and Hedging Activity

Derivatives are recognized on the balance sheet at their estimated fair value. On the date a derivative contract is entered into, the Company designates the derivative as a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (a “cash flow” hedge). The Company does not enter into derivatives for speculative purposes. Changes in the fair value of a derivative that qualifies as a cash flow hedge are recorded in “Accumulated Other Comprehensive Income,” until earnings are affected by the variability of cash flows. See Note 11 of the Company’s consolidated financial statements for additional information.

Long-Term Incentive Compensation Accrual

Long-term incentive compensation is recognized as expense ratably over the requisite service period of the award which is generally three years. The Board of Directors approve target performance measures for the three year period for each of the Company’s officers and non-employee Directors. Performance measures are based on a combination of sales growth targets and return on invested capital targets. No cash awards will be made to participants if actual Company performance does not exceed the minimum target performance measures. The calculation used to determine the necessary accrual uses a combination of actual results and projected results. We believe that our estimates are based upon outcomes that are reasonably likely to occur. These estimates and assumptions are based on historical results as well as future expectations. Actual results could vary from our estimates and assumptions.

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Impairment of Goodwill

In accordance with ASC 350, Goodwill and Other Intangible Assets, goodwill is not amortized but is required to be reviewed for impairment at least annually or when events or circumstances indicate that carrying value may exceed fair value. The Company is permitted the option to first assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the fair value of any reporting unit is less than its corresponding carrying value. If, after assessing the totality of events and circumstances, the Company concludes that it is not more likely than not that the fair value of any reporting unit is less than its corresponding carrying value then the Company is not required to take further action. However, if the Company concludes otherwise, then it is required to perform a quantitative impairment test, including computing the fair value of the reporting unit and comparing that value to its carrying value. The Company utilizes a weighting of the income approach and a market approach in the impairment test. We also consider valuation factors including the Company's market capitalization, future discounted cash flows and an estimated control premium based upon a review of comparable market transactions. Our consideration of discounted future cash flows included assumptions regarding growth rates and margins based on our historical trends. In addition, we applied a market discount rate calculated based upon an analysis of companies similar in size. If our future cash flows do not meet our projections or there is an event that impacts our market capitalization, the assumptions used in our goodwill analysis could be negatively impacted. The estimated fair value of the reporting unit exceeded the carrying value by approximately 38%. We will continue to monitor our market capitalization and impairment indicators.

If the fair value is less than its carrying value, a second step of the test is required to determine if recorded goodwill is impaired. In the event that goodwill is impaired, an impairment charge to earnings would become necessary. The Company also has the option to bypass the qualitative assessment for goodwill in any period and proceed directly to performing the quantitative impairment test.

New and Future Accounting Pronouncements

See Note 1 to our consolidated financial statements.

Item 7A: 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 and term loan are secured by substantially all of our assets. The interest rates applicable to our revolving credit facility and term loans fluctuate with the Wells Fargo Bank N.A. prime rate and LIBOR rates. There was outstanding $16.2 million in borrowings under our revolving credit facility and $18.9 million outstanding on our term loans as of June 30, 2018. 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 loan.

Our only material interest rate risk is associated with 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 and revolving credit facility. As of June 30, 2018, the remaining notional amount of the interest rate swap contract was $8.5 million. Through the use of the interest rate swap, as described above, we fixed the basis on which we pay interest, thus eliminating much 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 $46.3 million of foreign currency forward contracts and swaps outstanding as of June 30, 2018. The fair value of these contracts and swaps was approximately $(1.2) million. See Note 11 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
Report of Independent Registered Public Accounting Firm
Board of Directors and Stockholders
Key Tronic Corporation
Spokane Valley, Washington
Opinion on the Consolidated Financial Statements
We have audited the accompanying consolidated balance sheets of Key Tronic Corporation (the "Company") and subsidiaries as of June 30, 2018 and July 1, 2017, the related consolidated statements of income (loss), comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended June 20, 2018, and the related notes and schedule (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company and subsidiaries at June 30, 2018 and July 1, 2017, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2018, in conformity with accounting principles generally accepted in the United States of America.
We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of June 30, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and our report dated September 10, 2018 expressed an unqualified opinion thereon.
Basis for Opinion
These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.
Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP

We have served as the Company's auditor since 2003

Spokane, Washington
September 10, 2018

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands)

	June 30, 2018	July 1, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$343	$373
Trade receivables, net of allowance for doubtful accounts of $0 and $84	70,262	65,193
Inventories, net	110,315	101,590
Other	13,600	11,037
Total current assets	194,520	178,193
Property, plant and equipment, net	27,548	30,496
Other assets:		
Deferred income tax asset	7,882	6,981
Goodwill	9,957	9,957
Other intangible assets, net	3,726	4,800
Other	2,895	2,413
Total other assets	24,460	24,151
Total assets	$246,528	$232,840
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$76,198	$53,078
Accrued compensation and vacation	8,105	10,005
Current portion of debt, net	5,841	5,841
Other	8,769	8,829
Total current liabilities	98,913	77,753
Long-term liabilities:		
Term loans	12,932	18,773
Revolving loan	16,222	18,335
Other long-term obligations	380	1,412
Total long-term liabilities	29,534	38,520
Total liabilities	128,447	116,273
Commitments and contingencies (Note 4 and 9)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,760 and 10,760 shares, respectively	46,244	45,797
Retained earnings	72,806	73,545
Accumulated other comprehensive loss	(969)	(2,775)
Total shareholders' equity	118,081	116,567
Total liabilities and shareholders' equity	$246,528	$232,840

See accompanying notes to consolidated financial statements.

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

	Fiscal Year Ended		
	June 30, 2018	July 1, 2017	July 2, 2016
Net sales	$446,322	$467,797	$484,965
Cost of sales	412,153	429,497	446,140
Gross profit	34,169	38,300	38,825
Research, development and engineering expenses	6,186	6,393	6,397
Selling, general and administrative expenses	22,334	22,363	22,012
Loss on settlement of arbitration	4,535	—	—
Total operating expenses	33,055	28,756	28,409
Operating income	1,114	9,544	10,416
Interest expense, net	2,556	2,288	2,265
Income (loss) before income taxes	(1,442)	7,256	8,151
Income tax provision	(117)	1,639	1,618
Net income (loss)	$(1,325)	$	