

KENNAMETAL INC  
Form 10-Q  
May 09, 2011

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2011  
Commission file number 1-5318  
KENNAMETAL INC.**

(Exact name of registrant as specified in its charter)

**Pennsylvania**  
(State or other jurisdiction of incorporation or organization)

**25-0900168**  
(I.R.S. Employer Identification No.)

**World Headquarters  
1600 Technology Way  
P.O. Box 231  
Latrobe, Pennsylvania**  
(Address of principal executive offices)

**15650-0231**  
(Zip Code)

Website: [www.kennametal.com](http://www.kennametal.com)

Registrant's telephone number, including area code: **(724) 539-5000**

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of capital stock, as of the latest practicable date.

| Title of Each Class                       | Outstanding at April 30, 2011 |
|---|-------------------------------|
| Capital Stock, par value \$1.25 per share | 81,803,328                    |



**KENNAMETAL INC.  
FORM 10-Q  
FOR THE THREE AND NINE MONTHS ENDED MARCH 31, 2011  
TABLE OF CONTENTS**

| <u>Item No.</u>  | <u>Page No.</u> |
|--|-----------------|
| <b><u>PART I FINANCIAL INFORMATION</u></b>   |                 |
| <u>1. Financial Statements.</u>  |                 |
| <u>Condensed Consolidated Statements of Income (Unaudited) Three and nine months ended March 31, 2011 and 2010</u> | 4               |
| <u>Condensed Consolidated Balance Sheets (Unaudited) March 31, 2011 and June 30, 2010</u>                          | 5               |
| <u>Condensed Consolidated Statements of Cash Flow (Unaudited) Nine months ended March 31, 2011 and 2010</u>        | 6               |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>  | 7               |
| <u>2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                    | 21              |
| <u>3. Quantitative and Qualitative Disclosures About Market Risk</u>   | 27              |
| <u>4. Controls and Procedures</u>  | 27              |
| <b><u>PART II OTHER INFORMATION</u></b>  |                 |
| <u>1. Legal Proceedings</u>  | 28              |
| <u>2. Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 28              |
| <u>6. Exhibits</u>   | 29              |
| <u>Signatures</u>  | 30              |
| <u>EX-31.1</u>   |                 |
| <u>EX-31.2</u>   |                 |
| <u>EX-32.1</u>   |                 |
| <u>EX-101 INSTANCE DOCUMENT</u>  |                 |
| <u>EX-101 SCHEMA DOCUMENT</u>  |                 |
| <u>EX-101 CALCULATION LINKBASE DOCUMENT</u>  |                 |
| <u>EX-101 LABELS LINKBASE DOCUMENT</u>   |                 |
| <u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>   |                 |

---

**Table of Contents**

**FORWARD-LOOKING INFORMATION**

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are statements that do not relate strictly to historical or current facts. You can identify forward-looking statements by the fact they use words such as should, anticipate, estimate, approximate, expect, may, will, project, intend, plan, believe and meaning and expression in connection with any discussion of future operating or financial performance or events. Forward-looking statements in this Form 10-Q may concern, among other things, Kennametal's expectations regarding our strategy, goals, plans and projections regarding our financial position, liquidity and capital resources, results of operations, market position, and product development, all of which are based on current estimates that involve inherent risks and uncertainties. Among the factors that could cause the actual results to differ materially from those indicated in the forward-looking statements are risks and uncertainties related to: prolonged economic recession; restructuring and related actions (including associated costs and anticipated benefits); availability and cost of the raw materials we use to manufacture our products; our foreign operations and international markets, such as currency exchange rates, different regulatory environments, trade barriers, exchange controls, and social and political instability; changes in the regulatory environment in which we operate, including environmental, health and safety regulations; our ability to protect and defend our intellectual property; competition; our ability to retain our management and employees; demands on management resources; successful completion of information systems upgrades, including our enterprise system software; potential claims relating to our products; integrating acquisitions and achieving the expected savings and synergies; business divestitures; global or regional catastrophic events; energy costs; commodity prices; labor relations; demand for and market acceptance of new and existing products; implementation of environmental remediation matters; and implementation of a new segment structure. Should one or more of these risks or uncertainties materialize, or should the assumptions underlying the forward-looking statements prove incorrect, actual outcomes could vary materially from those indicated. These and other risks are more fully described in the Risk Factors Section of our Annual Report on Form 10-K and in our other periodic filings with the Securities and Exchange Commission. We undertake no obligation to release publicly any revisions to forward-looking statements as a result of future events or developments.

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****KENNAMETAL INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

| (in thousands, except per share amounts)                     | Three Months Ended<br>March 31, |            | Nine Months Ended<br>March 31, |              |
|--|---------------------------------|------------|--------------------------------|--------------|
|  | 2011                            | 2010       | 2011                           | 2010         |
| Sales  | \$ 614,830                      | \$ 493,165 | \$ 1,709,756                   | \$ 1,345,425 |
| Cost of goods sold   | 384,849                         | 322,841    | 1,091,010                      | 917,212      |
| Gross profit   | 229,981                         | 170,324    | 618,746                        | 428,213      |
| Operating expense  | 138,322                         | 120,062    | 395,447                        | 354,126      |
| Restructuring charges (Note 7)                               | 1,046                           | 20,720     | 7,697                          | 31,898       |
| Amortization of intangibles                                  | 2,836                           | 3,239      | 8,696                          | 9,946        |
| Operating income   | 87,777                          | 26,303     | 206,906                        | 32,243       |
| Interest expense   | 5,767                           | 6,531      | 17,294                         | 18,856       |
| Other expense (income), net                                  | 1,413                           | (1,496)    | 3,071                          | (6,314)      |
| Income from continuing operations before<br>income taxes     | 80,597                          | 21,268     | 186,541                        | 19,701       |
| Provision for income taxes                                   | 15,394                          | 11,065     | 41,092                         | 11,026       |
| Income from continuing operations                            | 65,203                          | 10,203     | 145,449                        | 8,675        |
| Loss from discontinued operations (Note 8)                   | -                               | -          | -                              | (1,423)      |
| Net income   | 65,203                          | 10,203     | 145,449                        | 7,252        |
| Less: Net income attributable to<br>noncontrolling interests | 520                             | 518        | 2,376                          | 1,417        |
| Net income attributable to Kennametal                        | \$ 64,683                       | \$ 9,685   | \$ 143,073                     | \$ 5,835     |
| Amounts attributable to Kennametal<br>Shareowners:           |                                 |            |                                |              |
| Income from continuing operations                            | \$ 64,683                       | \$ 9,685   | \$ 143,073                     | \$ 7,258     |

Edgar Filing: KENNAMETAL INC - Form 10-Q

|   |           |          |            |          |
|---|-----------|----------|------------|----------|
| Loss from discontinued operations                     | -         | -        | -          | (1,423)  |
| Net income  | \$ 64,683 | \$ 9,685 | \$ 143,073 | \$ 5,835 |
| PER SHARE DATA ATTRIBUTABLE TO KENNAMETAL SHAREOWNERS |           |          |            |          |
| Basic earnings (loss) per share:                      |           |          |            |          |
| Continuing operations                                 | \$ 0.79   | \$ 0.12  | \$ 1.74    | \$ 0.09  |
| Discontinued operations                               | -         | -        | -          | (0.02)   |
|   | \$ 0.79   | \$ 0.12  | \$ 1.74    | \$ 0.07  |
| Diluted earnings (loss) per share:                    |           |          |            |          |
| Continuing operations                                 | \$ 0.77   | \$ 0.12  | \$ 1.72    | \$ 0.09  |
| Discontinued operations                               | -         | -        | -          | (0.02)   |
|   | \$ 0.77   | \$ 0.12  | \$ 1.72    | \$ 0.07  |
| Dividends per share                                   | \$ 0.12   | \$ 0.12  | \$ 0.36    | \$ 0.36  |
| Basic weighted average shares outstanding             | 82,138    | 81,358   | 82,144     | 80,756   |
| Diluted weighted average shares outstanding           | 83,495    | 82,189   | 83,164     | 81,397   |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****KENNAMETAL INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

| (in thousands, except per share data)   | March 31,<br>2011   | June 30,<br>2010    |
|---|---------------------|---------------------|
| <b>ASSETS</b>   |                     |                     |
| Current assets:   |                     |                     |
| Cash and cash equivalents   | \$ 184,192          | \$ 118,129          |
| Accounts receivable, less allowance for doubtful accounts of \$24,245 and \$24,789        | 418,546             | 326,699             |
| Inventories (Note 11)   | 466,125             | 364,268             |
| Deferred income taxes   | 71,424              | 62,083              |
| Other current assets  | 52,510              | 44,752              |
| <b>Total current assets</b>   | <b>1,192,797</b>    | <b>915,931</b>      |
| Property, plant and equipment:  |                     |                     |
| Land and buildings  | 365,565             | 341,748             |
| Machinery and equipment   | 1,346,888           | 1,281,872           |
| Less accumulated depreciation   | (1,047,597)         | (959,085)           |
| <b>Property, plant and equipment, net</b>   | <b>664,856</b>      | <b>664,535</b>      |
| Other assets:   |                     |                     |
| Investments in affiliated companies   | 833                 | 2,251               |
| Goodwill (Note 18)  | 507,969             | 489,443             |
| Other intangible assets, less accumulated amortization of \$75,492 and \$63,343 (Note 18) | 153,858             | 155,306             |
| Deferred income taxes   | 12,310              | 11,827              |
| Other   | 36,599              | 28,530              |
| <b>Total other assets</b>   | <b>711,569</b>      | <b>687,357</b>      |
| <b>Total assets</b>   | <b>\$ 2,569,222</b> | <b>\$ 2,267,823</b> |
| <b>LIABILITIES</b>  |                     |                     |
| Current liabilities:  |                     |                     |
| Current maturities of long-term debt and capital leases (Note 12)                         | \$ 476              | \$ 3,539            |
| Notes payable to banks  | 5,700               | 19,454              |
| Accounts payable  | 166,085             | 125,360             |
| Accrued income taxes  | 23,109              | 17,857              |
| Accrued expenses  | 98,423              | 73,989              |
| Other current liabilities (Note 7)  | 156,333             | 152,806             |
| <b>Total current liabilities</b>  | <b>450,126</b>      | <b>393,005</b>      |
| Long-term debt and capital leases, less current maturities (Note 12)                      | 310,667             | 314,675             |
| Deferred income taxes   | 67,650              | 63,266              |



Edgar Filing: KENNAMETAL INC - Form 10-Q

|   |              |              |
|---|--------------|--------------|
| Accrued pension and postretirement benefits   | 146,382      | 129,701      |
| Accrued income taxes  | 5,870        | 5,193        |
| Other liabilities   | 26,140       | 28,540       |
| Total liabilities   | 1,006,835    | 934,380      |
| Commitments and contingencies   |              |              |
| EQUITY (Note 16)  |              |              |
| Kennametal Shareowners Equity:  |              |              |
| Preferred stock, no par value; 5,000 shares authorized; none issued                         | -            | -            |
| Capital stock, \$1.25 par value; 120,000 shares authorized; 81,814 and 81,903 shares issued | 102,267      | 102,379      |
| Additional paid-in capital  | 495,140      | 492,454      |
| Retained earnings   | 906,648      | 793,448      |
| Accumulated other comprehensive income (loss)   | 36,115       | (72,781)     |
| Total Kennametal Shareowners Equity   | 1,540,170    | 1,315,500    |
| Noncontrolling interests  | 22,217       | 17,943       |
| Total equity  | 1,562,387    | 1,333,443    |
| Total liabilities and equity  | \$ 2,569,222 | \$ 2,267,823 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****KENNAMETAL INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW (UNAUDITED)**

| Nine months ended March 31 (in thousands)                                     | 2011       | 2010 <sup>(1)</sup> |
|---|------------|---------------------|
| <b>OPERATING ACTIVITIES</b>   |            |                     |
| Net income  | \$ 145,449 | \$ 7,252            |
| Adjustments for non-cash items:   |            |                     |
| Depreciation  | 60,165     | 61,323              |
| Amortization  | 8,696      | 9,946               |
| Stock-based compensation expense  | 15,727     | 12,529              |
| Restructuring charges   | 2,609      | 366                 |
| Loss on divestitures  | -          | 527                 |
| Deferred income tax (benefit) provision                                       | (2,878)    | 306                 |
| Other   | 4,637      | (3,969)             |
| Changes in certain assets and liabilities, excluding effects of divestitures: |            |                     |
| Accounts receivable   | (71,692)   | (34,750)            |
| Inventories   | (74,706)   | 4,524               |
| Accounts payable and accrued liabilities                                      | 37,250     | 9,109               |
| Accrued income taxes  | 4,378      | 16,686              |
| Other   | (4,610)    | 8,788               |
| Net cash flow provided by operating activities                                | 125,025    | 92,637              |
| <b>INVESTING ACTIVITIES</b>   |            |                     |
| Purchases of property, plant and equipment                                    | (33,348)   | (30,438)            |
| Disposals of property, plant and equipment                                    | 8,063      | 4,087               |
| Proceeds from divestitures (Note 8)   | -          | 27,788              |
| Other   | 2,349      | 286                 |
| Net cash flow (used for) provided by investing activities                     | (22,936)   | 1,723               |
| <b>FINANCING ACTIVITIES</b>   |            |                     |
| Net decrease in notes payable   | (13,844)   | (12,187)            |
| Net decrease in short-term revolving and other lines of credit                | -          | (18,400)            |
| Term debt borrowings  | 365,082    | 439,327             |
| Term debt repayments  | (366,653)  | (555,041)           |
| Purchase of capital stock   | (26,457)   | (224)               |
| Net proceeds from equity offering   | -          | 120,693             |
| Dividend reinvestment and the effect of employee benefit and stock plans      | 15,081     | 6,603               |
| Cash dividends paid to shareowners  | (29,873)   | (29,429)            |
| Other   | (1,045)    | (1,096)             |
| Net cash flow used for financing activities                                   | (57,709)   | (49,754)            |
| Effect of exchange rate changes on cash and cash equivalents                  | 21,683     | (3,536)             |
| <b>CASH AND CASH EQUIVALENTS</b>  |            |                     |

Edgar Filing: KENNAMETAL INC - Form 10-Q

|  |            |            |
|--|------------|------------|
| Net increase in cash and cash equivalents      | 66,063     | 41,070     |
| Cash and cash equivalents, beginning of period | 118,129    | 69,823     |
| Cash and cash equivalents, end of period       | \$ 184,192 | \$ 110,893 |

(1) Amounts presented include cash flows from discontinued operations.

The accompanying notes are an integral part of these condensed consolidated financial statements.

6

---

**Table of Contents**

**KENNAMETAL INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. ORGANIZATION**

Kennametal Inc. was incorporated in Pennsylvania in 1943. Kennametal Inc. and its subsidiaries (collectively, Kennametal or the Company) are a leading global manufacturer and supplier of tooling, engineered components and advanced materials consumed in production processes. We believe that our reputation for manufacturing excellence, as well as our technological expertise and innovation in our principle products, has helped us to achieve a leading market presence in our primary markets. End users of our products include metalworking manufacturers and suppliers across a diverse array of industries including the aerospace, defense, transportation, machine tool, light machinery and heavy machinery industries, as well as manufacturers, producers and suppliers in a number of other industries including coal mining, highway construction, quarrying, oil and gas exploration and production industries. Our end users' products and services include everything from airframes to coal, engines to oil wells and turbochargers to construction. We operate two global business units consisting of Industrial and Infrastructure.

**2. BASIS OF PRESENTATION**

The condensed consolidated financial statements, which include our accounts and those of our majority-owned subsidiaries, should be read in conjunction with our 2010 Annual Report on Form 10-K. The condensed consolidated balance sheet as of June 30, 2010 was derived from the audited balance sheet included in our 2010 Annual Report on Form 10-K. These interim statements are unaudited; however, we believe that all adjustments necessary for a fair statement of the results of the interim periods were made and all adjustments are normal, recurring adjustments. The results for the nine months ended March 31, 2011 and 2010 are not necessarily indicative of the results to be expected for a full fiscal year. Unless otherwise specified, any reference to a year is to a fiscal year ended June 30. For example, a reference to 2011 is to the fiscal year ending June 30, 2011. When used in this Form 10-Q, unless the context requires otherwise, the terms we, our and us refer to Kennametal Inc. and its consolidated subsidiaries.

**3. NEW ACCOUNTING STANDARDS**

*Adopted*

As of January 1, 2011, Kennametal adopted changes to intangible impairment testing for reporting units with zero or negative carrying amounts. These changes require an entity to perform all steps in the test for a reporting unit whose carrying value is zero or negative if it is more likely than not that an intangible impairment exists based on qualitative factors, resulting in the elimination of an entity's ability to assert that such a reporting unit's intangible assets are not impaired and additional testing is not necessary despite the existence of qualitative factors that indicate otherwise. The adoption of this guidance did not have an impact on our condensed consolidated financial statements.

As of January 1, 2011, Kennametal adopted changes to the disclosures related to business combinations for a public entity that presents comparative financial statements. This guidance also expanded the supplemental pro forma business combination disclosures. The adoption of this guidance did not have an impact on our condensed consolidated financial statements.

As of July 1, 2010, Kennametal adopted new guidance on consolidations for enterprises involved with variable interest entities. The guidance modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar) rights should be consolidated and clarifies that the determination of whether a company is required to consolidate a variable interest entity is based on, among other things, an entity's

purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity and also requires additional disclosures about a company's involvement in variable interest entities and any significant changes in risk exposure due to that involvement. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

As of July 1, 2010, Kennametal adopted new guidance on accounting for transfers of financial assets. This guidance requires additional disclosure regarding transfers of financial assets, including securitization transactions, and where companies have continuing exposure to the risks related to transferred financial assets. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

As of July 1, 2010, Kennametal adopted new guidance on revenue recognition for multiple-deliverable revenue arrangements. The guidance allows companies to allocate arrangement consideration in multiple deliverable arrangements in a manner that better reflects the transaction's economics and may result in earlier revenue recognition. In addition, the residual method of allocating arrangement consideration is no longer permitted. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****4. SUPPLEMENTAL CASH FLOW DISCLOSURES**

|   |           |           |
|---|-----------|-----------|
| Nine months ended March 31 (in thousands)                                     | 2011      | 2010      |
| Cash paid (received) during the period for:                                   |           |           |
| Interest  | \$ 14,684 | \$ 16,043 |
| Income taxes  | 40,741    | (5,129)   |
| Supplemental disclosure of non-cash information:                              |           |           |
| Contribution of capital stock to employees defined contribution benefit plans | 948       | 4,248     |

**5. FAIR VALUE MEASUREMENTS**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy consists of three levels to prioritize the inputs used in valuations, as defined below:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, including quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates); and inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3: Inputs that are unobservable.

As of March 31, 2011, the fair values of the Company's financial assets and financial liabilities measured at fair value on a recurring basis are categorized as follows:

| (in thousands)                  | Level 1 | Level 2  | Level 3 | Total    |
|---------------------------------|---------|----------|---------|----------|
| Assets:                         |         |          |         |          |
| Derivatives <sup>(1)</sup>      | \$ -    | \$ 4,416 | \$ -    | \$ 4,416 |
| Total assets at fair value      | \$ -    | \$ 4,416 | \$ -    | \$ 4,416 |
| Liabilities:                    |         |          |         |          |
| Derivatives <sup>(1)</sup>      | \$ -    | \$ 1,640 | \$ -    | \$ 1,640 |
| Total liabilities at fair value | \$ -    | \$ 1,640 | \$ -    | \$ 1,640 |

(1)

Edgar Filing: KENNAMETAL INC - Form 10-Q

Foreign currency derivative and interest rate swap contracts are valued based on observable market spot and forward rates and are classified within Level 2 of the fair value hierarchy.

As of June 30, 2010, the fair value of the Company's financial assets and financial liabilities measured at fair value on a recurring basis are categorized as follows:

| (in thousands)                  | Level 1 | Level 2  | Level 3 | Total    |
|---------------------------------|---------|----------|---------|----------|
| Assets:                         |         |          |         |          |
| Derivatives <sup>(1)</sup>      | \$ -    | \$ 43    | \$ -    | \$ 43    |
| Total assets at fair value      | \$ -    | \$ 43    | \$ -    | \$ 43    |
| Liabilities:                    |         |          |         |          |
| Derivatives <sup>(1)</sup>      | \$ -    | \$ 3,453 | \$ -    | \$ 3,453 |
| Total liabilities at fair value | \$ -    | \$ 3,453 | \$ -    | \$ 3,453 |

<sup>(1)</sup> Foreign currency derivative and interest rate swap contracts are valued based on observable market spot and forward rates and are classified within Level 2 of the fair value hierarchy.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****6. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

As part of our financial risk management program, we use certain derivative financial instruments. We do not enter into derivative transactions for speculative purposes and therefore hold no derivative instruments for trading purposes. We use derivative financial instruments to provide predictability to the effects of changes in foreign exchange rates on our consolidated results and to achieve our targeted mix of fixed and floating interest rates on outstanding debt. We account for derivative instruments as a hedge of the related asset, liability, firm commitment or anticipated transaction, when the derivative is specifically designated as a hedge of such items. Our objective in managing foreign exchange exposures with derivative instruments is to reduce volatility in cash flow, allowing us to focus more of our attention on business operations. With respect to interest rate management, these derivative instruments allow us to achieve our targeted fixed-to-floating interest rate mix as a separate decision from funding arrangements in the bank and public debt markets. We measure hedge effectiveness by assessing the changes in the fair value or expected future cash flows of the hedged item. The ineffective portions are recorded in other (income) expense, net.

The fair value of derivatives designated in the condensed consolidated balance sheet are as follows:

| (in thousands)  | March 31,<br>2011 | June 30,<br>2010 |
|---|-------------------|------------------|
| Derivatives designated as hedging instruments                     |                   |                  |
| Other current assets - range forward contracts                    | \$ 3              | \$ 34            |
| Other current liabilities - range forward contracts               | (426)             | (2)              |
| Other assets - forward starting interest rate swap contracts      | 2,990             | -                |
| Other liabilities - forward starting interest rate swap contracts | (659)             | (2,348)          |
| Total derivatives designated as hedging instruments               | 1,908             | (2,316)          |
| Derivatives not designated as hedging instruments                 |                   |                  |
| Other current assets - currency forward contracts                 | 1,423             | 9                |
| Other current liabilities - currency forward contracts            | (555)             | (1,103)          |
| Total derivatives not designated as hedging instruments           | 868               | (1,094)          |
| Total derivatives   | \$ 2,776          | \$ (3,410)       |

Certain currency forward contracts hedging significant cross-border intercompany loans are considered as other derivatives and therefore do not qualify for hedge accounting. These contracts are recorded at fair value in the balance sheet, with the offset to other expense (income), net. Losses (gains) related to derivatives not designated as hedging instruments have been recognized as follows:

| (in thousands) | Three Months Ended<br>March 31, |      | Nine Months Ended<br>March 31, |      |
|----------------|---------------------------------|------|--------------------------------|------|
|                | 2011                            | 2010 | 2011                           | 2010 |



|  |        |            |            |        |
|--|--------|------------|------------|--------|
| Other expense (income), net - currency forward contracts | \$ 480 | \$ (6,261) | \$ (1,302) | \$ 794 |
|--|--------|------------|------------|--------|

#### FAIR VALUE HEDGES

Fixed-to-floating interest rate swap contracts, designated as fair value hedges, are entered into from time to time to hedge our exposure to fair value fluctuations on a portion of our fixed rate debt. These interest rate swap contracts convert a portion of our fixed rate debt to floating rate debt. These contracts require periodic settlement, and the difference between amounts to be received and paid under the interest rate swap contracts is recognized in interest expense. We had no such contracts outstanding at March 31, 2011 and June 30, 2010, respectively.

In February 2009, we terminated interest rate swap contracts to convert \$200.0 million of our fixed rate debt to floating rate debt. These contracts were originally set to mature in June 2012. Upon termination, we received a cash payment of \$13.2 million. This gain is being amortized as a component of interest expense over the remaining term of the related debt using the effective interest rate method. During the three and nine months ended March 31, 2011, \$1.5 million and \$4.4 million, respectively, were recognized as reductions in interest expense. During the three and nine months ended March 31, 2010, \$1.4 million and \$4.2 million, respectively, were recognized as reductions in interest expense.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****CASH FLOW HEDGES**

Currency forward contracts and range forward contracts (a transaction where both a put option is purchased and a call option is sold), designated as cash flow hedges, hedge anticipated cash flows from cross-border intercompany sales of products and services. Gains and losses realized on these contracts at maturity are recorded in accumulated other comprehensive loss, net of tax, and are recognized as a component of other expense (income), net when the underlying sale of products or services is recognized into earnings. The notional amount of the contracts translated into U.S. dollars at March 31, 2011 and 2010, was \$41.4 million and \$17.8 million, respectively. The time value component of the fair value of range forwards is excluded from the assessment of hedge effectiveness. Assuming the market rates remain constant with the rates at March 31, 2011, we expect to recognize a loss of \$0.4 million in the next 12 months on outstanding derivatives.

We enter into floating-to-fixed interest rate swap contracts, designated as cash flow hedges, from time to time to hedge our exposure to interest rate changes on a portion of our floating rate debt. These interest rate swap contracts convert a portion of our floating rate debt to fixed rate debt. We record the fair value of these contracts as an asset or a liability, as applicable, in the balance sheet, with the offset to accumulated other comprehensive loss, net of tax. At March 31, 2011, we had forward starting interest rate swap contracts outstanding for forecasted transactions that effectively converted a cumulative notional amount of \$125 million from floating to fixed interest rates. As of March 31, 2011, we recorded a net asset of \$2.3 million on these contracts which was recorded as an offset in other comprehensive income, net of tax. Over the next 12 months, assuming the market rates remain constant with the rates at March 31, 2011, we do not expect to recognize into earnings any significant gains or losses on outstanding derivatives. We had no such contracts outstanding at March 31, 2010.

Amounts related to cash flow hedges have been recognized as follows:

| (in thousands)   | Three Months Ended<br>March 31, |        | Nine Months Ended<br>March 31, |            |
|--|---------------------------------|--------|--------------------------------|------------|
|  | 2011                            | 2010   | 2011                           | 2010       |
| Gains (losses) recognized in other comprehensive loss  | \$ 239                          | \$ 8   | \$ 2,660                       | \$ (1,017) |
| Losses (gains) reclassified from accumulated other comprehensive loss into other expense (income), net | \$ 293                          | \$ 114 | \$ 603                         | \$ (1,234) |

No portion of the gains or losses recognized in earnings was due to ineffectiveness and no amounts were excluded from our effectiveness testing for the nine months ended March 31, 2011 and 2010, respectively.

**7. RESTRUCTURING CHARGES AND RELATED CHARGES**

We continued to implement restructuring plans to reduce costs and improve operating efficiencies. These actions taken during the nine months ended March 31, 2011 related primarily to the rationalization of certain manufacturing facilities. Restructuring and related charges recorded during the nine months ended March 31, 2011 amounted to \$14.9 million, including \$8.7 million of restructuring charges of which \$1.0 million were related to inventory disposals and recorded in cost of goods sold. Restructuring-related charges of \$3.0 million and \$3.2 million were recorded in cost of goods sold and operating expense, respectively, during the nine months ended March 31, 2011. Restructuring and related charges recorded during the nine months ended March 31, 2010 amounted to \$35.6 million, including \$32.2 million of restructuring charges, of which \$0.3 million related to inventory disposals and were recorded in cost of goods sold. Restructuring-related charges of \$2.3 million and \$1.1 million were recorded in cost of goods sold and operating expense, respectively, during the same period.

The combined total pre-tax charges are not expected to exceed \$165 million, and are expected to be approximately 70% Industrial and 30% Infrastructure. We expect the majority of these pre-tax charges to be severance charges. Total restructuring and related charges since inception of \$143 million have been recorded through March 31, 2011: approximately \$99 million in Industrial, approximately \$42 million in Infrastructure and approximately \$2 million in Corporate for the write-off our pre-existing ERP system. The remaining restructuring charges are expected to be completed within the next three months and are anticipated to be mostly cash expenditures.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

The restructuring accrual is recorded in other current liabilities in our condensed consolidated balance sheet and the amount attributable to each segment is as follows:

| (in thousands)       | June 30,<br>2010 | Expense  | Asset<br>Write-down | Cash<br>Expenditures | Translation | March 31,<br>2011 |
|----------------------|------------------|----------|---------------------|----------------------|-------------|-------------------|
| Industrial           |                  |          |                     |                      |             |                   |
| Severance            | \$ 18,327        | \$ 2,374 | \$ -                | \$ (13,678)          | \$ 1,471    | \$ 8,494          |
| Facilities           | 508              | 1,589    | (1,589)             | (408)                | -           | 100               |
| Other                | 403              | 1,355    | -                   | (778)                | 76          | 1,056             |
| Total Industrial     | 19,238           | 5,318    | (1,589)             | (14,864)             | 1,547       | 9,650             |
| Infrastructure       |                  |          |                     |                      |             |                   |
| Severance            | 7,637            | 1,523    | -                   | (8,779)              | 944         | 1,325             |
| Facilities           | 211              | 1,020    | (1,020)             | (211)                | -           | -                 |
| Other                | 168              | 870      | -                   | (500)                | 49          | 587               |
| Total Infrastructure | 8,016            | 3,413    | (1,020)             | (9,490)              | 993         | 1,912             |
| Total                | \$ 27,254        | \$ 8,731 | \$ (2,609)          | \$ (24,354)          | \$ 2,540    | \$ 11,562         |

| (in thousands)       | June 30,<br>2009 | Expense   | Asset<br>Write-down | Cash<br>Expenditures | Translation | June 30,<br>2010 |
|----------------------|------------------|-----------|---------------------|----------------------|-------------|------------------|
| Industrial           |                  |           |                     |                      |             |                  |
| Severance            | \$ 18,378        | \$ 29,082 | \$ -                | \$ (28,086)          | \$ (1,047)  | \$ 18,327        |
| Facilities           | 477              | 790       | (604)               | (142)                | (13)        | 508              |
| Other                | 176              | 1,393     | -                   | (1,241)              | 75          | 403              |
| Total Industrial     | 19,031           | 31,265    | (604)               | (29,469)             | (985)       | 19,238           |
| Infrastructure       |                  |           |                     |                      |             |                  |
| Severance            | 7,659            | 12,119    | -                   | (11,704)             | (437)       | 7,637            |
| Facilities           | 199              | 329       | (251)               | (59)                 | (7)         | 211              |
| Other                | 73               | 580       | -                   | (517)                | 32          | 168              |
| Total Infrastructure | 7,931            | 13,028    | (251)               | (12,280)             | (412)       | 8,016            |
| Total                | \$ 26,962        | \$ 44,293 | \$ (855)            | \$ (41,749)          | \$ (1,397)  | \$ 27,254        |

## 8. DISCONTINUED OPERATIONS

Edgar Filing: KENNAMETAL INC - Form 10-Q

On June 30, 2009, we completed the sale of our high speed steel drills and related product lines. This divestiture was accounted for as discontinued operations. Cash proceeds received from this divestiture amounted to \$28.5 million of which \$27.0 million was received during the nine months ended March 31, 2010. We did not incur any pre-tax charges related to this divestiture during the three and nine months ended March 31, 2011. We incurred pre-tax charges related to this divestiture of \$2.3 million during the nine months ended March 31, 2010. We do not expect to incur any additional pre-tax charges related to this divestiture.

The following represents the results of discontinued operations:

| (in thousands)  | Nine Months<br>Ended<br>March 31, 2010 |
|---|--|
| Sales   | \$ -                                   |
| Loss from discontinued operations before income taxes | \$ (2,269)                             |
| Income tax benefit                                    | 846                                    |
| Loss from discontinued operations                     | \$ (1,423)                             |

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****9. STOCK-BASED COMPENSATION**

On October 26, 2010, the Company's shareowners approved the Kennametal Inc., Stock and Incentive Plan of 2010 (the 2010 Plan). The 2010 Plan authorizes the issuance of up to 3,500,000 shares of the Company's common stock plus the remaining shares from the 2002 Plan. Shares can be issued in the form of incentive stock options, non-statutory stock options, stock appreciation rights, performance share awards, performance unit awards, restricted stock awards, restricted unit awards and share awards.

*Stock Options*

The assumptions used in our Black-Scholes valuation related to grants made during the nine months ended March 31, 2011 and 2010 were as follows:

|                                      | 2011  | 2010  |
|--------------------------------------|-------|-------|
| Risk-free interest rate              | 1.4%  | 2.3%  |
| Expected life (years) <sup>(1)</sup> | 4.5   | 4.5   |
| Expected volatility <sup>(2)</sup>   | 47.0% | 43.9% |
| Expected dividend yield              | 2.0%  | 1.8%  |

(1) Expected life is derived from historical experience.

(2) Expected volatility is based on the historical volatility of our stock.

Changes in our stock options for the nine months ended March 31, 2011 were as follows:

|  | Options   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Life<br>(years) | Aggregate<br>Intrinsic<br>value<br>(in<br>thousands) |
|--|-----------|--|---|--|
| Options outstanding, June 30, 2010                     | 3,582,075 | \$ 25.59                                 |   |  |
| Granted  | 545,987   | 27.01                                    |   |  |
| Exercised  | (539,658) | 22.04                                    |   |  |
| Lapsed and forfeited                                   | (68,854)  | 26.11                                    |   |  |
| Options outstanding, March 31, 2011                    | 3,519,550 | \$ 26.35                                 | 6.2   | \$ 44,527  |
| Options vested and expected to vest,<br>March 31, 2011 | 3,408,301 | \$ 26.38                                 | 6.1   | \$ 43,003  |
| Options exercisable, March 31, 2011                    | 2,053,102 | \$ 26.66                                 | 4.9   | \$ 25,348  |

During the nine months ended March 31, 2011 and 2010, compensation expense related to stock options was \$4.2 million and \$3.8 million, respectively. As of March 31, 2011, the total unrecognized compensation cost related to options outstanding was \$5.4 million and is expected to be recognized over a weighted average period of

2.4 years.

Weighted average fair value of options granted during the nine months ended March 31, 2011 and 2010 was \$9.22 and \$7.31, respectively. Fair value of options vested during the nine months ended March 31, 2011 and 2010 was \$4.4 million and \$4.1 million, respectively.

Tax benefits, relating to excess stock-based compensation deductions, are presented in the statement of cash flow as financing cash inflows. Tax benefits resulting from stock-based compensation deductions exceeded amounts reported for financial reporting purposes by \$2.4 million for the nine months ended March 31, 2011. Amounts reported for financial reporting purposes exceeded the tax benefit by \$0.2 million for the nine months ended March 31, 2010.

The amount of cash received from the exercise of capital stock options during the nine months ended March 31, 2011 and 2010 was \$11.3 million and \$4.3 million, respectively. The related tax benefit for the nine months ended March 31, 2011 and 2010 was \$2.6 million and \$0.5 million, respectively. The total intrinsic value of options exercised during the nine months ended March 31, 2011 and 2010 was \$8.0 million and \$1.8 million, respectively. Under the provisions of the 2010 Plan participants may deliver stock, owned by the holder for at least six months, in payment of the option price and receive credit for the fair market value of the shares on the date of delivery. The fair market value of shares delivered during the nine months ended March 31, 2011 was \$0.6 million and was immaterial for the nine months ended March 31, 2010.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)***Restricted Stock Awards*

Changes in our restricted stock awards for the nine months ended March 31, 2011 were as follows:

|  | Shares    |    | Weighted<br>Average<br>Fair<br>Value |
|--|-----------|----|--------------------------------------|
| Unvested restricted stock awards, June 30, 2010  | 198,701   | \$ | 32.71                                |
| Vested   | (105,466) |    | 32.56                                |
| Forfeited  | (1,040)   |    | 34.02                                |
| Unvested restricted stock awards, March 31, 2011 | 92,195    | \$ | 32.90                                |

During the nine months ended March 31, 2011 and 2010, compensation expense related to restricted stock awards was \$1.6 million and \$2.2 million, respectively. As of March 31, 2011, the total unrecognized compensation cost related to unvested restricted stock awards was \$1.3 million and is expected to be recognized over a weighted average period of 1.1 years.

*Restricted Stock Units – Time Vesting and Performance Vesting*

Performance vesting restricted stock units (performance units) were granted to certain individuals. These performance units are earned pro rata each year if certain performance goals are met over a 3-year period, and are also subject to a service condition that requires the individual to be employed by the Company at the payment date after the 3-year performance period.

Changes in our time vesting and performance vesting restricted stock units for the nine months ended March 31, 2011 were as follows:

|  | Performance<br>Vesting<br>Stock<br>Units | Performance<br>Vesting<br>Weighted<br>Average<br>Fair<br>Value | Time<br>Vesting<br>Stock<br>Units |    | Time Vesting<br>Weighted<br>Average<br>Fair<br>Value |
|--|--|--|-----------------------------------|----|--|
| Unvested performance vesting and time vesting restricted stock units, June 30, 2010  | -  | \$ -   | 546,713                           | \$ | 24.29  |
| Granted  | 134,807                                  | 26.89  | 525,250                           |    | 26.93  |
| Vested   | -  | -  | (73,806)                          |    | 23.24  |
| Forfeited  | (12,396)                                 | 26.89  | (40,883)                          |    | 25.51  |
| Unvested performance vesting and time vesting restricted stock units, March 31, 2011 | 122,411                                  | \$ 26.89   | 957,274                           | \$ | 25.78  |



During the nine months ended March 31, 2011 and 2010, compensation expense related to time vesting and performance vesting restricted stock units was \$8.6 million and \$1.9 million, respectively. As of March 31, 2011, the total unrecognized compensation cost related to unvested time vesting and performance vesting restricted stock units was \$15.2 million and is expected to be recognized over a weighted average period of 2.6 years.

*Restricted Stock Units STEP*

As of March 31, 2011, participating executives had been granted awards under the Kennametal Inc. 2008 Strategic Transformational Equity Program, under the 2002 Plan (STEP), equal to that number of restricted stock units having a value of \$27.8 million. A further amount of \$9.5 million remains available under the STEP for additional awards that could be made to other executives; however, the Company has decided that it will not make any further awards under the STEP. No new grants under the STEP were made in the nine months ended March 31, 2011, and it is assumed that none of these units will vest. There are no voting rights or dividends associated with restricted stock units under the STEP.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

Changes to the EPS performance-based portion of the STEP restricted stock units for the nine months ended March 31, 2011 were as follows:

|   | Stock<br>Units |    | Weighted<br>Average<br>Fair<br>Value |
|---|----------------|----|--------------------------------------|
| Unvested EPS performance-based restricted stock units, June 30, 2010  | 502,371        | \$ | 35.54                                |
| Granted   | -              |    | -                                    |
| Forfeited   | (41,519)       |    | 37.45                                |
| Unvested EPS performance-based restricted stock units, March 31, 2011 | 460,852        | \$ | 35.37                                |

Changes to the TSR performance-based portion of the STEP restricted stock units for the nine months ended March 31, 2011 were as follows:

|   | Stock<br>Units |    | Weighted<br>Average<br>Fair<br>Value |
|---|----------------|----|--------------------------------------|
| Unvested TSR performance-based restricted stock units, June 30, 2010  | 270,501        | \$ | 8.35                                 |
| Granted   | -              |    | -                                    |
| Forfeited   | (22,355)       |    | 9.20                                 |
| Unvested TSR performance-based restricted stock units, March 31, 2011 | 248,146        | \$ | 8.28                                 |

During the nine months ended March 31, 2011 and 2010, compensation expense related to STEP restricted stock units was \$0.3 million and \$0.5 million, respectively. As of March 31, 2011, the total unrecognized compensation cost related to unvested STEP restricted stock units was \$0.3 million and is expected to be recognized over a weighted average period of 0.5 years.

**10. BENEFIT PLANS**

We sponsor several defined benefit pension plans. Additionally, we provide varying levels of postretirement health care and life insurance benefits to some U.S. employees.

The table below summarizes the components of net periodic pension cost:

| (in thousands)                        | Three Months Ended<br>March 31, |          | Nine Months Ended<br>March 31, |          |
|---------------------------------------|---------------------------------|----------|--------------------------------|----------|
|                                       | 2011                            | 2010     | 2011                           | 2010     |
| Service cost                          | \$ 1,927                        | \$ 1,976 | \$ 5,748                       | \$ 5,971 |
| Interest cost                         | 10,319                          | 10,525   | 30,776                         | 31,875   |
| Expected return on plan assets        | (12,074)                        | (11,519) | (36,146)                       | (34,683) |
| Amortization of transition obligation | 13                              | 12       | 39                             | 41       |
| Amortization of prior service credit  | (70)                            | (70)     | (211)                          | (210)    |
| Special termination benefits          | -                               | 1,610    | -                              | 3,577    |

Edgar Filing: KENNAMETAL INC - Form 10-Q

|                                 |          |          |           |          |
|---------------------------------|----------|----------|-----------|----------|
| Settlement loss                 | 277      | -        | 810       | -        |
| Recognition of actuarial losses | 3,076    | 1,104    | 9,208     | 3,355    |
| Net periodic pension cost       | \$ 3,468 | \$ 3,638 | \$ 10,224 | \$ 9,926 |

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

The table below summarizes the components of the net periodic other postretirement benefit cost:

| (in thousands)                                 | Three Months Ended<br>March 31, |        | Nine Months Ended<br>March 31, |        |
|--|---------------------------------|--------|--------------------------------|--------|
|  | 2011                            | 2010   | 2011                           | 2010   |
| Service cost                                   | \$ 19                           | \$ 25  | \$ 57                          | \$ 74  |
| Interest cost                                  | 259                             | 316    | 777                            | 949    |
| Amortization of prior service cost             | -                               | 2      | -                              | 6      |
| Recognition of actuarial gains                 | (47)                            | (92)   | (142)                          | (276)  |
| Net periodic other postretirement benefit cost | \$ 231                          | \$ 251 | \$ 692                         | \$ 753 |

**11. INVENTORIES**

We used the last-in, first-out (LIFO) method of valuing inventories for approximately 47 percent and 51 percent of total inventories at March 31, 2011 and June 30, 2010, respectively. Because inventory valuations under the LIFO method are based on an annual determination of quantities and costs as of June 30 of each year, the interim LIFO valuations are based on our projections of expected year-end inventory levels and costs. Therefore, the interim financial results are subject to any final year-end LIFO inventory adjustments.

Inventories consisted of the following:

| (in thousands)                    | March 31,<br>2011 | June 30,<br>2010 |
|-----------------------------------|-------------------|------------------|
| Finished goods                    | \$ 292,068        | \$ 227,096       |
| Work in process and powder blends | 153,811           | 134,732          |
| Raw materials and supplies        | 91,359            | 62,673           |
| Inventories at current cost       | 537,238           | 424,501          |
| Less: LIFO valuation              | (71,113)          | (60,233)         |
| Total inventories                 | \$ 466,125        | \$ 364,268       |

**12. LONG-TERM DEBT AND CAPITAL LEASES**

Long-term debt and capital lease obligations consist primarily of Senior Unsecured Notes issued in June 2002 having an aggregate face amount of \$300.0 million, maturing in June 2012, as well as borrowings under a five-year, multi-currency, revolving credit facility (2010 Credit Agreement) which permits revolving credit loans of up to \$500.0 million for working capital, capital expenditures and general corporate purposes. The 2010 Credit Agreement allows for borrowings in U.S. dollars, euro, Canadian dollars, pound sterling and Japanese yen. Interest payable under the 2010 Credit Agreement is based upon the type of borrowing under the facility and may be (1) LIBOR plus an applicable margin, (2) the greater of the prime rate or the Federal Funds effective rate plus an applicable margin, or (3) fixed as negotiated by us.

The 2010 Credit Agreement requires us to comply with various restrictive and affirmative covenants, including two financial covenants: a maximum leverage ratio and a minimum consolidated interest coverage ratio (as those terms are defined in the agreement). We were in compliance with these financial covenants as of March 31, 2011. We had

no borrowings outstanding under the 2010 Credit Agreement as of March 31, 2011 and June 30, 2010. Borrowings under the 2010 Credit Agreement are guaranteed by our significant domestic subsidiaries. Fixed rate debt had a fair market value of \$319.1 million and \$325.5 million at March 31, 2011 and June 30, 2010, respectively. The fair value is determined based on the quoted market price of this debt as of March 31, 2011 and June 30, 2010, respectively.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****13. ENVIRONMENTAL MATTERS**

The operation of our business has exposed us to certain liabilities and compliance costs related to environmental matters. We are involved in various environmental cleanup and remediation activities at certain of our locations. *Superfund Sites* We are involved as a Potentially Responsible Party (PRP) at various sites designated by the U.S. Environmental Protection Agency (USEPA) as Superfund sites. For certain of these sites, we have evaluated the claims and potential liabilities and have determined that neither are material, individually or in the aggregate. For certain other sites, proceedings are in the very early stages and have not yet progressed to a point where it is possible to estimate the ultimate cost of remediation, the timing and extent of remedial action that may be required by governmental authorities or the amount of our liability alone or in relation to that of any other PRPs.

*Other Environmental* We establish and maintain reserves for other potential environmental costs, which amounted to \$5.3 million as of March 31, 2011. This accrual represents anticipated costs associated with the remediation of these issues. For the nine months ended March 31, 2011 we recorded approximately \$1.4 million related to an environmental liability in our international operations and unfavorable foreign currency translation adjustments of \$0.8 million, partially offset by a \$1.1 million reversal of an international environmental liability. In addition, we paid a civil penalty of \$0.2 million during the nine months ended March 31, 2011 related to our Chestnut Ridge, Pennsylvania facility closure.

The reserves we have established for environmental liabilities represent our best current estimate of the costs of addressing all identified environmental situations, based on our review of currently available evidence, and taking into consideration our prior experience in remediation and that of other companies, as well as public information released by the USEPA, other governmental agencies, and by the PRP groups in which we are participating. Although the reserves currently appear to be sufficient to cover these environmental liabilities, there are uncertainties associated with environmental liabilities, and we can give no assurance that our estimate of any environmental liability will not increase or decrease in the future. The reserved and unreserved exposures for all environmental concerns could change substantially due to factors such as the nature and extent of contamination, changes in remedial requirements, technological changes, discovery of new information, the financial strength of other PRPs, the identification of new PRPs and the involvement of and direction taken by the government on these matters.

We maintain a Corporate Environmental, Health and Safety (EHS) Department, as well as an EHS Steering Committee, to monitor compliance with environmental regulations and to oversee remediation activities. In addition, we have designated EHS coordinators who are responsible for each of our global manufacturing facilities. Our financial management team periodically meets with members of the Corporate EHS Department and the Corporate Legal Department to review and evaluate the status of environmental projects and contingencies. On a quarterly basis, we review financial provisions and reserves for environmental contingencies and adjust these reserves when appropriate.

**14. INCOME TAXES**

The effective income tax rate for the three months ended March 31, 2011 and 2010 was 19.1 percent compared to 52.0 percent, respectively. The current year rate reflects the favorable impact of stronger operating results under our pan-European business strategy. The prior year rate was unfavorably impacted by restructuring and related charges in tax jurisdictions that did not result in a tax benefit.

The effective income tax rate for the nine months ended March 31, 2011 and 2010 was 22.0 percent compared to 56.0 percent, respectively. The current year rate reflects the favorable impact of stronger operating results under our pan-European business strategy. The prior year rate reflects the impact of restructuring and related charges in tax jurisdictions that did not result in a tax benefit.

**15. EARNINGS PER SHARE**

Basic earnings per share are computed using the weighted average number of shares outstanding during the period, while diluted earnings per share are calculated to reflect the potential dilution that may occur related to the issuance of capital stock through grants of capital stock options, restricted stock awards and restricted stock units. The

difference between basic and diluted earnings per share relates solely to the effect of capital stock options, restricted stock awards and restricted stock units.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

For purposes of determining the number of diluted shares outstanding, weighted average shares outstanding for basic earnings per share calculations were increased due solely to the dilutive effect of unexercised capital stock options, unvested restricted stock awards and unvested restricted stock units by 1.4 million shares and 0.8 million shares for the three months ended March 31, 2011 and 2010, respectively and 1.0 million shares and 0.6 million shares for the nine months ended March 31, 2011 and 2010, respectively. Unexercised capital stock options, restricted stock units and restricted stock awards for the three months ended March 31, 2010 of 1.2 million shares and for the nine months ended March 31, 2011 and 2010 of 0.7 million and 3.0 million shares, respectively, were not included in the computation of diluted earnings per share because the inclusion would have been anti-dilutive. For the three months ended March 31, 2011 anti-dilutive shares were immaterial.

**16. EQUITY**

A summary of the changes in the carrying amounts of total equity, Kennametal shareowners' equity and equity attributable to noncontrolling interests as of March 31, 2011 and 2010 is as follows:

| (in thousands)  | Kennametal Shareowners' Equity |                            |                   |   |                           | Total equity |
|---|--------------------------------|----------------------------|-------------------|---|---------------------------|--------------|
|   | Capital stock                  | Additional paid-in capital | Retained earnings | Accumulated other comprehensive income (loss) | Non-controlling interests |              |
| Balance as of June 30, 2010                                 | \$ 102,379                     | \$ 492,454                 | \$ 793,448        | \$ (72,781)                                   | \$ 17,943                 | \$ 1,333,443 |
| Net income  | -                              | -                          | 143,073           | -   | 2,376                     | 145,449      |
| Other comprehensive income                                  | -                              | -                          | -                 | 108,896                                       | 2,030                     | 110,926      |
| Dividend reinvestment                                       | 9                              | 225                        | -                 | -   | -                         | 234          |
| Capital stock issued under employee benefit and stock plans | 762                            | 28,035                     | -                 | -   | -                         | 28,797       |
| Purchase of capital stock                                   | (883)                          | (25,574)                   | -                 | -   | -                         | (26,457)     |
| Cash dividends paid   | -                              | -                          | (29,873)          | -   | (132)                     | (30,005)     |
| Total equity, March 31, 2011                                | \$ 102,267                     | \$ 495,140                 | \$ 906,648        | \$ 36,115                                     | \$ 22,217                 | \$ 1,562,387 |

| (in thousands)              | Kennametal Shareowners' Equity |                            |                   |  |                           | Total equity |
|-----------------------------|--------------------------------|----------------------------|-------------------|--|---------------------------|--------------|
|                             | Capital stock                  | Additional paid-in capital | Retained earnings | Accumulated other comprehensive income | Non-controlling interests |              |
| Balance as of June 30, 2009 | \$ 91,540                      | \$ 357,839                 | \$ 786,345        | \$ 11,719                              | \$ 20,012                 | \$ 1,267,455 |
| Net income                  | -                              | -                          | 5,835             | -                                      | 1,417                     | 7,252        |
|                             | -                              | -                          | -                 | (8,504)                                | 136                       | (8,368)      |



Edgar Filing: KENNAMETAL INC - Form 10-Q

|   |            |            |            |          |           |              |
|---|------------|------------|------------|----------|-----------|--------------|
| Other comprehensive (loss) income                           |            |            |            |          |           |              |
| Dividend reinvestment                                       | 12         | 212        | -          | -        | -         | 224          |
| Capital stock issued under employee benefit and stock plans | 493        | 16,401     | -          | -        | -         | 16,894       |
| Purchase of capital stock                                   | (12)       | (212)      | -          | -        | -         | (224)        |
| Equity offering   | 10,063     | 110,630    | -          | -        | -         | 120,693      |
| Cash dividends paid   | -          | -          | (29,429)   | -        | (176)     | (29,605)     |
| Total equity, March 31, 2010                                | \$ 102,096 | \$ 484,870 | \$ 762,751 | \$ 3,215 | \$ 21,389 | \$ 1,374,321 |

The amounts of comprehensive income (loss) attributable to Kennametal shareowners and noncontrolling interests are disclosed in Note 17.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****17. COMPREHENSIVE INCOME (LOSS)**

Comprehensive income (loss) is as follows:

|   | Three Months Ended<br>March 31, |             | Nine Months Ended<br>March 31, |            |
|---|---------------------------------|-------------|--------------------------------|------------|
|   | 2011                            | 2010        | 2011                           | 2010       |
| Net income  | \$ 65,203                       | \$ 10,203   | \$ 145,449                     | \$ 7,252   |
| Unrealized gain (loss) on derivatives designated and qualified as cash flow hedges, net of income tax                             | 142                             | 55          | 365                            | (990)      |
| Reclassification of unrealized loss (gain) on expired derivatives designated and qualified as cash flow hedges, net of income tax | 98                              | (47)        | 2,285                          | (27)       |
| Unrecognized net pension and other postretirement benefit (losses) gains, net of income tax                                       | (1,294)                         | 2,045       | (2,916)                        | 2,599      |
| Reclassification of net pension and other postretirement benefit losses, net of income tax  | 1,868                           | 172         | 5,588                          | 1,363      |
| Foreign currency translation adjustments, net of income tax   | 38,646                          | (34,674)    | 105,604                        | (11,313)   |
| Total comprehensive income (loss)   | 104,663                         | (22,246)    | 256,375                        | (1,116)    |
| Comprehensive income attributable to noncontrolling interests   | 1,258                           | 124         | 4,406                          | 1,553      |
| Comprehensive income (loss) attributable to Kennametal Shareowners  | \$ 103,405                      | \$ (22,370) | \$ 251,969                     | \$ (2,669) |

**18. GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill represents the excess of cost over the fair value of the net assets of acquired companies. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment. We perform our annual impairment tests during the June quarter in connection with our annual planning process, unless there are impairment indicators that warrant a test prior to that. In conjunction with the implementation of our new operating structure on July 1, 2010, we tested goodwill for impairment and determined that there was no impairment at that time. We have noted no impairment indicators warranting additional testing. See Note 19 for further discussion regarding the Company's segments.

A summary, of the carrying amount of goodwill attributable to each segment, as well as the changes in such, is as follows:

| (in thousands)                | Industrial | Infrastructure | Total      |
|-------------------------------|------------|----------------|------------|
| Goodwill                      | \$ 393,974 | \$ 246,311     | \$ 640,285 |
| Accumulated impairment losses | (150,842)  | -              | (150,842)  |
| Balance as of June 30, 2010   | \$ 243,132 | \$ 246,311     | \$ 489,443 |
| Adjustments                   | \$ 192     | \$ -           | \$ 192     |
| Translation                   | 15,204     | 3,130          | 18,334     |

Edgar Filing: KENNAMETAL INC - Form 10-Q

|                               |            |            |            |
|-------------------------------|------------|------------|------------|
| Change in goodwill            | 15,396     | 3,130      | 18,526     |
| Goodwill                      | 409,370    | 249,441    | 658,811    |
| Accumulated impairment losses | (150,842)  | -          | (150,842)  |
| Balance as of March 31, 2011  | \$ 258,528 | \$ 249,441 | \$ 507,969 |

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

The components of our other intangible assets were as follows:

| (in thousands)             | Estimated Useful Life (in years) | March 31, 2011        |                          | June 30, 2010         |                          |
|----------------------------|----------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                            |                                  | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Contract-based             | 4 to 15                          | \$ 6,336              | \$ (5,321)               | \$ 6,357              | \$ (5,218)               |
| Technology-based and other | 4 to 15                          | 39,588                | (24,584)                 | 37,136                | (20,422)                 |
| Customer-related           | 10 to 20                         | 113,015               | (36,153)                 | 108,470               | (29,255)                 |
| Unpatented technology      | 30                               | 19,495                | (4,722)                  | 19,216                | (4,572)                  |
| Trademarks                 | 5 to 20                          | 10,930                | (4,712)                  | 10,647                | (3,876)                  |
| Trademarks                 | Indefinite                       | 39,986                | -                        | 36,823                | -                        |
| Total                      |                                  | \$ 229,350            | \$ (75,492)              | \$ 218,649            | \$ (63,343)              |

During the nine months ended March 31, 2011, we recorded amortization expense of \$8.7 million related to our other intangible assets and favorable foreign currency translation adjustments of \$7.2 million.

**19. SEGMENT DATA**

In order to take additional advantage of growth opportunities as well as to provide a better platform for continually improving the efficiency and effectiveness of operations, we implemented a new operating structure at the beginning of fiscal 2011.

The new structure provides for an enhanced market sector approach coupled with a more customer-centric focus for the sales organization and other key market-facing functions such as customer service, marketing, product management, engineering and product development. The new structure also involves the formation of a single, global integrated supply chain and logistics organization that unleashes additional opportunities to achieve higher customer satisfaction and realize lower costs to serve. Furthermore, the new structure provides for more uniform management of administrative functions on a global basis to further improve the consistency, effectiveness and efficiency of the services provided by these functions.

A key attribute of the new structure is the establishment of two new operating segments, by market sector, which replace the previous two operating segments that were based on a product focus. The two new reportable operating segments are named Industrial and Infrastructure. The Industrial business is focused on customers within the transportation, aerospace, defense and general engineering market sectors, as well as the machine tool industry. The Infrastructure business is focused on customers within the energy and earthworks industries. The formation of the two new reportable operating segments is consistent with the new management approach and internal financial reporting established under the new structure.

Under the new structure, more corporate expenses will be allocated to the new segments than were allocated to the previous segments. Corporate expenses related to executive retirement plans, the Company's Board of Directors and strategic initiatives, as well as certain other costs, will continue to be reported as Corporate.

Kennametal delivers productivity to customers seeking peak performance in demanding environments by providing innovative custom and standard wear-resistant solutions, enabled through our advanced materials sciences, application knowledge and commitment to a sustainable environment. Our product offering includes a wide array of standard and custom solution products in metalworking, such as metalcutting tools and tooling systems, and advanced materials, such as cemented tungsten carbide products, to address customer demands. These products are offered through a variety of channels via an enterprise approach to customers in both of our operating segments.

The Industrial segment serves customers that operate in industrial end markets such as aerospace, defense, transportation and general engineering. The customers in these end markets manufacture engines, airframes, automobiles, trucks, ships and various industrial goods. The technology needs and level of customization vary by customer and industry served. We deliver value to our Industrial segment customers through our application expertise and diverse product offering.

The Infrastructure segment serves customers that operate in the earthworks and energy end markets. These customers support primary industries such as oil and gas, power generation, underground mining, surface and hard rock mining, highway construction and road maintenance. Generally, our Infrastructure segment customers are served through a customer intimacy model that allows us to offer full system solutions by gaining an in-depth understanding of our customers' engineering needs. Our product offering promotes value by bringing enhanced performance and productivity to our customers' processes and systems.

**Table of Contents****KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

Our external sales and operating income by segment are as follows:

|  | Three Months Ended<br>March 31, |                     | Nine Months Ended<br>March 31, |                     |
|--|---------------------------------|---------------------|--------------------------------|---------------------|
|  | 2011                            | 2010 <sup>(1)</sup> | 2011                           | 2010 <sup>(1)</sup> |
| External sales:  |                                 |                     |                                |                     |
| Industrial   | \$ 391,763                      | \$ 305,802          | \$ 1,091,560                   | \$ 831,939          |
| Infrastructure   | 223,067                         | 187,363             | 618,196                        | 513,486             |
| Total external sales                                     | \$ 614,830                      | \$ 493,165          | \$ 1,709,756                   | \$ 1,345,425        |
| Operating income (loss):                                 |                                 |                     |                                |                     |
| Industrial   | \$ 54,145                       | \$ 10,808           | \$ 132,410                     | \$ (1,140)          |
| Infrastructure   | 35,639                          | 18,556              | 83,708                         | 48,454              |
| Corporate  | (2,007)                         | (3,061)             | (9,212)                        | (15,071)            |
| Total operating income                                   | \$ 87,777                       | \$ 26,303           | \$ 206,906                     | \$ 32,243           |
| Interest expense   | \$ 5,767                        | \$ 6,531            | \$ 17,294                      | \$ 18,856           |
| Other expense (income), net                              | 1,413                           | (1,496)             | 3,071                          | (6,314)             |
| Income from continuing operations before<br>income taxes | \$ 80,597                       | \$ 21,268           | \$ 186,541                     | \$ 19,701           |

Our total assets by segment are as follows:

| (in thousands) | March 31,<br>2011 | June 30,<br>2010 <sup>(1)</sup> |
|----------------|-------------------|---------------------------------|
| Total assets:  |                   |                                 |
| Industrial     | \$ 1,441,302      | \$ 1,310,635                    |
| Infrastructure | 758,363           | 682,169                         |
| Corporate      | 369,557           | 275,019                         |
| Total assets   | \$ 2,569,222      | \$ 2,267,823                    |

<sup>(1)</sup> Amounts for the three and nine months ended March 31, 2010 and for the period as of June 30, 2010 have been restated to reflect the change in reportable operating segments.

**Table of Contents**

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

**OVERVIEW**

Kennametal Inc. is a leading global manufacturer and supplier of tooling, engineered components and advanced materials consumed in production processes. We believe that our reputation for manufacturing excellence, as well as our technological expertise and innovation in our principal products, has helped us to achieve a leading market presence in our primary markets. We believe we are one of the largest global providers of consumable metalcutting tools and tooling supplies. End users of our products include metalworking manufacturers and suppliers across a diverse array of industries, including the aerospace, defense, transportation, machine tool, light machinery and heavy machinery industries, as well as manufacturers, producers and suppliers in a number of other industries including coal mining, highway construction, quarrying, and oil and gas exploration and production industries. Our end users products include items ranging from airframes to coal mining, engines to oil wells and turbochargers to construction. We experienced strong growth for the March quarter across both business segments and all regions. Our sales for the quarter ended March 31, 2011 grew 25 percent compared to sales for the March quarter one year ago. Operating margin for the quarter increased by \$61.5 million on sales that were \$121.7 million higher, resulting in 50.5 percent year-over-year operating leverage. During the quarter, we continued to experience certain raw material cost increases, particularly tungsten. We believe these costs will ultimately be recovered, as we continue to implement price increases as necessary.

Our restructuring programs remain on track to deliver the anticipated annual ongoing pre-tax savings of \$160 million to \$165 million once all programs are fully implemented. These programs delivered \$42 million of pre-tax benefits in the quarter ended March 31, 2011.

For the quarter ended March 31, 2011, we recorded net income attributable to Kennametal of \$64.7 million, or \$0.77 per diluted share, compared to \$9.7 million, or \$0.12 per diluted share, for the three months ended March 31, 2010. The drivers of our improved performance were higher sales volume and price realization, improved capacity utilization and incremental restructuring benefits of \$5.4 million. These benefits were partially offset by higher raw material costs, higher employment costs of \$12.9 million and the restoration of temporary cost reductions of \$4.7 million.

We generated cash flow from operating activities of \$125 million during the nine months ended March 31, 2011, driven by our operating performance.

In addition, we invested further in technology and innovation to continue delivering a high level of new products to our customers. Research and development expenses totaled \$18.2 million for the three months ended March 31, 2011. The following narrative provides further discussion and analysis of our results of operations, liquidity and capital resources, as well as other pertinent matters.

**RESULTS OF CONTINUING OPERATIONS**

**SALES**

Sales for the three months ended March 31, 2011 were \$614.8 million, an increase of \$121.6 million, or 25 percent, from \$493.2 million in the prior year quarter. Sales increased organically by 25 percent. The improvement in sales was driven by better performance in both business segments and across all regions.

Sales for the nine months ended March 31, 2011 were \$1,710.0 million, an increase of \$364.6 million, or 27 percent, from \$1,345.4 million in the prior year period. Sales increased organically by 29 percent, partially offset by a 1 percent unfavorable impact from foreign currency effects and an unfavorable impact from fewer business days. The improvement in sales was driven by better performance in both business segments and across all regions, led by growth in the general engineering and transportation served end markets of 41 percent and 32 percent, respectively.

**GROSS PROFIT**

Gross profit for the three months ended March 31, 2011 was \$230.0 million, an increase of \$59.7 million from \$170.3 million in the prior year quarter. This increase was due to higher organic sales, improved absorption of manufacturing costs due to higher production levels, restructuring and other cost reduction benefits, favorable product and market mix and favorable foreign currency effects of \$1.1 million. The impact of these items was partially offset

by higher raw material costs and the restoration of employment costs that had been temporarily reduced in the prior year. The gross profit margin for the three months ended March 31, 2011 was 37.4 percent, as compared to 34.5 percent generated in the prior year quarter.



**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

Gross profit for the nine months ended March 31, 2011 was \$618.7 million, an increase of \$190.5 million from \$428.2 million in the prior year period. This increase was due to higher organic sales, improved absorption of manufacturing costs due to higher production levels, favorable product and market mix and restructuring and other cost reduction benefits. The impact of these items was partially offset by higher raw material costs, restoration of employment costs that had been temporarily reduced in the prior year and unfavorable foreign currency effects of \$8.9 million. The prior year was also favorably impacted by one-time benefits from certain labor negotiations in Europe. The gross profit margin for the nine months ended March 31, 2011 was 36.2 percent, as compared to 31.8 percent generated in the prior year period.

**OPERATING EXPENSE**

Operating expense for the three months ended March 31, 2011 increased \$18.2 million or 15.2 percent to \$138.3 million compared to \$120.1 million in the prior year quarter. The increase is primarily attributable to an increase in employment costs of \$15.3 million due to the restoration of employment costs that had been temporarily reduced in the prior year and higher incentive compensation. In addition, we recorded expense of \$2.4 million for the write-off of our pre-existing ERP system in our Corporate segment.

Operating expense for the nine months ended March 31, 2011 increased \$41.3 million or 11.7 percent to \$395.4 million compared to \$354.1 million in the prior year period. The increase is primarily attributable to an increase in employment costs of \$33.2 million due to the restoration of employment costs that had been temporarily reduced in the prior year and higher incentive compensation, a \$4.0 million increase in professional fees and a \$2.2 million increase in advertising costs. These increases were partially offset by favorable foreign currency effects of \$5.6 million.

**RESTRUCTURING CHARGES**

We continued to implement restructuring plans to reduce costs and improve operating efficiencies. The actions taken in the March quarter related primarily to the continued rationalization of certain manufacturing facilities. The Company's restructuring programs are on track to deliver the anticipated annual ongoing pre-tax savings of \$160 million to \$165 million once all programs are fully implemented. The combined total pre-tax charges are not expected to exceed \$165 million. Total restructuring and related charges recorded from inception to March 31, 2011 were \$143 million. The remaining restructuring charges are expected to be completed within the next three months and are anticipated to be mostly cash expenditures.

Restructuring and related charges recorded during the three months ended March 31, 2011 amounted to \$5.5 million, including \$1.6 million of restructuring charges, of which \$0.6 million were related to inventory disposals and recorded in cost of goods sold. Restructuring related charges of \$1.5 million and \$2.4 million were recorded in cost of goods sold and operating expense, respectively, during the three months ended March 31, 2011. We realized pre-tax benefits from these restructuring programs of approximately \$42 million for the three months ended March 31, 2011.

Restructuring and related charges recorded during the nine months ended March 31, 2011 amounted to \$14.9 million, including \$8.7 million of restructuring charges, of which \$1.0 million were related to inventory disposals and recorded in cost of goods sold. Restructuring related charges of \$3.0 million and \$3.2 million were recorded in cost of goods sold and operating expense, respectively, during the nine months ended March 31, 2011. We realized pre-tax benefits from these restructuring programs of approximately \$122 million for the nine months ended March 31, 2011.

Restructuring and related charges recorded in the three months ended March 31, 2010 amounted to \$22.9 million, including \$21.0 million of restructuring charges, of which \$0.3 million related to inventory disposals recorded in cost of goods sold. Restructuring related charges of \$1.3 million and \$0.6 million were recorded in cost of goods sold and operating expense, respectively, during the three months ended March 31, 2010.

Restructuring and related charges recorded in the nine months ended March 31, 2010 amounted to \$35.6 million, including \$32.2 million of restructuring charges, of which \$0.3 million related to inventory disposals recorded in cost of goods sold. Restructuring related charges of \$2.3 million and \$1.1 million were recorded in cost of goods sold and operating expense, respectively, during the nine months ended March 31, 2010.



**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****INTEREST EXPENSE**

Interest expense for the three months ended March 31, 2011 of \$5.8 million decreased \$0.7 million, or 11.7 percent, from \$6.5 million in the prior year quarter. Interest expense for the nine months ended March 31, 2011 of \$17.3 million decreased \$1.6 million, or 8.3 percent, from \$18.9 million in the prior year quarter.

**OTHER EXPENSE (INCOME), NET**

Other expense, net for the three months ended March 31, 2011 was \$1.4 million, compared to other income, net of \$1.5 million for the three months ended March 31, 2010. The decrease was primarily driven by unfavorable foreign currency transaction results of \$2.7 million.

Other expense, net for the nine months ended March 31, 2011 was \$3.1 million, compared to other income, net of \$6.3 million for the nine months ended March 31, 2010. The decrease was primarily driven by unfavorable foreign currency transaction results of \$7.8 million.

**INCOME TAXES**

The effective income tax rate for the three months ended March 31, 2011 and 2010 was 19.1 percent compared to 52.0 percent, respectively. The current year rate reflects the favorable impact of stronger operating results under our pan-European business strategy. The prior year rate was unfavorably impacted by restructuring and related charges in tax jurisdictions that did not result in a tax benefit.

The effective income tax rate for the nine months ended March 31, 2011 and 2010 was 22.0 percent compared to 56.0 percent, respectively. The current year rate reflects the favorable impact of stronger operating results under our pan-European business strategy. The prior year rate reflects the impact of restructuring and related charges in tax jurisdictions that did not result in a tax benefit.

During 2011, we expect to generate a nominal amount of taxable income in the United Kingdom and other jurisdictions where we have valuation allowances recorded against our net deferred tax assets. The corresponding impact on the fiscal 2011 effective tax rate is expected to be immaterial. We believe the sustainability of future income in these jurisdictions remains uncertain. Accordingly, we have not adjusted the valuation allowance. We will again assess the sustainability of future income in these jurisdictions in conjunction with our annual planning process during our fiscal fourth quarter. If based on that assessment, we determine that it is more likely than not we will be able to realize the net deferred tax assets in these jurisdictions, we will adjust the valuation allowance. Such an adjustment would likely result in a material reduction to tax expense in the period the adjustment occurs.

**BUSINESS SEGMENT REVIEW**

Our operations are organized into two reportable operating segments consisting of Industrial and Infrastructure, and Corporate. The presentation of segment information reflects the manner in which we organize segments for making operating decisions and assessing performance. Corporate is comprised of costs related to executive retirement plans and strategic initiatives, as well as certain other costs.

Amounts for the three and nine months ended March 31, 2011 have been restated to reflect the change in reportable operating segments.

**INDUSTRIAL**

|                         | Three Months Ended<br>March 31, |            | Nine Months Ended<br>March 31, |            |
|-------------------------|---------------------------------|------------|--------------------------------|------------|
|                         | 2011                            | 2010       | 2011                           | 2010       |
| External sales          | \$ 391,763                      | \$ 305,802 | \$ 1,091,560                   | \$ 831,939 |
| Operating income (loss) | 54,145                          | 10,808     | 132,410                        | (1,140)    |

For the three months ended March 31, 2011, Industrial segment external sales increased by 28.1 percent, driven by organic sales growth of 29 percent and a 1 percent favorable foreign currency impact, partially offset by an

unfavorable impact due to fewer business days. On an organic basis, sales increased in all served market sectors led by strong growth in general engineering and transportation sales of 34 percent and 29 percent, respectively. On a regional basis, organic sales increased by approximately 32 percent in Asia, 29 percent in Europe and 23 percent in the Americas.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

For the three months ended March 31, 2011, Industrial segment operating income increased \$43.3 million. The primary drivers of the increase in operating income were higher sales volume and price realization, improved capacity utilization and incremental restructuring benefits. These benefits were partially offset by higher raw material costs and the restoration of temporary cost reductions.

For the nine months ended March 31, 2011, Industrial segment external sales increased by 31.2 percent, driven by organic sales growth of 35 percent, partially offset by unfavorable foreign currency effects of 2 percent and an unfavorable impact due to fewer business days. On an organic basis, sales increased in all served market sectors led by growth in general engineering and transportation sales of 41 percent and 32 percent, respectively. On a regional basis, organic sales increased by approximately 43 percent in Asia, 31 percent in the Americas and 31 percent in Europe.

For the nine months ended March 31, 2011, Industrial segment operating income increased \$133.6 million. The primary drivers of the increase in operating income were higher sales volume and price realization, improved capacity utilization and incremental restructuring benefits. These benefits were partially offset by higher raw material costs, higher employment costs and the restoration of temporary cost reductions.

**INFRASTRUCTURE**

|                  | Three Months Ended<br>March 31, |            | Nine Months Ended<br>March 31, |            |
|------------------|---------------------------------|------------|--------------------------------|------------|
|                  | 2011                            | 2010       | 2011                           | 2010       |
| External sales   | \$ 223,067                      | \$ 187,363 | \$ 618,196                     | \$ 513,486 |
| Operating income | 35,639                          | 18,556     | 83,708                         | 48,454     |

For the three months ended March 31, 2011, Infrastructure segment external sales increased by 19.1 percent, all driven by organic sales growth. The organic increase was driven by higher sales in the energy and earthworks markets of 21 percent and 17 percent, respectively. On a regional basis, organic sales increased by approximately 20 percent in the Americas, 15 percent in Asia and 11 percent in Europe.

For the three months ended March 31, 2011, Infrastructure segment operating income increased \$17.1 million to \$35.6 million. Operating income improved primarily due to higher sales volume and price realization, increased capacity utilization and incremental restructuring benefits, partially offset by higher raw material costs and the restoration of temporary cost reductions.

For the nine months ended March 31, 2011, Infrastructure segment external sales increased by 20.4 percent, all driven by organic sales growth. The organic increase was driven by higher sales in the energy and earthworks markets of 27 percent and 17 percent, respectively. On a regional basis, organic sales increased by approximately 26 percent in Asia, 21 percent in the Americas and 13 percent in Europe.

For the nine months ended March 31, 2011, Infrastructure segment operating income increased \$35.3 million to \$83.7 million. Operating income improved primarily due to higher sales volume and price realization, increased capacity utilization and incremental restructuring benefits, partially offset by higher raw material costs and the restoration of temporary cost reductions.

**CORPORATE**

|                               | Three Months Ended<br>March 31, |           | Nine Months Ended<br>March 31, |            |
|-------------------------------|---------------------------------|-----------|--------------------------------|------------|
|                               | 2011                            | 2010      | 2011                           | 2010       |
| Corporate unallocated expense | \$(2,007)                       | \$(3,061) | \$(9,212)                      | \$(15,071) |

For the three months ended March 31, 2011, unallocated expenses decreased \$1.1 million to \$2.0 million. The decrease was driven by a charge of \$2.4 million recorded to write-off our pre-existing ERP system, offset by a \$1.1 million reversal of an international environmental liability, higher foreign government subsidy income for certain research and a higher allocation of Corporate expense to the segments than in the prior year quarter.

For the nine months ended March 31, 2011, unallocated expenses decreased \$5.9 million to \$9.2 million. The decrease was driven by a charge of \$2.4 million recorded to write-off our pre-existing ERP system, offset by a \$1.1 million reversal of an international environmental liability, higher foreign government subsidy income for certain research and a higher allocation of Corporate expenses to the segments than in the prior year period.

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**LIQUIDITY AND CAPITAL RESOURCES**

Cash flow from operations is our primary source of funding for capital expenditures and internal growth.

To augment cash from operations and as an additional source of funds, we maintain a syndicated, five-year, multi-currency, revolving credit facility (2010 Credit Agreement) that extends to June 2015. The 2010 Credit Agreement permits revolving credit loans of up to \$500.0 million for working capital, capital expenditures and general corporate purposes. The 2010 Credit Agreement allows for borrowings in U.S. dollars, euro, Canadian dollars, pound sterling and Japanese yen. Interest payable under the 2010 Credit Agreement is based upon the type of borrowing under the facility and may be (1) LIBOR plus an applicable margin, (2) the greater of the prime rate or the Federal Funds effective rate plus an applicable margin, or (3) fixed as negotiated by us.

The 2010 Credit Agreement requires us to comply with various restrictive and affirmative covenants, including two financial covenants: a maximum leverage ratio and a minimum consolidated interest coverage ratio (as those terms are defined in the agreement). We were in compliance with these financial covenants as of March 31, 2011. We had no borrowings outstanding under the 2010 Credit Agreement as of March 31, 2011. Borrowings under the 2010 Credit Agreement are guaranteed by our significant domestic subsidiaries.

At March 31, 2011, cash and cash equivalents were \$184.2 million, total debt was \$316.8 million and total Kennametal shareowners' equity was \$1,540.2 million. Our current senior credit ratings are at investment grade levels. We believe that our current financial position, liquidity and credit ratings provide access to the capital markets. We closely monitor our liquidity position and the condition of the capital markets, as well as the counterparty risk of our credit providers.

There have been no material changes in our contractual obligations and commitments since June 30, 2010.

*Cash Flow Provided by Operating Activities*

During the nine months ended March 31, 2011, cash flow provided by operating activities was \$125.0 million, compared to \$92.6 million for the prior year period. Cash flow provided by operating activities for the current year period consisted of net income and non-cash items amounting to an inflow of \$234.4 million, partially offset by changes in certain assets and liabilities netting to \$109.4 million. Contributing to the changes in certain assets and liabilities was an increase in inventory of \$74.7 million driven by an increase in production to meet higher demand and an increase in accounts receivable of \$71.7 million due to higher sales volumes, partially offset by an increase in accounts payable and accrued liabilities of \$37.3 million.

During the nine months ended March 31, 2010, cash flow provided by operating activities consisted of net income and non-cash items amounting to \$88.3 million and cash provided by changes in certain assets and liabilities netting to \$4.4 million. Contributing to the changes in certain assets and liabilities was an increase in accrued income taxes of \$16.7 million driven by a \$21.4 million tax refund, an increase in accounts payable and accrued liabilities of \$9.1 million, an increase in other of \$8.8 million and a decrease in inventories of \$4.5 million partially offset by an increase in accounts receivable of \$34.8 million.

*Cash Flow (Used for) Provided by Investing Activities*

Cash flow used for investing activities was \$22.9 million for the nine months ended March 31, 2011, compared to cash flow provided by investing activities of \$1.7 million in the prior year period. During the current year period cash flow used for investing activities included capital expenditures, net of \$25.3 million, which consisted primarily of an Enterprise Resource Planning (ERP) system and equipment upgrades.

Cash flow provided by investing activities was \$1.7 million for the nine months ended March 31, 2010. Cash flow provided by investing activities included \$27.8 million in cash proceeds from divestitures, mostly offset by capital expenditures, net of \$26.4 million, which consisted primarily of equipment upgrades.

*Cash Flow Used for Financing Activities*

Cash flow used for financing activities was \$57.7 million for the nine months ended March 31, 2011 compared to \$49.8 million in the prior year period. During the current year period cash flow used for financing activities included \$29.9 million of cash dividends paid to shareowners, \$26.5 million used for the purchase of capital stock and

\$15.4 million net decrease in borrowings, partially offset by \$15.1 million of dividend reinvestment and the effect of employee benefit and stock plans.



**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

Cash flow used for financing activities was \$49.8 million for the nine months ended March 31, 2010. Cash flow used for financing activities included \$120.7 million in net proceeds from issuance of capital stock and \$6.6 million of dividend reinvestment and the effect of employee benefit and stock plans more than offset by \$146.3 million net decrease in borrowings and \$29.4 million of cash dividends paid to shareowners.

**FINANCIAL CONDITION**

At March 31, 2011, total assets increased \$301.4 million to \$2,569.2 million from \$2,267.8 million at June 30, 2010. Total liabilities increased \$72.4 million to \$1,006.8 million at March 31, 2011 from \$934.4 million at June 30, 2010. Working capital was \$742.7 million at March 31, 2011, an increase of \$219.8 million from \$522.9 million at June 30, 2010. The increase in working capital was driven primarily by an increase in inventories of \$101.9 million driven by an increase in production to meet higher demand, an increase in accounts receivable of \$91.8 million due to the increase in sales and an increase in cash and cash equivalents of \$66.1 million, partially offset by an increase in accounts payable of \$40.7 million due to increased production and an increase in accrued expenses of \$24.4 million. Foreign currency effects accounted for \$77.7 million of the working capital change.

Property, plant and equipment, net increased \$0.4 million from \$664.5 million at June 30, 2010 to \$664.9 million at March 31, 2011, primarily due to capital additions of \$33.3 million and favorable foreign currency impact of \$32.6 million, partially offset by depreciation expense of \$60.2 million.

At March 31, 2011, other assets were \$711.6 million, an increase of \$24.2 million from \$687.4 million at June 30, 2010. The drivers for the increase were an increase in goodwill of \$18.5 million and an increase in other assets of \$8.1 million. The change in goodwill was due to foreign currency translation. The increase in other assets was primarily driven by an increase in pension assets of \$6.4 million and an increase in fair value of forward starting interest rate swap contracts of \$3.0 million.

Long-term debt and capital leases decreased \$4.0 million to \$310.7 million at March 31, 2011 from \$314.7 million at June 30, 2010.

Kennametal shareowners' equity was \$1,540.2 million at March 31, 2011, an increase of \$224.7 million from \$1,315.5 million at June 30, 2010. The increase was primarily due to net income attributable to Kennametal of \$143.1 million, foreign currency translation adjustments of \$103.6 million and capital stock issued under employee benefit and stock plans of \$28.8 million, partially offset by cash dividends paid to shareowners of \$29.9 million and the purchase of capital stock of \$26.5 million.

**ENVIRONMENTAL MATTERS**

The operation of our business has exposed us to certain liabilities and compliance costs related to environmental matters. We are involved in various environmental cleanup and remediation activities at certain of our locations. With respect to the environmental proceedings listed below, if any one or more of them were decided against Kennametal, we believe that it would not have a material effect on our consolidated financial position. However, it is not possible to predict the ultimate outcome of any of these proceedings or whether such ultimate outcome may have a material effect on our consolidated financial position. We report these proceedings to comply with Securities and Exchange Commission regulations, which require us to disclose proceedings arising under federal, state or local provisions regulating the discharge of materials into the environment or protecting the environment if we reasonably believe that such proceedings will result in monetary sanctions of \$0.1 million or more.

*Superfund Sites* We are involved as a Potentially Responsible Party (PRP) at various sites designated by the U.S. Environmental Protection Agency (USEPA) as Superfund sites. For certain of these sites, we have evaluated the claims and potential liabilities and have determined that neither are material, individually or in the aggregate. For certain other sites, proceedings are in the very early stages and have not yet progressed to a point where it is possible to estimate the ultimate cost of remediation, the timing and extent of remedial action that may be required by governmental authorities or the amount of our liability alone or in relation to that of any other PRPs.

*Other Environmental* We establish and maintain reserves for other potential environmental costs which amounted to \$5.3 million as of March 31, 2011. This accrual represents anticipated costs associated with the remediation of these

issues. For the nine months ended March 31, 2011, we recorded approximately \$1.4 million related to an environmental liability in our international operations and unfavorable foreign currency translation adjustments of \$0.8 million, partially offset by a \$1.1 million reversal of an international environmental liability. In addition, we paid a civil penalty of \$0.2 million during the nine months ended March 31, 2011 related to our Chestnut Ridge, Pennsylvania facility closure discussed below.

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

In the course of preparing our Chestnut Ridge, Pennsylvania facility for closure, we discovered two outfalls for storm water that were not covered by the permits issued to the site by the Pennsylvania Department of Environmental Protection (PA DEP). We promptly plugged the outfalls and voluntarily reported the matter to the PA DEP. In June 2010, we received a draft Consent Order & Agreement from the PA DEP relating to the storm water outfalls and to a minor coolant spill in the facility. After negotiations, on November 17, 2010 the parties signed a final Consent Order & Agreement to resolve all matters, under which Kennametal agreed to conduct additional site investigations and submit reports to the PA DEP, and pay a civil penalty of \$0.2 million.

The reserves we have established for environmental liabilities represent our best current estimate of the costs of addressing all identified environmental situations, based on our review of currently available evidence, and taking into consideration our prior experience in remediation and that of other companies, as well as public information released by the USEPA, other governmental agencies, and by the PRP groups in which we are participating. Although the reserves currently appear to be sufficient to cover these environmental liabilities, there are uncertainties associated with environmental liabilities, and we can give no assurance that our estimate of any environmental liability will not increase or decrease in the future. The reserved and unreserved exposures for all environmental concerns could change substantially due to factors such as the nature and extent of contamination, changes in remedial requirements, technological changes, discovery of new information, the financial strength of other PRPs, the identification of new PRPs and the involvement of and direction taken by the government on these matters.

We maintain a Corporate EHS Department, as well as an EHS Steering Committee, to monitor compliance with environmental regulations and to oversee remediation activities. In addition, we have designated EHS coordinators who are responsible for each of our global manufacturing facilities. Our financial management team periodically meets with members of the Corporate EHS Department and the Corporate Legal Department to review and evaluate the status of environmental projects and contingencies. On a quarterly basis, we review financial provisions and reserves for environmental contingencies and adjust these reserves when appropriate.

**DISCUSSION OF CRITICAL ACCOUNTING POLICIES**

There have been no changes to our critical accounting policies since June 30, 2010.

**NEW ACCOUNTING STANDARDS**

See Note 3 to our condensed consolidated financial statements set forth in Part I Item 1 of this Form 10-Q for a description of new accounting standards.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes to our market risk exposure since June 30, 2010.

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this quarterly report on Form 10-Q, the Company's management evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). The Company's disclosure controls were designed to provide a reasonable assurance that information required to be disclosed in reports that we file or submit under the Securities Exchange Act of 1934, as amended (Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. However, the controls have been designed to provide reasonable assurance of achieving the controls' stated goals. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of March 31, 2011.

There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

The disclosures set forth in Part I, Item 2 Management's Discussion and Analysis of Financial Conditions and Results of Operations under the heading Environmental Matters are incorporated into this Item.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****ISSUER PURCHASES OF EQUITY SECURITIES**

| Period                               | Total<br>Number of<br>Shares<br>Purchased <sup>(1)</sup> | Average<br>Price<br>Paid per<br>Share | Total Number of<br>Shares<br>Purchased as Part<br>of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that May<br>Yet<br>Be Purchased<br>Under<br>the Plans or<br>Programs <sup>(2)</sup> |
|--------------------------------------|--|---------------------------------------|---|--|
| January 1 through January 31, 2011   | 11,901   | \$ 39.48                              | -   | 7,702,200  |
| February 1 through February 28, 2011 | 379,837  | 40.36                                 | 374,100   | 7,328,100  |
| March 1 through March 31, 2011       | 29,612   | 38.46                                 | 26,500  | 7,301,600  |
| Total                                | 421,350  | \$ 40.20                              | 400,600   |  |

<sup>(1)</sup> During the current period, 1,898 shares were purchased on the open market on behalf of Kennametal to fund the Company's dividend reinvestment program. Also, during the current period, employees delivered 15,048 shares of restricted stock to Kennametal, upon vesting, to satisfy tax-withholding requirements and 3,804 shares of Kennametal stock as payment for the exercise price of stock options.

<sup>(2)</sup> On October 26, 2010, the Company publicly announced a repurchase programs of up to 8 million shares of its outstanding common stock.

**Table of Contents****ITEM 6. EXHIBITS**

|              |  |                 |
|--------------|--|-----------------|
| <b>(31)</b>  | <b>Rule 13a-14(a)/15d-14(a) Certifications</b>   |                 |
| (31.1)       | Certification executed by Carlos M. Cardoso, Chairman, President and Chief Executive Officer of Kennametal Inc.  | Filed herewith. |
| (31.2)       | Certification executed by Frank P. Simpkins, Vice President and Chief Financial Officer of Kennametal Inc.   | Filed herewith. |
| <b>(32)</b>  | <b>Section 1350 Certifications</b>   |                 |
| (32.1)       | Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Carlos M. Cardoso, Chairman, President and Chief Executive Officer of Kennametal Inc., and Frank P. Simpkins, Vice President and Chief Financial Officer of Kennametal Inc. | Filed herewith. |
| <b>(101)</b> | <b>XBRL</b>  |                 |
| (101.INS)**  | XBRL Instance Document   | Filed herewith. |
| (101.SCH)**  | XBRL Taxonomy Extension Schema Document  | Filed herewith. |
| (101.CAL)**  | XBRL Taxonomy Extension Calculation Linkbase Document  | Filed herewith. |
| (101.LAB)**  | XBRL Taxonomy Extension Label Linkbase Document  | Filed herewith. |
| (101.PRE)**  | XBRL Taxonomy Extension Presentation Linkbase Document   | Filed herewith. |

\*\* The XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, and is not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of these sections.

**Table of Contents**

**SIGNATURES**

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

**KENNAMETAL INC.**

Date: May 9, 2011

By: /s/ Martha A. Bailey  
Martha A. Bailey  
Vice President Finance and Corporate  
Controller

30