

KENNAMETAL INC
Form 10-Q
February 08, 2012
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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 DECEMBER 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

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

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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 January 31, 2012
Capital Stock, par value \$1.25 per share	79,751,985

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KENNAMETAL INC.

FORM 10-Q

FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2011

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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, intend, plan, believe and other words of similar 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: economic recession; anticipated benefits resulting from our recently completed restructuring activities; 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; 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; and implementation of environmental remediation matters. 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 December 31,		Six Months Ended December 31,	
	2011	2010	2011	2010
Sales	\$ 641,741	\$ 565,768	\$ 1,300,618	\$ 1,094,926
Cost of goods sold	409,855	365,743	817,672	706,161
Gross profit	231,886	200,025	482,946	388,765
Operating expense	134,566	132,105	280,555	257,125
Restructuring charges (Note 7)	-	3,391	-	6,651
Amortization of intangibles	3,272	2,912	6,733	5,860
Operating income	94,048	61,617	195,658	119,129
Interest expense	5,256	5,564	10,743	11,527
Other (income) expense, net	(1,258)	(253)	(684)	1,658
Income before income taxes	90,050	56,306	185,599	105,944
Provision for income taxes	15,579	12,016	37,555	25,698
Net income	74,471	44,290	148,044	80,246
Less: Net income attributable to noncontrolling interests	774	821	2,361	1,856
Net income attributable to Kennametal	\$ 73,697	\$ 43,469	\$ 145,683	\$ 78,390
PER SHARE DATA ATTRIBUTABLE TO KENNAMETAL SHAREOWNERS				
Basic earnings per share	\$ 0.92	\$ 0.53	\$ 1.82	\$ 0.95
Diluted earnings per share:	\$ 0.91	\$ 0.52	\$ 1.79	\$ 0.94
Dividends per share	\$ 0.14	\$ 0.12	\$ 0.26	\$ 0.24
Basic weighted average shares outstanding	79,765	82,186	80,212	82,146
Diluted weighted average shares outstanding	80,936	83,337	81,357	83,012

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)	December 31, 2011	June 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 128,537	\$ 204,565
Accounts receivable, less allowance for doubtful accounts of \$19,118 and \$20,958	404,945	447,835
Inventories (Note 10)	571,063	519,973
Deferred income taxes	59,028	60,257
Other current assets	56,240	54,955
Total current assets	1,219,813	1,287,585
Property, plant and equipment:		
Land and buildings	350,820	373,971
Machinery and equipment	1,353,299	1,396,306
Less accumulated depreciation	(1,046,822)	(1,073,215)
Property, plant and equipment, net	657,297	697,062
Other assets:		
Investments in affiliated companies	734	829
Goodwill (Note 17)	494,757	511,328
Other intangible assets, less accumulated amortization of \$80,952 and \$78,712 (Note 17)	155,571	152,279
Deferred income taxes	32,053	29,876
Other	84,513	75,510
Total other assets	767,628	769,822
Total assets	\$ 2,644,738	\$ 2,754,469
LIABILITIES		
Current liabilities:		
Current maturities of long-term debt and capital leases (Note 11)	\$ 303,693	\$ 307,304
Notes payable to banks	2,646	3,659
Accounts payable	196,086	222,678
Accrued income taxes	42,300	38,098
Accrued expenses	78,400	102,576
Other current liabilities (Note 7)	122,714	167,206
Total current liabilities	745,839	841,521
Long-term debt and capital leases, less current maturities (Note 11)	1,599	1,919
Deferred income taxes	82,064	83,310
Accrued pension and postretirement benefits	125,405	134,919
Accrued income taxes	2,974	3,094
Other liabilities	56,683	31,065
Total liabilities	1,014,564	1,095,828

Commitments and contingencies

EQUITY (Note 15)

Kennametal Shareowners Equity:

Preferred stock, no par value; 5,000 shares authorized; none issued	-	-
Capital stock, \$1.25 par value; 120,000 shares authorized; 79,583 and 81,129 shares issued	99,479	101,411
Additional paid-in capital	425,935	470,758
Retained earnings	1,107,983	983,374
Accumulated other comprehensive (loss) income	(23,152)	82,529
Total Kennametal Shareowners Equity	1,610,245	1,638,072
Noncontrolling interests	19,929	20,569
Total equity	1,630,174	1,658,641
Total liabilities and equity	\$ 2,644,738	\$ 2,754,469

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)**

Six months ended December 31 (in thousands)	2011	2010
OPERATING ACTIVITIES		
Net income	\$ 148,044	\$ 80,246
Adjustments for non-cash items:		
Depreciation	41,261	39,883
Amortization	6,733	5,860
Stock-based compensation expense	12,404	12,591
Restructuring charges	-	1,622
Deferred income tax (benefit) provision	(2,144)	505
Other	(12,063)	771
Changes in certain assets and liabilities:		
Accounts receivable	23,240	1,600
Inventories	(83,421)	(45,089)
Accounts payable and accrued liabilities	(67,269)	(21,163)
Accrued income taxes	7,833	(3,993)
Other	(3,519)	(5,432)
Net cash flow provided by operating activities	71,099	67,401
INVESTING ACTIVITIES		
Purchases of property, plant and equipment	(35,593)	(21,150)
Disposals of property, plant and equipment	2,557	7,451
Purchase of technology license	(10,000)	-
Other	(912)	1,138
Net cash flow used for investing activities	(43,948)	(12,561)
FINANCING ACTIVITIES		
Net decrease in notes payable	(661)	(16,139)
Term debt borrowings	275,054	255,055
Term debt repayments	(275,183)	(256,564)
Purchase of capital stock	(66,721)	(10,275)
Dividend reinvestment and the effect of employee benefit and stock plans	10,948	10,186
Cash dividends paid to shareowners	(21,074)	(19,929)
Other	(7,169)	(1,489)
Net cash flow used for financing activities	(84,806)	(39,155)
Effect of exchange rate changes on cash and cash equivalents	(18,373)	13,343
CASH AND CASH EQUIVALENTS		
Net (decrease) increase in cash and cash equivalents	(76,028)	29,028
Cash and cash equivalents, beginning of period	204,565	118,129
Cash and cash equivalents, end of period	\$ 128,537	\$ 147,157

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

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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, 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 operate two global business segments 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 2011 Annual Report on Form 10-K. The condensed consolidated balance sheet as of June 30, 2011 was derived from the audited balance sheet included in our 2011 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 adjustments. The results for the six months ended December 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 2012 is to the fiscal year ending June 30, 2012. 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

Issued

In December 2011, the Financial Accounting Standards Board (FASB) deferred the requirement to present reclassifications of other comprehensive income on the face of the income statement. Companies would still be required to adopt the other requirements contained in the accounting guidance on presentation of other comprehensive income. This guidance is effective for Kennametal beginning July 1, 2012.

In September 2011, the FASB issued additional guidance on testing goodwill for impairment. The guidance permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. This guidance is effective for Kennametal beginning July 1, 2012.

In June 2011, the FASB issued guidance on presentation of comprehensive income. This guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. An entity can elect to present items of net income and other comprehensive income in one continuous statement or in two separate consecutive statements. Each component of net income and other comprehensive income, together with totals for comprehensive income and its two parts, net income and other comprehensive income, would need to be displayed under either alternative. This guidance is effective for Kennametal beginning July 1, 2012.

In May 2011, the FASB issued guidance on fair value measurements and disclosure. The objective of this guidance is a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and international financial reporting standards (IFRS). Many of the amendments in this guidance represent clarifications to existing guidance or changes in the measurement guidance for determining fair value. The most significant change in disclosures is an expansion of the information required for

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Level 3 measurements. Disclosures will be required about the use of a nonfinancial asset measured or disclosed at fair value if its use differs from its highest and best use. In addition, entities must report the level in the fair value hierarchy of assets and liabilities not recorded at fair value but where fair value is disclosed. This guidance is effective for Kennametal beginning January 1, 2012.

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

4. SUPPLEMENTAL CASH FLOW DISCLOSURES

Six months ended December 31 (in thousands)	2011	2010
Cash paid during the period for:		
Interest	\$ 12,917	\$ 12,653
Income taxes	26,298	30,362
Supplemental disclosure of non-cash information:		
Contribution of capital stock to employees defined contribution benefit plans	-	948

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 December 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 ⁽¹⁾	\$ -	\$ 1,794	\$ -	\$ 1,794
Total assets at fair value	\$ -	\$ 1,794	\$ -	\$ 1,794
Liabilities:				
Derivatives ⁽¹⁾	\$ -	\$ 23,722	\$ -	\$ 23,722
Total liabilities at fair value	\$ -	\$ 23,722	\$ -	\$ 23,722

As of June 30, 2011, 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
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Assets:				
Derivatives ⁽¹⁾	\$ -	\$ 896	\$ -	\$ 896
Total assets at fair value	\$ -	\$ 896	\$ -	\$ 896
Liabilities:				
Derivatives ⁽¹⁾	\$ -	\$ 3,330	\$ -	\$ 3,330
Total liabilities at fair value	\$ -	\$ 3,330	\$ -	\$ 3,330

⁽¹⁾ 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 expense (income), net.

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

	December 31,	June 30,
(in thousands)	2011	2011
Derivatives designated as hedging instruments		
Other current assets - range forward contracts	\$ 1,732	\$ 87
Other current liabilities - range forward contracts	(3)	(159)
Other assets - forward starting interest rate swap contracts	-	772
Other liabilities - forward starting interest rate swap contracts	(22,908)	(3,169)
Total derivatives designated as hedging instruments	(21,179)	(2,469)
Derivatives not designated as hedging instruments		
Other current assets - currency forward contracts	62	37
Other current liabilities - currency forward contracts	(811)	(2)
Total derivatives not designated as hedging instruments	(749)	35
Total derivatives	\$ (21,928)	\$ (2,434)

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 (income) expense, net. (Gains) losses related to derivatives not designated as hedging instruments have been recognized as follows:

	Three Months Ended		Six Months Ended	
(in thousands)	December 31,	December 31,	December 31,	December 31,
	2011	2010	2011	2010
Other expense (income), net - currency forward contracts	\$ 734	\$ 618	\$ 783	\$ (2,029)

FAIR VALUE HEDGES

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

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three and six months ended December 31, 2011, \$1.5 million and \$3.0 million, respectively, were recognized as a reduction in interest expense. During the three and six months ended December 31, 2010, \$1.4 million and \$2.9 million, respectively, were recognized as a reduction 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) income, net of tax, and are recognized as a component of other (income) expense, 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 December 31, 2011 and 2010, was \$68.0 million and \$64.1 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 December 31, 2011, we expect to recognize a gain of \$1.0 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) income, net of tax. In December 2011, we amended the maturity date of our forward starting interest rate swap contracts for forecasted interest payments in an anticipated debt issuance. These contracts effectively convert a cumulative notional amount of \$150.0 million from floating to fixed interest rates. The amendment of the existing contracts resulted in a de-designation of the original cash flow hedge and a designation of a new cash flow hedge as the forecasted transaction continues to be probable. Hedge ineffectiveness was determined to be immaterial for the new cash flow hedge. As of December 31, 2011 and June 30, 2011, we recorded a liability of \$22.9 million and \$2.4 million, respectively, 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 December 31, 2011, we do not expect to recognize into earnings any significant gains or losses on outstanding derivatives.

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

(in thousands)	Three Months Ended		Six Months Ended	
	December 31, 2011	December 31, 2010	December 31, 2011	December 31, 2010
Losses (gains) recognized in other comprehensive income (loss)	\$ 904	\$ (5,871)	\$ 11,587	\$ (2,229)
(Gains) losses reclassified from accumulated other comprehensive income into other (income) expense, net	\$ (75)	\$ 82	\$ 166	\$ 192

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 six months ended December 31, 2011 and 2010.

7. RESTRUCTURING AND RELATED CHARGES

During fiscal year 2011, we completed our restructuring plans to reduce costs and improve operating efficiencies. These actions related to the rationalization of certain manufacturing and service facilities as well as other employment cost reduction programs. There were no restructuring and related charges for the six months ended December 31, 2011.

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Restructuring and related charges recorded during the six months ended December 31, 2010 amounted to \$9.4 million, including \$7.1 million of restructuring charges of which \$0.5 million were related to inventory disposals and recorded in cost of goods sold. Restructuring-related charges of \$1.5 million and \$0.8 million were recorded in cost of goods sold and operating expense, respectively, during the same period.

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, 2011	Expense	Asset		Cash		December 31, 2011
			Write-down	Expenditures	Translation		
Industrial							
Severance	\$ 7,811	\$ -	\$ -	\$ (4,926)	\$ (216)	\$ 2,669	
Facilities	525	-	-	(500)	(25)	-	
Other	1,604	-	-	(496)	(136)	972	
Total Industrial	9,940	-	-	(5,922)	(377)	3,641	
Infrastructure							
Severance	1,650	-	-	(1,558)	(92)	-	
Facilities	269	-	-	(226)	(10)	33	
Other	852	-	-	(212)	(58)	582	
Total Infrastructure	2,771	-	-	(1,996)	(160)	615	
Total	\$ 12,711	\$ -	\$ -	\$ (7,918)	\$ (537)	\$ 4,256	

(in thousands)	June 30, 2010	Expense	Asset		Cash		June 30, 2011
			Write-down	Expenditures	Translation		
Industrial							
Severance	\$ 18,327	\$ 4,363	\$ -	\$ (16,510)	\$ 1,631	\$ 7,811	
Facilities	508	2,318	(1,857)	(444)	-	525	
Other	403	2,031	-	(931)	101	1,604	
Total Industrial	19,238	8,712	(1,857)	(17,885)	1,732	9,940	
Infrastructure							
Severance	7,637	2,484	-	(9,399)	928	1,650	
Facilities	211	1,319	(1,057)	(204)	-	269	
Other	168	1,156	-	(530)	58	852	
Total Infrastructure	8,016	4,959	(1,057)	(10,133)	986	2,771	
Total	\$ 27,254	\$ 13,671	\$ (2,914)	\$ (28,018)	\$ 2,718	\$ 12,711	

8. 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 Kennametal Inc., Stock Incentive Plan of 2002, as amended (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 six months ended December 31, 2011 and 2010 were as follows:

	2011	2010
Risk-free interest rate	1.2%	1.4%
Expected life (years) ⁽²⁾	4.5	4.5
Expected volatility ⁽³⁾	47.5%	47.0%
Expected dividend yield	1.5%	2.0%

(2) Expected life is derived from historical experience.

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

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

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

	Options	Weighted Average Exercise Price	Weighted Average Remaining Life (years)	Aggregate Intrinsic value (in thousands)
Options outstanding, June 30, 2011	3,388,003	\$ 26.50		
Granted	354,618	38.95		
Exercised	(317,708)	24.98		
Lapsed and forfeited	(28,630)	29.35		
Options outstanding, December 31, 2011	3,396,283	\$ 27.92	6.1	\$ 30,978
Options vested and expected to vest, December 31, 2011	3,307,211	\$ 27.86	6.0	\$ 30,325
Options exercisable, December 31, 2011	2,181,305	\$ 27.19	4.9	\$ 21,235

During the six months ended December 31, 2011 and 2010, compensation expense related to stock options was \$3.4 million and \$3.5 million, respectively. As of December 31, 2011, the total unrecognized compensation cost related to options outstanding was \$5.7 million and is expected to be recognized over a weighted average period of 2.2 years.

Weighted average fair value of options granted during the six months ended December 31, 2011 and 2010 was \$13.84 and \$9.22, respectively. Fair value of options vested during the six months ended December 31, 2011 and 2010 was \$4.5 million and \$4.2 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 \$2.1 million and \$1.3 million for the six months ended December 31, 2011 and 2010, respectively.

The amount of cash received from the exercise of capital stock options six months ended December 31, 2011 and 2010 was \$7.9 million and \$7.0 million, respectively. The related tax benefit for the six months ended December 31, 2011 and 2010 was \$1.6 million and \$1.7 million, respectively. The total intrinsic value of options exercised during the six months ended December 31, 2011 and 2010 was \$5.0 million and \$4.8 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 six months ended December 31, 2011 was immaterial and for the six months ended December 31, 2010 was \$0.4 million.

Restricted Stock Awards

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

	Shares	Weighted Average Fair Value
Unvested restricted stock awards, June 30, 2011	89,315	\$ 32.90
Vested	(50,056)	33.53
Forfeited	(582)	29.60
 Unvested restricted stock awards, December 31, 2011	 38,677	 \$ 32.14

During the six months ended December 31, 2011 and 2010, compensation expense related to restricted stock awards was \$0.6 million and \$1.2 million, respectively. As of December 31, 2011, the total unrecognized compensation cost related to unvested restricted stock awards was \$0.3 million and is expected to be recognized over a weighted average period of 0.7 years.

Table of Contents**KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)***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 six months ended December 31, 2011 were as follows:

	Performance Vesting	Performance Vesting Weighted Average Fair Value	Time Vesting	Time Vesting Weighted Average Fair Value
	Stock Units	Value	Stock Units	Value
Unvested performance vesting and time vesting restricted stock units, June 30, 2011	116,368	\$ 26.89	906,082	\$ 25.81
Granted	129,977	38.95	334,726	38.94
Vested	-	-	(198,862)	25.60
Forfeited	-	-	(20,129)	31.69
Unvested performance vesting and time vesting restricted stock units, December 31, 2011	246,345	\$ 31.27	1,021,817	\$ 30.04

During the six months ended December 31, 2011 and 2010, compensation expense related to time vesting and performance vesting restricted stock units was \$8.2 million and \$6.6 million, respectively. As of December 31, 2011, the total unrecognized compensation cost related to unvested time vesting and performance vesting restricted stock units was \$20.7 million and is expected to be recognized over a weighted average period of 2.5 years.

Restricted Stock Units STEP

On November 26, 2007, the Company adopted a one-time, long-term equity program, the Kennametal Inc. 2008 Strategic Transformational Equity Program, under the 2002 Plan (STEP). The STEP was designed to compensate participating executives for achievement of certain performance conditions during the period which began on October 1, 2007 and ended on September 30, 2011. Each participant was awarded a maximum number of restricted stock units, each representing a contingent right to receive one share of capital stock of the Company to the extent the unit was earned during the performance period and would have become payable under the STEP. The performance conditions were based on the Company's total shareholder return (TSR) which governed 35 percent of the awarded restricted stock units, and cumulative adjusted earnings per share (EPS), which governed 65 percent of the awarded restricted stock units. The performance period for the STEP ended on September 30, 2011 and the minimum threshold levels of performance were not achieved. Therefore, all outstanding restricted stock units were forfeited by participating executives. As of December 31, 2011, no restricted stock units had been earned or paid under the STEP. There were no voting rights or dividends associated with restricted stock units under the STEP.

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

	Stock	Weighted
	Units	Average Fair
		Value
Unvested EPS performance-based restricted stock units, June 30, 2011	431,789	\$ 35.23
Forfeited	(431,789)	35.23
Unvested EPS performance-based restricted stock units, December 31, 2011	-	\$ -

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

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

	Stock Units	Weighted Average Fair Value
Unvested TSR performance-based restricted stock units, June 30, 2011	232,497	\$ 8.21
Forfeited	(232,497)	8.21
Unvested TSR performance-based restricted stock units, December 31, 2011	-	\$ -

During the six months ended December 31, 2011 and 2010, compensation expense related to STEP restricted stock units was \$0.2 million and \$0.3 million, respectively.

9. 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		Six Months Ended	
	December 31, 2011	2010	December 31, 2011	2010
Service cost	\$ 1,721	\$ 1,909	\$ 3,449	\$ 3,822
Interest cost	10,331	10,208	20,711	20,458
Expected return on plan assets	(12,706)	(12,027)	(25,415)	(24,073)
Amortization of transition obligation	16	12	32	26
Amortization of prior service credit	(46)	(70)	(93)	(141)
Settlement loss	262	270	519	533
Recognition of actuarial losses	2,062	3,064	4,125	6,132
Net periodic pension cost	\$ 1,640	\$ 3,366	\$ 3,328	\$ 6,757

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

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(in thousands)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2011	2010	2011	2010
Service cost	\$ 19	\$ 19	\$ 37	\$ 38
Interest cost	257	259	514	518
Amortization of prior service cost	(22)	-	(44)	-
Recognition of actuarial gains	(14)	(47)	(28)	(94)
Net periodic other postretirement benefit cost	\$ 240	\$ 231	\$ 479	\$ 462

10. INVENTORIES

We used the last-in, first-out (LIFO) method of valuing inventories for approximately 53 percent and 50 percent of total inventories at December 31, 2011 and June 30, 2011, 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.

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

Inventories consisted of the following:

(in thousands)	December 31, 2011	June 30, 2011
Finished goods	\$ 331,885	\$ 303,716
Work in process and powder blends	234,785	202,940
Raw materials	127,018	109,683
Inventories at current cost	693,688	616,339
Less: LIFO valuation	(122,625)	(96,366)
Total inventories	\$ 571,063	\$ 519,973

11. LONG-TERM DEBT AND CAPITAL LEASES

Current maturities of 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.

On October 21, 2011, we entered into an amendment to our 2010 Credit Agreement, which is used to augment cash from operations and as an additional source of funds. The five-year, multi-currency, revolving credit facility (2011 Credit Agreement) permits revolving credit loans of up to \$600.0 million for working capital, capital expenditures and general corporate purposes. The 2011 Credit Agreement allows for borrowings in U.S. dollars, euro, Canadian dollars, pound sterling and Japanese yen. Interest payable under the 2011 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 2011 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 December 31, 2011. We had no borrowings outstanding under the 2011 Credit Agreement as of December 31, 2011. We had no borrowings outstanding under the 2010 Credit Agreement as of June 30, 2011.

Borrowings under the 2011 Credit Agreement are guaranteed by our significant domestic subsidiaries.

Fixed rate debt had a fair market value of \$307.6 million and \$315.8 million at December 31, 2011 and June 30, 2011, respectively. The fair value is determined based on the quoted market price of this debt as of December 31, 2011 and June 30, 2011, respectively.

12. 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.

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Superfund Sites We are involved as a Potentially Responsible Party (PRP) at various sites designated by the U.S. Environmental Protection Agency (US EPA) 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 \$4.7 million and \$5.4 million as of December 31, 2011 and June 30, 2011, respectively. This accrual represents anticipated costs associated with the remediation of these issues. We recorded favorable foreign currency translation adjustments of \$0.6 million and cash payments of \$0.1 million against the reserve for the six months ended December 31, 2011.

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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 US EPA, 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.

13. INCOME TAXES

The effective income tax rate for the three months ended December 31, 2011 and 2010 was 17.3 percent and 21.3 percent, respectively. The current year rate was favorably impacted by a \$4.2 million reduction of a valuation allowance in the Netherlands in the quarter as well as stronger operating results under our pan-European operations. The prior year rate benefitted from the RD&E credit extension.

The effective income tax rate for the six months ended December 31, 2011 and 2010 was 20.2 percent and 24.3 percent, respectively. The current year rate was favorably impacted by a \$4.2 million reduction of a valuation allowance in the Netherlands in the quarter and the favorable impact of stronger operating results under our pan-European operations.

During the quarter, we assessed the sustainability of future income in the Netherlands. Based on this assessment, we believe that it is more likely than not that we will be able to realize a portion of the net deferred tax assets in this jurisdiction.

14. 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.

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 1.2 million shares and 1.1 million shares for the three months ended December 31, 2011 and 2010, respectively, and 1.1 million shares and 0.9 million shares for the six months ended December 31, 2011 and 2010, respectively. Unexercised capital stock options, restricted stock units and restricted stock awards of 0.7 million and 0.6 million shares for the three months ended December 31, 2011 and 2010, respectively, and 0.7 million shares for both the six months ended December 31, 2011 and 2010, were not included in the computation of diluted earnings per share because the inclusion would have been anti-dilutive.

Table of Contents**KENNAMETAL INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****15. EQUITY**

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

	Kennametal Shareowners' Equity					Total equity
	Capital stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Non-controlling interests	
(in thousands)						
Balance as of June 30, 2011	\$ 101,411	\$ 470,758	\$ 983,374	\$ 82,529	\$ 20,569	\$ 1,658,641
Net income	-	-	145,683	-	2,361	148,044
Other comprehensive loss	-	-	-	(105,681)	(2,834)	(108,515)
Dividend reinvestment	6	132	-	-	-	138
Capital stock issued under employee benefit and stock plans	568	19,260	-	-	-	19,828
Purchase of capital stock	(2,506)	(64,215)	-	-	-	(66,721)
Cash dividends paid	-	-	(21,074)	-	(167)	(21,241)
Total equity, December 31, 2011	\$ 99,479	\$ 425,935	\$ 1,107,983	\$ (23,152)	\$ 19,929	\$ 1,630,174

	Kennametal Shareowners' Equity					Total equity
	Capital stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive (loss) income	Non-controlling interests	
(in thousands)						
Balance as of June 30, 2010	\$ 102,379	\$ 492,454	\$ 793,448	\$ (72,781)	\$ 17,943	\$ 1,333,443
Net income	-	-	78,390	-	1,856	80,246
Other comprehensive income	-	-	-	70,174	1,292	71,466

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Dividend reinvestment	7	152	-	-	-	159
Capital stock issued under employee benefit and stock plans	496	20,953	-	-	-	21,449
Purchase of capital stock	(379)	(9,896)	-	-	-	(10,275)
Cash dividends paid	-	-	(19,929)	-	(132)	(20,061)

Total equity, December 31, 2010 \$ 102,503 \$ 503,663 \$ 851,909 \$ (2,607) \$ 20,959 \$ 1,476,427

The amounts of comprehensive income (loss) attributable to Kennametal shareowners and noncontrolling interests are disclosed in Note 16.

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

16. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) is as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	December 31, 2011	2010	December 31, 2011	2010
Net income	\$ 74,471	\$ 44,290	\$ 148,044	\$ 80,246
Unrealized (loss) gain on derivatives designated and qualified as cash flow hedges, net of income tax (benefit) expense of (\$0.5) million, \$3.6 million, (\$7.3) million and \$1.4 million, respectively	(789)	5,780	(11,534)	2,187
Reclassification of unrealized (gain) loss on expired derivatives designated and qualified as cash flow hedges, net of income tax expense (benefit) of \$0.1 million, (\$0.1) million, (\$0.1) million and (\$0.1) million, respectively	(186)	177	123	223
Unrecognized net pension and other postretirement benefit gain (loss), net of income tax expense (benefit) of \$0.1 million, \$0.1 million, \$0.4 million and (\$0.5) million, respectively	217	564	1,065	(1,622)
Reclassification of net pension and other postretirement benefit loss, net of income tax benefit of \$0.7 million, \$1.0 million, \$1.5 million and \$1.9 million, respectively	1,286	1,859	2,573	3,720
Foreign currency translation adjustments, net of income tax expense (benefit) of (\$18.2) million, (\$4.3) million, (\$60.0) million and \$40.2 million, respectively	(30,865)	(7,293)	(100,742)	66,958
Total comprehensive income	44,134	45,377	39,529	151,712
Comprehensive (loss) income attributable to noncontrolling interests	(359)	604	(473)	3,148
Comprehensive income attributable to Kennametal Shareowners	\$ 44,493	\$ 44,773	\$ 40,002	\$ 148,564

17. 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. We have noted no impairment indicators warranting additional testing.

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

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(in thousands)	Industrial	Infrastructure	Total
Goodwill	\$ 411,945	\$ 250,225	\$ 662,170
Accumulated impairment losses	(150,842)	-	(150,842)
Balance as of June 30, 2011	\$ 261,103	\$ 250,225	\$ 511,328
Adjustments	\$ 76	\$ -	\$ 76
Translation	(14,638)	(2,009)	(16,647)
Change in goodwill	(14,562)	(2,009)	(16,571)
Goodwill	397,383	248,216	645,599
Accumulated impairment losses	(150,842)	-	(150,842)
Balance as of December 31, 2011	\$ 246,541	\$ 248,216	\$ 494,757

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	December 31, 2011		June 30, 2011	
	Useful Life	Gross Carrying	Accumulated	Gross Carrying	Accumulated
	(in years)	Amount	Amortization	Amount	Amortization
Contract-based	4 to 15	\$ 21,452	\$ (5,590)	\$ 6,349	\$ (5,380)
Technology-based and other	4 to 15	37,878	(23,829)	39,743	(25,442)
Customer-related	10 to 20	109,256	(39,276)	113,977	(38,275)
Unpatented technology	30	19,318	(5,883)	19,540	(4,740)
Trademarks	5 to 20	12,385	(6,374)	10,902	(4,875)
Trademarks	Indefinite	36,234	-	40,480	-
Total		\$ 236,523	\$ (80,952)	\$ 230,991	\$ (78,712)

During the three months ended December 31, 2011, we entered into a technology license agreement in our infrastructure segment. This resulted in a \$15.0 million increase of contract-based intangible assets. The technology license agreement will be amortized using the straight-line method over an estimated useful life of 10 years.

During the six months ended December 31, 2011, we recorded amortization expense of \$6.7 million related to our other intangible assets and unfavorable foreign currency translation adjustments of \$5.0 million.

18. SEGMENT DATA

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.

Corporate expenses related to executive retirement plans, the Company's Board of Directors and strategic initiatives, as well as certain other costs, are reported as Corporate.

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

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

(in thousands)	Three Months Ended		Six Months Ended	
	December 31, 2011	December 31, 2010	December 31, 2011	December 31, 2010
External sales:				
Industrial	\$ 409,887	\$ 369,139	\$ 827,706	\$ 699,797
Infrastructure	231,854	196,629	472,912	395,129
Total external sales	\$ 641,741	\$ 565,768	\$ 1,300,618	\$ 1,094,926
Operating income:				
Industrial	\$ 62,898	\$ 42,157	\$ 135,583	\$ 78,265
Infrastructure	33,312	21,566	65,866	48,069
Corporate	(2,162)	(2,106)	(5,791)	(7,205)
Total operating income	\$ 94,048	\$ 61,617	\$ 195,658	\$ 119,129
Interest expense	\$ 5,256	\$ 5,564	\$ 10,743	\$ 11,527
Other (income) expense, net	(1,258)	(253)	(684)	1,658
Income before income taxes	\$ 90,050	\$ 56,306	\$ 185,599	\$ 105,944

19. SUBSEQUENT EVENTS

On January 17, 2012, Kennametal announced that we signed a definitive agreement to purchase the Deloro Stellite Holdings 1 Limited (Deloro Stellite) from Duke Street Capital for approximately 277 million. The U.K.-based Deloro Stellite, with approximately 220 million in annual sales, is a global manufacturer and provider of alloy-based critical wear solutions for extreme environments involving high temperature, corrosion and abrasion. Deloro Stellite employs approximately 1,300 people across seven primary operating facilities globally, including locations in the U.S., Canada, Germany, Italy, India and China. Through proprietary metal alloys and materials expertise as well as specialized engineering design and fabrication capabilities, Deloro Stellite delivers value-added, tailored wear solutions for customers in our current end markets of energy, which includes oil and gas and power generation, transportation, and aerospace.

We plan to fund the acquisition through existing credit facilities and operating cash flow, and remain committed to maintaining our investment grade ratings.

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**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 December quarter across both business segments and all regions. Our sales of \$641.7 million for the quarter ended December 31, 2011 grew 13 percent compared to sales for the December quarter one year ago. Sales growth was primarily due to organic growth which includes both volume and price.

Raw materials prices have doubled compared to the prior year, but continue to stabilize. Our margin performance during the quarter reflected our ability to recover inflation costs related to these raw materials, primarily tungsten, our main raw material. We had previously executed appropriate pricing actions and have continued to maintain our cost discipline during the quarter. We continue to monitor changes in raw material prices to ensure appropriate pricing.

Operating income was \$94.0 million, an increase of \$32.4 million compared to operating income of \$61.6 million in the prior year quarter. The increase in operating income was driven by higher sales volume, higher price realization and incremental restructuring benefits, partially offset by higher raw material costs.

We delivered a record December quarter earnings per diluted share of \$0.91.

We had cash inflow from operating activities of \$71.1 million during the six months ended December 31, 2011, driven by our operating performance. Capital expenditures were \$35.6 million during the six months ended December 31, 2011.

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 included in operating expense totaled \$8.5 million for the three months ended December 31, 2011.

On January 17, 2012, Kennametal announced that we signed a definitive agreement to purchase the Deloro Stellite Holdings 1 Limited (Deloro Stellite) from Duke Street Capital for approximately 277 million. The U.K.-based Deloro Stellite, with approximately 220 million in annual sales, is a global manufacturer and provider of alloy-based critical wear solutions for extreme environments involving high temperature, corrosion and abrasion. Deloro Stellite employs approximately 1,300 people across seven primary operating facilities globally, including locations in the U.S., Canada, Germany, Italy, India and China. Through proprietary metal alloys and materials expertise as well as specialized engineering design and fabrication capabilities, Deloro Stellite delivers value-added, tailored wear solutions for customers in our current end markets of energy, which includes oil and gas and power generation, transportation, and aerospace.

This acquisition is in alignment with our growth strategy and positions the Company to further achieve geographic and end market balance. The transaction is expected to be accretive to earnings in the fiscal year ending June 30, 2013. We plan to fund the acquisition through existing credit facilities and operating cash flow, and remain committed to maintaining our investment grade ratings.

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

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Sales for the three months ended December 31, 2011 were \$641.7 million, an increase of \$75.9 million, or 13 percent, from \$565.8 million in the prior year quarter. Sales increased due to organic growth of 14 percent offset by unfavorable impact of fewer business days. The improvement in sales was driven by better performance in both business segments and across all regions. Organic sales growth drivers were energy markets of 25 percent, aerospace and defense of 16 percent, earthworks market of 15 percent, general engineering of 12 percent and transportation of 7 percent.

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

Sales for the six months ended December 31, 2011 were \$1,300.6 million, an increase of \$205.6 million, or 19 percent, from \$1,095.0 million in the prior year quarter. Sales increased due to organic growth of 16 percent and a 3 percent favorable impact from foreign currency effects. The improvement in sales was driven by better performance in both business segments and across all regions. Organic sales growth drivers were energy markets of 22 percent, general engineering of 17 percent, earthworks market of 15 percent, aerospace and defense of 12 percent and transportation of 10 percent.

GROSS PROFIT

Gross profit for the three months ended December 31, 2011 was \$231.9 million, an increase of \$31.9 million from \$200.0 million in the prior year quarter. This increase was primarily due to increased organic sales of \$79.4 million, partially offset by higher raw material costs. The gross profit margin for the three months ended December 31, 2011 was 36.1 percent, as compared to 35.4 percent generated in the prior year quarter.

Gross profit for the six months ended December 31, 2011 was \$482.9 million, an increase of \$94.1 million from \$388.8 million in the prior year quarter. This increase was primarily due to increased organic sales of \$170.5 million, partially offset by higher raw material costs. The gross profit margin for the six months ended December 31, 2011 was 37.1 percent, as compared to 35.5 percent generated in the prior year quarter.

OPERATING EXPENSE

Operating expense for the three months ended December 31, 2011 increased \$2.5 million or 1.9 percent to \$134.6 million compared to \$132.1 million in the prior year quarter. The increase is primarily due to an increase in employment costs of \$5.6 million, including higher sales compensation of \$3.6 million due to better operating performance, partially offset by lower professional fees of \$2.0 million.

Operating expense for the six months ended December 31, 2011 increased \$23.5 million or 9.1 percent to \$280.6 million compared to \$257.1 million in the prior year quarter. The increase is primarily due to an increase in employment costs of \$13.4 million, including higher sales compensation of \$6.8 million due to better operating performance and unfavorable impact of foreign currency results of \$8.7 million.

RESTRUCTURING CHARGES

During fiscal year 2011, we completed our restructuring plans to reduce costs and improve operating efficiencies. These actions related to the rationalization of certain manufacturing and service facilities as well as other employment cost reduction programs. As the restructuring programs were completed in fiscal 2011, there were no restructuring and related charges for the three and six months ended December 31, 2011. The Company's restructuring programs are delivering annual ongoing pre-tax savings of approximately \$170 million now that all programs are fully implemented.

Restructuring and related charges recorded during the three months ended December 31, 2010 amounted to \$5.1 million, including \$3.8 million of restructuring charges, of which \$0.5 million were related to inventory disposals and recorded in cost of goods sold. Restructuring related charges of \$0.5 million and \$0.8 million were recorded in cost of goods sold and operating expense, respectively, during the three months ended December 31, 2010.

Restructuring and related charges recorded during the six months ended December 31, 2010 amounted to \$9.4 million, including \$7.1 million of restructuring charges, of which \$0.5 million were related to inventory disposals and recorded in cost of goods sold. Restructuring related charges of \$1.5 million and \$0.8 million were recorded in cost of goods sold and operating expense, respectively, during the six months ended December 31, 2010.

INTEREST EXPENSE

Interest expense for the three months ended December 31, 2011 of \$5.3 million decreased \$0.3 million or 5.5 percent, from \$5.6 million in the prior year quarter. Interest expense for the six months ended December 31, 2011 of \$10.7 million decreased \$0.8 million or 6.8 percent, from \$11.5 million in the prior year quarter.

OTHER (INCOME) EXPENSE, NET

Other income, net for the three months ended December 31, 2011 was \$1.3 million compared to \$0.3 million for the prior year quarter. The increase was primarily driven by favorable foreign currency transaction results of \$1.6 million.

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