

KENNAMETAL INC  
Form 10-Q  
February 06, 2014  
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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, 2013  
Commission file number 1-5318  
KENNAMETAL INC.  
(Exact name of registrant as specified in its charter)

Pennsylvania 25-0900168  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

World Headquarters 15650-0231  
1600 Technology Way  
P.O. Box 231  
Latrobe, Pennsylvania  
(Address of principal executive offices) (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

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, 2014 |
| Capital Stock, par value \$1.25 per share | 78,600,322                      |



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FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2013  
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**FORWARD-LOOKING INFORMATION**

This Quarterly Report on 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” and other words of similar meaning and expression in connection with any discussion of future operating or financial performance or events. We have also included forward looking statements in this Quarterly Report on Form 10-Q concerning, among other things, our strategy, goals, plans and projections regarding our financial position, liquidity and capital resources, results of operations, market position, and product development. These statements are based on current estimates that involve inherent risks and uncertainties. Should one or more of these risks or uncertainties materialize, or should the assumptions underlying the forward-looking statements prove incorrect, our actual results could vary materially from our current expectations. There are a number of factors that could cause our actual results to differ from those indicated in the forward-looking statements. They include: economic recession; 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. We provide additional information about many of the specific risks we face in the “Risk Factors” Section of our Annual Report on Form 10-K. We can give no assurance that any goal or plan set forth in forward-looking statements can be achieved and readers are cautioned not to place undue reliance on such statements, which speak only as of the date made. We undertake no obligation to release publicly any revisions to forward-looking statements as a result of future events or developments.

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## 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 |           | Six Months Ended |             |
|--|--------------------|-----------|------------------|-------------|
|  | December 31,       |           | December 31,     |             |
|  | 2013               | 2012      | 2013             | 2012        |
| Sales  | \$689,936          | \$633,144 | \$1,309,743      | \$1,262,603 |
| Cost of goods sold   | 482,965            | 433,697   | 904,536          | 854,808     |
| Gross profit   | 206,971            | 199,447   | 405,207          | 407,795     |
| Operating expense  | 148,421            | 127,778   | 282,685          | 266,638     |
| Restructuring charges (Note 8)                                   | 2,310              | —         | 2,310            | —           |
| Amortization of intangibles                                      | 6,524              | 5,200     | 11,667           | 10,307      |
| Operating income   | 49,716             | 66,469    | 108,545          | 130,850     |
| Interest expense   | 8,037              | 6,970     | 15,118           | 12,926      |
| Other expense (income), net                                      | 856                | 655       | 1,466            | (246)       |
| Income before income taxes                                       | 40,823             | 58,844    | 91,961           | 118,170     |
| Provision for income taxes                                       | 16,656             | 15,535    | 29,236           | 27,815      |
| Net income   | 24,167             | 43,309    | 62,725           | 90,355      |
| Less: Net (loss) income attributable to noncontrolling interests | (42)               | 1,167     | 679              | 1,823       |
| Net income attributable to Kennametal                            | \$24,209           | \$42,142  | \$62,046         | \$88,532    |
| PER SHARE DATA ATTRIBUTABLE TO KENNAMETAL SHAREOWNERS            |                    |           |                  |             |
| Basic earnings per share   | \$0.31             | \$0.53    | \$0.79           | \$1.11      |
| Diluted earnings per share                                       | \$0.30             | \$0.52    | \$0.78           | \$1.09      |
| Dividends per share  | \$0.18             | \$0.16    | \$0.36           | \$0.32      |
| Basic weighted average shares outstanding                        | 78,729             | 79,713    | 78,587           | 79,980      |
| Diluted weighted average shares outstanding                      | 79,776             | 80,986    | 79,597           | 81,164      |

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

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## KENNAMETAL INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

| (in thousands)  | Three Months Ended |          | Six Months Ended |           |
|---|--------------------|----------|------------------|-----------|
|   | December 31,       |          | December 31,     |           |
|   | 2013               | 2012     | 2013             | 2012      |
| Net income  | \$24,167           | \$43,309 | \$62,725         | \$90,355  |
| Unrealized loss on derivatives designated and qualified as cash flow hedges, net of income tax benefit of \$0.2 million, \$0.1 million, \$0.5 million and \$0.4 million, respectively                             | (273 )             | (102 )   | (843 )           | (673 )    |
| Reclassification of unrealized loss on expired derivatives designated and qualified as cash flow hedges, net of income tax benefit of \$0.3 million, \$0.2 million, \$0.5 million and \$0.2 million, respectively | 440                | 293      | 849              | 378       |
| Unrecognized net pension and other postretirement benefit loss, net of income tax benefit of \$0.3 million, \$0.1 million, \$1.0 million and \$0.5 million, respectively  | (810 )             | (362 )   | (2,776 )         | (1,480 )  |
| Reclassification of net pension and other postretirement benefit loss, net of income tax benefit of \$0.2 million, \$1.4 million, \$0.4 million and \$2.8 million, respectively                                   | 498                | 2,421    | 982              | 4,835     |
| Foreign currency translation adjustments, net of income tax expense of \$0.7 million, \$0.4 million, \$2.1 million and \$1.5 million, respectively  | 11,675             | 13,367   | 39,586           | 38,445    |
| Total comprehensive income  | 35,697             | 58,926   | 100,523          | 131,860   |
| Comprehensive income attributable to noncontrolling interests   | 371                | 1,223    | 906              | 2,509     |
| Comprehensive income attributable to Kennametal Shareowners   | \$35,326           | \$57,703 | \$99,617         | \$129,351 |

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

Table of ContentsKENNAMETAL INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

| (in thousands, except per share data)   | December 31,<br>2013 | June 30,<br>2013 |
|---|----------------------|------------------|
| <b>ASSETS</b>   |                      |                  |
| Current assets:   |                      |                  |
| Cash and cash equivalents   | \$ 163,289           | \$ 377,316       |
| Accounts receivable, less allowance for doubtful accounts of \$13,320 and \$11,949          | 467,759              | 445,322          |
| Inventories (Note 11)   | 730,678              | 578,795          |
| Deferred income taxes   | 51,753               | 49,707           |
| Other current assets  | 65,359               | 48,333           |
| Total current assets  | 1,478,838            | 1,499,473        |
| Property, plant and equipment:  |                      |                  |
| Land and buildings  | 440,224              | 381,215          |
| Machinery and equipment   | 1,603,440            | 1,466,942        |
| Less accumulated depreciation   | (1,169,286 )         | (1,106,675 )     |
| Property, plant and equipment, net  | 874,378              | 741,482          |
| Other assets:   |                      |                  |
| Investments in affiliated companies   | 659                  | 671              |
| Goodwill (Note 18)  | 977,644              | 721,755          |
| Other intangible assets, less accumulated amortization of \$125,176 and \$111,440 (Note 18) | 355,581              | 222,765          |
| Deferred income taxes   | 33,582               | 39,590           |
| Other   | 87,518               | 75,303           |
| Total other assets  | 1,454,984            | 1,060,084        |
| Total assets  | \$ 3,808,200         | \$ 3,301,039     |
| <b>LIABILITIES</b>  |                      |                  |
| Current liabilities:  |                      |                  |
| Current maturities of long-term debt and capital leases (Note 12)                           | \$ 28,281            | \$ 3,738         |
| Notes payable to banks  | 81,815               | 40,581           |
| Accounts payable  | 188,614              | 190,623          |
| Accrued income taxes  | 15,943               | 19,471           |
| Accrued expenses  | 85,835               | 88,433           |
| Other current liabilities   | 138,821              | 124,747          |
| Total current liabilities   | 539,309              | 467,593          |
| Long-term debt and capital leases, less current maturities (Note 12)                        | 1,035,633            | 703,626          |
| Deferred income taxes   | 102,574              | 102,935          |
| Accrued pension and postretirement benefits   | 169,751              | 162,245          |
| Accrued income taxes  | 19,094               | 27,530           |
| Other liabilities   | 38,535               | 24,817           |
| Total liabilities   | 1,904,896            | 1,488,746        |
| Commitments and contingencies   |                      |                  |
| <b>EQUITY (Note 16)</b>   |                      |                  |
| Kennametal Shareowners' Equity:   |                      |                  |
| Preferred stock, no par value; 5,000 shares authorized; none issued                         | —                    | —                |
| Capital stock, \$1.25 par value; 120,000 shares authorized; 78,587 and 77,842 shares issued | 98,234               | 97,303           |

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|                                      |             |             |
|--------------------------------------|-------------|-------------|
| Additional paid-in capital           | 392,103     | 374,300     |
| Retained earnings                    | 1,433,093   | 1,399,227   |
| Accumulated other comprehensive loss | (51,433     | ) (89,004 ) |
| Total Kennametal Shareowners' Equity | 1,871,997   | 1,781,826   |
| Noncontrolling interests             | 31,307      | 30,467      |
| Total equity                         | 1,903,304   | 1,812,293   |
| Total liabilities and equity         | \$3,808,200 | \$3,301,039 |

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



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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW (UNAUDITED)

| (in thousands)  | Six Months Ended |           |
|---|------------------|-----------|
|   | December 31,     |           |
|   | 2013             | 2012      |
| <b>OPERATING ACTIVITIES</b>   |                  |           |
| Net income  | \$62,725         | \$90,355  |
| Adjustments for non-cash items:   |                  |           |
| Depreciation  | 48,267           | 45,460    |
| Amortization  | 11,667           | 10,307    |
| Stock-based compensation expense  | 12,108           | 15,450    |
| Deferred income tax provision   | 13,116           | 2,389     |
| Other   | 1,587            | 174       |
| Changes in certain assets and liabilities:                                |                  |           |
| Accounts receivable   | 26,942           | 73,898    |
| Inventories   | (27,044)         | (22,941)  |
| Accounts payable and accrued liabilities                                  | (34,322)         | (135,823) |
| Accrued income taxes  | (13,997)         | (21,114)  |
| Other   | (16,432)         | (3,920)   |
| Net cash flow provided by operating activities                            | 84,617           | 54,235    |
| <b>INVESTING ACTIVITIES</b>   |                  |           |
| Purchases of property, plant and equipment                                | (48,804)         | (34,372)  |
| Disposals of property, plant and equipment                                | 444              | 704       |
| Business acquisitions, net of cash acquired (Note 5)                      | (634,615)        | —         |
| Other   | (60)             | (87)      |
| Net cash flow used for investing activities                               | (683,035)        | (33,755)  |
| <b>FINANCING ACTIVITIES</b>   |                  |           |
| Net increase (decrease) in notes payable                                  | 40,910           | (39,168)  |
| Net increase (decrease) in short-term revolving and other lines of credit | 14,900           | (27,200)  |
| Term debt borrowings  | 345,485          | 864,244   |
| Term debt repayments  | (5,000)          | (655,915) |
| Purchase of capital stock   | (4,400)          | (46,616)  |
| Dividend reinvestment and the effect of employee benefit and stock plans  | 18,072           | 6,085     |
| Cash dividends paid to Shareowners  | (28,180)         | (25,748)  |
| Other   | 250              | (2,659)   |
| Net cash flow provided by financing activities                            | 382,037          | 73,023    |
| Effect of exchange rate changes on cash and cash equivalents              | 2,354            | 6,802     |
| <b>CASH AND CASH EQUIVALENTS</b>  |                  |           |
| Net (decrease) increase in cash and cash equivalents                      | (214,027)        | 100,305   |
| Cash and cash equivalents, beginning of period                            | 377,316          | 116,466   |
| Cash and cash equivalents, end of period                                  | \$163,289        | \$216,771 |

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**

From its founding in 1938, the McKenna family incorporated Kennametal Inc. 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 we deliver in our products and services, helps us to achieve a leading position in our primary markets. End users of our products include metalworking and machinery manufacturers and suppliers across a diverse array of industries, including the aerospace, defense, transportation, machine tool, light machinery and heavy machinery, as well as producers and suppliers in a number of equipment-intensive industries such as coal mining, road construction and quarrying, as well as oil and gas exploration, refining, production and supply. Our end users' applications range from airframes to mining operations, engines to oil wells and turbochargers to processing. 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 2013 Annual Report on Form 10-K. The condensed consolidated balance sheet as of June 30, 2013 was derived from the audited balance sheet included in our 2013 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, 2013 and 2012 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 2014 is to the fiscal year ending June 30, 2014. When used in this Quarterly Report on Form 10-Q, unless the context requires otherwise, the terms "we," "our" and "us" refer to Kennametal Inc. and its subsidiaries.

**3. NEW ACCOUNTING STANDARDS****Adopted**

As of July 1, 2013, Kennametal adopted disclosure requirements related to reclassifications out of accumulated other comprehensive income by component. See Note 17 to these condensed consolidated financial statements for required disclosures. Other than the change in disclosures, the adoption of this guidance had no impact on the condensed consolidated financial statements.

As of July 1, 2013, Kennametal adopted additional guidance on testing indefinite lived intangible assets 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 an indefinite lived intangible asset is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step impairment test. The adoption of this guidance had no impact on the condensed consolidated financial statements.

**4. SUPPLEMENTAL CASH FLOW DISCLOSURES**

|                                  | Six Months Ended |      |
|----------------------------------|------------------|------|
|                                  | December 31,     |      |
| (in thousands)                   | 2013             | 2012 |
| Cash paid during the period for: |                  |      |

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|   |          |          |
|---|----------|----------|
| Interest  | \$14,231 | \$11,338 |
| Income taxes  | 24,868   | 45,072   |
| Supplemental disclosure of non-cash information:                                  |          |          |
| Changes in accounts payable related to purchases of property, plant and equipment | 8,600    | —        |

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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5. ACQUISITIONS

TMB

On November 4, 2013, the Company completed its transaction to acquire the Tungsten Materials Business (TMB) from Allegheny Technologies Incorporated (ATI) which included all of the assets of TDY Industries, LLC, a wholly owned subsidiary of ATI, used or held for use by TDY in connection with the business; and all of the shares of TDY Limited and ATI Holdings SAS, both wholly-owned subsidiaries of ATI, for a purchase price of \$607.0 million. We funded the acquisition primarily through a combination of cash from operations and available borrowings under our existing credit facility.

TMB, with approximately \$340.0 million in annual sales, is a leading producer of tungsten metallurgical powders, as well as tooling technologies and components. The business has approximately 1,175 employees in 12 locations across 7 countries. The acquisition aligns with Company's long-term growth strategies, expands presence in aerospace and energy end markets, further augments the Company's tooling portfolio and accelerates our metallurgical strategy including planned tungsten carbide recycling and production.

As part of the acquisition of TMB, Kennametal incurred \$1.7 million and \$2.8 million for the three and six months ended December 31, 2013 of acquisition-related costs, which are included in operating expenses.

Purchase Price Allocation

This acquisition was accounted for under the acquisition method of accounting and accordingly, the purchase price has been allocated to the assets acquired and liabilities assumed based on estimated fair values at the date of acquisition. The Condensed Consolidated Balance Sheet as of December 31, 2013 reflects the preliminary allocation of the purchase price and is subject to revision when appraisals are finalized, which is expected to be in the fourth quarter of fiscal 2014.

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The preliminary allocation of the purchase price to the fair values of the assets acquired and liabilities assumed is as follows:

| (in thousands)                              | Total     |
|---|-----------|
| <b>ASSETS</b>                               |           |
| Current assets:                             |           |
| Cash and cash equivalents                   | \$1,294   |
| Accounts Receivable                         | 41,164    |
| Inventory                                   | 98,664    |
| Other current assets                        | 4,014     |
| Total current assets                        | \$145,136 |
| Property and equipment                      | 125,283   |
| Goodwill                                    | 242,363   |
| Other intangible assets                     | 124,200   |
| Deferred income taxes                       | 3,699     |
| Other                                       | 1,565     |
| Total assets                                | \$642,246 |
| <b>LIABILITIES</b>                          |           |
| Current liabilities:                        |           |
| Accounts payable                            | \$21,001  |
| Accrued payroll                             | 3,646     |
| Deferred income taxes                       | 3,563     |
| Accrued expenses                            | 1,959     |
| Total current liabilities                   | \$30,169  |
| Accrued pension and postretirement benefits | 88        |
| Other long-term liabilities                 | 5,021     |
| Total liabilities                           | 35,278    |
| Net assets acquired                         | \$606,968 |

In connection with this acquisition, we identified and valued certain intangible assets, including existing customer relationships, technologies and trademarks, as further discussed in Note 18. It is expected that the majority of the preliminary goodwill recorded of \$242.4 million will be deductible for tax purposes. The goodwill is attributable to the operating synergies we expect to gain from the acquisition. These intangible assets are part of both the Industrial and Infrastructure segments.

TMB contributed net sales of \$44.8 million and a net loss of \$7.2 million during the two months ended December 31, 2013, including \$1.7 million of acquisition-related pre-tax costs.

## Unaudited Pro Forma Financial Information

The following unaudited pro forma summary of operating results presents the consolidated results of operations as if the TMB acquisition had occurred on July 1, 2012. These amounts were calculated after applying our accounting policies and adjusting TMB's results to reflect increased depreciation and amortization expense resulting from recording fixed assets and intangible assets at fair value. The pro forma results for the three and six months ended December 31, 2013 exclude \$1.7 million and \$2.8 million of acquisition-related pre-tax costs. The pro forma results

for the three and six months ended December 31, 2013 includes \$4.5 million and \$9.0 million, respectively, of integration-related and restructuring-related expenses. The pro forma results have been presented for comparative purposes only and are not indicative of future results of operations or what would have occurred had the acquisition been made on July 1, 2012.

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Unaudited pro forma summary of operating results of Kennametal, assuming the acquisition had occurred as of July 1, 2012, are as follows:

| (in thousands, except per share amounts)   | Three Months Ended December 31, |           | Six Months Ended December 31, |             |
|--|---------------------------------|-----------|-------------------------------|-------------|
|  | 2013                            | 2012      | 2013                          | 2012        |
| Pro forma (unaudited):                     |                                 |           |                               |             |
| Net Sales                                  | \$721,062                       | \$731,941 | \$1,434,250                   | \$1,468,196 |
| Net income attributable to Kennametal      | \$35,934                        | \$33,112  | \$70,778                      | \$78,239    |
| Per share data attributable to Kennametal: |                                 |           |                               |             |
| Basic earnings per share                   | \$0.46                          | \$0.42    | \$0.90                        | \$0.98      |
| Diluted earnings per share                 | \$0.45                          | \$0.41    | \$0.89                        | \$0.96      |

## Emura

On August 1, 2013, the Company acquired the operating assets of Comercializadora Emura S.R.L. and certain related entities (Emura), based in La Paz, Bolivia, and secured related material sourcing agreements for a purchase price of \$40.1 million, of which \$26.1 million represents cash paid of which \$25.6 million was paid in fiscal year 2014 and \$0.5 million was paid in fiscal year 2013, and \$14.0 million of contingent consideration (see Note 6). Emura is the region's principal operation engaged in collecting, testing, processing and exporting tungsten ore material, and was a long-standing supplier to Kennametal. The addition of Emura enhances the Company's strategic tungsten sourcing capabilities to serve growth globally.

## Other

The Company acquired one other acquisition in the Infrastructure segment for \$2.0 million.

## 6. 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, 2013, 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> | \$—     | \$129   | \$—     | \$129 |
| Total assets at fair value | \$—     | \$129   | \$—     | \$129 |

Liabilities:

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|                                 |     |         |          |          |
|---------------------------------|-----|---------|----------|----------|
| Derivatives <sup>(1)</sup>      | \$— | \$1,227 | \$—      | \$1,227  |
| Contingent consideration        | —   | —       | 14,000   | 14,000   |
| Total liabilities at fair value | \$— | \$1,227 | \$14,000 | \$15,227 |

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The fair value of contingent consideration payable that was classified as Level 3 relates to our probability assessments of expected future milestone targets, primarily associated with product delivery, related to the Emura acquisition. The contingent consideration is to be paid over the next 3 years.

As of June 30, 2013, 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>      | \$—     | \$775   | \$—     | \$775 |
| Total assets at fair value      | \$—     | \$775   | \$—     | \$775 |
| Liabilities:                    |         |         |         |       |
| Derivatives <sup>(1)</sup>      | \$—     | \$530   | \$—     | \$530 |
| Total liabilities at fair value | \$—     | \$530   | \$—     | \$530 |

<sup>(1)</sup> Currency derivatives are valued based on observable market spot and forward rates and are classified within Level 2 of the fair value hierarchy.

## 7. 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 account for derivative instruments as a hedge of the related asset, liability, firm commitment or anticipated transaction, when the derivative is specifically designated and qualifies as a hedge of such items. Our objective in managing foreign exchange exposures with derivative instruments is to reduce volatility in cash flow. 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 and not designated as hedging instruments in the condensed consolidated balance sheet are as follows:

| (in thousands)  | December 31,<br>2013 | June 30,<br>2013 |
|---|----------------------|------------------|
| Derivatives designated as hedging instruments           |                      |                  |
| Other current assets - range forward contracts          | \$73                 | \$658            |
| Other current liabilities - range forward contracts     | (1,095               | ) (522           |
| Other assets - range forward contracts                  | —                    | 69               |
| Total derivatives designated as hedging instruments     | (1,022               | ) 205            |
| Derivatives not designated as hedging instruments       |                      |                  |
| Other current assets - currency forward contracts       | 56                   | 48               |
| Other current liabilities - currency forward contracts  | (132                 | ) (8             |
| Total derivatives not designated as hedging instruments | (76                  | ) 40             |
| Total derivatives                                       | \$(1,098             | ) \$245          |

Certain currency forward contracts that hedge 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 condensed consolidated balance sheet, with the offset to other expense (income), net. Losses related to derivatives not designated as hedging instruments have been recognized as follows:

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| (in thousands)   | Three Months Ended |       | Six Months Ended |         |
|--|--------------------|-------|------------------|---------|
|  | December 31,       |       | December 31,     |         |
|  | 2013               | 2012  | 2013             | 2012    |
| Other expense (income), net - currency forward contracts | \$72               | \$261 | \$114            | \$1,470 |

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

## 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. We had no such contracts outstanding at December 31, 2013 or June 30, 2013.

## CASH FLOW HEDGES

Range forward contracts (a transaction where both a put option is purchased and a call option is sold) are designated as cash flow hedges and 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, 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 December 31, 2013 and June 30, 2013, was \$60.8 million and \$102.2 million, respectively. The time value component of the fair value of range forward contracts is excluded from the assessment of hedge effectiveness. Assuming the market rates remain constant with the rates at December 31, 2013, we expect to recognize into earnings in the next 12 months \$0.8 million of losses on outstanding derivatives.

In February 2012, we settled forward starting interest rate swap contracts to convert \$150.0 million of our floating rate debt to fixed rate debt. Upon settlement, we made a cash payment of \$22.4 million. The loss is being amortized as a component of interest expense over the term of the related debt using the effective interest rate method. During the three months ended December 31, 2013 and 2012, \$0.5 million and \$0.5 million was recognized as interest expense, respectively. During the six months ended December 31, 2013 and 2012, \$1.0 million and \$0.9 million was recognized as interest expense, respectively.

The following represents gains and losses related to cash flow hedges:

| (in thousands)   | Three Months Ended<br>December 31, |         | Six Months Ended<br>December 31, |         |
|--|------------------------------------|---------|----------------------------------|---------|
|  | 2013                               | 2012    | 2013                             | 2012    |
| Losses recognized in other comprehensive loss, net   | \$(273)                            | \$(102) | \$(843)                          | \$(673) |
| Losses reclassified from accumulated other comprehensive loss into other expense (income), net | \$324                              | \$298   | \$714                            | \$257   |

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, 2013 and 2012.

## 8. RESTRUCTURING

During the quarter, we announced our intent to implement restructuring actions to achieve synergies across Kennametal as a result of the TMB acquisition. We initiated actions during the current quarter related to employment reductions. These and other restructuring actions are expected to be completed over the next three years. Total pre-tax charges are expected to be in the range of \$40 million to \$50 million.

In conjunction with these initiatives, we recorded restructuring charges of \$2.3 million during the quarter ended December 31, 2013.

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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, 2013 | Expense | Translation | Cash Expenditures | December 31, 2013 |
|----------------------|---------------|---------|-------------|-------------------|-------------------|
| Industrial           |               |         |             |                   |                   |
| Severance            | \$—           | \$1,085 | \$1         | \$(984)           | ) \$102           |
| Total Industrial     | —             | 1,085   | 1           | (984)             | ) 102             |
| Infrastructure       |               |         |             |                   |                   |
| Severance            | —             | 1,225   | 9           | (535)             | ) 699             |
| Total Infrastructure | —             | 1,225   | 9           | (535)             | ) 699             |
| Total                | \$—           | \$2,310 | \$10        | \$(1,519)         | ) \$801           |

## 9. STOCK-BASED COMPENSATION

## Stock Options

The assumptions used in our Black-Scholes valuation related to grants made during the six months ended December 31, 2013 and 2012 were as follows:

|                                      | 2013 | 2012   |   |
|--------------------------------------|------|--------|---|
| Risk-free interest rate              | 1.3  | % 0.6  | % |
| Expected life (years) <sup>(1)</sup> | 4.5  | 4.5    |   |
| Expected volatility <sup>(2)</sup>   | 40.4 | % 49.5 | % |
| Expected dividend yield              | 1.5  | % 1.4  | % |

<sup>(1)</sup> Expected life is derived from historical experience.

<sup>(2)</sup> Expected volatility is based on the implied historical volatility of our stock.

Changes in our stock options for the six months ended December 31, 2013 were as follows:

|  | Options   | Weighted Average Exercise Price | Weighted Average Remaining Life (years) | Aggregate Intrinsic value (in thousands) |
|--|-----------|---------------------------------|---|--|
| Options outstanding, June 30, 2013                     | 2,729,068 | \$30.40                         |   |  |
| Granted  | 342,662   | 45.24                           |   |  |
| Exercised  | (479,164) | ) 26.25                         |   |  |
| Lapsed and forfeited                                   | (14,836)  | ) 38.68                         |   |  |
| Options outstanding, December 31, 2013                 | 2,577,730 | \$33.10                         | 5.8                                     | \$48,899                                 |
| Options vested and expected to vest, December 31, 2013 | 2,535,445 | \$32.97                         | 5.8                                     | \$48,439                                 |
| Options exercisable, December 31, 2013                 | 1,759,651 | \$30.14                         | 4.6                                     | \$38,586                                 |

During the six months ended December 31, 2013 and 2012, compensation expense related to stock options was \$3.5 million and \$4.0 million, respectively. As of December 31, 2013, the total unrecognized compensation cost related to options outstanding was \$4.0 million and is expected to be recognized over a weighted average period of 2.8 years.

Weighted average fair value of options granted during the six months ended December 31, 2013 and 2012 was \$13.79 and \$13.52, respectively. Fair value of options vested during the six months ended December 31, 2013 and 2012 was \$5.0 million and \$5.1 million, respectively.

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Tax benefits, relating to excess stock-based compensation deductions, are presented in the condensed consolidated statements of cash flow as financing cash inflows. Tax benefits resulting from stock-based compensation deductions exceeded amounts reported for financial reporting purposes by \$4.5 million and \$1.1 million for the six months ended December 31, 2013 and 2012, respectively.

The amount of cash received from the exercise of capital stock options during the six months ended December 31, 2013 and 2012 was \$12.7 million and \$3.8 million, respectively. The related tax benefit for the six months ended December 31, 2013 and 2012 was \$2.7 million and \$0.8 million, respectively. The total intrinsic value of options exercised during the six months ended December 31, 2013 and 2012 was \$9.2 million and \$2.5 million, respectively. Under the provisions of the Kennametal Inc. Stock and Incentive Plan of 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, 2013 was \$0.2 million. The fair market value of shares delivered during the six months ended December 31, 2012 was immaterial.

**Restricted Stock Units – Time Vesting and Performance Vesting**

Performance vesting restricted stock units are earned pro rata each year if certain performance goals are met over a three-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 three-year performance period, with the exception of retirement eligible grantees, who upon retirement are entitled to receive payment for any units that have been earned, including a prorated portion in the partially completed fiscal year in which the retirement occurs.

Changes in our time vesting and performance vesting restricted stock units for the six months ended December 31, 2013 were as follows:

|   | Performance<br>Vesting<br>Stock<br>Units | Performance<br>Vesting<br>Weighted<br>Average Fair<br>Value | Time Vesting<br>Stock Units | Time Vesting<br>Weighted<br>Average Fair<br>Value |
|---|--|---|-----------------------------|---|
| Unvested performance vesting and time vesting restricted stock units, June 30, 2013     | 367,612                                  | \$32.08   | 815,210                     | \$34.53   |
| Granted   | 82,449                                   | 45.24   | 305,501                     | 45.17   |
| Vested  | (156,798                                 | ) 26.89   | (297,811                    | ) 32.44   |
| Performance metric not achieved   | (95,907                                  | ) 45.24   | —                           | —   |
| Forfeited   | —  | —   | (31,705                     | ) 39.54   |
| Unvested performance vesting and time vesting restricted stock units, December 31, 2013 | 197,356                                  | \$40.92   | 791,195                     | \$39.23   |

During the six months ended December 31, 2013 and 2012, compensation expense related to time vesting and performance vesting restricted stock units was \$8.4 million and \$11.4 million, respectively. As of December 31, 2013, the total unrecognized compensation cost related to unvested time vesting and performance vesting restricted stock units was \$20.1 million and is expected to be recognized over a weighted average period of 2.6 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.



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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

| (in thousands)                        | Three Months Ended |           | Six Months Ended |           |
|---------------------------------------|--------------------|-----------|------------------|-----------|
|                                       | December 31,       |           | December 31,     |           |
|                                       | 2013               | 2012      | 2013             | 2012      |
| Service cost                          | \$1,732            | \$1,956   | \$3,448          | \$3,908   |
| Interest cost                         | 10,308             | 9,601     | 20,484           | 19,182    |
| Expected return on plan assets        | (14,916 )          | (14,074 ) | (29,712 )        | (28,152 ) |
| Amortization of transition obligation | 20                 | 18        | 38               | 36        |
| Amortization of prior service credit  | (58 )              | (48 )     | (117 )           | (97 )     |
| Recognition of actuarial losses       | 670                | 3,752     | 1,312            | 7,499     |
| Net periodic pension (credit) cost    | \$(2,244 )         | \$1,205   | \$(4,547 )       | \$2,376   |

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

| (in thousands)                                 | Three Months Ended |       | Six Months Ended |       |
|--|--------------------|-------|------------------|-------|
|  | December 31,       |       | December 31,     |       |
|  | 2013               | 2012  | 2013             | 2012  |
| Service cost                                   | \$14               | \$18  | \$28             | \$36  |
| Interest cost                                  | 251                | 234   | 502              | 469   |
| Amortization of prior service cost             | (28 )              | (28 ) | (56 )            | (55 ) |
| Recognition of actuarial loss                  | 79                 | 104   | 158              | 208   |
| Net periodic other postretirement benefit cost | \$316              | \$328 | \$632            | \$658 |

**11. INVENTORIES**

We used the last-in, first-out (LIFO) method of valuing inventories for 46 percent and 52 percent of total inventories at December 31, 2013 and June 30, 2013, 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)                    | December 31, | June 30,   |
|-----------------------------------|--------------|------------|
|                                   | 2013         | 2013       |
| Finished goods                    | \$378,940    | \$303,307  |
| Work in process and powder blends | 299,254      | 244,180    |
| Raw materials                     | 152,981      | 137,602    |
| Inventories at current cost       | 831,175      | 685,089    |
| Less: LIFO valuation              | (100,497 )   | (106,294 ) |
| Total inventories                 | \$730,678    | \$578,795  |

**12. LONG-TERM DEBT**

Our \$600 million five-year, multi-currency, revolving credit facility (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 all covenants as of December 31, 2013. We had \$360.7 million and \$3.6 million of borrowings outstanding under the 2011 Credit Agreement as of December 31, 2013 and June 30, 2013, respectively. Borrowings under the 2011



Credit Agreement are guaranteed by our significant domestic subsidiaries. The 2011 Credit Agreement matures in April 2018.

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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Fixed rate debt had a fair market value of \$680.3 million and \$680.1 million at December 31, 2013 and June 30, 2013, respectively. The Level 1 fair value is determined based on the quoted market price of this debt as of December 31, 2013 and June 30, 2013, respectively.

### 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 United States 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 that are being monitored, the matters 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 PRP.

Other Environmental Matters We establish and maintain reserves for other potential environmental issues. At December 31, 2013 and June 30, 2013, the balances of these reserves were \$5.2 million and \$5.1 million, respectively. These reserves represent anticipated costs associated with the remediation of these issues.

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 liabilities 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 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 December 31, 2013 and 2012 was 40.8 percent and 26.4 percent, respectively. The effective income tax rate for the six months ended December 31, 2013 and 2012 was 31.8 percent and 23.5 percent, respectively. The increase for both the three and six month periods was primarily driven by a \$7.2 million tax charge incurred in the quarter related to a change in assertion of a foreign subsidiary's certain undistributed earnings, which are no longer considered permanently reinvested. This change in assertion during the current quarter is related to the repatriation of \$57.0 million. All earnings of other non U.S. subsidiaries are indefinitely reinvested and no deferred taxes have been provided on those earnings. This tax charge was partially offset by a lower relative U.S. current year earnings contribution.

### 15. EARNINGS PER SHARE

Basic earnings per share is computed using the weighted average number of shares outstanding during the period, while diluted earnings per share is calculated to reflect the potential dilution that occurs related to the issuance of capital stock under stock option grants, 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.

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## 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 1.0 million shares and 1.3 million shares for the three months ended December 31, 2013 and 2012, respectively, and 1.0 million shares and 1.2 million shares for the six months ended December 31, 2013 and 2012, respectively. Unexercised capital stock options, restricted stock units and restricted stock awards of 0.2 million shares and 0.9 million shares for the three months ended December 31, 2013 and 2012, respectively, and 0.3 million shares and 1.0 million shares for the six months ended December 31, 2013 and 2012, respectively, were not included in the computation of diluted earnings per share because the option exercise price was greater than the average market price, and therefore the inclusion would have been anti-dilutive.

## 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 December 31, 2013 and 2012 is as follows:

| (in thousands)  | Kennametal Shareowners' Equity |                            |                   |                                      |                           |              |
|---|--------------------------------|----------------------------|-------------------|--------------------------------------|---------------------------|--------------|
|   | Capital stock                  | Additional paid-in capital | Retained earnings | Accumulated other comprehensive loss | Non-controlling interests | Total equity |
| Balance as of June 30, 2013                                 | \$97,303                       | \$374,300                  | \$1,399,227       | \$(89,004)                           | ) \$30,467                | \$1,812,293  |
| Net income  | —                              | —                          | 62,046            | —                                    | 679                       | 62,725       |
| Other comprehensive income                                  | —                              | —                          | —                 | 37,571                               | 227                       | 37,798       |
| Dividend reinvestment                                       | 3                              | 149                        | —                 | —                                    | —                         | 152          |
| Capital stock issued under employee benefit and stock plans | 1,056                          | 21,926                     | —                 | —                                    | —                         | 22,982       |
| Purchase of capital stock                                   | (128)                          | ) (4,272)                  | —                 | —                                    | —                         | (4,400)      |
| Cash dividends paid   | —                              | —                          | (28,180)          | —                                    | (66)                      | ) (28,246)   |
| Balance as of December 31, 2013                             | \$98,234                       | \$392,103                  | \$1,433,093       | \$(51,433)                           | ) \$31,307                | \$1,903,304  |

| (in thousands)  | Kennametal Shareowners' Equity |                            |                   |                                      |                           |              |
|---|--------------------------------|----------------------------|-------------------|--------------------------------------|---------------------------|--------------|
|   | Capital stock                  | Additional paid-in capital | Retained earnings | Accumulated other comprehensive loss | Non-controlling interests | Total equity |
| Balance as of June 30, 2012                           | \$100,106                      | \$447,433                  | \$1,246,973       | \$(150,662)                          | ) \$24,371                | \$1,668,221  |
| Net income  | —                              | —                          | 88,532            | —                                    | 1,823                     | 90,355       |
| Other comprehensive income                            | —                              | —                          | —                 | 40,819                               | 686                       | 41,505       |
| Dividend reinvestment                                 | 4                              | 134                        | —                 | —                                    | —                         | 138          |
| Capital stock issued under employee benefit and stock | 415                            | 18,601                     | —                 | —                                    | —                         | 19,016       |

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|                                      |          |           |             |              |          |             |
|--------------------------------------|----------|-----------|-------------|--------------|----------|-------------|
| plans                                |          |           |             |              |          |             |
| Purchase of capital stock            | (1,587 ) | (45,029 ) | —           | —            | —        | (46,616 )   |
| Cash dividends paid                  | —        | —         | (25,748 )   | —            | (1,949 ) | (27,697 )   |
| Purchase of noncontrolling interests | —        | —         | —           | —            | (479 )   | (479 )      |
| Balance as of December 31, 2012      | \$98,938 | \$421,139 | \$1,309,757 | \$(109,843 ) | \$24,452 | \$1,744,443 |

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The amounts of comprehensive income attributable to Kennametal Shareowners and noncontrolling interests are disclosed in the condensed consolidated statements of comprehensive income.

## 17. ACCUMULATED OTHER COMPREHENSIVE LOSS

Total accumulated other comprehensive loss (AOCL) consists of net income and other changes in equity from transactions and other events from sources other than shareowners. It includes postretirement benefit plan adjustments, currency translation adjustments, and unrealized gains and losses from derivative instruments designated as cash flow hedges.

The components of and changes in AOCL were as follows (net of tax) for the three months ended December 31, 2013:

| Attributable to Kennametal:                       | Postretirement<br>benefit plans | Currency<br>translation<br>adjustment | Derivatives | Total        |
|---|---------------------------------|---------------------------------------|-------------|--------------|
| Balance, September 30, 2013                       | \$(85,419                       | )\$35,510                             | \$(12,642   | )\$(62,551 ) |
| Other comprehensive loss before reclassifications | (810                            | )11,263                               | (273        | )10,180      |
| Amounts reclassified from AOCL                    | 498                             | —                                     | 440         | 938          |
| Net current period other comprehensive loss       | (312                            | )11,263                               | 167         | 11,118       |
| AOCL, December 31, 2013                           | \$(85,731                       | )\$46,773                             | \$(12,475   | )\$(51,433 ) |
| Attributable to noncontrolling interests:         |                                 |                                       |             |              |
| Balance, September 30, 2013                       | \$—                             | \$535                                 | \$—         | \$535        |
| Other comprehensive loss before reclassifications | —                               | 413                                   | —           | 413          |
| Net current period other comprehensive loss       | —                               | 413                                   | —           | 413          |
| AOCL, December 31, 2013                           | \$—                             | \$948                                 | \$—         | \$948        |

The components of and changes in AOCL were as follows (net of tax) for the six months ended December 31, 2013:

| Attributable to Kennametal:                       | Postretirement<br>benefit plans | Currency<br>translation<br>adjustment | Derivatives | Total        |
|---|---------------------------------|---------------------------------------|-------------|--------------|
| Balance, June 30, 2013                            | \$(83,937                       | )\$7,414                              | \$(12,481   | )\$(89,004 ) |
| Other comprehensive loss before reclassifications | (2,776                          | )39,359                               | (843        | )35,740      |
| Amounts reclassified from AOCL                    | 982                             | —                                     | 849         | 1,831        |
| Net current period other comprehensive loss       | (1,794                          | )39,359                               | 6           | 37,571       |

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|   |           |           |           |            |   |
|---|-----------|-----------|-----------|------------|---|
| AOCL, December 31, 2013                           | \$(85,731 | )\$46,773 | \$(12,475 | )\$(51,433 | ) |
| Attributable to noncontrolling interests:         |           |           |           |            |   |
| Balance, June 30, 2013                            | \$—       | \$721     | \$—       | \$721      |   |
| Other comprehensive loss before reclassifications | —         | 227       | —         | 227        |   |
| Net current period other comprehensive loss       | —         | 227       | —         | 227        |   |
| AOCL, December 31, 2013                           | \$—       | \$948     | \$—       | \$948      |   |

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Reclassifications out of AOCL for the three and six months ended December 31, 2013 consisted of the following:

| Details about AOCL components          | Three months ended December 31, 2013 | Six months ended December 31, 2013 | Affected line item in the Income Statement |
|--|--------------------------------------|------------------------------------|--|
| Gains and losses on cash flow hedges:  |                                      |                                    |  |
| Forward starting interest rate swaps   | \$486                                | \$973                              | Interest expense                           |
| Currency exchange contracts            | 224                                  | 396                                | Other expense (income), net                |
| Total before tax                       | 710                                  | 1,369                              |  |
| Tax benefit                            | 270                                  | 520                                | Provision for income taxes                 |
| Net of tax                             | \$440                                | \$849                              |  |
| Postretirement benefit plans:          |                                      |                                    |  |
| Amortization of transition obligations | \$20                                 | \$38                               | See pension note 10 for further details    |
| Amortization of prior service credit   | (86                                  | )(173                              | ) See pension note 10 for further details  |
| Recognition of actuarial losses        | 749                                  | 1,470                              | See pension note 10 for further details    |
| Total before taxes                     | 683                                  | 1,335                              |  |
| Tax benefit                            | 185                                  | 353                                | Provision for income taxes                 |
| Net of tax                             | \$498                                | \$982                              |  |

## 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. We noted no impairment indicators warranting additional testing.

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 | TMB Acquisition | Total     |
|--|------------|----------------|-----------------|-----------|
| Goodwill                                   | \$273,757  | \$598,840      | \$—             | \$872,597 |
| Accumulated impairment losses              | (15,674    | )(135,168      | ) —             | (150,842  |
| Balance as of June 30, 2013 <sup>(1)</sup> | \$258,083  | \$463,672      | \$—             | \$721,755 |
| Acquisition                                | \$—        | \$—            | \$242,363       | \$242,363 |
| Translation                                | 5,209      | 8,317          | —               | 13,526    |
| Change in goodwill                         | 5,209      | 8,317          | 242,363         | 255,889   |
| Goodwill                                   | 278,966    | 607,157        | 242,363         | 1,128,486 |
| Accumulated impairment losses              | (15,674    | )(135,168      | ) —             | (150,842  |
| Balance as of December 31, 2013            | \$263,292  | \$471,989      | \$242,363       | \$977,644 |

<sup>(1)</sup> The balance as of June 30, 2013 have been restated to reflect the change in reportable operating segments.

The assignment of the goodwill for the TMB acquisition has not yet been completed and therefore has not been allocated between the segments.





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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The components of our other intangible assets were as follows:

| (in thousands)             | Estimated<br>Useful Life<br>(in years) | December 31, 2013        |                             | June 30, 2013            |                             |
|----------------------------|--|--------------------------|-----------------------------|--------------------------|-----------------------------|
|                            |  | Gross Carrying<br>Amount | Accumulated<br>Amortization | Gross Carrying<br>Amount | Accumulated<br>Amortization |
| Contract-based             | 3 to 15                                | \$21,842                 | \$(9,421 )                  | \$21,450                 | \$(8,374 )                  |
| Technology-based and other | 4 to 20                                | 55,317                   | (27,606 )                   | 38,005                   | (26,006 )                   |
| Customer-related           | 10 to 20                               | 283,460                  | (66,880 )                   | 178,318                  | (58,148 )                   |
| Unpatented technology      | 15 to 30                               | 63,275                   | (11,244 )                   | 45,972                   | (9,761 )                    |
| Trademarks                 | 5 to 20                                | 19,435                   | (10,025 )                   | 14,055                   | (9,151 )                    |
| Trademarks                 | Indefinite                             | 37,428                   | —                           | 36,405                   | —                           |
| Total                      |  | \$480,757                | \$(125,176 )                | \$334,205                | \$(111,440 )                |

During the six months ended December 31, 2013, we recorded amortization expense of \$11.7 million related to our other intangible assets and favorable currency translation adjustments of \$3.8 million.

On November 4, 2013, we acquired TMB from ATI, the operations of which are included in both the Industrial and Infrastructure segments. As a result of the acquisition, we increased goodwill by \$242.4 million and other intangible assets by \$124.2 million based on our preliminary purchase price allocations. Other intangible assets consisted of customer-related intangibles, technology-based intangibles and trademarks. We are in the process of assessing the allocation of goodwill and other intangible assets, as well as the useful lives of the other intangible assets. The majority of both the goodwill and other intangible assets will be allocated to the Infrastructure segment, as this is primarily where the operating synergies associated with the acquisition are expected to be realized. The Company estimates that acquired intangibles will add approximately \$8 million to annual amortization expense per year.

On August 1, 2013, we acquired the assets of Emura in our Infrastructure segment. As a result of the acquisition we increased other intangible assets by \$16.0 million based on our preliminary purchase price allocations. We recorded supplier relationship intangible assets in technology-based and other of \$15.5 million with an estimated useful life of 20 years, contract-based intangibles of \$0.4 million with an estimated useful life of 3 years and trademarks of \$0.1 million with an estimated useful life of 20 years. These intangible assets will be amortized over their respective estimated useful lives.

**19. SEGMENT DATA**

Kennametal delivers productivity to customers seeking peak performance in demanding environments by providing innovative custom and standard wear-resistant solutions. To provide these solutions, we harness our knowledge of advanced materials and application development with a commitment to environmental sustainability. Our product offering includes a wide selection of standard and customized technologies for metalworking, such as sophisticated metalcutting tools, tooling systems and services, as well as advanced, high-performance materials, such as cemented tungsten carbide products, super alloys, coatings and investment castings to address customer demands. We offer these products through a variety of channels to meet customer-specified needs.

At the start of fiscal 2014, the Company enhanced its organizational structure to align a broader base management team with customer-facing products and technology platforms, as well as to further increase cross-selling opportunities. This operating structure supports the Company's stated growth objectives across diverse market sectors, preserves the focus on customers and increases product innovation. Consistent with previous allocation methodologies, corporate expenses related to each segment have been classified accordingly.

The Industrial segment generally 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 types of industrial equipment. The technology and customization requirements for customers we serve vary by customer, application and industry. The value we deliver to our Industrial segment customers centers on our application expertise and our diverse offering of products and services.

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KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The Infrastructure segment generally serves customers that operate in the earthworks and energy sectors who support primary industries such as oil and gas, power generation, underground, surface and hard-rock mining, highway construction and road maintenance. Generally, we rely on customer intimacy to serve this segment. By gaining an in-depth understanding of our customers' engineering and development needs, we are able to offer complete system solutions and high-performance capabilities to optimize and add value to their operations.

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.

Our sales and operating income by segment are as follows:

| (in thousands)  | Three Months Ended   |                     | Six Months Ended     |                     |
|---|----------------------|---------------------|----------------------|---------------------|
|   | December 31,<br>2013 | 2012 <sup>(1)</sup> | December 31,<br>2013 | 2012 <sup>(1)</sup> |
| Sales:  |                      |                     |                      |                     |
| Industrial  | \$370,647            | \$336,007           | \$708,876            | \$671,201           |
| Infrastructure  | 319,289              | 297,137             | 600,867              | 591,402             |
| Total sales   | \$689,936            | \$633,144           | \$1,309,743          | \$1,262,603         |
| Operating income:                                     |                      |                     |                      |                     |
| Industrial  | \$33,218             | \$40,677            | \$73,038             | \$80,004            |
| Infrastructure  | 18,604               | 27,906              | 40,294               | 55,503              |
| Corporate   | (2,106 )             | (2,114 )            | (4,787 )             | (4,657 )            |
| Total operating income                                | 49,716               | 66,469              | 108,545              | 130,850             |
| Interest expense                                      | 8,037                | 6,970               | 15,118               | 12,926              |
| Other expense (income), net                           | 856                  | 655                 | 1,466                | (246 )              |
| Income from continuing operations before income taxes | \$40,823             | \$58,844            | \$91,961             | \$118,170           |

<sup>(1)</sup> Amounts for the three and six months ended December 31, 2012 have been restated to reflect the change in reportable operating segments.

Segment assets by segment are as follows:

| (in thousands)                | December 31,<br>2013 | June 30, 2013 <sup>(2)</sup> |
|-------------------------------|----------------------|------------------------------|
| Total assets:                 |                      |                              |
| Industrial                    | \$1,329,156          | \$1,190,026                  |
| Infrastructure                | 1,834,544            | 1,522,470                    |
| Corporate                     | 402,137              | 588,543                      |
| Goodwill from TMB acquisition | 242,363              | —                            |
| Total assets                  | \$3,808,200          | \$3,301,039                  |

<sup>(2)</sup> Amounts as of June 30, 2013 have been restated to reflect the change in reportable operating segments.

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

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OVERVIEW

Kennametal Inc. is a leading global manufacturer and supplier of tooling, engineered components and advanced materials consumed in production processes. We deliver productivity to customers seeking peak performance in demanding environments by providing innovative custom and standard wear-resistant solutions. To provide these solutions, we harness our knowledge of advanced materials and application development with a commitment to environmental sustainability. Our solutions are built around industry-essential technology platforms. These include metalworking tools, engineered components, surface technologies and earth cutting tools that are mission-critical to the performance of our customers battling extreme conditions such as fatigue wear, corrosion and high temperatures. We believe that our reputation for manufacturing excellence, as well as our technological expertise and innovation we deliver in our products and services, help us to achieve a leading position in our primary markets: general engineering, transportation, aerospace, defense, energy and earthworks. End users of our products include metalworking and machinery manufacturers and suppliers across a diverse array of industries, including the aerospace, defense, transportation, machine tool, light machinery and heavy machinery, as well as producers and suppliers in a number of equipment-intensive industries such as coal mining, road construction and quarrying, as well as oil and gas exploration, refining, production and supply. Our end users' applications range from airframes to mining operations, engines to oil wells and turbochargers to processing. We believe we are one of the largest global providers of consumable metalcutting tools and tooling supplies.

On November 4, 2013, we acquired Allegheny Technologies Incorporated's (ATI) Tungsten Materials Business (TMB) for approximately \$607 million. TMB, with approximately \$340.0 million in annual sales, is a leading producer of tungsten metallurgical powders, as well as tooling technologies and components. The business has approximately 1,175 employees in 12 locations across seven countries. The acquired business brings industry-leading tungsten carbide production wear products and recycling capabilities, as well as a tooling and product portfolio with a strong position in the aerospace, energy and process industries. The acquisition is aligned with our metallurgical growth strategy and positions us to further diversify our portfolio.

Our sales of \$689.9 million for the quarter ended December 31, 2013 increased 9 percent compared to sales for the December quarter one year ago. Operating income was \$49.7 million, a decrease of \$16.8 million as compared to \$66.5 million in the prior year quarter. TMB had an operating loss of \$7.9 million in the current quarter, including the impacts of purchase accounting. Operating income declined due to higher employment costs related to the annual employee merit increase and increased commissions on higher sales, two months operating loss of TMB of \$7.9 million, restructuring charges of \$2.3 million and acquisition-related charges of \$1.7 million. This decrease was partially offset by the favorable impact of organic growth and lower raw material costs. Organic sales growth includes both volume and price.

During the quarter, we announced that we intend to undertake restructuring actions and expect to incur pre-tax charges of approximately \$40 million to \$50 million over the next three years. We recorded pre-tax restructuring charges of \$2.3 million during the three months ended December 31, 2013. We expected to generate annual savings of approximately \$35 million to \$45 million once these initiatives are fully implemented.

We reported current quarter earnings per diluted share of \$0.30, which included TMB operating loss of \$0.09, tax repatriation expense of \$0.09, acquisition-related charges of \$0.02 and restructuring and related charges of \$0.02.

Raw material prices were relatively stable in the market during the quarter.

We generated cash flow from operating activities of \$84.6 million during the six months ended December 31, 2013. Capital expenditures were \$48.8 million during the quarter.

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 \$10.8 million for the three months ended December 31, 2013.

The following narrative provides further discussion and analysis of our results of operations, liquidity and capital resources, as well as other pertinent matters.

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

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RESULTS OF CONTINUING OPERATIONS

SALES

Sales for the three months ended December 31, 2013 were \$689.9 million, an increase of \$56.8 million or 9 percent, from \$633.1 million in the prior year quarter. The increase in sales was driven by the impact of acquisition of TMB of 7 percent and organic growth of 2 percent. The increase in sales was primarily due to improved demand from customers in our Industrial end markets and distribution sales for the quarter reflecting double-digit growth from prior year, partially offset by continuing weakness in the mining sector. Excluding TMB, sales increased by approximately 6 percent in general engineering, 4 percent in transportation and 2 percent in the energy markets, while aerospace and defense decreased by 6 percent and earthworks market decreased by 5 percent, respectively.

Sales for the six months ended December 31, 2013 were \$1,309.7 million, an increase of \$47.1 million or 4 percent, from \$1,262.6 million in the prior year period. The increase in sales was driven by the impacts of acquisition of 4 percent and organic growth of 1 percent, partially offset by the unfavorable impact from fewer business days of 1 percent. The increase in sales was primarily due to improved demand from customers in our industrial end markets and distribution sales, partially offset by weakness in the mining sector and demand softness in the energy market. Excluding TMB, sales increased by approximately 4 percent in general engineering and 2 percent in transportation, while earthworks decreased by 8 percent, aerospace and defense decreased by 7 percent and energy markets decreased by 1 percent, respectively.

GROSS PROFIT

Gross profit for the three months ended December 31, 2013 was \$207.0 million, an increase of \$7.6 million from \$199.4 million in the prior year quarter. The increase was primarily due to lower raw material costs and higher organic sales, partially offset by higher manufacturing spend. The gross profit margin for the three months ended December 31, 2013 was 30.0 percent, as compared to 31.5 percent generated in the prior year quarter.

Gross profit for the six months ended December 31, 2013 was \$405.2 million, a decrease of \$2.6 million from \$407.8 million in the prior year period. The decrease was primarily due to non-recurring physical inventory adjustment of \$5.7 million related to our mining business and higher manufacturing spend, partially offset by lower raw material costs. The gross profit margin for the six months ended December 31, 2013 was 30.9 percent, as compared to 32.3 percent generated in the prior year quarter.

OPERATING EXPENSE

Operating expense for the three months ended December 31, 2013 increased \$20.6 million or 16.2 percent to \$148.4 million as compared to \$127.8 million in the prior year quarter. The increase was primarily due to higher employment costs of \$7.6 million driven mainly by our annual employee merit increase and an increase in commissions due to higher sales, additional operating expenditures related to TMB of \$7.3 million and TMB acquisition-related costs of \$1.7 million.

Operating expense for the six months ended December 31, 2013 increased \$16.1 million or 6.0 percent to \$282.7 million as compared to \$266.6 million in the prior year period. The increase was primarily due to higher employment costs of \$7.6 million driven by our annual employee merit increase and an increase in commissions due to higher sales, additional operating expenditures related to TMB of \$7.3 million, TMB acquisition-related costs of \$2.8 million and unfavorable foreign currency impact of \$0.7 million, partially offset by favorable impact of cost containment measures.

#### RESTRUCTURING CHARGES

During the quarter, we announced our intent to implement restructuring actions to achieve synergies across Kennametal and TMB by consolidating operations among both organizations, reducing administrative overhead and leveraging the supply chain. Consistent with this announcement, we initiated actions during the current quarter related to employment reductions and recorded restructuring charges of \$2.3 million during the six months ended December 31, 2013. Industrial and Infrastructure charges were \$1.1 million and \$1.2 million, respectively. See Note 8 in our condensed consolidated financial statements set forth in Part I Item 1 of this Quarterly Report on Form 10-Q.



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

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Total restructuring costs are expected to be in the range of \$40 million to \$50 million and are expected to be completed over the next three years. Annual ongoing benefits from these actions are expected to be in the range of \$35 million to \$45 million, once these initiatives are fully implemented.

INTEREST EXPENSE

Interest expense for the three months ended December 31, 2013 increased \$1.0 million to \$8.0 million as compared to \$7.0 million in the prior year quarter. For the six months ended December 31, 2013 interest expense increased \$2.2 million to \$15.1 million as compared to \$12.9 million in the prior year period. The increase in both periods was primarily due to higher year-over-year borrowings due to acquisitions and the higher borrowing rate for our \$400 million 2.65 percent Senior Unsecured Notes issued in November 2012.

OTHER EXPENSE (INCOME), NET

Other expense, net for the three months ended December 31, 2013 was \$0.9 million compared to \$0.7 million for the prior year quarter. The increase was primarily due to unfavorable currency exchange rate losses of \$0.4 million, partially offset by higher interest income.

Other expense, net for the six months ended December 31, 2013 was \$1.5 million compared to other income, net of \$0.2 million for the prior year quarter. The decrease was primarily due to unfavorable currency exchange rate losses of \$1.8 million.

INCOME TAXES

The effective income tax rate for the three months ended December 31, 2013 and 2012 was 40.8 percent and 26.4 percent, respectively. The effective income tax rate for the six months ended December 31, 2013 and 2012 was 31.8 percent and 23.5 percent, respectively. The increase for both the three and six month periods was primarily driven by a \$7.2 million tax charge incurred in the quarter related to a change in assertion of a foreign subsidiary's certain undistributed earnings, which are no longer considered permanently reinvested. This change in assertion during the current quarter is related to the repatriation of \$57.0 million. All earnings of other non U.S. subsidiaries are indefinitely reinvested and no deferred taxes have been provided on those earnings. This tax charge was partially offset by a lower relative U.S. current year earnings contribution.

BUSINESS SEGMENT REVIEW

We operate two reportable segments consisting of Industrial and Infrastructure. Corporate expenses that are not allocated are reported in Corporate. Segment determination is based upon internal organizational structure, the manner in which we organize segments for making operating decisions and assessing performance, the availability of separate financial results and materiality considerations.

Amounts for the three and six months ended December 31, 2012 have been restated to reflect the enhanced operating structure as of July 1, 2013.

INDUSTRIAL

Six Months Ended

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| (in thousands)   | Three Months Ended   |           | December 31, |           |
|------------------|----------------------|-----------|--------------|-----------|
|                  | December 31,<br>2013 | 2012      | 2013         | 2012      |
| Sales            | \$370,647            | \$336,007 | \$708,876    | \$671,201 |
| Operating income | 33,218               | 40,677    | 73,038       | 80,004    |

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

For the three months ended December 31, 2013, Industrial sales increased by 10 percent due to 6 percent organic growth and 5 percent growth related to the acquisition of TMB, partially offset by a 1 percent decline due to fewer business days. Excluding TMB, sales increased by 8 percent in transportation, 7 percent in general engineering, 5 percent in energy and 2 percent in aerospace and defense. The transportation market benefited from increased demand in the light vehicle markets in Europe, U.S. and China and general engineering increased due to improvements in demand from distribution channels. Energy sales reflected increased activity in industrial applications. Sales increased in all geographies. On a regional basis, excluding TMB, sales increased by approximately 12 percent in Asia, 7 percent in Europe and 2 percent in the Americas. The sales increase in Asia was driven by the growth in all of the end markets. The sales increase in Europe was primarily driven by the performance in the transportation, general engineering and energy end markets. The sales increase in the Americas was primarily driven by the performance in the transportation and general engineering end markets, partially offset by the decline in the energy end market.

For the three months ended December 31, 2013, Industrial operating income decreased by \$7.5 million. Industrial operating income was reduced by the effects of TMB operations of \$6.1 million, restructuring and related charges of \$1.1 million and TMB acquisition-related charges of \$0.6 million, partially offset by organic sales growth. Industrial operating margin was 9.0 percent compared with 12.1 percent in the prior year.

For the six months ended December 31, 2013, Industrial sales increased by 6 percent due to 3 percent organic growth, 2 percent growth related to acquisitions and 1 percent due to more business days. Excluding TMB, sales increased by 4 percent in transportation, 4 percent in general engineering, 2 percent in energy and remained relatively flat in aerospace and defense. The transportation market benefited from increased demand in the light vehicle market in Europe, U.S. and China and general engineering increased due to improvements in production and overall demand for machinery and demand from distribution channels. Energy sales reflected increased activity in industrial applications. On a regional basis, excluding TMB, sales increased by approximately 6 percent in Asia, 5 percent in Europe and 1 percent in the Americas. Asia experienced growth in all end markets except transportation. The sales increase in Europe was primarily driven by the performance in the transportation and general engineering end markets. The sales increase in the Americas was primarily driven by the performance in the transportation and general engineering end markets, partially offset by a decline in the energy end market.

For the six months ended December 31, 2013, Industrial operating income decreased by \$7.0 million. Industrial operating income was negatively impacted by the effects of TMB operations of \$6.1 million, restructuring and related charges of \$1.1 million and TMB acquisition related charges of \$0.6 million. Industrial operating margin was 10.3 percent compared with 11.9 percent in the prior year.

## INFRASTRUCTURE

| (in thousands)   | Three Months Ended |           | Six Months Ended |           |
|------------------|--------------------|-----------|------------------|-----------|
|                  | December 31,       |           | December 31,     |           |
|                  | 2013               | 2012      | 2013             | 2012      |
| Sales            | \$319,289          | \$297,137 | \$600,867        | \$591,402 |
| Operating income | 18,604             | 27,906    | 40,294           | 55,503    |

For the three months ended December 31, 2013, Infrastructure sales increased by 7 percent, driven by 10 percent growth related to the acquisition of TMB, partially offset by a 2 percent organic decline and 1 percent unfavorable impact from fewer business days. Excluding TMB, sales increased by 1 percent in energy and 1 percent in general engineering, offset by a 12 percent decrease in transportation and a 5 percent decrease in earthworks. Earthworks sales decreased due to persistently weak underground coal mining markets in China and the U.S., partially offset by continued strength globally in highway construction sales. Energy sales were slightly positive year over year reflecting some improvements in oil and gas drilling activity in the U.S., coupled with gains in production, completion and process applications. On a regional basis, excluding TMB, sales grew by 8 percent in Europe and declined by 7 percent in the Americas and 4 percent in Asia, respectively. The sales increase in Europe was driven primarily by the performance in the energy, earthworks and transportation end markets. The sales decrease in the Americas was driven primarily by a decline in energy, earthworks and transportation end markets. The sales decrease in Asia was driven primarily by the decline in the earthworks and transportation end markets, partially offset by an increase in the general engineering and energy end markets.

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

For the three months ended December 31, 2013, Infrastructure operating income decreased by \$9.3 million. Infrastructure operating income was negatively impacted by the effects of TMB operations of \$1.7 million, restructuring and related charges of \$1.2 million and TMB acquisition related charges of \$1.1 million. Infrastructure operating margin was 5.8 percent compared with 9.4 percent in the prior year.

For the six months ended December 31, 2013, Infrastructure sales increased by 2 percent, driven by 5 percent growth related to acquisitions and 1 percent favorable impact from more business days, partially offset by a 4 percent organic decline. Excluding TMB, sales increased by 3 percent in general engineering, offset by a 8 percent decrease in earthworks, a 5 percent decrease in transportation and a 2 percent decrease in energy. General engineering reflects higher volumes from integrators and distributors. Earthworks sales decreased due to persistently weak underground coal mining markets in China and the U.S. Energy sales decreased due to lower drilling activity in oil and gas in the U.S., partially offset by gains in production and completion applications. On a regional basis, excluding TMB, sales grew 5 percent in Europe and declined by 7 percent in the Americas and 4 percent in Asia, respectively. The sales increase in Europe was driven primarily by the performance in the transportation, energy and general engineering end markets. The sales decrease in the Americas was driven primarily by the decline in the energy, earthworks and transportation end markets. The sales decrease in Asia was driven primarily by the decline in the earthworks and transportation end markets, partially offset by an increase in energy and general engineering end markets.

For the six months ended December 31, 2013, Infrastructure operating income decreased by \$15.2 million. Infrastructure operating income was negatively impacted by a non recurring physical inventory adjustment of \$5.7 million related to our mining business, effects of TMB operations of \$1.7 million, restructuring and related charges of \$1.2 million and the TMB acquisition related charges of \$1.1 million. Infrastructure operating margin was 6.7 percent compared with 9.4 percent in the prior year.

## CORPORATE

| (in thousands)                | Three Months Ended<br>December 31, |            | Six Months Ended<br>December 31, |            |
|-------------------------------|------------------------------------|------------|----------------------------------|------------|
|                               | 2013                               | 2012       | 2013                             | 2012       |
| Corporate unallocated expense | \$(2,106 )                         | \$(2,114 ) | \$(4,787 )                       | \$(4,657 ) |

For the three and six months ended December 31, 2013, Corporate unallocated expense remained relatively flat compared to prior year period.

## LIQUIDITY AND CAPITAL RESOURCES

Cash flow from operations and borrowings against our five-year, multi-currency, revolving credit facility (2011 Credit Agreement) are the primary sources of funding for capital expenditures and internal growth. Year to date December 31, 2013, cash flow provided by operating activities was \$84.6 million, driven by our operating performance, and we had outstanding borrowings on our 2011 Credit Agreement of \$360.7 million, primarily used to fund the acquisition of TMB.

The 2011 Credit Agreement is used to augment cash from operations and as an additional source of funds. The 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 matures in April 2018.

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 all covenants as of December 31, 2013. For the six months ended December 31, 2013, average daily domestic borrowings outstanding under the 2011 Credit Agreement were approximately \$112.4 million. Borrowings under the 2011 Credit Agreement are guaranteed by our significant domestic subsidiaries.

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

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Other than the repatriation of \$57.0 million discussed in Note 14 set forth in Part I Item 1 of this Quarterly Report on Form 10-Q, we consider the unremitted earnings of our non-U.S. subsidiaries that have not previously been taxed in the U.S. to be permanently reinvested. As of December 31, 2013, cash and cash equivalents of \$158.5 million and short-term intercompany advances made by our foreign subsidiaries to our U.S. parent of \$21.8 million would not be available for use in the U.S. on a long term basis, without incurring U.S. federal and state income tax consequences. We have not, nor do we anticipate the need to, repatriate funds to the U.S. to satisfy domestic liquidity needs arising in the ordinary course of business, including liquidity needs associated with our domestic debt service requirements.

At December 31, 2013, cash and cash equivalents were \$163.3 million, total debt was \$1,145.7 million and total Kennametal Shareowners' equity was \$1,872.0 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 continue to 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, 2013.

**Cash Flow Provided by Operating Activities**

During the six months ended December 31, 2013, cash flow provided by operating activities was \$84.6 million, compared to \$54.2 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 \$149.5 million, partially offset by changes in certain assets and liabilities netting to an outflow of \$64.9 million. Contributing to the changes in certain assets and liabilities were a decrease in accounts payable and accrued liabilities of \$34.3 million primarily driven by timing of payroll payments and decrease in federal tax payments of \$16.5 million, an increase in inventory of \$27.0 million primarily driven by higher work in process and finished goods inventory, a decrease in other of \$16.5 million and a decrease in accrued income taxes of \$14.0 million. Offsetting these cash outflows were a decrease in accounts receivable of \$26.9 million due to improved collections.

During the six months ended December 31, 2012, cash flow provided by operating activities consisted of net income and non-cash items amounting to an inflow of \$164.1 million, partially offset by changes in certain assets and liabilities netting to an outflow of \$109.9 million. Contributing to the changes in certain assets and liabilities was a decrease in accounts payable and accrued liabilities of \$135.8 million primarily driven by lower accounts payable, lower accrued payroll and payment of \$19.0 million of incentive compensation, an increase in inventory of \$22.9 million primarily due to previously committed raw materials purchases, a decrease in accrued income taxes of \$21.2 million and a decrease in other of \$3.9 million, partially offset by a decrease in accounts receivable of \$73.9 million due to lower sales volume.

**Cash Flow Used for Investing Activities**

Cash flow used for investing activities was \$683.0 million for the six months ended December 31, 2013, compared to \$33.8 million in the prior year period. During the current year period, cash flow used for investing activities included \$634.6 million used for acquisitions, primarily TMB of \$607.0 million and two other acquisitions in the Infrastructure segment. Capital expenditures, net were \$48.4 million, which consisted primarily of equipment upgrades.

For the six months ended December 31, 2012, cash flow used for investing activities included capital expenditures, net of \$33.7 million, which consisted primarily of equipment upgrades.

**Cash Flow Provided by Financing Activities**

Cash flow provided by financing activities was \$382.0 million for the six months ended December 31, 2013 compared to \$73.0 million in the prior year period. During the current year period, cash flow provided by financing activities primarily included \$396.3 million net increase in borrowings and \$18.1 million of dividend reinvestment and the effect of employee benefit and stock plans. These cash flows were offset by \$28.2 million of cash dividends paid to Shareowners and \$4.4 million used for the purchase of capital stock.

During the six months ended December 31, 2012, cash flow provided by financing activities included \$142.0 million net increase in borrowings and \$6.1 million of dividend reinvestment and the effect of employee benefit and stock plans. These cash flows were offset by \$46.6 million used for the purchase of capital stock, \$25.7 million of cash dividends paid to Shareowners and \$2.8 million of other.



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

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FINANCIAL CONDITION

Working capital was \$939.5 million at December 31, 2013, a decrease of \$92.4 million from \$1,031.9 million at June 30, 2013. Cash and cash equivalents decreased \$214.0 million and current maturities of long-term debt, capital leases and notes payable increased \$65.8 million mainly to fund the TMB acquisition. Other current liabilities increased \$14.1 million, driven by the impact of recent acquisitions. These items were partially offset by an increase in inventory of \$151.9 million mainly due to the TMB acquisition contributing \$98.7 million, an increase in accounts receivable of \$22.4 million mainly due to the impact of the TMB acquisition of \$41.2 million, partially offset by improved collections and an increase in other current assets of \$17.0 million mainly due to the TMB acquisition. Currency exchange effects accounted for \$11.8 million of the working capital change.

Property, plant and equipment, net increased \$132.9 million from \$741.5 million at June 30, 2013 to \$874.4 million at December 31, 2013, primarily due to \$131.3 million from acquisitions during the current period, capital additions of \$40.2 million and favorable currency exchange impact of \$11.8 million, partially offset by depreciation expense of \$48.3 million.

At December 31, 2013, other assets were \$1,455.0 million, an increase of \$394.9 million from \$1,060.1 million at June 30, 2013. The primary drivers for the increase were an increase in goodwill of \$255.9 million, an increase in other intangible assets of \$132.8 million and an increase in other assets of \$12.2 million. The change in goodwill was due to a \$242.4 million TMB acquisition impact during the current quarter and favorable currency exchange effects of \$13.5 million. The change in other intangible assets was due to a \$140.2 million acquisition impact during the current period and favorable currency exchange effects of \$3.8 million, offset by amortization expense of \$11.7 million. The change in other assets was primarily due to lower pension discount rates.

Long-term debt and capital leases increased by \$332.0 million to \$1,035.6 million at December 31, 2013 from \$703.6 million at June 30, 2013. The increase was primarily driven by \$332.5 million borrowings under the 2011 Credit Agreement for the acquisition of TMB.

Kennametal Shareowners' equity was \$1,872.0 million at December 31, 2013, an increase of \$90.2 million from \$1,781.8 million at June 30, 2013. The increase was primarily due to net income attributable to Kennametal of \$62.0 million, currency exchange adjustments of \$39.4 million and capital stock issued under employee benefit and stock plans of \$23.0 million, partially offset by cash dividends paid to Shareowners of \$28.2 million and the purchase of capital stock of \$4.4 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.

**Superfund Sites** We are involved as a potentially responsible party (PRP) at various sites designated by the United States 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 that are being monitored, the matters 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 PRP.

**Other Environmental Matters** We establish and maintain reserves for other potential environmental issues. At December 31, 2013 and June 30, 2013, the balances of these reserves were \$5.2 million and \$5.1 million, respectively. These reserves represent anticipated costs associated with the remediation of these issues.

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

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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 liabilities 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, 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, 2013.

**NEW ACCOUNTING STANDARDS**

See Note 3 to our condensed consolidated financial statements set forth in Part I Item 1 of this Quarterly Report on 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, 2013.

**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 are effective to provide reasonable assurance at December 31, 2013 to ensure that

information required to be disclosed in the reports that we file or submit under the Exchange Act is (i) accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure and (ii) recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

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.

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The SEC's general guidance permits the exclusion of an assessment of the effectiveness of a registrant's disclosure controls and procedures as they relate to its internal controls over financial reporting for an acquired business during the first year following such acquisition, if among other circumstances and factors there is not adequate time between the acquisition date and the date of assessment. As previously noted in this Form 10-Q, the Company completed the acquisition of TMB and Emura on November 4, 2013 and August 1, 2013, respectively. TMB represents 17 percent of the Company's total assets as of December 31, 2013. Emura represents 1 percent of the Company's total assets as of December 31, 2013. Management's assessment and conclusion on the effectiveness of the Company's disclosure controls and procedures as of December 31, 2013 excluded an assessment of the internal control over financial reporting of TMB and Emura.

## PART II. OTHER INFORMATION

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

| Period                               | Total Number of Shares Purchased <sup>(1)</sup> | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs <sup>(2)</sup> |
|--------------------------------------|---|------------------------------|--|---|
| October 1 through October 31, 2013   | 482   | \$45.52                      | —  | 10,325,100  |
| November 1 through November 30, 2013 | 2,781   | 47.05                        | —  | 10,325,100  |
| December 1 through December 31, 2013 | 3,150   | 47.72                        | —  | 10,325,100  |
| Total                                | 6,413   | \$47.26                      | —  |   |

During the current period, 1,522 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 1,741 shares of restricted stock to Kennametal, upon vesting, to satisfy tax withholding requirements and 3,150 shares of Kennametal stock as payment for the exercise price of stock options.

(2) On July 25, 2013, the Company publicly announced an amended repurchase program for up to 17 million shares of its outstanding capital stock.

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ITEM 6. EXHIBITS

|           |  |   |
|-----------|--|---|
| (10)      | Material Contracts   |   |
| (10.1)    | Kennametal Inc. Stock and Incentive Plan of 2010 (As Amended and Restated October 22, 2013)  | Appendix A to the 2013 Proxy Statement filed September 17, 2013 (File No. 001-05318) is incorporated herein by reference. |
| (31)      | Rule 13a-14(a)/15d-14(a) Certifications  |   |
| (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.   |
| (32)      | Section 1350 Certifications  |   |
| (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.   |
| (101)     | XBRL   |   |
| (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.DEF) | XBRL Taxonomy Definition Linkbase  | Filed herewith.   |
| (101.LAB) | XBRL Taxonomy Extension Label Linkbase Document  | Filed herewith.   |
| (101.PRE) | XBRL Taxonomy Extension Presentation Linkbase Document   | Filed herewith.   |

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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: February 6, 2014

By: /s/ Martha Fusco

Martha Fusco  
Vice President Finance and Corporate Controller