

KENNAMETAL INC
Form 10-Q
February 05, 2019
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2018
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.)

600 Grant Street
Suite 5100 15219-2706
Pittsburgh, Pennsylvania
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (412) 248-8000

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 every Interactive Data File required to be submitted 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 such files). YES NO

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

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

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

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, 2019
Capital Stock, par value \$1.25 per share	82,233,615

Table of Contents

KENNAMETAL INC.
FORM 10-Q
FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2018
TABLE OF CONTENTS

Item No. Page No.

PART I - FINANCIAL INFORMATION

1. Financial Statements

Condensed Consolidated Statements of Income (Unaudited)
Three and six months ended December 31, 2018 and 2017 4

Condensed Consolidated Statements of Comprehensive Income (Unaudited)
Three and six months ended December 31, 2018 and 2017 4

Condensed Consolidated Balance Sheets (Unaudited)
December 31, 2018 and June 30, 2018 5

Condensed Consolidated Statements of Cash Flow (Unaudited)
Six months ended December 31, 2018 and 2017 6

Notes to Condensed Consolidated Financial Statements (Unaudited) 7

2. Management's Discussion and Analysis of Financial Condition and Results of Operations 23

3. Quantitative and Qualitative Disclosures About Market Risk 34

4. Controls and Procedures 35

PART II - OTHER INFORMATION

1. Legal Proceedings 36

2. Unregistered Sales of Equity Securities and Use of Proceeds 36

6. Exhibits 36

Signatures 37

Table of Contents

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: downturns in the business cycle or the economy; our ability to achieve anticipated benefits of our restructuring, simplification and modernization initiatives; risks related to our foreign operations and international markets, such as fluctuations in 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; potential for future goodwill and other intangible asset impairment charges; our ability to protect and defend our intellectual property; continuity and security of information technology infrastructure; competition; our ability to retain our management and employees; demands on management resources; availability and cost of the raw materials we use to manufacture our products; product liability claims; integrating acquisitions and achieving the expected savings and synergies; global or regional catastrophic events; demand for and market acceptance of our products; business divestitures; labor relations; 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. Except as required by law, we do not intend to release publicly any revisions to forward-looking statements as a result of future events or developments.

Table of Contents

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KENNAMETAL INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(in thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2018	2017	2018	2017
Sales (Note 3)	\$587,394	\$571,345	\$1,174,080	\$1,113,799
Cost of goods sold	388,796	381,844	764,389	742,348
Gross profit	198,598	189,501	409,691	371,451
Operating expense	114,635	122,138	237,920	242,731
Restructuring and asset impairment charges (Note 7)	1,545	45	2,620	5,570
Amortization of intangibles	3,560	3,677	7,141	7,338
Operating income	78,858	63,641	162,010	115,812
Interest expense	8,104	7,231	16,201	14,379
Other income, net	(4,022)	(3,220)	(6,782)	(7,437)
Income before income taxes	74,776	59,630	152,591	108,870
Provision for income taxes	18,529	17,472	37,921	27,074
Net income	56,247	42,158	114,670	81,796
Less: Net income attributable to noncontrolling interests	1,549	557	3,274	1,011
Net income attributable to Kennametal	\$54,698	\$41,601	\$111,396	\$80,785
PER SHARE DATA ATTRIBUTABLE TO KENNAMETAL SHAREHOLDERS				
Basic earnings per share	\$0.66	\$0.51	\$1.35	\$0.99
Diluted earnings per share	\$0.66	\$0.50	\$1.34	\$0.98
Dividends per share	\$0.20	\$0.20	\$0.40	\$0.40
Basic weighted average shares outstanding	82,331	81,477	82,218	81,274
Diluted weighted average shares outstanding	83,310	82,778	83,233	82,446

KENNAMETAL INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(in thousands)	Three Months		Six Months Ended	
	Ended December 31,		December 31,	
	2018	2017	2018	2017
Net income	\$56,247	\$42,158	\$114,670	\$81,796
Other comprehensive (loss) income, net of tax				
Unrealized gain (loss) on derivatives designated and qualified as cash flow hedges	170	(286)	(91)	(905)
Reclassification of unrealized loss on derivatives designated and qualified as cash flow hedges	262	1,007	857	1,403
Unrecognized net pension and other postretirement benefit gain (loss)	871	(625)	1,194	(2,590)

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Reclassification of net pension and other postretirement benefit loss	1,298	1,569	2,606	3,348
Foreign currency translation adjustments	(3,400)	13,924	(19,605)	33,793
Total other comprehensive (loss) income, net of tax	(799)	15,589	(15,039)	35,049
Total comprehensive income	55,448	57,747	99,631	116,845
Less: comprehensive income attributable to noncontrolling interests	2,049	1,445	2,542	2,184
Comprehensive income attributable to Kennametal Shareholders	\$53,399	\$56,302	\$97,089	\$114,661

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, 2018	June 30, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 96,276	\$556,153
Accounts receivable, less allowance for doubtful accounts of \$10,951 and \$11,807, respectively	380,683	401,290
Inventories (Note 10)	578,566	525,466
Other current assets	63,509	63,257
Total current assets	1,119,034	1,546,166
Property, plant and equipment:		
Land and buildings	349,857	351,953
Machinery and equipment	1,753,544	1,702,243
Less accumulated depreciation	(1,248,298)	(1,229,983)
Property, plant and equipment, net	855,103	824,213
Other assets:		
Goodwill (Note 17)	300,003	301,802
Other intangible assets, less accumulated amortization of \$151,364 and \$145,334, respectively (Note 17)	168,486	176,468
Deferred income taxes	16,052	17,015
Other	72,430	60,073
Total other assets	556,971	555,358
Total assets	\$ 2,531,108	\$ 2,925,737
LIABILITIES		
Current liabilities:		
Current maturities of long-term debt (Note 11)	\$ —	\$399,266
Notes payable to banks	3,371	934
Accounts payable	198,350	221,903
Accrued income taxes	28,621	18,603
Accrued expenses	57,780	95,239
Other current liabilities	123,931	150,586
Total current liabilities	412,053	886,531
Long-term debt, less current maturities (Note 11)	591,688	591,505
Deferred income taxes	28,563	26,991
Accrued pension and postretirement benefits	157,818	159,522
Accrued income taxes	8,374	6,249
Other liabilities	24,328	24,612
Total liabilities	1,222,824	1,695,410
Commitments and contingencies		
EQUITY (Note 15)		
Kennametal Shareholders' Equity:		
Preferred stock, no par value; 5,000 shares authorized; none issued	—	—
Capital stock, \$1.25 par value; 120,000 shares authorized; 82,160 and 81,646 shares issued, respectively	102,700	102,058
Additional paid-in capital	522,413	511,909
Retained earnings	979,259	900,683

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Accumulated other comprehensive loss	(334,632) (320,325)
Total Kennametal Shareholders' Equity	1,269,740	1,194,325	
Noncontrolling interests	38,544	36,002	
Total equity	1,308,284	1,230,327	
Total liabilities and equity	\$ 2,531,108	\$ 2,925,737	

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

Table of Contents

KENNAMETAL INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW (UNAUDITED)

(in thousands)	Six Months Ended	
	December 31,	
	2018	2017
OPERATING ACTIVITIES		
Net income	\$ 114,670	\$ 81,796
Adjustments for non-cash items:		
Depreciation	47,807	46,061
Amortization	7,141	7,338
Stock-based compensation expense	13,435	11,995
Restructuring and asset impairment charges (Note 7)	(257)	3,172
Deferred income tax provision	1,512	7,241
Other	2,109	3,474
Changes in certain assets and liabilities:		
Accounts receivable	14,026	(3,290)
Inventories	(59,190)	(9,080)
Accounts payable and accrued liabilities (Note 4)	(82,828)	(92,320)
Accrued income taxes	7,995	3,966
Accrued pension and postretirement benefits	(9,760)	(13,824)
Other	4,841	(5,455)
Net cash flow provided by operating activities	61,501	41,074
INVESTING ACTIVITIES		
Purchases of property, plant and equipment (Note 4)	(88,076)	(59,523)
Disposals of property, plant and equipment	2,490	846
Other	89	244
Net cash flow used for investing activities	(85,497)	(58,433)
FINANCING ACTIVITIES		
Net increase in notes payable	2,473	643
Net decrease in short-term revolving and other lines of credit	(174)	—
Term debt repayments	(400,000)	(141)
Purchase of capital stock	(107)	(109)
The effect of employee benefit and stock plans and dividend reinvestment	(2,182)	15,020
Cash dividends paid to Shareholders	(32,820)	(32,456)
Other	151	(271)
Net cash flow used for financing activities	(432,659)	(17,314)
Effect of exchange rate changes on cash and cash equivalents	(3,222)	3,984
CASH AND CASH EQUIVALENTS		
Net decrease in cash and cash equivalents	(459,877)	(30,689)
Cash and cash equivalents, beginning of period	556,153	190,629
Cash and cash equivalents, end of period	\$ 96,276	\$ 159,940
The accompanying notes are an integral part of these condensed consolidated financial statements.		

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. 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 2018 Annual Report on Form 10-K. The condensed consolidated balance sheet as of June 30, 2018 was derived from the audited balance sheet included in our 2018 Annual Report on Form 10-K. These interim statements are unaudited; however, we believe that all adjustments necessary for a fair statement of the results of the interim periods were made and all adjustments are normal recurring adjustments. The results for the six months ended December 31, 2018 and 2017 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 2019 is to the fiscal year ending June 30, 2019. 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.

2. NEW ACCOUNTING STANDARDS

Adopted

In May 2014, the Financial Accounting Standards Board (FASB) issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," which requires an entity to recognize revenue in a manner that depicts the transfer of promised goods to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange. The standard also expands the disclosure requirements around contracts with customers. We adopted Topic 606 July 1, 2018 using the modified retrospective transition method applied to those contracts that were not completed as of that date. The adoption did not have a material impact on the condensed consolidated financial statements beyond the additional disclosure requirements. Refer to Notes 3 and 18 to the condensed consolidated financial statements for further details.

In August 2016, the FASB issued ASU No. 2016-15, "Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)," which addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice with respect to how these are classified in the statement of cash flows. We adopted this ASU July 1, 2018. Adoption of this guidance did not have a material effect on our condensed consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, "Intra-Entity Transfers of Assets Other Than Inventory," which clarifies that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. We adopted this ASU July 1, 2018. Adoption of this guidance did not have a material effect on our condensed consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost," which requires that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. We adopted this ASU July 1, 2018, with the amendments applied on a retrospective basis. Refer to Note 9 to the condensed consolidated financial statements for further details.

In May 2017, the FASB issued ASU No. 2017-09, "Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting," which clarifies when to account for a change to the terms or conditions of a share-based payment award as a modification. Under the new guidance, modification accounting is required only if the fair value, the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. We adopted this ASU July 1, 2018. Adoption of this guidance did not have a material effect on

our condensed consolidated financial statements.

Issued

In February 2016, the FASB issued ASU No. 2016-02, "Leases: Topic 842," which replaces the existing guidance in ASC 840, Leases. The standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for substantially all leases. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. This standard is effective for Kennametal beginning July 1, 2019. Currently, we are inventorying our leasing arrangements and gathering lease data in order to determine the impact this ASU will have on our consolidated financial statements.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

3. REVENUE RECOGNITION

Revenue Accounting Description and Policy

The Company's contracts with customers are comprised of purchase orders, and for larger customers, may also include long-term agreements. We account for a contract when it has approval and commitment from both parties, the rights of the parties and payment terms are identified, the contract has commercial substance and collectability of consideration is probable. These contracts with customers typically relate to the manufacturing of products, which represent single performance obligations that are satisfied when control of the product passes to the customer. The Company considers the timing of right to payment, transfer of risk and rewards, transfer of title, transfer of physical possession and customer acceptance when determining when control transfers to the customer. As a result, revenue is generally recognized at a point in time - either upon shipment or delivery - based on the specific shipping terms in the contract. The shipping terms vary across all businesses and depend on the product, customary local commercial terms and the type of transportation. Shipping and handling activities are accounted for as activities to fulfill a promise to transfer a product to a customer and as such, costs incurred are recorded when the related revenue is recognized.

Payment for products is due within a limited time period after shipment or delivery, typically within 30 to 90 calendar days of the respective invoice dates. The Company does not generally offer extended payment terms.

Revenue is measured as the amount of consideration we expect to receive in exchange for transferring goods.

Amounts billed and due from our customers are classified as accounts receivable, less allowance for doubtful accounts on the condensed consolidated balance sheet. Certain contracts with customers, primarily distributor customers, have an element of variable consideration that is estimated when revenue is recognized under the contract. Variable consideration primarily includes volume incentive rebates, which are based on achieving a certain level of purchases and other performance criteria as established by our distributor programs. These rebates are estimated based on projected sales to the customer and accrued as a reduction of net sales as they are earned. The majority of our products are consumed by our customers or end users in the manufacture of their products. Historically, we have experienced very low levels of returned products and do not consider the effect of returned products to be material.

See "Note 18. Segment Data" for disaggregation of revenue by geography and end market.

Contract Balances

The Company records a contract asset when it has a right to payment from a customer that is conditioned on events that have occurred other than the passage of time. The Company also records a contract liability when customers prepay but the Company has not yet satisfied its performance obligation. The Company did not have any material remaining performance obligations, contract assets or liabilities as of December 31, 2018 and June 30, 2018.

Practical Expedient

The Company pays sales commissions related to certain contracts, which qualify as incremental costs of obtaining a contract. However, the Company applies the practical expedient that allows an entity to recognize incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that would have been recognized is one year or less. These costs are recorded within operating expense in our condensed consolidated statement of income.

4. SUPPLEMENTAL CASH FLOW DISCLOSURES

	Six Months Ended December 31,	
(in thousands)	2018	2017
Cash paid during the period for:		
Income taxes	\$ 28,414	\$ 15,866
Interest	16,745	13,714

Supplemental
disclosure of non-cash
information:

Changes in accounts payable related to purchases of property, plant and equipment	(100)	14,200
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8

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

During the current quarter, the Company revised its condensed consolidated statement of cash flow for the six months ended December 31, 2017 to correctly present the changes in accounts payable and accrued liabilities and in purchases of property, plant and equipment, resulting in a decrease of \$25.7 million to previously reported net cash flow provided by operating activities and a corresponding decrease to previously reported net cash flow used for investing activities. Revisions of \$22.7 million will be made in future filings to the condensed consolidated statements of cash flow for the nine months ended March 31, 2018 with similar effects on the condensed consolidated statements of cash flow. The supplemental disclosure of non-cash information for changes in accounts payable related to purchases of property, plant and equipment for the six months ended December 31, 2017 was also revised accordingly, at an increase of \$14.2 million. The amount of that disclosure will be revised in future filings for the nine months ended March 31, 2018 to depict an increase of \$11.2 million. The Company has evaluated the correction and determined it was not material to the previously issued interim financial statements. The correction had no effect on the previously issued annual financial statements.

5. FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received on the sale of 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, 2018, the fair values of the Company's financial assets and financial liabilities are categorized as follows:

(in thousands)	Level 1	Level 2	Level 3	Total
Assets:				
Derivatives ⁽¹⁾	\$	—\$ 513	\$	—\$513
Total assets at fair value	\$	—\$ 513	\$	—\$513
Liabilities:				
Derivatives ⁽¹⁾	\$	—\$ 49	\$	—\$49
Total liabilities at fair value	\$	—\$ 49	\$	—\$49

As of June 30, 2018, the fair values of the Company's financial assets and financial liabilities are categorized as follows:

(in thousands)	Level 1	Level 2	Level 3	Total
Assets:				
Derivatives ⁽¹⁾	\$	—\$1,665	\$	—\$1,665
Total assets at fair value	\$	—\$1,665	\$	—\$1,665
Liabilities:				

Derivatives ⁽¹⁾	\$	—\$207	\$	—\$207
Total liabilities at fair value	\$	—\$207	\$	—\$207

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

There have been no changes in classification and transfers between levels in the fair value hierarchy in the current period.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

6. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

As part of our financial risk management program, we use certain derivative financial instruments. We do not enter into derivative transactions for speculative purposes and, therefore, hold no derivative instruments for trading purposes. We 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 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, 2018	June 30, 2018
Derivatives designated as hedging instruments		
Other current assets - range forward contracts	\$ 513	\$799
Other current liabilities - range forward contracts	—	(5)
Other assets - range forward contracts	—	27
Total derivatives designated as hedging instruments	513	821
Derivatives not designated as hedging instruments		
Other current assets - currency forward contracts	—	839
Other current liabilities - currency forward contracts	(49)	(202)
Total derivatives not designated as hedging instruments	(49)	637
Total derivatives	\$ 464	\$1,458

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

(in thousands)	Three Months Ended December 31, 2018	2017	Six Months Ended December 31, 2018	2017
Other income, net - currency forward contracts	\$(2)	\$(92)	\$76	\$(208)

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 are recorded in accumulated other comprehensive loss and are recognized as a component of other 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, 2018 and June 30, 2018, was \$43.5 million and \$62.9 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, 2018, we expect to recognize into earnings \$0.3 million of income on outstanding derivatives in the next 12 months.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
(in thousands)	2018	2017	2018	2017
Gains (losses) recognized in other comprehensive (loss) income, net	\$170	\$(287)	\$(91)	\$(906)
Losses reclassified from accumulated other comprehensive loss into other income, net	\$565	\$870	\$1,097	\$1,262

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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, 2018 and 2017.

NET INVESTMENT HEDGES

As of December 31, 2018, we had certain foreign currency-denominated intercompany loans payable with total aggregate principal amounts of €71.0 million as net investment hedges to hedge the foreign exchange exposure of our net investment in Euro-based subsidiaries. We recorded a gain of \$0.5 million and a loss of \$0.5 million as a component of foreign currency translation adjustments in other comprehensive (loss) income for the three months ended December 31, 2018 and 2017, respectively. We recorded a gain of \$0.5 million and a loss of \$1.9 million as a component of foreign currency translation adjustments in other comprehensive (loss) income for the six months ended December 31, 2018 and 2017, respectively.

As of December 31, 2018, the foreign currency-denominated intercompany loans payable designated as net investment hedges consisted of:

Instrument	Notional (EUR in thousands) ⁽²⁾	Notional (USD in thousands) ⁽²⁾	Maturity
Foreign currency-denominated intercompany loan payable	€40,125	\$ 45,927	June 27, 2019
Foreign currency-denominated intercompany loan payable	27,728	31,738	June 26, 2022
Foreign currency-denominated intercompany loan payable	6,509	7,450	November 20, 2021
Foreign currency-denominated intercompany loan payable	2,024	2,316	October 11, 2019

⁽²⁾ Includes principal and accrued interest.

7. RESTRUCTURING AND RELATED CHARGES

In the June quarter of fiscal 2018, we implemented and substantially completed restructuring actions to simplify the Industrial segment's cost structure by directing resources to more profitable business and increasing sales force productivity. We supplemented this with the rationalization of small manufacturing facilities in the Infrastructure and Industrial segments, which we expect to complete in fiscal 2019. Total restructuring and related charges since inception of \$13.9 million have been recorded for this program through December 31, 2018.

We recorded restructuring and related charges of \$2.1 million and \$1.5 million for the three months ended December 31, 2018 and 2017, respectively. Of these amounts, restructuring charges totaled \$1.5 million for the three months ended December 31, 2018 and were less than \$0.1 million for the three months ended December 31, 2017.

Restructuring-related charges of \$0.6 million and \$1.3 million were recorded in cost of goods sold for the three months ended December 31, 2018 and 2017, respectively. For the three months ended December 31, 2017, restructuring-related charges of \$0.2 million were recorded in operating expense.

We recorded restructuring and related charges of \$3.1 million and \$8.4 million for the six months ended December 31, 2018 and 2017, respectively. Of these amounts, restructuring charges totaled \$2.6 million and \$5.6 million, respectively. Restructuring-related charges of \$0.5 million and \$2.5 million were recorded in cost of goods sold for the six months ended December 31, 2018 and 2017, respectively. For the six months ended December 31, 2017, restructuring-related charges of \$0.3 million were recorded in operating expense.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

As of December 31, 2018, the total restructuring accrual is recorded in other current liabilities in our condensed consolidated balance sheet. As of June 30, 2018, \$17.5 million and \$0.1 million of the restructuring accrual is recorded in other current liabilities and other liabilities, respectively. The amount attributable to each segment is as follows:

(in thousands)	June 30, 2018	Expense	Asset Write-Down	Translation	Cash Expenditures	December 31, 2018
Industrial						
Severance	\$7,967	\$1,552	\$ —	\$ (128)	\$ (3,568)	\$ 5,823
Facilities	—	(9)	9	—	—	—
Other	—	29	—	(1)	10	38
Total Industrial	\$7,967	\$1,572	\$ 9	\$ (129)	\$ (3,558)	\$ 5,861
Widia						
Severance	\$2,087	\$113	\$ —	\$ (9)	\$ (261)	\$ 1,930
Facilities	—	—	—	—	—	—
Other	15	2	—	—	1	18
Total Widia	\$2,102	\$115	\$ —	\$ (9)	\$ (260)	\$ 1,948
Infrastructure						
Severance	\$7,558	\$1,159	\$ —	\$ (96)	\$ (2,665)	\$ 5,956
Facilities	—	(248)	248	—	—	—
Other	12	22	—	—	7	41
Total Infrastructure	\$7,570	\$933	\$ 248	\$ (96)	\$ (2,658)	\$ 5,997
Total	\$17,639	\$2,620	\$ 257	\$ (234)	\$ (6,476)	\$ 13,806

8. STOCK-BASED COMPENSATION

Stock Options

Changes in our stock options for the six months ended December 31, 2018 were as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Life (years)	Aggregate Intrinsic value (in thousands)
Options outstanding, June 30, 2018	989,992	\$ 33.08		
Exercised	(136,405)	29.18		
Lapsed or forfeited	(7,000)	45.24		
Options outstanding, December 31, 2018	846,587	\$ 33.61	4.0	\$ 3,018
Options vested and expected to vest, December 31, 2018	846,587	\$ 33.61	4.0	\$ 3,018
Options exercisable, December 31, 2018	841,920	\$ 33.68	4.0	\$ 2,960

Fair value of options vested during the six months ended December 31, 2018 and 2017 was \$1.2 million and \$1.7 million, respectively. The amount of cash received from the exercise of capital stock options during the six months ended December 31, 2018 and 2017 was \$3.9 million and \$19.1 million, respectively. The total intrinsic value of options exercised during the six months ended December 31, 2018 and 2017 was \$1.8 million and \$4.8 million, respectively.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Restricted Stock Units – Performance Vesting and Time Vesting

Changes in our performance vesting and time vesting restricted stock units for the six months ended December 31, 2018 were as follows:

	Performance Vesting Stock Units	Performance Vesting Weighted Average Fair Value	Time Vesting Stock Units	Time Vesting Weighted Average Fair Value
Unvested, June 30, 2018	409,297	\$ 31.22	1,083,675	\$ 30.47
Granted	161,066	40.10	536,910	38.92
Vested	(36,394)	31.86	(461,851)	31.22
Performance metric adjustments, net	41,196	29.69	—	—
Forfeited	(44,179)	31.04	(26,371)	32.27
Unvested, December 31, 2018	530,986	\$ 33.77	1,132,363	\$ 34.15

During the six months ended December 31, 2018 and 2017, compensation expense related to time vesting and performance vesting restricted stock units was \$12.8 million and \$11.0 million, respectively. As of December 31, 2018, the total unrecognized compensation cost related to unvested time vesting and performance vesting restricted stock units was \$26.7 million and is expected to be recognized over a weighted average period of 2.3 years.

9. PENSION AND OTHER POSTRETIREMENT BENEFITS

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

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
(in thousands)				
Service cost	\$407	\$406	\$818	\$810
Interest cost	7,970	7,678	15,960	15,335
Expected return on plan assets	(13,434)	(14,132)	(26,896)	(28,221)
Amortization of transition obligation	23	23	45	46
Amortization of prior service (credit) cost	(5)	(41)	(10)	132
Recognition of actuarial losses	1,679	1,718	3,374	3,428
Net periodic pension income	\$(3,360)	\$(4,348)	\$(6,709)	\$(8,470)

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
(in thousands)				
Interest cost	\$153	\$157	\$307	\$314
Amortization of prior service credit	(22)	(6)	(45)	(11)
Recognition of actuarial loss	62	70	124	140

Net periodic other postretirement benefit cost \$193 \$221 \$386 \$443

In accordance with ASU 2017-07, as described in Note 2, the service cost of \$0.4 million and \$0.8 million for the three and six months ended December 31, 2018 and 2017 was reported as a component of cost of goods sold and operating expense. The other components of net periodic pension income and net periodic other postretirement benefit cost totaling a net benefit of \$3.6 million and \$7.1 million for the three and six months ended December 31, 2018 were presented as a component of other income, net. For the three and six months ended December 31, 2017, we reclassified a net benefit of \$3.0 million and \$6.1 million, respectively, from cost of goods sold to other income, net and a net benefit of \$1.5 million and \$2.8 million, respectively, from operating expense to other income, net.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

10. INVENTORIES

We used the last-in, first-out (LIFO) method of valuing inventories for 39 percent and 40 percent of total inventories at December 31, 2018 and June 30, 2018, respectively. Since 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, 2018	June 30, 2018
Finished goods	\$306,680	\$279,240
Work in process and powder blends	256,271	232,973
Raw materials	99,145	96,859
Inventories at current cost	662,096	609,072
Less: LIFO valuation	(83,530)	(83,606)
Total inventories	\$578,566	\$525,466

11. LONG-TERM DEBT

Our five-year, multi-currency, revolving credit facility, as amended and restated in June 2018 (Credit Agreement), provides for revolving credit loans of up to \$700 million for working capital, capital expenditures and general corporate purposes. The 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 Credit Agreement). We were in compliance with all such covenants as of December 31, 2018. We had no borrowings outstanding under the Credit Agreement as of December 31, 2018 and June 30, 2018. Borrowings under the Credit Agreement are guaranteed by our significant domestic subsidiaries. The Credit Agreement matures in June 2023.

Fixed rate debt had a fair market value of \$597.5 million and \$996.4 million at December 31, 2018 and June 30, 2018, respectively. The Level 2 fair value is determined based on the quoted market prices for similar debt instruments as of December 31, 2018 and June 30, 2018, respectively.

On July 9, 2018, the Company completed the early redemption of its previously outstanding \$400.0 million of 2.650 percent Senior Unsecured Notes due 2019.

12. ENVIRONMENTAL MATTERS

The operation of our business has exposed us to certain liabilities and compliance costs related to environmental matters. We are involved in various environmental cleanup and remediation activities at certain of our locations. We establish and maintain reserves for certain potential environmental issues. At December 31, 2018 and June 30, 2018, the balances of these reserves were \$12.5 million and \$12.6 million, respectively. These reserves represent anticipated costs associated with the remediation of these issues and are generally not discounted.

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 United States Environmental Protection Agency (USEPA), other governmental agencies and by the Potentially Responsible Party (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.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Superfund Sites Among other environmental laws, we are subject to the Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), under which we have been designated by the USEPA as a PRP with respect to environmental remedial costs at certain Superfund sites. We have evaluated our claims and liabilities associated with these Superfund sites based upon best currently available information. We believe our environmental accruals are adequate to cover our portion of the environmental remedial costs at the Superfund sites where we have been designated a PRP, to the extent these expenses are probable and reasonably estimable.

13. INCOME TAXES

Tax Cuts and Jobs Act of 2017 (TCJA)

The three primary items from TCJA that effect the Company for fiscal 2019 are the reduction in the statutory tax rate, the one-time tax that is imposed on our unremitted foreign earnings (Toll Tax) and the tax on global intangible low-taxed income (GILTI) which we elected to record as a period cost.

The U.S. federal tax rate reduction was effective as of January 1, 2018. As a June 30 fiscal year-end taxpayer, our fiscal 2018 U.S. federal statutory tax rate was a blended rate of 28.1 percent. Our U.S. federal statutory tax rate is 21.0 percent in fiscal 2019.

During the three months ended December 31, 2018, we finalized our estimate of the Toll Tax charge based upon the U.S. Department of the Treasury regulations and other relevant guidance issued through December 31, 2018. The adjustment to the toll charge during the quarter resulted in an additional net benefit of \$3.9 million, decreasing the total Toll Tax charge to \$78.0 million. We do not expect to make a cash payment associated with the Toll Tax. In addition to the direct effects of TCJA, the provisions of TCJA caused the Company to re-evaluate its permanent reinvestment assertion in all jurisdictions, concluding that a portion of the unremitted earnings and profits of certain non-U.S. subsidiaries and affiliates will no longer be permanently reinvested. These changes in assertion required the recognition of a tax charge of \$6.1 million primarily for foreign withholding and U.S. state income taxes. The remaining amount of unremitted earnings of non-U.S. subsidiaries continue to be indefinitely reinvested. With regard to the unremitted earnings which remain indefinitely reinvested, 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 this time, the Company does not anticipate a material impact to the fiscal 2019 condensed consolidated financial statements from the base erosion anti-abuse tax or a deduction for foreign-derived intangible income.

In accordance with the SEC Staff Accounting Bulletin 118, we have finalized our accounting for the impacts of the TCJA provisions enacted in fiscal 2018, including the remeasurement of deferred tax assets and liabilities at the reduced U.S. federal rate of 21.0 percent.

Effective Tax Rates

The effective income tax rates for the three months ended December 31, 2018 and 2017 were 24.8 percent and 29.3 percent, respectively. The current year rate reflects the lower U.S. federal statutory tax rate, the \$6.1 million charge related to changes in the indefinite reinvestment assertion on certain foreign subsidiaries' undistributed earnings which are no longer considered permanently reinvested, GILTI and the \$3.9 million benefit recorded to reflect the finalization of the amount of the Toll Tax. The prior year rate includes the tax effects associated with the release of a valuation allowance that was previously recorded against our net deferred tax assets in the U.S. and a charge related to an out of period adjustment.

The effective income tax rates for the six months ended December 31, 2018 and 2017 were 24.9 percent. The current year rate reflects the lower U.S. federal statutory tax rate, the \$6.1 million charge related to changes in the indefinite reinvestment assertion on certain foreign subsidiaries' undistributed earnings which are no longer considered permanently reinvested, GILTI and the \$3.9 million benefit recorded to reflect the finalization of the amount of the

Toll Tax. The prior year rate includes a benefit from the release of a valuation allowance that was previously recorded against our net deferred tax assets in the U.S. and a charge related to an out of period adjustment.

14. 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 would occur related to the issuance of capital stock under stock option grants, performance awards and restricted stock units. The difference between basic and diluted earnings per share relates solely to the effect of capital stock options, performance awards and restricted stock units.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following tables provide the computation of diluted shares outstanding for the three and six months ended December 31, 2018 and 2017:

(in thousands)	Three Months Ended		Six Months Ended	
	December 31, 2018	2017	December 31, 2018	2017
Weighted-average shares outstanding during period	82,331	81,477	82,218	81,274
Add: Unexercised capital stock options, unvested performance awards and unvested restricted stock units	979	1,301	1,015	1,172
Number of shares on which diluted earnings per share is calculated	83,310	82,778	83,233	82,446
Unexercised capital stock options, performance awards and restricted stock units not included in the computation because the option exercise price was greater than the average market price	469	219	400	483

15. EQUITY

A summary of the changes in the carrying amounts of total equity, Kennametal Shareholders' equity and equity attributable to noncontrolling interests as of December 31, 2018 and 2017 is as follows:

(in thousands)	Kennametal Shareholders' Equity					
	Capital stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Non-controlling interests	Total equity
Balance as of June 30, 2018	\$ 102,058	\$ 511,909	\$ 900,683	\$ (320,325)	\$ 36,002	\$ 1,230,327
Net income	—	—	111,396	—	3,274	114,670
Other comprehensive loss	—	—	—	(14,307)	(732)	(15,039)
Dividend reinvestment	3	104	—	—	—	107
Capital stock issued under employee benefit and stock plans ⁽³⁾	642	10,504	—	—	—	11,146
Purchase of capital stock	(3)	(104)	—	—	—	(107)
Cash dividends	—	—	(32,820)	—	—	(32,820)
Balance as of December 31, 2018	\$ 102,700	\$ 522,413	\$ 979,259	\$ (334,632)	\$ 38,544	\$ 1,308,284

(in thousands)	Kennametal Shareholders' Equity					
	Capital stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Non-controlling interests	Total equity
Balance as of June 30, 2017	\$ 100,832	\$ 474,547	\$ 765,607	\$ (323,692)	\$ 35,359	\$ 1,052,653
Net income	—	—	80,785	—	1,011	81,796
Other comprehensive income	—	—	—	33,876	1,173	35,049
Dividend reinvestment	3	106	—	—	—	109
Capital stock issued under employee benefit and stock plans ⁽³⁾	1,065	25,841	—	—	—	26,906
Purchase of capital stock	(3)	(106)	—	—	—	(109)

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Cash dividends	—	—	(32,456)	—	—	(32,456)
Balance as of December 31, 2017	\$101,897	\$500,388	\$813,936	\$ (289,816)	\$ 37,543	\$1,163,948

⁽³⁾ Net of restricted stock units delivered upon vesting to satisfy tax withholding requirements.

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

16. ACCUMULATED OTHER COMPREHENSIVE LOSS

The components of, and changes in, accumulated other comprehensive loss (AOCL) were as follows, net of tax, for the six months ended December 31, 2018:

(in thousands)	Postretirement benefit plans	Currency translation adjustment	Derivatives	Total
Attributable to Kennametal:				
Balance, June 30, 2018	\$ (187,755)	\$(127,347)	\$ (5,223)	\$(320,325)
Other comprehensive income (loss) before reclassifications	1,194	(18,873)	(91)	(17,770)
Amounts reclassified from AOCL	2,606	—	857	3,463
Net current period other comprehensive income (loss)	3,800	(18,873)	766	(14,307)
AOCL, December 31, 2018	\$ (183,955)	\$(146,220)	\$ (4,457)	\$(334,632)
Attributable to noncontrolling interests:				
Balance, June 30, 2018	\$ —	\$(2,913)	\$ —	\$(2,913)
Other comprehensive loss before reclassifications	—	(732)	—	(732)
Net current period other comprehensive loss	—	(732)	—	(732)
AOCL, December 31, 2018	\$ —	\$(3,645)	\$ —	\$(3,645)

The components of, and changes in, AOCL were as follows, net of tax, for the six months ended December 31, 2017:

(in thousands)	Postretirement benefit plans	Currency translation adjustment	Derivatives	Total
Attributable to Kennametal:				
Balance, June 30, 2017	\$ (189,038)	\$(126,606)	\$ (8,048)	\$(323,692)
Other comprehensive (loss) income before reclassifications	(2,590)	32,620	(905)	29,125
Amounts reclassified from AOCL	3,348	—	1,403	4,751
Net current period other comprehensive income	758	32,620	498	33,876
AOCL, December 31, 2017	\$ (188,280)	\$(93,986)	\$ (7,550)	\$(289,816)
Attributable to noncontrolling interests:				
Balance, June 30, 2017	\$ —	\$(2,164)	\$ —	\$(2,164)
Other comprehensive income before reclassifications	—	1,173	—	1,173
Net current period other comprehensive income	—	1,173	—	1,173
AOCL, December 31, 2017	\$ —	\$(991)	\$ —	\$(991)

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Reclassifications out of AOCL for the three and six months ended December 31, 2018 and 2017 consisted of the following:

(in thousands)	Three Months Ended December 31,		Six Months Ended December 31,		Affected line item in the Income Statement
	2018	2017	2018	2017	
Gains and losses on cash flow hedges:					
Forward starting interest rate swaps	\$588	\$566	\$1,176	\$1,132	Interest expense
Currency exchange contracts	(241)	768	(41)	726	Other income, net
Total before tax	347	1,334	1,135	1,858	
Tax impact	(85)	(327)	(278)	(455)	Provision for income taxes
Net of tax	\$262	\$1,007	\$857	\$1,403	
Postretirement benefit plans:					
Amortization of transition obligations	\$23	\$23	\$45	\$46	Other income, net
Amortization of prior service (credit) cost	(27)	(47)	(55)	121	Other income, net
Recognition of actuarial losses	1,741	1,788	3,498	3,568	Other income, net
Total before tax	1,737	1,764	3,488	3,735	
Tax impact	(439)	(195)	(882)	(387)	Provision for income taxes
Net of tax	\$1,298	\$1,569	\$2,606	\$3,348	

The amount of income tax allocated to each component of other comprehensive (loss) income for the three months ended December 31, 2018 and 2017 were as follows:

(in thousands)	2018			2017		
	Pre-tax	Tax impact	Net of tax	Pre-tax	Tax impact	Net of tax
Unrealized gain (loss) on derivatives designated and qualified as cash flow hedges	\$ 225	\$(55)	\$170	\$(379)	\$93	\$(286)
Reclassification of unrealized loss on derivatives designated and qualified as cash flow hedges	347	(85)	262	1,334	(327)	1,007
Unrecognized net pension and other postretirement benefit gain (loss)	1,134	(263)	871	(834)	209	(625)
Reclassification of net pension and other postretirement benefit loss	1,737	(439)	1,298	1,764	(195)	1,569
Foreign currency translation adjustments	(3,407)	7	(3,400)	13,996	(72)	13,924
Other comprehensive (loss) income	\$ 36	\$(835)	\$(799)	\$15,881	\$(292)	\$15,589

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The amount of income tax allocated to each component of other comprehensive (loss) income for the six months ended December 31, 2018 and 2017 were as follows:

(in thousands)	Pre-tax	2018 Tax impact	Net of tax	Pre-tax	2017 Tax impact	Net of tax
Unrealized loss on derivatives designated and qualified as cash flow hedges	\$(121)	)\$30	\$(91)	\$(1,199)	)\$294	\$(905)
Reclassification of unrealized loss on derivatives designated and qualified as cash flow hedges	1,135	(278 )	)857	1,858	(455 )	)1,403
Unrecognized net pension and other postretirement benefit gain (loss)	1,551	(357 )	)1,194	(3,434)	)844	(2,590)
Reclassification of net pension and other postretirement benefit loss	3,488	(882 )	)2,606	3,735	(387 )	)3,348
Foreign currency translation adjustments	(19,679)	)74	(19,605)	34,058	(265 )	)33,793
Other comprehensive (loss) income	\$(13,626)	\$(1,413)	\$(15,039)	\$35,018	\$31	\$35,049

17. GOODWILL AND OTHER INTANGIBLE ASSETS

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

(in thousands)	Industrial	Widia	Infrastructure	Total
Gross goodwill	\$411,458	\$41,186	\$633,211	\$1,085,855
Accumulated impairment losses	(137,204)	(13,638)	(633,211)	(784,053)
Balance as of June 30, 2018	\$274,254	\$27,548	\$—	\$301,802

Activity for the six months ended December 31, 2018:

Change in gross goodwill due to translation	(1,604)	(195)	—	(1,799)
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Gross goodwill	409,854	40,991	633,211	1,084,056
Accumulated impairment losses	(137,204)	(13,638)	(633,211)	(784,053)
Balance as of December 31, 2018	\$272,650	\$27,353	\$—	\$300,003

The components of our other intangible assets were as follows:

(in thousands)	Estimated Useful Life (in years)	December 31, 2018		June 30, 2018	
		Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Contract-based	3 to 15	\$7,055	\$(7,043)	\$7,061	\$(7,036)
Technology-based and other	4 to 20	46,333	(31,314)	46,666	(30,923)
Customer-related	10 to 21	205,189	(89,701)	206,162	(85,301)
Unpatented technology	10 to 30	31,697	(14,259)	31,854	(13,096)
Trademarks	5 to 20	12,377	(9,047)	12,450	(8,978)
Trademarks	Indefinite	17,199	—	17,609	—
Total		\$319,850	\$(151,364)	\$321,802	\$(145,334)

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

18. SEGMENT DATA

Our reportable operating segments have been determined in accordance with our internal management structure, which is organized based on operating activities, the manner in which we organize segments for making operating decisions and assessing performance and the availability of separate financial results. We do not allocate certain corporate expenses related to, among other things, executive retirement plans, our Board of Directors and strategic initiatives to our reportable operating segments. These costs are instead reported in Corporate. None of our three reportable operating segments represent the aggregation of two or more operating segments.

In the Industrial segment, we focus on customers in the transportation, general engineering, aerospace and defense market sectors, delivering high performance metalworking tools for specified purposes. Our customers in these end markets use our products and services in the manufacture of engines, airframes, automobiles, trucks, ships and various other types of industrial equipment. The technology and customization services we provide vary by customer, application and industry. Industrial goes to market under the Kennametal® brand through its direct sales force, a network of independent and national chain distributors, integrated supplier channels and via the Internet. Application engineers and technicians are critical to the sales process and directly assist our customers with specified product design, selection, application and support.

The Widia segment offers a focused assortment of standard custom metal cutting solutions to general engineering, aerospace, energy and transportation customers. We serve our customers primarily through a network of value added resellers, integrated supplier channels and via the Internet. Widia markets its products under the WIDIA®, WIDIA Hanita® and WIDIA GTD® brands.

The Infrastructure segment generally serves customers that operate in the energy and earthworks market sectors that support primary industries such as oil and gas, power generation and chemicals; underground, surface and hard-rock mining; highway construction and road maintenance; and process industries such as food and feed. Our success is determined by our ability to gain an in-depth understanding of our customers' engineering and development needs, to provide complete system solutions and high-performance capabilities to optimize and add value to their operations. Infrastructure markets its products primarily under the Kennametal® brand and sells through a direct sales force as well as distributors.

Our sales and operating income by segment are as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	December 31, 2018	2017	December 31, 2018	2017
Sales:				
Industrial	\$317,320	\$312,448	\$637,878	\$609,912
Widia	48,954	47,744	97,626	92,987
Infrastructure	221,120	211,153	438,576	410,900
Total sales	\$587,394	\$571,345	\$1,174,080	\$1,113,799
Operating income:				
Industrial	\$57,519	\$40,504	\$116,061	\$72,543
Widia	1,728	474	3,822	154
Infrastructure	20,614	23,833	44,474	44,223
Corporate	(1,003)	(1,170)	(2,347)	(1,108)
Total operating income	78,858	63,641	162,010	115,812
Interest expense	8,104	7,231	16,201	14,379
Other income, net	(4,022)	(3,220)	(6,782)	(7,437)
Income from continuing operations before income taxes	\$74,776	\$59,630	\$152,591	\$108,870

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following table presents Kennametal's revenue disaggregated by geography:

	Three Months Ended				December 31, 2017			
	December 31, 2018							
(in thousands)	Industrial	Widia	Infrastructure	Total Kennametal	Industrial	Widia	Infrastructure	Total Kennametal
Americas	40%	45%	66%	50%	37%	46%	65%	48%
EMEA	41	26	15	30	42	26	16	31
Asia Pacific	19	29	19	20	21	28	19	21
	Six Months Ended				December 31, 2017			
	December 31, 2018							
(in thousands)	Industrial	Widia	Infrastructure	Total Kennametal	Industrial	Widia	Infrastructure	Total Kennametal
Americas	40%	45%	66%	50%	38%	47%	64%	48%
EMEA	40	25	15	29	41	25	16	31
Asia Pacific	20	30	19	21	21	28	20	21

The following tables presents Kennametal's revenue disaggregated by end market:

	Three Months Ended December 31, 2018			
	Industrial	Widia	Infrastructure	Total Kennametal
(in thousands)				
General engineering	44%	100%	32%	44%
Transportation	34	—	—	18
Aerospace and defense	13	—	—	7
Energy	9	—	36	19
Earthworks	—	—	32	12
	Three Months Ended December 31, 2017			
	Industrial	Widia	Infrastructure	Total Kennametal
(in thousands)				
General engineering	42%	100%	32%	43%
Transportation	37	—	—	20
Aerospace and defense	12	—	—	6
Energy	9	—	32	17
Earthworks	—	—	36	14
	Six Months Ended December 31, 2018			
	Industrial	Widia	Infrastructure	Total Kennametal
(in thousands)				
General engineering	44%	100%	32%	44%
Transportation	34	—	—	19
Aerospace and defense	13	—	—	7
Energy	9	—	35	18
Earthworks	—	—	33	12

Table of Contents

KENNAMETAL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(in thousands)	Six Months Ended December 31, 2017			
	Industrial	Widia	Infrastructure	Total Kennametal
General engineering	42%	100%	31%	43%
Transportation	37	—	—	20
Aerospace and defense	12	—	—	6
Energy	9	—	32	17
Earthworks	—	—	37	14

22

Table of Contents

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

OVERVIEW

Kennametal Inc. was incorporated in Pennsylvania in 1943 as a manufacturer of tungsten carbide metal cutting tooling. From this beginning, the Company has grown into a global leader in the development and application of tungsten carbides, ceramics, super-hard materials and solutions used in metal cutting and mission-critical wear applications to combat extreme conditions associated with wear fatigue, corrosion and high temperatures. The Company's reputation for material technology, metal cutting application knowledge, as well as expertise and innovation in the development of custom solutions and services, contributes to its leading position in its primary markets.

Our product offering includes a wide selection of standard and customized technologies for metalworking applications, such as turning, milling, hole making, tooling systems and services. End users of the Company's metalworking products include manufacturers engaged in a diverse array of industries including: the manufacturers of transportation vehicles and components, machine tools and light and heavy machinery; airframe and aerospace components; and energy-related components for the oil and gas industry, as well as power generation.

In addition, we produce specialized wear components and metallurgical powders that are used for custom-engineered and challenging applications. End users of these products include producers and suppliers in equipment-intensive operations such as coal mining, road construction, quarrying, oil and gas exploration, refining, production and supply.

Throughout the MD&A, we refer to measures used by management to evaluate performance. We also refer to a number of financial measures that are not defined under accounting principles generally accepted in the United States of America (U.S. GAAP), including organic sales growth, constant currency regional sales growth (decline) and constant currency end market sales growth (decline). We provide the definitions of these non-GAAP financial measures at the end of the MD&A section as well as details on the use and derivation of these financial measures.

Operating results for the second quarter of fiscal year 2019 reflect continued margin improvement on the eighth consecutive quarter of sales growth. Our sales of \$587.4 million for the quarter ended December 31, 2018 increased 3 percent from the prior year quarter, reflecting growth in all segments and constant currency regional sales growth in all regions. These results reflect the ongoing monetization of our growth and simplification/modernization initiatives. Operating income was \$78.9 million, compared to \$63.6 million in the prior year quarter. The increase in operating income reflects organic sales growth and incremental simplification/modernization benefits, partially offset by higher raw material costs and a temporary increase in manufacturing expenses at certain locations due to the timing of simplification/modernization efforts underway. Price realization continued to outpace raw material cost inflation, and operating margin improved to 13.4 percent from 11.1 percent in the prior year quarter reflecting improvement in both gross profit and operating expense. The Industrial, Infrastructure and Widia segments had operating margins of 18.1 percent, 9.3 percent and 3.5 percent, respectively.

In connection with our simplification/modernization initiative, we recorded \$2 million of pre-tax restructuring and related charges in the current quarter and incremental pre-tax benefits from simplification/modernization restructuring were approximately \$3 million in the quarter. Annualized run-rate pre-tax benefits of approximately \$12 million have been achieved in connection with these simplification/modernization restructuring initiatives.

In the quarter, we finalized the accounting for the tax effects of enactment of the Tax Cuts and Jobs Act of 2017 (TCJA) based upon the U.S. Department of the Treasury (USDT) regulations and other relevant guidance issued through December 31, 2018, including the re-evaluation of our permanent reinvestment assertion in certain jurisdictions. See Note 13 to our condensed consolidated financial statements for a complete discussion on income taxes and the Liquidity and Capital Resources section of the MD&A for further information regarding the results of the re-evaluation of our permanent reinvestment assertion.

We reported current quarter earnings per diluted share of \$0.66, which include net discrete tax charges of \$0.03 and restructuring and related charges of \$0.02 per share. The earnings per diluted share of \$0.50 in the prior year quarter

included net discrete tax charges of \$0.02 per share.

We had a net cash inflow from operating activities of \$61.5 million during the six months ended December 31, 2018 compared to \$41.1 million during the prior year quarter. The year-over-year change is due primarily to increased cash flow from operations before changes in certain other assets and liabilities, partially offset by higher working capital. Capital expenditures were \$88.1 million and \$59.5 million during the six months ended December 31, 2018 and 2017, respectively, with the increase due in part to higher spending for modernization.

Table of Contents

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

RESULTS OF CONTINUING OPERATIONS

SALES

Sales for the three months ended December 31, 2018 were \$587.4 million, an increase of \$16.0 million or 3 percent, from \$571.3 million in the prior year quarter. The increase in sales was driven by 4 percent organic sales growth and a 2 percent increase due to more business days, partially offset by a 3 percent unfavorable currency exchange impact. Sales for the six months ended December 31, 2018 were \$1,174.1 million, an increase of \$60.3 million or 5 percent, from \$1,113.8 million in the prior year period. The increase in sales was driven by 7 percent organic sales growth and a 1 percent increase due to more business days, partially offset by a 3 percent unfavorable currency exchange impact.

(in percentages)	Three Months Ended December 31, 2018		Six Months Ended December 31, 2018	
	As Reported	Constant Currency	As Reported	Constant Currency
End market sales growth (decline):				
Aerospace and defense	18%	22%	18%	20%
Energy	14	15	14	15
General engineering	5	8	8	10
Transportation	(9)	(5)	(3)	1
Earthworks	(9)	(7)	(5)	(3)
Regional sales growth (decline):				
Americas	7%	9%	9%	10%
Europe, the Middle East and Africa (EMEA)	—	5	1	5
Asia Pacific	(3)	2	4	7

GROSS PROFIT

Gross profit for the three months ended December 31, 2018 was \$198.6 million, an increase of \$9.1 million from \$189.5 million in the prior year quarter. The increase was primarily due to organic sales growth and incremental simplification/modernization benefits, partially offset by higher raw material costs, a temporary increase in manufacturing expenses at certain locations due to the timing of simplification/modernization efforts underway, unfavorable foreign currency exchange impact of approximately \$7 million and higher compensation expense. The gross profit margin for the three months ended December 31, 2018 was 33.8 percent, as compared to 33.2 percent in the prior year quarter.

Gross profit for the six months ended December 31, 2018 was \$409.7 million, an increase of \$38.2 million from \$371.5 million in the prior year period. The increase was primarily due to organic sales growth, incremental simplification/modernization benefits and favorable mix, partially offset by higher raw material costs, a temporary increase in manufacturing expenses at certain locations due to the timing of simplification/modernization efforts underway and unfavorable foreign currency exchange impact of approximately \$10 million. The gross profit margin for the six months ended December 31, 2018 was 34.9 percent, as compared to 33.3 percent in the prior year period.

OPERATING EXPENSE

Operating expense for the three months ended December 31, 2018 was \$114.6 million compared to \$122.1 million for the three months ended December 31, 2017. The decrease was primarily due to favorable currency exchange impact of approximately \$3 million, lower compensation expense and incremental restructuring simplification benefits.

Operating expense for the six months ended December 31, 2018 was \$237.9 million compared to \$242.7 million for the six months ended December 31, 2017. The decrease was primarily due to favorable currency exchange impact of approximately \$4 million and incremental restructuring simplification benefits.

Table of Contents

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

We invested further in technology and innovation to continue delivering high quality products to our customers. Research and development expenses included in operating expense totaled \$8.9 million and \$9.5 million for the three months ended December 31, 2018 and 2017, respectively, and \$18.6 million and \$19.1 million for the six months ended December 31, 2018 and 2017, respectively.

RESTRUCTURING AND RELATED CHARGES AND ASSET IMPAIRMENT CHARGES

In the June quarter of fiscal 2018, we implemented and substantially completed restructuring actions to simplify the Industrial segment's cost structure by directing resources to more profitable business and increasing sales force productivity. We supplemented this with the rationalization of small manufacturing facilities in the Infrastructure and Industrial segments, which we expect to complete in fiscal 2019. Total restructuring and related charges since inception of \$13.9 million have been recorded for this program through December 31, 2018.

We recorded restructuring and related charges of \$2.1 million and \$1.5 million for the three months ended December 31, 2018 and 2017, respectively. Of these amounts, restructuring charges totaled \$1.5 million for the three months ended December 31, 2018 and were less than \$0.1 million for the three months ended December 31, 2017.

Restructuring-related charges of \$0.6 million and \$1.3 million were recorded in cost of goods sold for the three months ended December 31, 2018 and 2017, respectively. For the three months ended December 31, 2017, restructuring-related charges of \$0.2 million were recorded in operating expense.

We recorded restructuring and related charges of \$3.1 million and \$8.4 million for the six months ended December 31, 2018 and 2017, respectively. Of these amounts, restructuring charges totaled \$2.6 million and \$5.6 million, respectively. Restructuring-related charges of \$0.5 million and \$2.5 million were recorded in cost of goods sold for the six months ended December 31, 2018 and 2017, respectively. For the six months ended December 31, 2017, restructuring-related charges of \$0.3 million were recorded in operating expense.

INTEREST EXPENSE

Interest expense for the three months ended December 31, 2018 increased to \$8.1 million compared to \$7.2 million for the three months ended December 31, 2017. Interest expense for the six months ended December 31, 2018 increased to \$16.2 million compared to \$14.4 million for the six months ended December 31, 2017. Both increases were primarily due to the incremental interest expense associated with the \$300.0 million of 4.625 percent Senior Unsecured Notes due 2028 issued in June 2018. On July 9, 2018, the Company completed the early redemption of its previously outstanding \$400.0 million of 2.650 percent Senior Unsecured Notes due 2019.

OTHER INCOME, NET

Other income for the three months ended December 31, 2018 increased to \$4.0 million compared to \$3.2 million for the three months ended December 31, 2017 primarily due to lower foreign currency transaction losses, partially offset by lower pension income in the current quarter.

Other income for the six months ended December 31, 2018 decreased to \$6.8 million compared to \$7.4 million for the six months ended December 31, 2017 primarily due to lower pension income in the current period, partially offset by lower foreign currency transaction losses.

PROVISION FOR INCOME TAXES

The effective income tax rates for the three months ended December 31, 2018 and 2017 were 24.8 percent and 29.3 percent, respectively. The current year rate reflects the lower U.S. federal statutory tax rate, the \$6.1 million charge related to changes in the indefinite reinvestment assertion on certain foreign subsidiaries' undistributed earnings which

are no longer considered permanently reinvested, the tax on global intangible low-taxed income (GILTI) and the \$3.9 million benefit recorded to reflect the finalization of the amount of the one-time tax that is imposed on our unremitted foreign earnings (Toll Tax). The prior year rate includes the tax effects associated with the release of a valuation allowance that was previously recorded against our net deferred tax assets in the U.S. and a charge related to an out of period adjustment.

Table of Contents

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

The effective income tax rates for the six months ended December 31, 2018 and 2017 were 24.9 percent. The current year rate reflects the lower U.S. federal statutory tax rate, the \$6.1 million charge related to changes in the indefinite reinvestment assertion on certain foreign subsidiaries' undistributed earnings which are no longer considered permanently reinvested, GILTI and the \$3.9 million benefit recorded to reflect the finalization of the amount of the Toll Tax. The prior year rate includes a benefit from the release of a valuation allowance that was previously recorded against our net deferred tax assets in the U.S. and a charge related to an out of period adjustment.

See Note 13 in our condensed consolidated financial statements set forth in Part I, Item 1 of this Quarterly Report on Form 10-Q.

BUSINESS SEGMENT REVIEW

We operate three reportable segments consisting of Industrial, Widia and Infrastructure. Expenses that are not allocated are reported in Corporate. Segment determination is based upon the manner in which we organize segments for making operating decisions and assessing performance and the availability of separate financial results.

Our sales and operating income by segment are as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	December 31, 2018	2017	December 31, 2018	2017
Sales:				
Industrial	\$317,320	\$312,448	\$637,878	\$609,912
Widia	48,954	47,744	97,626	92,987
Infrastructure	221,120	211,153	438,576	410,900
Total sales	\$587,394	\$571,345	\$1,174,080	\$1,113,799
Operating income:				
Industrial	\$57,519	\$40,504	\$116,061	\$72,543
Widia	1,728	474	3,822	154
Infrastructure	20,614	23,833	44,474	44,223
Corporate	(1,003)	(1,170)	(2,347)	(1,108)
Total operating income	78,858	63,641	162,010	115,812
Interest expense	8,104	7,231	16,201	14,379
Other income, net	(4,022)	(3,220)	(6,782)	(7,437)
Income from continuing operations before income taxes	\$74,776	\$59,630	\$152,591	\$108,870

INDUSTRIAL

(in thousands, except operating margin)	Three Months Ended		Six Months Ended	
	December 31, 2018	2017	December 31, 2018	2017
Sales	\$317,320	\$312,448	\$637,878	\$609,912
Operating income	57,519	40,504	116,061	72,543
Operating margin	18.1	% 13.0	% 18.2	% 11.9
	Three Months Ended December 31, 2018		Six Months Ended December 31, 2018	
(in percentages)				
Organic sales growth	3%		7%	
Foreign currency exchange impact ⁽¹⁾	(4)		(3)	
Business days impact ⁽²⁾	3		1	

Sales growth

2%

5%

26

Table of Contents

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

(in percentages)	Three Months Ended December 31, 2018		Six Months Ended December 31, 2018	
	As Reported	Constant Currency	As Reported	Constant Currency
End market sales growth (decline):				
Aerospace and defense	18%	22%	18%	20%
General engineering	6	9	8	10
Energy	3	6	3	5
Transportation	(9)	(5)	(3)	1
Regional sales growth (decline):				
Americas	10%	12%	10%	12%
EMEA	—	5	2	6
Asia Pacific	(8)	(4)	—	4

For the three months ended December 31, 2018, Industrial sales increased 2 percent from the prior year quarter. Sales in aerospace benefited from higher demand for engines and frames globally as well as strength in accessory sales in the Americas. General engineering sales experienced growth from strength in the indirect channel particularly in the Americas. Energy growth was driven primarily by oil and gas drilling in the Americas, and sales in Asia and EMEA to transportation OEMs were weaker than in the prior year quarter primarily due to lower production levels. The sales increase in the Americas was driven primarily by increases in the general engineering and aerospace end markets, while growth in EMEA, excluding the unfavorable impact of currency exchange, was mostly due to increases in the general engineering and aerospace end markets, partially offset by a decrease in transportation. The sales decrease in Asia Pacific was primarily driven by a decline in the transportation end market in China.

For the three months ended December 31, 2018, Industrial operating income increased by \$17.0 million, driven primarily by organic sales growth and incremental simplification/modernization benefits, partially offset by a temporary increase in manufacturing expenses at certain locations due to the timing of simplification/modernization efforts underway.

For the six months ended December 31, 2018, Industrial sales increased 5 percent from the prior year period. Sales in aerospace benefited from higher demand for engines and frames globally as well as accessory sales in the Americas. General engineering sales experienced growth from strength in the indirect channel particularly in the Americas and a more robust light and general engineering sector in EMEA. Energy growth was driven primarily by oil and gas drilling in the Americas. Sales in Asia and EMEA to transportation OEMs were weaker than in the prior year period, while sales to transportation suppliers increased in the Americas and EMEA. The sales increase in the Americas was primarily driven by the performance in the general engineering, aerospace and energy end markets. The sales increase in EMEA was primarily driven by growth in the general engineering and aerospace end markets, while the increase in Asia Pacific, excluding the unfavorable impact of currency exchange, was driven by growth in general engineering and aerospace, partially offset by a decrease in transportation.

For the six months ended December 31, 2018, Industrial operating income increased by \$43.5 million, driven primarily by organic sales growth, incremental simplification/modernization benefits and favorable mix, partially offset by a temporary increase in manufacturing expenses at certain locations due to the timing of simplification/modernization efforts underway and higher raw material costs.

WIDIA

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	Three Months Ended		Six Months Ended			
	December 31,		December 31,			
(in thousands)	2018	2017	2018	2017		
Sales	\$48,954	\$47,744	\$97,626	\$92,987		
Operating income	1,728	474	3,822	154		
Operating margin	3.5	% 1.0	% 3.9	% 0.2	%	%

27

Table of Contents

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

(in percentages)	Three Months Ended December 31, 2018	Six Months Ended December 31, 2018
Organic sales growth	4%	7%
Foreign currency exchange impact ⁽¹⁾ (4)		(3)
Business days impact ⁽²⁾	3	1
Sales growth	3%	5%

(in percentages)	Three Months Ended December 31, 2018		Six Months Ended December 31, 2018	
	As Reported	Constant Currency	As Reported	Constant Currency
Regional sales growth:				
Asia Pacific	5%	12%	12%	18%
EMEA	2	8	4	9
Americas	2	2	1	2

For the three and six months ended December 31, 2018, Widia sales increased 3 percent and 5 percent, respectively, from the prior year period. For both periods, strong sales in Asia Pacific were mainly driven by accelerating results in India, followed by sales growth in EMEA which reflects progress with aerospace growth initiatives. In the Americas we continued to make steady progress in establishing an effective distribution network and have exited portions of our portfolio in order to improve profitability.

For the three months ended December 31, 2018, Widia operating income increased by \$1.3 million primarily due to organic sales growth. For the six months ended December 31, 2018, Widia operating income increased by \$3.7 million primarily due to organic sales growth and \$0.9 million less restructuring and related charges in the current period.

INFRASTRUCTURE

(in thousands)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Sales	\$221,120	\$211,153	\$438,576	\$410,900
Operating income	20,614	23,833	44,474	44,223
Operating margin	9.3	% 11.3	% 10.1	% 10.8

(in percentages)	Three Months Ended December 31, 2018	Six Months Ended December 31, 2018
Organic sales growth	4%	7%
Foreign currency exchange impact ⁽¹⁾ (1)		(1)
Business days impact ⁽²⁾	2	1
Sales growth	5%	7%

Table of Contents

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

(in percentages)	Three Months Ended December 31, 2018		Six Months Ended December 31, 2018	
	As Reported	Constant Currency	As Reported	Constant Currency
End market sales growth (decline):				
Energy	18%	19%	18%	18%
General engineering	7	9	9	11
Earthworks	(9)	(7)	(5)	(3)
Regional sales growth (decline):				
Americas	6%	7%	9%	9%
Asia Pacific	2	7	6	10
EMEA	1	4	(1)	1

For the three months ended December 31, 2018, Infrastructure sales increased by 5 percent from the prior year quarter. The U.S. oil and gas market drove year-over-year growth in energy with average U.S. land rig counts up 17 percent compared to the prior year quarter, while strong growth in general engineering was driven primarily by more robust activity in the general economy across all regions. Earthworks end market sales were down year-over-year due primarily to timing of large projects in the Americas. The sales increases in all regions were driven primarily by the performance in the energy and general engineering end markets.

For the three months ended December 31, 2018, Infrastructure operating income decreased by \$3.2 million driven primarily by higher raw material costs, partially offset by organic sales growth, favorable mix and incremental simplification/modernization benefits.

For the six months ended December 31, 2018, Infrastructure sales increased by 7 percent from the prior year period. The U.S. oil and gas market drove year-over-year growth in energy with average U.S. land rig counts up 14 percent compared to the prior year period, while strong growth in general engineering was driven primarily by more robust activity in the general economy across all regions. Earthworks end market sales were down year-over-year due to continuing disruption in South African coal production and softness in construction activities in the Americas and EMEA. The sales increase in the Americas was driven primarily by growth in the energy and general engineering end markets, partially offset by a decrease in earthworks, while the sales increase in Asia Pacific was driven by growth in all three end markets: earthworks, energy, and general engineering. The slight increase in EMEA, excluding the unfavorable impact of currency exchange, was driven by the energy and general engineering end markets, partially offset by declines in the earthworks end market.

For the six months ended December 31, 2018, Infrastructure operating income remained flat compared to the prior year period. Increases driven by organic sales growth, favorable mix, \$1.9 million less restructuring and related charges in the current period and incremental simplification/modernization benefits were offset by higher raw material costs.

CORPORATE

(in thousands)	Three Months Ended December 31,		Six Months Ended December 31,	
	2018	2017	2018	2017
Corporate expense	\$(1,003)	\$(1,170)	\$(2,347)	\$(1,108)

For the three months ended December 31, 2018, Corporate expense decreased by \$0.2 million from the prior year quarter. For the six months ended December 31, 2018, Corporate expense increased by \$1.2 million from the prior year period primarily driven by higher employment expenses.

LIQUIDITY AND CAPITAL RESOURCES

Cash flow from operations is the primary source of funding for capital expenditures. For the six months ended December 31, 2018, cash flow provided by operating activities was \$61.5 million, primarily due to the net inflow from net income with adjustments for non-cash items, partially offset by a net outflow from changes in other assets and liabilities.

Table of Contents

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

Our five-year, multi-currency, revolving credit facility, as amended and restated in June 2018 (Credit Agreement), is used to augment cash from operations and is an additional source of funds. The Credit Agreement provides for revolving credit loans of up to \$700.0 million for working capital, capital expenditures and general corporate purposes. The Credit Agreement allows for borrowings in U.S. dollars, euros, Canadian dollars, pounds sterling and Japanese yen. Interest payable under the 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 Credit Agreement matures in June 2023.

The 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 Credit Agreement). We were in compliance with all such covenants as of December 31, 2018. For the six months ended December 31, 2018, average daily borrowings outstanding under the Credit Agreement were approximately \$17.3 million. We had no borrowings outstanding under the Credit Agreement as of December 31, 2018 and June 30, 2018. Borrowings under the Credit Agreement are guaranteed by our significant domestic subsidiaries.

During the three months ended December 31, 2018, we finalized the accounting for the Toll Tax charge and the remeasurement of deferred tax assets and liabilities at the reduced U.S. federal rate of 21.0 percent based upon USDT regulations and other relevant guidance issued through December 31, 2018. The adjustment to the Toll Tax charge during the quarter resulted in an additional net benefit of \$3.9 million, decreasing the total Toll Tax charge to \$78.0 million. We do not expect to make a cash payment associated with the Toll Tax.

In addition to the direct effects of TCJA, the provisions of TCJA caused the Company to re-evaluate its permanent reinvestment assertion in all jurisdictions, concluding that a portion of the unremitted earnings and profits of certain non-U.S. subsidiaries and affiliates will no longer be permanently reinvested. These changes in assertion required the recognition of a tax charge of \$6.1 million primarily for foreign withholding and U.S. state income taxes. The remaining amount of unremitted earnings of non-U.S. subsidiaries continue to be indefinitely reinvested. With regard to the unremitted earnings which remain indefinitely reinvested, 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, 2018, cash and cash equivalents were \$96.3 million, Total Kennametal Shareholders' equity was \$1,269.7 million and total debt was \$595.1 million. Our current senior credit ratings are at investment grade levels. We believe that our current financial position, liquidity and credit ratings provide us access to the capital markets. We believe that we have sufficient resources available to meet cash requirements for the next 12 months. 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.

Other than the completion of the early redemption of our previously outstanding \$400.0 million of 2.650 percent Senior Unsecured Notes due 2019 on July 9, 2018, there have been no material changes in our contractual obligations and commitments since June 30, 2018.

Cash Flow Provided by Operating Activities

During the six months ended December 31, 2018, cash flow provided by operating activities was \$61.5 million, compared to \$41.1 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 \$186.4 million and changes in certain assets and liabilities netting to an outflow of \$124.9 million. Contributing to the changes in certain assets and liabilities were a decrease in accounts payable and accrued liabilities of \$82.8 million and an increase in inventories of \$59.2 million due in part to increasing demand and raw material price increases. Partially offsetting these cash

outflows was a decrease in accounts receivable of \$14.0 million.

During the six months ended December 31, 2017, cash flow used for operating activities consisted of net income and non-cash items amounting to an inflow of \$161.1 million and changes in certain assets and liabilities netting to an outflow of \$120.0 million. Contributing to the changes in certain assets and liabilities were a decrease of accounts payable and accrued liabilities of \$92.3 million, a decrease in accrued pension and postretirement benefits of \$13.8 million and an increase in inventories of \$9.1 million due in part to increasing volumes.

Cash Flow Used for Investing Activities

Cash flow used for investing activities was \$85.5 million for the six months ended December 31, 2018, compared to \$58.4 million for the prior year period. During the current year period, cash flow used for investing activities included capital expenditures, net of \$85.6 million, which consisted primarily of equipment upgrades and modernization initiatives.

Table of Contents

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

For the six months ended December 31, 2017, cash flow used for investing activities included capital expenditures, net of \$58.7 million, which consisted primarily of equipment upgrades.

Cash Flow Used for Financing Activities

Cash flow used for financing activities was \$432.7 million for the six months ended December 31, 2018 compared to \$17.3 million in the prior year period. During the current year period, cash flow used for financing activities included outflows of \$400.0 million of term debt repayments from the early extinguishment of our 2.650 percent Senior Unsecured Notes, \$32.8 million of cash dividends paid to Shareholders and \$2.2 million of the effect of employee benefit and stock plans and dividend reinvestment, partially offset by an inflow from a net increase in notes payable of \$2.5 million.

For the six months ended December 31, 2017, cash flow used for financing activities included outflows of \$32.5 million of cash dividends paid to Shareholders, partially offset by an inflow of \$15.0 million of the effect of employee benefit and stock plans and dividend reinvestment.

FINANCIAL CONDITION

Working capital was \$707.0 million at December 31, 2018, an increase of \$47.3 million from \$659.6 million at June 30, 2018. The increase in working capital was primarily driven by a decrease in current maturities of long-term debt of \$399.3 million due to the early redemption of our \$400 million of 2.650 percent Senior Unsecured Notes, an increase in inventories of \$53.1 million due primarily to increasing demand and raw material price increases, a decrease in accrued expenses of \$37.5 million primarily due to payroll timing and lower accrued vacation pay, a decrease in other current liabilities of \$26.7 million primarily due to bonus and restructuring payments and a decrease in accounts payable of \$23.6 million. Partially offsetting these items was a decrease in cash and cash equivalents of \$459.9 million, a decrease in accounts receivable of \$20.6 million and an increase in accrued income taxes of \$10.0 million due primarily to increased taxable income in taxpaying jurisdictions. Currency exchange rate effects decreased working capital by a total of approximately \$12 million, the impact of which is included in the aforementioned changes.

Property, plant and equipment, net increased \$30.9 million from \$824.2 million at June 30, 2018 to \$855.1 million at December 31, 2018, primarily due to capital additions of \$88.0 million, partially offset by depreciation expense of \$47.8 million, a negative currency exchange impact of approximately \$7 million and disposals of \$2.5 million.

At December 31, 2018, other assets were \$557.0 million, an increase of \$1.6 million from \$555.4 million at June 30, 2018. The primary driver for the increase was an increase in other assets of \$12.4 million primarily due to an increase in pension plan assets, partially offset by an \$8.0 million decrease in other intangible assets, which was due to amortization expense of \$7.1 million and unfavorable currency exchange effects of approximately \$1 million, and a decrease in goodwill of \$1.8 million primarily due to unfavorable currency exchange effects.

Kennametal Shareholders' equity was \$1,269.7 million at December 31, 2018, an increase of \$75.4 million from \$1,194.3 million at June 30, 2018. The increase was primarily due to net income attributable to Kennametal of \$111.4 million and capital stock issued under employee benefit and stock plans of \$11.1 million, partially offset by cash dividends paid to Shareholders of \$32.8 million and unfavorable currency exchange of \$18.9 million.

DISCUSSION OF CRITICAL ACCOUNTING POLICIES

Effective July 1, 2018 with the adoption of Financial Accounting Standards Board (FASB) guidance on revenue from contracts with customers, our critical accounting policy for revenue recognition has been modified. 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 our revenue accounting policy.

There have been no other changes to our critical accounting policies since June 30, 2018.

NEW ACCOUNTING STANDARDS

See Note 2 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.

31

Table of Contents

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

RECONCILIATION OF FINANCIAL MEASURES NOT DEFINED BY U.S. GAAP

In accordance with SEC rules, below are the definitions of the non-GAAP financial measures we use in this report and the reconciliation of these measures to the most closely related GAAP financial measure. We believe that these measures provide useful perspective on underlying business trends and results and provide a supplemental measure of year-over-year results. The non-GAAP financial measures described below are used by management in making operating decisions, allocating financial resources and for business strategy purposes. These measures may be useful to investors as they provide supplemental information about business performance and provide investors a view of our business results through the eyes of management. These non-GAAP financial measures are not intended to be considered by the user in place of the related GAAP financial measure, but rather as supplemental information to our business results. These non-GAAP financial measures may not be the same as similar measures used by other companies due to possible differences in method and in the items or events being adjusted.

Organic sales growth Organic sales growth is a non-GAAP financial measure of sales growth (which is the most directly comparable GAAP measure) excluding the impacts of acquisitions, divestitures, business days and foreign currency exchange from year-over-year comparisons. We believe this measure provides investors with a supplemental understanding of underlying sales trends by providing sales growth on a consistent basis. Also, we report organic sales growth at the consolidated and segment levels.

Constant currency end market sales growth (decline) Constant currency end market sales growth (decline) is a non-GAAP financial measure of sales growth (decline) (which is the most directly comparable GAAP measure) by end market excluding the impacts of acquisitions, divestitures and foreign currency exchange from year-over-year comparisons. We note that, unlike organic sales growth, constant currency end market sales growth (decline) does not exclude the impact of business days. We believe this measure provides investors with a supplemental understanding of underlying end market trends by providing end market sales growth (decline) on a consistent basis. Also, we report constant currency end market sales growth (decline) at the consolidated and segment levels. Widia sales are reported only in the general engineering end market. Therefore, we do not provide constant currency end market sales growth for the Widia segment and, thus, do not include a reconciliation for that metric.

Constant currency regional sales growth (decline) Constant currency regional sales growth (decline) is a non-GAAP financial measure of sales growth (decline) (which is the most directly comparable GAAP measure) by region excluding the impacts of acquisitions, divestitures and foreign currency exchange from year-over-year comparisons. We note that, unlike organic sales growth, constant currency regional sales growth (decline) does not exclude the impact of business days. We believe this measure provides investors with a supplemental understanding of underlying regional trends by providing regional sales growth (decline) on a consistent basis. Also, we report constant currency regional sales growth (decline) at the consolidated and segment levels.

Reconciliations of organic sales growth to sales growth are as follows:

Three Months Ended December 31, 2018	Industrial	Widia	Infrastructure	Total
Organic sales growth	3%	4%	4%	4%
Foreign currency exchange impact ⁽¹⁾	(4)	(4)	(1)	(3)
Business days impact ⁽²⁾	3	3	2	2
Sales growth	2%	3%	5%	3%
Six Months Ended December 31, 2018	Industrial	Widia	Infrastructure	Total
Organic sales growth	7%	7%	7%	7%
Foreign currency exchange impact ⁽¹⁾	(3)	(3)	(1)	(3)
Business days impact ⁽²⁾	1	1	1	1
Sales growth	5%	5%	7%	5%

Table of Contents

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

Reconciliations of constant currency end market sales growth (decline) to end market sales growth (decline)⁽³⁾, are as follows:

Industrial

Three Months Ended December 31, 2018	General engineering	Transportation	Aerospace and defense	Energy
Constant currency end market sales growth (decline)	9%	(5)%	22%	6%
Foreign currency exchange impact ⁽¹⁾	(3)	(4)	(4)	(3)
End market sales growth (decline) ⁽³⁾	6%	(9)%	18%	3%

Infrastructure

Three Months Ended December 31, 2018	Energy	Earthworks	General engineering
Constant currency end market sales growth (decline)	19%	(7)%	9%
Foreign currency exchange impact ⁽¹⁾	(1)	(2)	(2)
End market sales growth (decline) ⁽³⁾	18%	(9)%	7%

Total

Three Months Ended December 31, 2018	General engineering	Transportation	Aerospace and defense	Energy	Earthworks
Constant currency end market sales growth	8%	(5)%	22%	15%	(7)%
Foreign currency exchange impact ⁽¹⁾	(3)	(4)	(4)	(1)	(2)
End market sales growth (decline) ⁽³⁾	5%	(9)%	18%	14%	(9)%

Industrial

Six Months Ended December 31, 2018	General engineering	Transportation	Aerospace and defense	Energy
Constant currency end market sales growth	10%	1%	20%	5%
Foreign currency exchange impact ⁽¹⁾	(2)	(4)	(2)	(2)
End market sales growth ⁽³⁾	8%	(3)%	18%	3%

Infrastructure

Six Months Ended December 31, 2018	Energy	Earthworks	General engineering
Constant currency end market sales growth (decline)	18%	(3)%	11%
Foreign currency exchange impact ⁽¹⁾	—	(2)	(2)
End market sales growth (decline) ⁽³⁾	18%	(5)%	9%

Total

Six Months Ended December 31, 2018	General engineering	Transportation	Aerospace and defense	Energy	Earthworks
Constant currency end market sales growth	10%	1%	20%	15%	(3)%
Foreign currency exchange impact ⁽¹⁾	(2)	(4)	(2)	(1)	(2)
End market sales growth (decline) ⁽³⁾	8%	(3)%	18%	14%	(5)%

Table of Contents

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

Reconciliations of constant currency regional sales growth (decline) to reported regional sales growth (decline)⁽⁴⁾, are as follows:

	Three Months Ended			Six Months Ended		
	December 31, 2018			December 31, 2018		
	Americas	EMEA	Asia Pacific	Americas	EMEA	Asia Pacific
Industrial						
Constant currency regional sales growth	12%	5%	(4)%	12%	6%	4%
Foreign currency exchange impact ⁽¹⁾	(2)	(5)	(4)	(2)	(4)	(4)
Regional sales growth (decline) ⁽⁴⁾	10%	—%	(8)%	10%	2%	—%
Widia						
Constant currency regional sales growth	2%	8%	12%	2%	9%	18%
Foreign currency exchange impact ⁽¹⁾	—	(6)	(7)	(1)	(5)	(6)
Regional sales growth ⁽⁴⁾	2%	2%	5%	1%	4%	12%
Infrastructure						
Constant currency regional sales growth	7%	4%	7%	9%	1%	10%
Foreign currency exchange impact ⁽¹⁾	(1)	(3)	(5)	—	(2)	(4)
Regional sales growth (decline) ⁽⁴⁾	6%	1%	2%	9%	(1)%	6%
Total						
Constant currency regional sales growth	9%	5%	2%	10%	5%	7%
Foreign currency exchange impact ⁽¹⁾	(2)	(5)	(5)	(1)	(4)	(3)
Regional sales growth (decline) ⁽⁴⁾	7%	—%	(3)%	9%	1%	4%

⁽¹⁾ Foreign currency exchange impact is calculated by dividing the difference between current period sales at prior period foreign exchange rates and prior period sales by prior period sales.

⁽²⁾ Business days impact is calculated by dividing the year-over-year change in weighted average working days (based on mix of sales by country) by prior period weighted average working days.

⁽³⁾ Aggregate sales for all end markets sum to the sales amount presented on Kennametal's financial statements.

⁽⁴⁾ Aggregate sales for all regions sum to the sales amount presented on Kennametal's financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes to our market risk exposures since June 30, 2018.

Table of Contents

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, 2018 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.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are party to legal claims and proceedings that arise in the ordinary course of business, which may relate to our operations or assets, including real, tangible or intellectual property. Although certain of these types of actions are currently pending, we do not believe that any individual proceeding is material or that our pending legal proceedings in the aggregate are material to Kennametal. See "Note 12. Environmental Matters" for a discussion of our exposure to certain environmental liabilities.

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

Period	Total Number of Shares Purchased ⁽¹⁾	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 ⁽²⁾
October 1 through October 31, 2018	216	\$ 39.50	—	10,100,100
November 1 through November 30, 2018	2,024	39.84	—	10,100,100
December 1 through December 31, 2018	10,734	32.62	—	10,100,100
Total	12,974	\$ 33.86	—	

During the current period, 1,341 shares were purchased on the open market on behalf of Kennametal to fund the (1) Company's dividend reinvestment program. Also, during the current period employees delivered 11,633 shares of restricted stock to Kennametal, upon vesting, to satisfy tax withholding requirements.

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

UNREGISTERED SALES OF EQUITY SECURITIES

None.

ITEM 6. EXHIBITS

(31)	Rule 13a-14(a)/15d-14(a) Certifications	
(31.1)	<u>Certification executed by Christopher Rossi, President and Chief Executive Officer of Kennametal Inc.</u>	Filed herewith.
(31.2)	<u>Certification executed by Damon J. Audia, Vice President and Chief Financial Officer of Kennametal Inc.</u>	Filed herewith.
(32)	Section 1350 Certifications	
(32.1)	<u>Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Christopher Rossi, President and Chief Executive Officer of Kennametal Inc., and Damon J. Audia, Vice President and Chief Financial Officer of Kennametal Inc.</u>	Filed herewith.
(101)	XBRL	
(101.INS)	XBRL Instance Document	Filed herewith.
(101.SCH)	XBRL Taxonomy Extension Schema Document	

(101.CAL) XBRL Taxonomy Extension Calculation Linkbase Document

(101.DEF) XBRL Taxonomy Definition Linkbase

(101.LAB) XBRL Taxonomy Extension Label Linkbase Document

(101.PRE) XBRL Taxonomy Extension Presentation Linkbase Document

Filed
herewith.
Filed
herewith.
Filed
herewith.
Filed
herewith.

Table of Contents

SIGNATURES

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

KENNAMETAL INC.

Date: February 5, 2019 By: /s/ Patrick S. Watson
Patrick S. Watson
Vice President Finance and Corporate Controller