Kimball Electronics (Q4 / FY 2019 Results)

August 1, 2019

Corporate Speakers:

- Donald Charron; Kimball Electronics, Inc.; Chairman & CEO
- Michael Sergesketter; Kimball Electronics, Inc.; VP & CFO

Participants:

- Michael Morales; Walthausen & Co., LLC; Research Analyst

PRESENTATION

Operator: Good morning, ladies and gentlemen. My name is Mel, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics Fourth Quarter Fiscal Conference Call 2019. (Operator Instructions).

Today's call, August 1, 2019, will be recorded and may contain forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. Risk factors that may influence the outcome of forward-looking statements can be seen in Kimball's annual report on Form 10-K for the year ended June 30, 2018, and in today's release.

The panel for today's call is Don Charron, Chairman of the Board and Chief Executive Officer; and Mike Sergesketter, Vice President and Chief Financial Officer of Kimball Electronics.

I would now like to turn today's call over to Don Charron. Mr. Charron, you may begin.

Donald Charron: Thank you, Mel, and welcome, everyone, to our fourth quarter conference call. Our earnings release was issued yesterday afternoon on the results of our fourth quarter and fiscal year ended June 30, 2019. We have posted a financial summary presentation to accompany this conference call.

The presentation can be found on our Investor Relations website within the Events and Presentations tab. Or if you are listening via the webcast, you can follow along by advancing the slides or download them from the Downloads tab on the webcast portal.

I will begin by making a few remarks on the overall quarter, and then I will turn it over to Mike for the financial overview. After that, we will answer any questions that you may have.

We delivered record sales in our fourth quarter fiscal year 2019, and the full fiscal year 2019 was another record-breaking year for our company as we achieved double-digit sales growth for the fourth time in the past 5 years.

Since fiscal year 2015, our first year as a stand-alone public company, our net sales have increased 44%. We are extremely pleased with the success that we have had with the organic growth of our business even while experiencing softness in select markets. We recognize that there is still work to do to achieve our profitability goals.

As new programs ramp up to projected run rates and we drive improvements in the GES operations, we expect to realize leverage from our sales growth. With the dedication and commitment of our associates around the world, we will continue our relentless pursuit to create greater value for our shareowners.

Strong double-digit growth in 3 of our 4 end market verticals helped to set a new quarterly record for the fourth quarter of fiscal year 2019. New program launches and ramp-ups more than offset continued softness in certain other programs primarily caused by global macroeconomic conditions and trade uncertainties.

Our newly acquired GES business continues to be sluggish as we cycle through the downturn of the semiconductor and smart mobile device manufacturing end markets, which are the primary end markets that GES serves today. Our acquisition integration work with GES, including our growth and diversification strategy, continues as we remain focused on our overall strategy to become a multifaceted manufacturing solutions company.

Our operating margin came in below our target and our expectations, which was disappointing given our exceptional performance in the third quarter of fiscal year 2019. In addition to the impact from the slow start from GES, we experienced lower margins with the increase of certain new programs ramping up as well as higher labor and benefit costs.

Across all of our units, we continue to drive Lean Six Sigma projects and global supply chain initiatives to improve yield and throughput and drive improvement in our margins. Margin expansion and capital efficiency will continue to be priorities of focus for us going forward.

In general, component availability continues to improve, and we are experiencing fewer component shortages. We increased our inventory levels during the prior periods to minimize disruption. As supply catches up to demand, we expect to work our inventory back down to normal levels.

Our cash conversion days increased to 77 days for the quarter ended June 30, 2019, which is up from 63 days in the same quarter last year. Accounts receivable days, or DSO, increased 2 days. Our accounts payable, or AP, days decreased 5 days, while inventory, or PDSOH plus CAD, increased 7 days.

Thus far, we have managed to minimize the direct impact of the China tariffs. However, the indirect impact on the overall demand in China and the added strain on supplier and customer relationships continue to be a concern. During the fourth quarter of fiscal year 2019, over $1 million of tariffs on purchased raw material were rebilled to our customers. We are anxiously awaiting the outcome of the U.S. and China trade talks.

We invested $9.8 million in capital expenditures in the fourth quarter of fiscal year 2019, bringing our total for fiscal year 2019 to $25.8 million. I'll remind you, the majority of these capital investments were for capacity expansion and to support the launch and ramp-up of new programs.

During fiscal year 2019, we also returned $23.4 million to our shareowners by purchasing 1.3 million shares of our common stock, which brings our total to $67.9 million and 4.5 million shares purchased since October 2015 under our Board-authorized share repurchase program.

And finally, as I stated earlier, we continue to work diligently on the integration of GES. The acquisition of GES brings us new technologies and capabilities in automation, test and measurement industrial applications and is a significant step on our strategy as a multifaceted manufacturing solutions provider. We are excited about the opportunities to present the GES capabilities to our existing customers and to deploy these technologies and solutions in our own manufacturing facilities.

Now I will turn it over to Mike to discuss our fourth quarter results in more detail. We will then open the call to your questions. Mike?

Michael Sergesketter: Thanks, Don. During my comments, I will be referring to the slide deck Don mentioned, which can be found on our Investor Relations website within the Events and Presentations tab. Or if you're listening via the webcast, you can follow along by advancing the slides on the webcast portal.

As shown on Slide 3, our fourth quarter net sales were a new quarterly record of $318.6 million, which was a 15% increase compared to net sales of $276.8 million in the prior year fourth quarter. Adversely affecting our net sales for the quarter were foreign exchange rates, which reduced our net sales 3% during the fourth quarter a year ago. However, partially offsetting the impact of foreign currency rates were sales resulting from the GES acquisition, which added 2% to our consolidated net sales in the quarter.

Slide 4 represents our net sales mix by vertical market. Three of our 4 end market verticals experienced double-digit growth over the prior year quarter. Our automotive vertical was up 12% compared to the same quarter a year ago as higher demand in North America, largely from new program introductions and, to a lesser extent, Europe, more than offset lower demand in China.

Our medical vertical was up 16% in the current quarter compared to the prior year fourth quarter to a new quarterly record of over $100 million. The year-over-year increase was primarily related to strong demand for existing programs. Our industrial vertical was up 20% from a year ago as a result of additional revenue associated with the current year

GES acquisition, new program introductions and an increase in demand for climate control products.

Lastly, our public safety vertical was up slightly from the prior year fourth quarter.

Our gross margin in the fourth quarter, reflected on Slide 5, was 7.3%, which declined from 8.2% in the fourth quarter of last fiscal year. Our decrease in gross margin in the current year quarter compared to a year ago included an adverse impact from GES on the lower-than-expected volumes as well as unfavorable mix and higher labor and benefit costs, which more than offset the leverage of increased volumes.

Selling and administrative expenses, Slide 6 in the deck, were $13.1 million in the fourth quarter, which were up approximately $1.6 million in absolute dollars and relatively flat as a percentage of net sales compared to the prior year fourth quarter. The increase in selling and administrative absolute dollars was partly related to the amortization of finite live intangible assets, which were acquired with the GES acquisition. We also incurred higher warranty expense and technology-related costs during the quarter.

Adjusted operating income for the fourth quarter, on Slide 7 in the deck, came in at $10.1 million or 3.2% of net sales. This compares to operating income of $11.3 million or 4.1% of net sales in the same period a year ago. The current quarter operating income was adjusted for $200,000 of income recognized related to proceeds received from class action lawsuits of which we were members.

Other income and expense net was an expense of $1.6 million in this fourth quarter, which compares to an expense of $1 million in the fourth quarter of fiscal year 2018. Other expense net in the current year fourth quarter was primarily the result of $1.4 million of interest expense on increased borrowings on our credit facilities, including the financing of the GES acquisition and for general corporate purposes. Other expense net in the prior year fourth quarter was primarily the result of net foreign currency losses from unfavorable exchange rate fluctuations.

The effective tax rate for the current year fourth quarter was approximately 14%. The current year quarter effective tax rate was favorably impacted by approximately $400,000 in both state tax credits and adjustments and federal R&D tax credit adjustments. In the prior year fourth quarter, the effective tax rate was an inflated 43%. The significantly higher prior year quarter rate was largely the result of adjustments related to the U.S. Tax Cuts and Jobs Act, or tax reform, as well as our higher fiscal year 2018 blended U.S. federal tax corporate rate of 28% and a valuation allowance recorded related to state tax credits.

Slide 8 reflects our adjusted net income trend. Our GAAP net income in the fourth quarter of fiscal year 2019 came in at $7.5 million, and we had adjusted net income of $7.4 million after adjusting for the after-tax impact of proceeds received from the class action lawsuits. This compares to GAAP net income of $5.8 million and adjusted net income of $7.2 million in the fourth quarter of fiscal 2018. The non-GAAP adjusted net income of $7.2 million a year ago excluded adjustments related to tax reform.

Diluted earnings per share ended up at $0.29 for the fourth quarter of this fiscal year, which is up from $0.22 of GAAP diluted EPS reported in the same quarter last year and $0.27 after adjusting for the impact from tax reform. Cash and cash equivalents at June 30, 2019, were $49.3 million.

Operating cash flow trends are shown on Slide 11. Our cash flow provided by operating activities during the current year fourth quarter was $12.2 million as cash provided by net income plus noncash items and a decrease in inventories more than offset a decrease in our accounts payable. Our cash flow provided by operating activities in the fourth quarter -- in the prior year fourth quarter was $19.3 million.

Our cash conversion days increased 14 days for the 3 months ended June 30, 2019, when compared to the same period in the prior year largely related to an increase in raw material inventories to maintain appropriate buffer stock levels in the current tight supply environment.

Our cash conversion day calculation compared to the prior year quarter includes 15 days for contract asset days recognized as the result of the new revenue recognition guidance that we adopted during the first quarter of the current fiscal year, which was only partially offset by an 8-day reduction in our PDSOH, or production days sales on hand, our inventory metric.

The contract asset days are a new metric this fiscal year and relate to the acceleration of revenue for work performed to date and recognized over time as we manufacture the product. The majority of our contracts and revenue are now recognized over time in accordance with the new revenue recognition guidance.

The increase from the addition of the contract asset days should primarily be offset with the reduction in the PDSOH inventory days as inventory is relieved when revenue is recognized over time under the new revenue guidance. Also contributing to the increase in cash conversion days compared to the same period a year ago was a 5-day reduction in our accounts payable days and a 2-day increase in our DSO, or days sales outstanding, receivables metric.

Slide 12 reflects our capital and depreciation trends. Capital investments in the fourth quarter totaled $9.8 million largely related to manufacturing equipment to increase capacity and to support new production awards. Borrowings on our credit facilities at June 30, 2019, were $126 million, which were up from $8 million on June 30, 2018.

The increase in borrowings during the current year is in large part related to funding the GES acquisition for working capital needs and for other domestic cash needs, including further repurchases of common stock. Our short-term liquidity available, represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled $111 million at June 30, 2019.

In conclusion, our financial condition is strong, and we are in excellent position to continue the solid growth trend while also driving hard to achieve our operating margin and return on invested capital goals.

With that, I would like to open up today's call to questions from analysts. Mel, do we have any analysts with questions in the queue?

QUESTIONS AND ANSWERS

Operator: (Operator Instructions) We have the first question from Mr. Mike Morales of Walthausen & Co.

Michael Morales: Thinking about gross margins a little bit, you called out some headwinds from GES, some from a mix shift. Can you help -- qualitatively help me think about those buckets as it relates to being a headwind to gross margins in the quarter? And what was the biggest impact?

Donald Charron: Yes. Certainly, the GES performance was a significant portion of the decline in gross margin. But I would also say we saw at least a similar-sized decline in gross margin caused by the other headwinds that we mentioned in terms of increases in labor and benefit cost and a shift in mix.

Michael Morales: So in thinking about GES, if I think back to the second quarter, I think the commentary around then was that the second quarter of our fiscal '19 was kind of a trough for GES and then expectations for the fourth quarter would be stronger. I know the semi end markets have been weak. Has your expectation changed on GES heading into 2020 at all?

Donald Charron: Well, we know that all of this in terms of these end markets isn't new to us. These aren't end markets that we've traditionally played in. And again, it's -- we're not the primary drivers for the acquisition. The technology and what the capabilities of GES would bring to our business ambitions is why we drove the acquisition.

Clearly, we were expecting from a seasonality standpoint, looking at GES' historic results, we were entering into what has traditionally been stronger season for them, speaking about the June ending quarter, for example. The cyclicality part of their business, we're still studying.

And yes, the semiconductor end market vertical and the smart mobile device assembly areas have been the areas that they've traditionally served. And those are both down right now, and we would expect they'll cycle back eventually. I don't know that we have an accurate prediction on when they would cycle back.

But just I will say as good news is they remain solidly positioned with some really key customers in the Bay Area, and their pipeline looks really good in terms of the opportunities there. What we've been experiencing is really more related to push-outs and delays in some of those programs that they're actively working in. So we're excited about what is to come, but we're also watching and learning as we go through this down cycle for them in these core markets they serve.

Michael Morales: Sure, sure. That color was helpful. Thinking about the mix shift, is that -- would I be accurate in saying that that's primarily in the auto from the mature Chinese programs to the ramping U.S. programs in auto?

Donald Charron: That's a good -- the significant majority of it, yes, we -- and the impacts of the utilization within the footprint. So China, obviously, we've been talking about for the last 4 quarters in terms of the downturn in the automotive end market demand there.

And we've been offsetting it with primarily new program ramp-ups in North America, which we knew were coming, and we're excited about our progress there. But as we've explained in the past during these calls, we're most challenged during the start-up, ramp-up phase of these programs. And the majority of the programs that we were producing in China where in, what we would call, a fairly mature state.

Michael Morales: Sure, sure. So I guess, directionally speaking, as these U.S. programs ramp, would it be fair to think about them comparable to potentially better margins than the Chinese programs that you had?

Donald Charron: Comparable.

Michael Sergesketter: Comparable, yes.

Michael Morales: And then last for me, as you see it today, the commentary on the component availability was helpful. Would it be fair to characterize the environment as no longer a headwind, maybe not a tailwind at this point on the availability but at least no longer a headwind as you look into fiscal '20?

Donald Charron: Yes. We would say that. We're seeing improvement in several component categories. Now we also had been working through some inflationary pressure on some of those same components that were hard to get. I would say that those headwinds have not subsided, but we look forward to the, let's say, prices of some of those components that we did see inflation on during the past, let's say, 4 or 5 quarters.

As a result of availability, we would expect that to subside in this period coming up over the next, let's say, 4 to 6 quarters, but we'll see. There's a lot of factors that depend on whether or not we'll go back to, let's say, pre-shortage pricing on some of these component categories.

Operator: (Operator Instructions) No further question at this time. Please go ahead, Mr. Charron.

Donald Charron: Thank you. That brings us to the end of today's call. We appreciate your interest and look forward to speaking with you on our next call. Thank you, and have a great day.

Operator: At this time, listeners may simply hang up to disconnect from the call. Thank you, and have a nice day.