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KE - Q4 2015 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

Don Charron *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Mike Sergesketter *Kimball Electronics Inc. - Vice President and Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Andrew Hong *B. Riley - Analyst*

Valine Mesanith *Don Smith - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentleman. My name is Abigail 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 2015 Financial Results Conference Call.

(Operator Instructions).

Today's call, August 6, 2015, will be recorded and may contain forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. Risk factors may influence outcome of forward-looking statements and can be seen in Kimball's Form 10 declared effective on August - I'm sorry, on October 7, 2014 and today's release.

The panels 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.

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Thank you, Abigail. And welcome everyone to our fourth quarter conference call. Our earnings release was issued this morning on the results of our fourth quarter and fiscal year ended June 30, 2015. We have also 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 find it in the downloads tab on the webcast portal.

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

The spin-off for Kimball International was completed on October 31, 2014 and while the legal separation was complete at that time, there were still several activities remaining to be completed to separate the infrastructure and effectively achieve full separation.

During this period, we have been relying on our former parent company for certain services as outlined by the transition services agreement included in filings with the SEC. We are very pleased to report that this work has now been substantially completed six months ahead of our original schedule. Our support teams did a remarkable job staying focused on the spin related activities and made sure that they did not impact our operations.

Completing these spin related activities will not only allow us to redirect valuable resources to other important initiatives that will also help us lower our cost structure and offset some of the added costs to becoming a standalone public company.



After three consecutive quarters of double-digit growth, we experienced some softness in our fourth quarter. Sales in our industrial vertical were down 11% compared to the fourth quarter of last year. In the first nine months of this fiscal year, sales in our industrial vertical were up 12% compared to the first nine months of last fiscal year. Lower end market demand and customer inventory adjustments primarily contributed to the year-over-year decline in fourth quarter sales.

On a brighter note, sales on our automotive vertical led again by strong demand in the China market were up 7% despite the loss of the JCI business which was down almost \$17 million from the same quarter last year. While our automotive demand for China market remained strong in the fourth quarter, it is important to note that China's Automobile Manufacture Association recently lowered their forecasted growth rate for calendar year 2015 as a slowdown in the China automotive market is expected.

Overall, our book of business is relatively stable and we continue to work closely with our customers to understand their expected demand going forward. We have set a mid-range goal of achieving \$1 billion in annual sales by fiscal year 2018. Our new business opportunities pipeline remains healthy and we will continue to work diligently to achieve that goal.

As I stated in our last call, our business and operations teams are focused on margin improvement and effective capital utilization. Our [lean six sigma] projects and global purchasing initiatives helped us succeed our adjusted operating income goal of 4% for the sixth consecutive quarter. Given the expected slowdown in the China automotive market, the impact of our upcoming ramp up in Romania and the launch of our next generation automation to support multiple new automotive programs, we are keeping our goal of 4% operating income for fiscal year 2016.

We continue to take advantage of the flexibility provided by our strong balance sheet making investments that would drive future growth and sales and profits, new capital to support the European capacity expansion in Romania, and a significant new business wins will in most cases be deployed in advance of the sales growth and therefore put short term pressure on the targets we set for our capital metrics. Maintaining margin improvement and effective capital utilization will continue to be priorities of focus for us going forward.

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

Mike Sergesketter - Kimball Electronics Inc. - Vice President and Chief Financial Officer

Thanks, Don. I'll briefly cover our financial highlights for the fourth quarter and as Don mentioned, we'll then open it up for your questions.

Our fourth quarter net sales were \$201.1 million, an increase of 1% from the prior year fourth quarter. Comparing our sales growth by vertical to the same quarter a year ago, our automotive vertical was up 7% largely on the strength of the China market as Don mentioned.

The impact on sales from JCI - from the JCI exit in the fourth quarter was a \$16.8 million reduction compared to last year. Excluding the impact of JCI, our automotive sales were up 44%, again largely on the strength of the China market.

Our medical vertical was up 3% from both increased demand for existing products and new program awards. As Don mentioned, our industrial vertical was down 11% in Q4 from the prior year as a result of lower end market demand and inventory adjustments for our customers. And our public safety vertical was up 5% compared to a year ago from both increased demand for existing products and new customer awards.

Our gross margin in the fourth quarter was 8.8%, a small decline of 30 basis points from a year ago, however was in line with our expectations. Selling and administrative expenses were down \$1.7 million or 90 basis points as a percent of sales compared to the prior year fourth quarter. The main drivers of the decrease include incremental cost related to the spin-off in the fourth quarter a year ago or \$1.4 million while the spin-off cost in this quarter were not significant.

We are currently moving in to our new headquarters building with the move expected to be completed in the next couple of weeks. With the move, the spin-off will be substantially complete and we do not expect further cost related to the spin-off, to be significant.



Also reduced cost related to the elimination of the former parent charges and allocations more than offset the increase, public company cost and compensation cost related to additional team members we brought on board to support Kimball Electronics as a standalone public company.

Other income and expense was a net expense of \$400,000 in both the current year and the prior year fourth quarters. Changes in foreign exchange rates, net of derivative gains and losses was the primary driver of the other expense.

Effective tax rate for the fourth quarter was 15%. The rate for the quarter was largely favorably impacted by an unusual high mix of earnings in our foreign jurisdictions at lower statutory tax rates compared to the US rates and a [through up] of the estimated annual effective tax rate to the full year rate. The full year fiscal 2015 rate ended at 24.6% which was very close to where we expected our full year rate to be.

Net income in the fourth quarter of fiscal 2015 was \$7.4 million compared to \$5.4 million in the fourth quarter of last year or when excluding spin-off cost, net income was \$6.8 million for Q4 of last year.

Diluted earnings per share was \$0.25 in the fourth quarter of this fiscal year, compared to \$0.18 in the prior year quarter or \$0.23 last year when excluding the spin-off cost.

Cash and cash equivalents to June 30, 2015 were \$65.2 million. Cash flow provided by our operations in the fourth quarter was \$16.8 million driven largely by earnings plus non-cash charges, an increase in our accounts payable.

Capital investments in the fourth quarter totaled \$13.9 million primarily for new manufacturing equipment and progress payments on our Romanian expansion.

We have no long-term debt as of June 30, 2015 and our short-term liquidity available represented as cash and cash equivalents plus the unused amount of our credit facilities totaled \$125.1 million. Our balance sheet continues to be very strong and we think we're well-positioned for growth.

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

Operator

(Operator Instructions). One moment please for the first question. Our first question comes from the line of [Andrew Hong with B. Riley]. Your line is open.

QUESTIONS AND ANSWERS

Andrew Hong - *B. Riley - Analyst*

Thanks for taking my question. You've done a great job back filing the lost JCI business with new customers and programs from China so meaning that's a little bit more of a risk right now. To give us a sense of your exposure to China auto, can you share the percentage of your auto sales to China in the June '15 quarter and then the June '14 quarter as well?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Andrew, this is Don. You know, we don't disclose those figures for competitive reasons. You know, I think you can understand that. But I - we'd also like to tell - a little bit of color on, you know, the sort of forecasted growth rate change perhaps in China, and maybe that will help.



You know, what we've seen obviously in our own business is a rate of growth that is even higher rate of growth than what the automotive market is growing in China. And the reason for that is, you know, we're still ramping up new programs that were awarded, you know, in most cases a year-and-a-half to two years ago so that's affecting our positive growth rate.

And also, you know, in terms of our business in China where we have content and the types of products or product categories that we are in production on, are also, you know, doing very well in the market. For example, in our past calls we mentioned electronic power steering and anti-lock breaks, both are doing very well in terms of the adaption rate in the China market.

And so our growth rate in our China business unit for automotive wouldn't necessarily be pegged directly to the growth rate of the actual automotive market in China. You know, I think the total car market there is predicted to be somewhere around 22 or 23 million vehicles. If in fact, that rate of growth slows to something less than that, it would impact our business, but certainly not a one-to-one correlation given what I have mentioned earlier about where we are in our book of business in China.

Andrew Hong - *B. Riley - Analyst*

Maybe as a follow up to that question. So I think the way to interpret your comment is that whatever automotive unit growth in China is, you should be able to exceed that number, correct? Based on increase in content, new programs ramping?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

That's right. That's right.

Andrew Hong - *B. Riley - Analyst*

Okay. And then maybe you could give us a little bit more color on the industrial [push ups] because it seems like that business was down, I think you said 11% year-over-year, so it looks like it was a pretty sharp decline. Maybe you could give us a sense of when that business or that segment could recover?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Yes. The industrial vertical for us [starkly] has been a vertical where we've experienced the most variation, you know, quarter-to-quarter. As I mentioned in the webcast comment, we actually put the first nine months of this fiscal year. We're experiencing nice growth in the industrial vertical. So yes, it was pretty abrupt to what happened in Q4.

I think the only other explanation than what we've already commented in terms of just end market softness and some inventory adjustments by our customers, we really don't necessarily have the visibility to be able to predict one way or another what we could expect from that vertical going forward.

But I would say that, you know, when we look at some of the largest customers we have in the industrial vertical, it geographically is pretty widespread. We're supporting customers in North America and Europe. And so we hope at least that it gives us a little better opportunity to see a recovery there in the not too distant future. We're not sort of dependent on just one market and one geography.

Andrew Hong - *B. Riley - Analyst*

Okay. Maybe it will be helpful if you give us a sense of how you think gross margins will trend throughout the fiscal year as you work through some of those target expenses you talked about.

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Yes. We have a number of factors that we're working and doing our best to manage our way through.

Certainly the Romanian start up is on our list as we look to get that facility certified by the start-up customers and projects that we selected and start production there. That's a big piece of our story and then - and of course we've got a number of new product introductions that we're working on. That's always going on in our business, but we've got a larger than normal amount going on in the business right now. And so as we work through the launch periods for those new business awards, that too will have impact.

And so as we look at our overall growth margin picture though, we think that we have a good chance to maintain some stability around the gross margins that we've achieved in the past, but maybe trying to improve from that level would be a challenge for us.

As we stated in the press release and also in the comments of the webcast, we're maintaining our operating margin goal of 4% for fiscal year 2016. If you look at 2015, obviously we did better than the 4% goal. So what we're obviously saying is that we're going to have a challenge to maintain our 4% goal, but we think it's achievable and that's why we're keeping the goal for 2016 even though it's lower than what we actually achieved in 2015.

Andrew Hong - *B. Riley - Analyst*

Got it. Okay. And then just one last question if you don't mind. Just some color on the September quarter would be a little helpful. So I was thinking maybe model changeovers and holidays in Europe could cause overall revenue to decrease compared to the June quarter, or will you have enough new business to kind of offset that?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Well certainly, this upcoming quarter, the quarter we've just started our Q1, is the quarter that if there is a seasonality impact and I say, if there is, that's certainly not something that's so pronounced that we could predict it. But you're right, in our automotive practice especially, we have the model year change over here in the US that lot of our customers and their customers go through at this time of year, so it's always a time for us to watch very closely how the demand for our production could change in this period.

And then, yes, we had pretty big [factors] in Europe, and Europe also is really hard to predict given the vacation period peak in August, and just how that could affect overall production demand. So we - you know, we don't have any way to really provide you any accurate sort of data by how it develops here within this quarter, but I would say that we would not, as we have said in the past say that there is a pronounced seasonal effect. It's just we watch very carefully these things happening at this time of the year and how it affects our production demand.

Andrew Hong - *B. Riley - Analyst*

Thanks very much for taking my questions.

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Thank you, Andrew.

Operator

(Operator Instructions). And we have a question from the line of [Valine Mesanith with Don Smith]. Your line is open.



Valine Mesanith - *Don Smith - Analyst*

Hi, Don and Mike. My question relates to the \$1 billion target that you guys have for 2018. Many businesses are struggling to find growth. What gives you confidence in that target and which segment of your business would the growth come from?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Well, you know, the growth rate that we would have to achieve to reach our goal of a billion in 2018 is a compound annual growth rate of about 8%. So that is a pretty significant growth rate for us to set our target on. When we set that target as a management team, we're first looking at our existing book of business and just how we feel about our overall book of business with existing customers and the growth opportunities we have there. And then we're also looking at our new business opportunities pipeline, things that we have recently been awarded and things that we're quoting that we think we've got a good chance to win in the future.

And so those are - that's what we're looking at and that's what we have looked at when we set the target of \$1 billion and yes, we're going to push ourselves hard to achieve that target. We think the growth opportunity is there in our foreign market verticals and we think we're well-positioned to take full advantage of the growth opportunities in the market.

Valine Mesanith - *Don Smith - Analyst*

Am I correct to assume that the bulk of that growth will come from the automotive segment?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Certainly automotive will remain strong for us. I mean it's done well this past year as we've noted even despite - or despite the loss of the JCI business, we still posted some very respectable growth this year. And yes, we have confidence in our automotive vertical that we'll continue to see growth there as we go forward.

As I mentioned in my webcast comments earlier, we were bringing online our next generation automation to support a significant new automotive program that we were awarded last year. And yes, we fully expect that that will enable future growth going forward. So our automotive vertical will be a big part of the story for us reaching a billion dollars in 2018.

Valine Mesanith - *Don Smith - Analyst*

And [add] the billion dollars then, would your financial model look any different or targets, would your targets look any different?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

We're working on that right now in terms of setting some longer and let's say at least mid-range targets beyond 2016 anyway for what we could achieve on the operating income line and we hope to be able to communicate that in the future as we kind of get through fiscal year '16 here in the ramp up in Romania. But we would expect that we would be at least updating our operating income target once we get through this significant period of new business ramp ups and of course bringing Romania online.

Valine Mesanith - *Don Smith - Analyst*

Thanks.



Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Thank you.

Operator

(Operator Instructions). And I'm showing no further - I do apologize. We have a follow up question from the line of Andrew Hong with B. Riley. Your line is open.

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Are you there, Andrew?

Andrew Hong - *B. Riley - Analyst*

Sorry. I was on mute. Thanks for squeezing me in. On the Romania expansion, can you quantify how much investment you have to make and when will the bulk of that investment be done?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Well, first of all, we have in our outlook a little bit about our overall capital expenditure outlook for the upcoming year. You saw that we spent this year in capital expenditures about \$36 million in CapEx for the year and our outlook for this upcoming year is that we would be at a similar level for the upcoming fiscal year and that includes Romania, also includes other investments we're making in the business.

But the total Romania piece, once we get to phase one where we've basically paid for the construction of the building and the phase one equipment going into that facility to support the start-up project will be in the \$10 million to \$15 million range.

Andrew Hong - *B. Riley - Analyst*

Perfect.

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

It is included in the CapEx numbers both from fiscal year '15 and the outlook for fiscal year '16.

Andrew Hong - *B. Riley - Analyst*

Got it. Do you have a targeted date as to when that project phase one will be completed?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

When all the capital will be deployed?



Andrew Hong - *B. Riley - Analyst*

I'm sorry. When phase one of Romania will be completed?

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Well, the construction of the facility is expected to be completed by the end of December of this calendar year. And then we'll then go through getting through the production readiness phase where we're actually building products and shipping on the customers for validation. And that phase could take anywhere from another three to six months after the building is complete or it's dependent upon customer approval of the operation and the validation of the sample units produced but it would be at least another three to six months after the completion of the construction of the facility.

Andrew Hong - *B. Riley - Analyst*

Got it. Okay. Thanks for taking my questions.

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Thank you, Andrew.

Operator

(Operator Instructions). I'm showing no further questions at this time. I'd like to turn the call back to Don Charron for closing remarks.

Don Charron - *Kimball Electronics Inc. - Chairman of the Board and Chief Executive Officer*

Thank you. And 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 good day.

Operator

At this time listeners, you may simply hang up to disconnect from the call.

Thank you and have a nice day.

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