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KE - Q3 2018 Kimball Electronics Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Donald D. Charron** *Kimball Electronics, Inc. - Chairman & CEO*

**Michael K. Sergesketter** *Kimball Electronics, Inc. - VP & CFO*

## CONFERENCE CALL PARTICIPANTS

**Chase Basta**

**Hendi Susanto** *G. Research, LLC - Research Analyst*

## PRESENTATION

### Operator

Good morning, ladies and gentlemen. My name is Norma, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics Third Quarter Fiscal 2018 Financial Results Conference Call. (Operator Instructions)

Today's call, May 3, 2018, 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, 2017, and 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 the call over to Don Charron. You may begin, sir.

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### **Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

Thank you, Norma. And welcome, everyone, to our third quarter conference call. Our earnings release was issued yesterday afternoon on the results of our third quarter ended March 31, 2018. 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 & 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 it over to Mike for the financial overview. After that, we will answer any questions that you may have.

Our sales in the third quarter of fiscal year 2018 were up 10% sequentially from the previous quarter and up 22% when compared to the third quarter of fiscal year 2017. Very strong growth in our automotive and medical end market verticals helped us set a new quarterly sales record for the ninth consecutive quarter. We are now on a pace to significantly exceed our goal, set almost 3 years ago, of \$1 billion in annual sales in fiscal year 2018. As we stated last quarter, our compound annual growth rate, or CAGR, was approximately 8% over the past 3 years and our goal is to sustain this growth rate over the next few years as we look to grow the company beyond \$1 billion in annual sales.

We are pleased to have set new quarterly records for net income and diluted EPS in the third quarter of fiscal year 2018. The fourth quarter of fiscal year 2018 will be a pivotal quarter for our margin expansion efforts, as we continue to focus on yield and throughput improvements on recently launched new programs. For the progress on the ramp-up in Romania to help us achieve our goal of 4.5% operating income.

Our next phase of ramp-up activity in Romania is on track. We expect our sales run rate to more than double from the fourth quarter of fiscal year 2017 to the fourth quarter of fiscal year 2018, and we expect to approach our break-even point for operating income by the end of this next fiscal quarter. The impact of the Romania ramp-up on our third quarter fiscal year 2018 operating income was approximately 50 basis points, so reaching this important milestone will have a measurable effect on our consolidated operating income margin.



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While we have made progress toward our long-term goal of 12.5% ROIC, we still have work to do to achieve this important goal. Margin expansion and capital efficiency will continue to be priorities of focus for us. We continued to leverage our strong balance sheet and cash flow to make investments that would drive further growth in sales and profits. We invested \$7.2 million in capital expenditures in the third quarter of fiscal year 2018, bringing our fiscal year 2018 total to \$22 million.

As we stated during our first and second quarter calls, due to stronger-than-expected demand from several of our existing customers, we expect fiscal year 2018 capital expenditures to approximate the fiscal year 2017 level of \$34 million. We remain focused on doing what's necessary to secure the raw materials in this tight supply market so that we can ramp-up production to the new order levels.

And finally, as we stated on our last call, our work has begun on the implementation of our board approved updated strategic plan. We are committed to optimizing our EMS business by focusing on capital efficiency, margin expansion and high-quality revenue growth, and we are committed to making new investments that will help us develop ourselves beyond EMS to a multifaceted manufacturing solutions company. We are also exploring opportunities that would establish new platforms and create optionality for us in the near future.

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

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**Michael K. Sergesketter** - Kimball Electronics, Inc. - VP & CFO

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 & Presentations tab; or if you're listening via webcast, you can find it in the downloads tab on the webcast portal.

As shown on Slide 3, our third quarter net sales were a record \$283.9 million, which was a 22% increase compared to net sales of \$232.9 million in the prior year third quarter. Partially assisting in the increase from a year ago was the favorable exchange rate movements which accounted for 7% of our net sales growth.

Slide 4 represents our net sales mix by vertical market. Comparing our net sales by vertical to the same quarter a year ago, our automotive vertical was up over 40% compared to a year ago to a new quarterly record of \$136.2 million. The increase from a year ago was largely due to the ramp-up of new program introductions as well as strong demand in all 3 of our geographic markets.

Our medical vertical was up 30% in the current quarter compared to Q3 of last year from both increased demand for existing programs and the ramp-up of new programs.

Our industrial vertical was down a slight 1% from a year ago as increases from the continued ramp-up of new product launches related to smart metering devices was more than offset by the exit of certain programs and softer demand in other existing programs.

Lastly, our public safety vertical was down by double digits from the prior year third quarter as a result of overall demand and programs reaching end of life.

Our gross margin in the third quarter, reflected on Slide 5, was 8.1%, which was up slightly from 8% in the same quarter last year and was flat sequentially from the second quarter of this fiscal year. Our increase in the gross margin in the current year quarter compared to a year ago was the result of leverage from the higher sales, which was partially offset by the impact of costs associated with the support of new product introductions and a less favorable product mix.

Selling and administrative expenses, Slide 6 in the deck, were \$11.7 million in the third quarter, which were up \$2.5 million in absolute dollars, and up 30 basis points compared to the prior year third quarter. The increase in selling and administrative absolute dollars compared to the prior year was in part due to increased employee costs, including salary expense and related benefit costs, and incentive compensation costs, including noncash stock compensation expense which accounted for a 20 basis point increase. Partially offsetting the increased S&A costs were lower expenses related to the normal revaluation of the Supplemental Employee Retirement Plan, or SERP, liability.



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Our operating income for the third quarter, on Slide 7 in the deck, came in at \$11.2 million, or 3.9% of sales, which compares to operating income of \$9.5 million or 4.1% of net sales in the same period a year ago. Other income net was \$1.9 million in the fiscal year 2018 third quarter compared to income of \$300,000 in the third quarter of fiscal year 2017. Other income net, in the current year third quarter was primarily the result of \$2.1 million in net foreign currency exchange gains driven by strengthening of the currencies in our foreign locations compared to the U.S. dollar.

In the prior year third quarter, other income net, included a \$400,000 gain on the fair value of the investments in our Supplemental Employee Retirement Plan and less than \$100,000 in net foreign currency exchange gains.

The effective tax rate for the current year third quarter was 17.5% compared to 17.8% effective tax rate in the prior year third quarter. In the current year quarter, we recognized approximately \$200,000 of discrete tax benefits, including \$100,000 related to a measurement period adjustment in the revaluation of the deferred tax assets associated with tax reform. In the prior year third quarter, we recognized approximately \$500,000 of discrete tax benefits. The reduction in the U.S. corporate tax rate to a blended 28.1% for our fiscal year 2018 did not have a significant impact on our effective tax rate for the current quarter.

Slide 8 reflects our adjusted net income trend. Our reported GAAP net income in the third quarter of fiscal year 2018 came in with a new quarterly record of \$10.8 million which is a 33% increase compared to the \$8.1 million of net income recorded in the third quarter of fiscal year 2017. Our non-GAAP adjusted net income was \$10.7 million in the current year third quarter, excluding the tax reform measurement period adjustment I mentioned previously.

Diluted earnings per share ended up at a quarterly record of \$0.40 for the third quarter of this fiscal year, which compares to \$0.30 for the same quarter last year. Cash and cash equivalents at March 31, 2018, were \$44.2 million.

Operating cash flow trends are shown on Slide 11. Our cash flow from operations during the current year third quarter was \$9.5 million, as our net income plus noncash items more than offset usage of cash related to an increase in working capital, primarily from an increase in receivables related to the higher sales levels. Our cash flow from operating activities in the prior year third quarter was \$8.7 million.

Our cash conversion days increased 1 day from the -- for the 3 months ended March 31, 2018, when compared to the same period in the prior year as our PDSOH, or Production Days Sales On Hand, which is our inventory metric, increased by 5 days to support increased volumes and the implantation of a new inventory management program for one of our largest medical customers, which more than offset a 4-day decline in our DSO, or days sales outstanding, which is our receivables metric, partly from higher volumes and faster payments from customers utilizing factoring programs.

Slide 12 reflects our capital and depreciation trends. Capital investments in the third quarter totaled \$7.2 million, largely related to our investment in new manufacturing equipment to support new production awards and increase manufacturing capacity.

Borrowings on our credit facilities at March 31, 2018, were \$16.3 million, which was up \$6.3 million from June 30, 2017. Our short-term liquidity available represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled \$99 million at March 31, 2018. I'd like to conclude by saying that our balance sheet continues to be strong, and I believe we're well positioned for continued growth.

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

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from Hendi Susanto of Gabelli & Company.



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**Hendi Susanto** - G. Research, LLC - Research Analyst

First question is for Don. Don we are seeing 44% positive growth in automotive. How sustainable is the high growth in automotive we are seeing in Q3 going into Q4 and possibly next fiscal year?

**Donald D. Charron** - Kimball Electronics, Inc. - Chairman & CEO

Well, we certainly had strong demand this past quarter and it was unexpected demand in terms of programs that we had, the visibility to ramp-up programs that we had in that period were pretty significant that, also, as Mike mentioned, the growth that we experienced, really, was from all 3 regions of the world. Fairly strong demand. I really can't comment on the outlook from there, but I would certainly say that we were very surprised at how strong the demand was during the quarter.

**Hendi Susanto** - G. Research, LLC - Research Analyst

And is it fair to assume that there are still more new design wins in Q4 that were not realized?

**Donald D. Charron** - Kimball Electronics, Inc. - Chairman & CEO

Well, we still do still have a pretty, healthy launch schedule ahead of us. As we've mentioned in past calls, we've been running at what we would consider to be something near a 2x or a double sort of rate of launches. And again, looking at our CapEx, it's a pretty good proxy for the launch activity were supporting because most of that CapEx, as Mike mentioned, is to support new equipment for those new programs. But we don't see, as we look out in the future, that sort of 2x run rate would continue on for several years. We've been through a really, I would say, an unusual period of time in the last, now coming on 3 years, where we've been at somewhat of a 2x normal rate of, let's say, a new product introduction activity. We do see that renormalizing to something more similar to a run rate that we've had when our CapEx approximated depreciation.

**Hendi Susanto** - G. Research, LLC - Research Analyst

Okay. And then, Don, you mentioned that you want Kimball Electronics to go beyond EMS to multifaceted services company. Can you share more colors in terms of organic versus organic toward that goal?

**Donald D. Charron** - Kimball Electronics, Inc. - Chairman & CEO

Yes. We would see most of our work there, here in the early stages of launching our new platform strategy to be an acquisitions versus organic development. We are very interested in working our way into the ecosystems of companies that are servicing the needs of the smart factory in the feature. So we like areas like automation and test and measurement, and those are the areas that we're looking to make investments into the future. Those are areas, by the way, that we know in our own factories. We know the megatrends. We have a lot of those investments going on in our own factories. So we also are keenly interested in being in a good position to service ourself as a high-tech manufacturer in the future.

**Hendi Susanto** - G. Research, LLC - Research Analyst

Got it. And then, Mike, I have a question about the Romanian facility. So you set a goal of Romanian facility reaching breakeven by fiscal year 2018 end. What will the ramp gross margin boost or anything that you can share like post reaching the breakeven by June this year?

**Michael K. Sergesketter** - Kimball Electronics, Inc. - VP & CFO

Well, as Don stated in his comments, about a 50 basis point impact we saw in operating income in the quarter and what we've been communicating, we expected to reach breakeven run rate by Q4 of this year within the quarter. And so, I think, maybe a good way to look at it is in terms of that 50

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basis points or something that we would expect to see some improvement on going forward as that facility gets up to operating speed and it gets to breakeven.

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**Hendi Susanto** - *G. Research, LLC - Research Analyst*

So is it reasonable to assume that 50 basis point boost may, on a quarterly basis, may take place in the next fiscal year?

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**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

Well, certainly. And as we look at our current business, our goal we've set for the consolidated line for the company is 4.5%. Obviously, this quarter, all in, we ended at 3.9% in the operating income line. So as we look forward, if the current business can, let's say, hold serve and stay at that 3.9% level, we would look to have the improvement we make in Romania add to it at the consolidated level.

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**Hendi Susanto** - *G. Research, LLC - Research Analyst*

Okay. And then what does Romania facility running at breakeven, in the -- I mean, like how does it correlate to the factor utilizations? Can you share what kind of factor utilization range that will correspond to breakeven run rate? Can you give me some idea?

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**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

Yes. It would be somewhere around a 60% utilization of the phase 1 construction at that point.

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**Operator**

(Operator Instructions) Our next question comes from Chase Basta of AWH Capital.

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**Chase Basta**

Just following up on the automotive vertical strength. Is there a concerted effort to grow here or is this kind of just a result of meeting demand?

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**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

I'd say, it's -- our strategy in terms of this end market vertical has been pretty steady, Chase. I mean, it's an important part of our overall plan for growth. We do have portfolio target -- long-term portfolio targets that we're sort of aiming for, but we're not going to turn away any organic growth that we think is growth that we can meet our capital return goals on. So we've been, as I've stated in the past calls, we've been fortunate in winning new programs and launching those new programs. And really the strong growth that we saw this past quarter is really the result of the ramp-up of those programs. And just stronger-than-expected growth in terms of where our content, where we build electronics and what cars those go on around the world. And I think that's, also, something for us we're very fortunate about because there's a lot of variables there that kind of factor in your ultimate growth rate. And having the right content, on the right vehicles, in the right regions of the world, is not something that just happens by itself. So we feel pretty good about the quarter we just finished. The growth rate was higher than we had expected. One good thing is we've got those same programs that contributed to Q3 are going to be in production going forward, and we still have some ramp-up activity ahead of us. But certainly, we can't predict, like anyone can hardly predict, on what the total SARs will end of for the full year.



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**Chase Basta**

Okay. I think you guys called out mix as having a slight negative impact on margins in the quarter. Is that kind of the result of growth in the automotive vertical or is it more a result of higher mix of new business ramping up or what kind of drove that?

**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

Well, as we said, also, in past calls, Chase, it would be more about the MPI activity. When we look at sort of the product lifecycle of a program, like in automotive for example, maybe 2 years in development, 7 years in production, the midpoint in production is probably our sweet spot. It's -- the most challenged we are is in the launch time frame because we're deploying capital, hiring resources in ahead of that launch and then typically those programs take maybe as much as 3, 4 or 5 quarters to ramp up to their full production, maybe go on a vehicle platform at a time in that ramp-up phase. So we're most challenged at the front end of these programs when we get them into production. So when we talked about yield and throughput improvements on recently launched programs, usually, that first 12 months, we're really putting our shoulder into it because that's where we're trying to get that -- those program to their quoted rates and margins and return on invested capital. So we -- this next quarter coming up, Q4, we stated -- we called it a pivotal quarter, and it is just that for us, not only for Romania reaching our long-stated goal of breakeven on the OI line, or operating income line, I should say, for Q4. But we also have some new program launches that occurred over the last 12 months, and we expect to start to approach their quoted run rates. And the combination of those 2, we think, should get us to our stated goal of 4.5% operating income.

**Chase Basta**

And just to make sure I understand on Romania, okay, so it's a 50 basis point headwind this quarter. Are you guys saying that goes to 0 for the whole next quarter or is it like exiting that quarter at 0?

**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

So we expect to approach our breakeven by the end of the quarter.

**Chase Basta**

Okay. And then you guys have been pretty steady buyers of your stock at prices considerably higher than it's rated at in the recent months. And I didn't see any commentary on buybacks in the press release, despite a pretty nice operating cash flow and a lot of cash on the balance sheet. I'm just kind of curious what the thought process is there? Are there other opportunities imminent in the pipeline that you're kind of holding that cash aside for? Or just kind of what's the thought process there?

**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

Well, our standard answer is to a same answer, Chase. The timing, the actual number of shares that we repurchase, it depends on a number of factors. And you're right, other investment opportunities would be one of those factors, the market, our price, all of those are key factors in our decision. And we have -- each quarter, in our board meeting, we -- with our Board of Directors, in that meeting we decide what those priorities are. And then, of course, as I mentioned in my commentary on our new platform strategy, we do expect that investment stream to be primarily acquisitions as we launch ourselves into that new strategy. And so as we work on those projects, we have to follow the rules that governed buyback programs when you're stating that you're going to be acquisitive in the market. So all of that has to be balanced and rules have to be followed. And yes, you're correct, we didn't buy any shares during the quarter and it's for all those reasons that I just mentioned.



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**Chase Basta**

Okay. It makes sense. And my final question is you guys plan to hit your fiscal 2018 targets next quarter in terms of both annual sales and operating margin goals. Do you plan on updating those goals for fiscal '19 or some period going forward?

**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

It's part of our process. So we're going through updating our operating plans now for the upcoming fiscal year 2019. And as we close out '18, we'll look at those goals, we'll look at the progress. And yes, as we've done in the past years, when we make our fourth quarter release, we'll do our best to provide in the outlook section of our Q4 press release and update to those targets.

**Operator**

At this time, I'd like to turn the call back to Don Charron for closing comments.

**Donald D. Charron** - *Kimball Electronics, Inc. - Chairman & CEO*

Thank you, Norma. 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**

Ladies and gentlemen, thank you for your participation in today's conference. You may disconnect. Have a wonderful day.

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