Kimball Electronics, Inc. (Q12020 Results)

November 6, 2019

Corporate Speakers:

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

PRESENTATION

Operator: Good morning, ladies and gentlemen. My name is Sydney, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics First Quarter Fiscal 2020 Financial Results Conference Call. (Operator Instructions)

Today's call, November 6, 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, 2019, 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, Sydney, and welcome, everyone, to our first quarter conference call. Our earnings release was issued yesterday afternoon on the results of our fiscal year 2020 first quarter ended September 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 & Presentations tab. Or if you're 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 would turn it over to Mike for the financial overview. After that, we will answer any questions that you may have.

We delivered excellent growth results in the first quarter of fiscal year 2020 despite a general softening in the overall market. We achieved double-digit growth in 3 of our 4 end market verticals when compared to the same period last year, and we set a new quarterly record for net sales in our medical end market vertical. We are also starting to gain some traction in the new business opportunities pipeline for our GES business as we cycle through the downturn of the semiconductor and smart mobile device manufacturing end markets, which, today, are still the primary end markets that our GES customers serve.

Our integration work with GES continues as we have now identified a dozen or so value-creating automation, optical inspection and artificial intelligence projects that will eventually improve the productivity of our own existing manufacturing facilities and further leverage the technology we acquired with this acquisition.

We're extremely pleased with the progress we made in expanding our operating margins in the first quarter when compared both year-over-year and sequentially to the fourth quarter of fiscal year 2019. As new programs ramp up to projected run rates and we continue to drive improvements in the GES operations, we expect to realize additional leverage from our sales growth. 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 further improvement in our margins. Margin expansion and capital efficiency will continue to be priorities of focus for us.

Our cash conversion days decreased from 77 days for the previous quarter ended June 30, 2019, to 73 days for the current quarter ended September 30, 2019. However, it was up from 68 days in the same quarter last year. Accounts receivable days, or DSO, decreased 9 days from the previous quarter as we took advantage of available supplier financing programs from various customers. Also compared to the prior quarter, our accounts payable, or AP days, decreased 3 days, while inventory or PDSOH plus contract asset days increased 2 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 continues to be a concern. During the first quarter of fiscal year 2020, over $1 million of tariffs on purchased raw material were rebilled to our customers. We continue to anxiously await the outcome of the U.S. and China trade talks.

We're also keeping a close eye on the impact from the UAW strike at GM and our production for the remainder of the second quarter of fiscal year 2020. And during the month of October, our production lines that support our customers, who support GM in North America, produced only a fraction of their normal run rate. Our production lines are now back up and running, but not yet at their normal run rate.

We invested $11.7 million in capital expenditures in the first quarter of fiscal year 2020. The majority of these capital investments were to support the launch and ramp-up of new programs and for capacity expansion.

During the first quarter of fiscal year 2020, we also returned $3.5 million to our share owners by purchasing 230,000 shares of our common stock, which brings our total to $71.4 million and 4.7 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 and supports industrial applications in various areas. This is a significant step in 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 as part of our overall digital and Industry 4.0 strategy.

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

Michael Sergesketter: Thanks, Don. During my comments, I'll 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 follow along by advancing the slides on the webcast portal.

As shown on Slide 3, our first quarter net sales were $313.4 million, which was an 18% increase compared to net sales of $265.6 million in the prior year first quarter. Adversely impacting our net sales for the quarter were foreign exchange rates, which reduced our net sales by approximately 2% compared to the first quarter a year ago. However, offsetting the impact of the 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 17% compared to the same quarter a year ago from increased volumes in each of our markets, led by North America, which was largely driven by the continued ramp-up of new programs.

Our medical vertical was up 23% in the current quarter compared to the prior year first quarter to a new quarterly record of $101.3 million. The year-over-year increase was primarily related to strong demand for existing programs.

Our industrial vertical was up 13% from a year ago as a result of additional revenue associated with the GES acquisition and increase in demand in smart metering programs and new program introductions.

Lastly, sales in our public safety vertical was flat with the prior year first quarter.

Our gross margin in the first quarter, reflected on Slide 5, was 7.1%, which improved 30 basis points from 6.8% in the first quarter of last fiscal year. Our increase in gross margin in the current year quarter compared to a year ago was the result of the improvements at existing business units, largely from the leverage of increased volumes, improved efficiencies at certain locations and lower domestic health care costs, which more than offset an adverse impact from the GES in the quarter.

Selling and administrative expenses, Slide 6 in the deck, were $11.1 million in the first quarter, which was down approximately $200,000 in absolute dollars and is down 60 basis points as a percent of net sales compared to the prior year first quarter. The decrease in selling and administrative absolute dollars included lower information system consulting costs and lower stock compensation expense, which more than offset the amortization of finite live intangible assets acquired with the GES acquisition.

Operating income for the first quarter, on Slide 7 in the deck, came in at $11.1 million or 3.5% of net sales. This compares to operating income of $7 million or 2.6% of net sales in the same period a year ago. Other income expense net was an expense of $2.4 million in this first quarter, which compares to expense of $600,000 in the first quarter of fiscal year 2019.

Other expense net in the current year first quarter was primarily the result of $1.2 million in interest expense on increased borrowings on our credit facilities and net foreign currency losses of approximately $1.1 million from unfavorable exchange rate fluctuations. The increase in borrowings on our credit facilities was primarily the result of the financing of the GES acquisition last year and for general corporate purposes.

Other expense net in the prior year first quarter was largely the result out of approximately $700,000 in net foreign currency losses and $400,000 of interest expense, which were partially offset by approximately $500,000 in foreign government subsidies.

The effective tax rate for the current year first quarter was 24.3%, which compares to 21.8% in the prior year first quarter. The current year quarter effective tax rate was unfavorably impacted by approximately $300,000 in discrete excess tax expense related to performance shares granted during the quarter, while the prior year first quarter included approximately $100,000 of discrete excess tax benefits related to the granting of performance shares.

Slide 8 reflects our adjusted net income trend. Our net income in the first quarter of fiscal year 2020 came in at $6.6 million. This compares to GAAP net income of $5.1 million and non-GAAP adjusted net income of $5 million in the first quarter of fiscal 2019. The non-GAAP adjusted net income in the prior year excludes proceeds received from a class action lawsuit, of which we were a member.

Diluted earnings per share was $0.26 for the first quarter of this fiscal year, which is up $0.07 from $0.19 diluted earnings per share reported for the same quarter last year. Cash and cash equivalents at September 30, 2019, were $55.4 million.

Operating cash flow trends are shown on Slide 11. Our cash flow provided by operating activities during the current year first quarter was $39.6 million, which was driven by net income, plus noncash items and a decrease in accounts receivable, largely resulting from increased utilization of third-party accounts receivable factoring arrangements. In the prior year first quarter, operating activities used $10 million of cash.

Our cash conversion days, or CCD, increased 5 days for the 3 months ended September 30, 2019 when compared to the same period in the prior year, largely related to a decrease in accounts payable days, which more than offset a decrease in days sales outstanding, or DSO. However, compared sequentially to the fourth quarter of fiscal year 2019, our CCD decreased 4 days as a reduction in our DSO more than offset a decrease in our AP days. As I mentioned earlier, during the current year quarter, we increased the utilization of our third-party accounts receivable factoring arrangements, which helped drive our DSO lower.

Slide 12 reflects our capital and depreciation trends. As Don mentioned, our capital investments in the first quarter totaled $11.7 million, largely related to manufacturing equipment to support new production awards and to increase capacity. Borrowings on our credit facility at September 30, 2019 were $110 million, which were down $17 million from our borrowings at June 30, 2019. A portion of our cash provided by operating activities during the current quarter was utilized to pay down our current debt.

Our short-term liquidity available represented as cash and cash equivalents, plus the unused amount of our credit facilities, totaled $132 million at September 30, 2019.

In conclusion, our financial condition is strong, and we're in excellent position to continue this solid growth trend while also driving hard to continue to improve our operating margin and our return on invested capital.

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

Operator: (Operator Instructions) And I'm not showing any questions at this time.

Donald Charron: Okay. 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.