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KE - Q2 2017 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

Don Charron *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Mike Sergesketter *Kimball Electronics, Inc. - VP and CFO*

CONFERENCE CALL PARTICIPANTS

Louis Moser *Mastek Investors - Analyst*

Hendi Susanto *Gabelli & Company - Analyst*

Austin Hopper *AWH Capital, L.P - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Skylar and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics Second Quarter Fiscal Year 2017 Financial Results Conference Call.

(Operator Instructions)

Today's call, February 2, 2017, 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, 2016 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.

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Thank you, Skylar, and welcome, everyone, to our second quarter conference call. Our earnings release was issued yesterday afternoon on the results of our second quarter ended December 31, 2016. 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 will turn it over to Mike for the financial overview. After that, we will answer any questions that you may have.

Our sales in the second quarter of fiscal year 2017 improved slightly over the previous quarter and were up significantly when compared to the second quarter of last year. Continued strength across multiple geographies in the automotive end market vertical and double-digit growth in our industrial end market vertical helped us set a new quarterly sales record for the fourth consecutive quarter.

Assisted by our Medivative and Aircom acquisitions, our medical end market vertical sales in the second quarter of fiscal year 2017 were 6% higher than the same period last year. Our sales in our public safety end market vertical were essentially flat in the second quarter of fiscal year 2017 when compared to the second quarter of fiscal year 2016.



We continue to make good progress on the launches of a number of new business awards with both existing and new customers. Our new business opportunities pipeline remains healthy and we continue to work diligently to achieve our goal of \$1 billion in annual sales by fiscal year 2018. We set this goal over two years ago and despite the subsequent currency exchange resets caused by the stronger U.S. dollar, we believe that the goal is still within our reach.

We made solid headway in our margin improvement efforts and we converted well on the strong demand during the quarter. We continue to face margin pressure and have work to do to achieve our goal of 12.5% ROIC. Margin expansion and capital efficiency will continue to be priorities of focus for us going forward.

This is a pivotal year for us as we work through another year of significant new program launches, the ramp-up of our new Romania operation, and the integration of our recent Medivative and Aircom acquisitions.

We continue to make excellent progress in Romania. Production for our first and second industrial customers continues to ramp as planned. After receiving approvals last quarter, production for our first automotive and public safety customers began to ramp up late during the second quarter of fiscal year 2017. This positions us well to make sequential incremental improvements each quarter as we approach our breakeven point early next fiscal year.

We continue to make good progress on the integration of our recent Medivative and Aircom acquisitions. The combination of the two companies adds capabilities and expertise in mechanical design, machining and metal fabrication and plastic injection molding to our package of value. These new capabilities have strategically positioned us to open new doors for future growth in sales and profits. Since the acquisition, we have been awarded two new programs from existing medical customers that we expect to ramp later this fiscal year.

And finally, we continue to take advantage of the flexibility provided by our strong balance sheet, making investments that will drive future growth in sales and profits. In addition to the \$35 million in capital expenditures in fiscal year 2016, we invested \$20 million in capital expenditures in the first half of fiscal year 2017. It is important to remind you that a large portion of these capital expenditures directly support new business awards. We are focused on getting through the launch cycle, ramping up production and ensuring that these new programs and the newly deployed capital that supports them achieve our expected returns.

During the second quarter of fiscal year 2017, we also returned \$7.4 million to our share owners by purchasing 529,000 shares of our common stock, which brings our total to \$26.9 million and 2.2 million shares purchased under the original \$20 million share repurchase program approved by our Board in October of 2015 and then was later increased by an additional \$20 million with no expiration date by an approval by our Board in September of 2016.

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

Mike Sergesketter - *Kimball Electronics, Inc. - VP and CFO*

Thanks, Don. Our second quarter net sales were \$230.3 million, which was an 11% increase compared to net sales of \$207.1 million in the prior year second quarter. If we exclude incremental sales in the second quarter from the Medivative and Aircom acquisitions, the net sales were still up 9% over the prior year.

Comparing changes in our net sales by vertical to the same quarter last year, our automotive vertical was very strong in the second quarter up 16% from the same quarter last year, driven by continued strong demand in all markets and new program introductions.

As Don mentioned, net sales in our medical vertical increased by 6% from the prior year, which was driven by sales generated from our recent acquisitions. However, if we exclude sales generated from the acquisitions then our medical vertical net sales were down slightly from the same quarter last year. Our industrial vertical revenue was up 13% from a year ago, largely as a result of increased customer demand for climate control products and new product launches related to smart metering.



Our gross margin in the second quarter was 8.9%, which was up 110 basis points from the 7.8% posted in the same quarter last year. The increase in margins was assisted by the leverage from the higher sales volume, cost productivity, lower domestic healthcare claims, and favorable product mix, but was also partially offset by costs related to new product introductions and the continued ramp-up of the Romania operation.

Selling and administrative expenses were \$8.3 million in the second quarter, which were down \$900,000, or 90 basis points when compared to the prior year second quarter. The decline in selling and administrative costs compared to the prior year were largely due to incremental cost of \$700,000 related to the start-up of the Romania facility being included in selling and administrative cost in the second quarter last year.

In addition to the prior year second quarter costs related to warranty claims and our Supplemental Employee Retirement Plan or SERP favorably impacted the current year comparison.

As a reminder, the SERP costs are a result of the normal revaluation to fair value of the SERP liability. These costs, cost [side], is selling and administrative costs are exactly offset by income from the revaluation to fair value of the SERP investments, which is recorded in other income and therefore, there is no impact to the company's net earnings during the period.

Other income and expense was a net expense of \$1 million in the current year second quarter compared to an expense of \$600,000 in the second quarter of the prior year, which was primarily the result of higher net foreign currency exchange losses, driven by the further strengthening of the U.S. dollar. The effective tax rate for the second quarter increased to 30.4% from 28.1% in the prior year second quarter, largely as a result of the favorable impact in the prior year quarter of the extension of the domestic research and development credit that was made retroactive to calendar year 2015.

Net income in the second quarter of fiscal year 2017 was \$7.8 million compared with \$4.6 million in the second quarter of fiscal 2016. Diluted earnings per share was \$0.28 in the second quarter of this fiscal year, compared to \$0.16 a year ago.

Cash and cash equivalents at December 31 2016 were \$42.7 million. Cash flow provided by our operating activities during the current year second quarter was \$12.1 million, which compares to cash flow provided by operating activities of \$16.8 million in the second quarter of last year.

This quarter's operating cash flow was primarily the result of earnings during the quarter plus non-cash adjustments. The prior year second quarter operating cash flow also benefited from larger favorable working capital fluctuations.

Borrowings on our credit facilities at December 31, 2016 remain at \$9 million unchanged from June 30. Capital investments in the second quarter totaled \$9.4 million, largely related to investments in new manufacturing equipment to support new product introductions and capacity expansion.

As Don mentioned, we also repurchased \$7.4 million of our common stock during the quarter. Our short-term liquidity available represented as cash and cash equivalents plus the unused amount of our credit facilities totaled \$93.3 million at December 31.

I would like to conclude by saying our balance sheet is very strong and we continue to focus on margin improvement and capital efficiency.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have a question from [Louis Moser] with [Mastek] Investors. Your line is now open.



Louis Moser - Mastek Investors - Analyst

I was wondering if your outlook for the rest of the year is in comparison to how well you did in the first quarter -- the recent quarter, what your thoughts are?

Don Charron - Kimball Electronics, Inc. - Chairman of the Board and CEO

Well, as I mentioned, in regards to our goal of reaching \$1 billion in annual revenue by 2018, we review that each and every quarter. Obviously, we're looking at our current book of business, our planned new product introductions, and of course, the outlook for that business based on what we're hearing from our customers.

And in doing that review this past quarter, we believe we're still on track to reach \$1 billion by fiscal year 2018. So, obviously, this quarter, we finished at \$230 million. We expect to continue to grow the business and have the business continue on track to that \$1 billion, or \$250 million per quarter run rate, as we look out over the next several quarters and actually get into fiscal year 2018.

Louis Moser - Mastek Investors - Analyst

Okay. So would you say that your next quarter would be pretty comparable then to what you just reported earnings and sales?

Don Charron - Kimball Electronics, Inc. - Chairman of the Board and CEO

Well, we don't provide guidance. So, no, I wouldn't have a comment on that. But I would say that, again, we expect to continue to progress on a line towards that run rate of \$250 million a quarter, just \$1 billion total annual run rate in fiscal year 2018. And so we're at the halfway point here in fiscal year 2017, we're just a couple of quarters away from starting fiscal year 2018. So that's the best I can give you in terms of what we feel like we're on in terms of our growth path.

Louis Moser - Mastek Investors - Analyst

I'm not sure that if you have a buying program for the stock, did you mention that?

Don Charron - Kimball Electronics, Inc. - Chairman of the Board and CEO

Yes, we do have a share repurchase program that's been active as of October of last year when the Board approved the first tranche of that repurchase program. And as I mentioned just a little earlier, we -- the Board did approve an additional \$20 million tranche to that original plan and we're already into that tranche with our buying activity this quarter.

Louis Moser - Mastek Investors - Analyst

Okay. So your stock price switches around [\$0.17] in the quarter is -- you feel is undervalued if you're going to continue to purchase additional shares?

Don Charron - Kimball Electronics, Inc. - Chairman of the Board and CEO

Well, we look at that each and every Board meeting. At the Board, we look at how our shares are trading relative to, let's say, companies and our peer group relative to what we think the stock should be trading at. And yes, each quarter -- each, I should say, each Board meeting, we have that on the agenda and we look at it and we make the necessary decisions at that point in terms of when and how much we would be buying.



Louis Moser - *Mastek Investors - Analyst*

Okay. Thanks very much.

Operator

Our next question comes from Hendi Susanto with Gabelli & Company. Your line is open.

Hendi Susanto - *Gabelli & Company - Analyst*

Good morning, Don and Mike. Congratulation on good results.

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Thank you, Hendi.

Mike Sergesketter - *Kimball Electronics, Inc. - VP and CFO*

Thank you.

Hendi Susanto - *Gabelli & Company - Analyst*

Mike and Don, I would like to understand more about the Romanian facility ramp-up. What does the ramp-up of the Romanian facility look like this calendar year? And perhaps you can share some insight where it will be at the end of the calendar year?

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Yes. So I think the good news, Hendi, is that, we continue to gain customer approvals, as I mentioned in the opening remarks. So we can now start to build a more predictable path. We're still working through some ramp-up details with some of the customers that have recently given us approvals and we are expecting two more approvals yet this fiscal year. So that's still a bit of a variable to the overall plan. But we -- what we can see now is that, we expect to make sequential incremental improvements each quarter, as we ramp-up, and we expect that Romania will begin to approach its breakeven point early next fiscal year.

Hendi Susanto - *Gabelli & Company - Analyst*

And then let's say once the transition is done, would you be able to share what kind of gross margin we can expect for the overall of the company?

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

We wouldn't probably talk about gross margin expectations, Hendi, but we will continue to talk about our expectations around operating income margin. We're looking very closely at our current goal of 4%, and what we might do with our cost structure, what we might do with some of our margin improvement efforts, and we do expect to come out with an update soon on an operating income target that would be an update to our 4% target that we've publicly stated many times in the past.



Obviously, our ultimate goal is to get the company to 12.5% return on invested capital. And so as we look at the new capital deployments we've made and we look at our current invested capital and how that continues to grow with our growth pursuits, obviously, we're looking at both, where we end up there, the capital efficiency we end up with the capital deployed, and of course, the margin we need then to achieve our 12.5% return on invested goal -- return on invested capital goal. But I just want to underscore, the main driver for us is to get the business to 12.5% return on invested capital.

Hendi Susanto - *Gabelli & Company - Analyst*

And then, Don, just to clarify your statement about the operating income margin target of 4%, does that include or exclude the assumption of completion of the Romanian facility transitions?

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Yes, we kept that goal at 4% with the understanding that we would have somewhat of a drag to our operating income with the Romanian operation start-up.

Hendi Susanto - *Gabelli & Company - Analyst*

Got it. Thank you, Don. Thank you, Mike.

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Thanks, Hendi.

Mike Sergesketter - *Kimball Electronics, Inc. - VP and CFO*

Thank you.

Operator

Our next question comes from Austin Hopper with AWH Capital. Your line is open.

Austin Hopper - *AWH Capital, L.P. - Analyst*

Hey, good morning, guys, and congrats on a quarter. My main two questions already answered about Romania and your operating margin guidance. Can you just maybe talk about the opportunity in automotive -- they had another strong quarter, just kind of what you're seeing over in China and how you view that going forward? Thank you.

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Well, Austin, yes, automotive was again strong -- very strong for the quarter and we continue to win new programs there in that vertical. So we're pretty pleased with what's happening there overall, big picture in terms of our growth and our win rate and what we're doing. And I think that coupled with the fact that automotives remain fairly strong in multiple geographies, so it's not just China. We also have some pretty nice things that are happening for us here in North America and in Europe. So it's pretty widespread for us.



We expect it to continue to be strong. We're always at this time of year for China, you brought that up, we're waiting for them to come back from their -- from their holiday, Spring Festival holiday. And there's always seems to be some new market information that you can extract valuable pieces of information from -- after they do get back from that important holiday there. So we're anxiously waiting maybe more market news in terms of what the automotive market in China will do.

But we already know the applications that we have running today already, what vehicle platforms we're on. What new programs are ramping. And so we feel like, we've got a good strong path ahead of us yet as we look out over the next four or five quarters in automotive.

Austin Hopper - *AWH Capital, L.P. - Analyst*

Great. Thank you.

Operator

(Operator Instructions) And I'm showing no further questions at this time.

Don Charron - *Kimball Electronics, Inc. - Chairman of the Board and CEO*

Thank you, Skylar. 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.

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