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KE - Q1 2017 Kimball Electronics Inc Earnings Call

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## CORPORATE PARTICIPANTS

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

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

## CONFERENCE CALL PARTICIPANTS

**Herve Francois** *B. Riley - Analyst*

**Hendi Susanto** *Gabelli & Company - Analyst*

**Chase Basta** *AWH Capital - Analyst*

## PRESENTATION

### Operator

Good morning, ladies and gentlemen. My name is Shanice, 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 Year 2017 financial results conference call.

(Operator Instructions)

Today's call, November 3, 2016, 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 10k for the year ended in June 30, 2016 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 today's call over to Don Charron. Mr. Charron, you may begin.

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### Donald Charron - *Kimball Electronics Inc. - Chairman of the Board, CEO*

Thank you, Shanice. Welcome, everyone, to our first quarter conference call. Our earnings release was issued yesterday afternoon on the results of our first quarter ended September 30, 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 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 it over to Mike for the financial overview. After that, we will answer any questions that you may have.

Our sales in the first quarter of fiscal year 2017 improved slightly over the previous quarter, and we're up significantly when compared to the first quarter of last year. Continued strengths across multiple geographies in the automotive and market vertical, and double-digit growth in our medical and market vertical helped us set a new quarterly sales record for the third consecutive quarter.

Our sales in our medical and market vertical were assisted by our Medivative and Aircom acquisitions. We were encouraged by the third consecutive quarter of sequential growth in our industrial and market vertical, where our sales in the first quarter of fiscal year 2017 were 4% higher than the same period last year. Our sales in our public safety and market vertical were down 20% in the quarter of fiscal year 2017 while compared to the first quarter of fiscal year 2016, primarily due to softness in demand and a program going end of life.



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 opportunity pipelines remains healthy and we continue to work diligently to achieve our goal of \$1 billion in the annual sales by fiscal years 2018. With that fiscal two years ago and despite the subsequent currency exchange reset caused by the stronger U.S. dollar and weakening global economic environment, we believe that the goal is still within our reach.

We continue to experience pressure on our margin and we still have work to do to achieve our goal at 12.5% ROIC. Margin expansion and capital efficiency will continue to be priorities of focus for us going forward. This will be 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 of our first industrial customer continues to ramp as planned and we recently received approval from our second industrial customer to start production. We also recently received approvals to start production from our first automotive and public customers. These approvals will now help us build a more predictable path to profitability in Romania.

We are making good progress on the integration of our recent Medivative and Aircom acquisition. The combination of the two companies adds capabilities and expertise in mechanical design engineering, machining, and metal fabrication, injection molding, combination devices, medical instruments, and complex system assembly, all to our package of value. These new capabilities have strategically positioned us to open new doors for future growth in sales and profits. As previously announced, Medivative is expected to be neutral to slightly accretive to our fiscal year 2017 results while Aircom is expected to be slightly dilutive to our fiscal year 2017 results. The effect on our operating results for the first quarter of fiscal year 2017 related to these acquisitions was not material.

And, finally, we continue to take advantage of the flexibility provided by our strong balance sheet, making investments that would drive future growth in sales and profits. In addition to the \$35 million in capital expenditures in fiscal year 2016, we invested \$10 million in capital expenditures in the first quarter 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 return.

During the first quarter of fiscal year 2017, we also return \$6.4 million to our share owners by purchasing 508,000 shares of our common stock, which brings our total to \$19.6 million and \$1.7 million shares, purchased under the \$20 million share, we purchased program approved by our Board in October of 2015. In September of 2016, our Board approved an additional \$20 million to the existing share repurchase program with no expiration date.

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?

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

Thanks, Don. Our first quarter net sales were \$226.5 million which was 13% increase compared to net sales of \$200.4 million in the prior year first quarter. If we exclude the incremental sales in the first quarter from the Medivative and Aircom acquisitions, net sales are still up 10% over the prior quarter of the prior year.

Comparing our net sales by vertical to the same quarter a year ago, our automotive vertical was very strong in the first quarter of 28% from the same quarter last year, driven by continued strong demand in all markets, but China is still leading the way.

In addition, new program introduction continue to ramp up helping us to feed the growth. Net sales in our medical vertical increased to 11% from prior year, which was partly driven by sales generated from the recent acquisition. Excluding sales from the acquisitions, our medical vertical net sales still increased in the mid-single digits from increased demand with existing programs and new program launches. Our industrial vertical revenue was up largely as the results of increased customer demand for climate control products as well as new product launches related to smart metering, and as Don mentioned, our public safety vertical declined from the prior year.



Our gross margin in the first quarter was 8.1%, which was up 50 basis points from the 7.6% posted in the same quarter last year. The increase in margin was assisted by the leverage from the higher sales volume and favorable product mix, but was also partially offset by cost related to the ramp of the Romania operation.

We recorded other general income in the first quarter of \$4 million related to proceeds we received from the distribution of funds due to the settlement of a class action lawsuit of which the Company was a member. The suit related to price-fixing of electronic components by certain EMS suppliers over a number of years, which resulted in an inflated prices and overcharges to purchasers of those components.

Selling in administrative expenses were \$9.5 million in the first quarter, which was up \$1.1 million, but just 10 basis points when compared to the prior year first quarter. The increase in selling in administrative absolute dollars compared to the prior year were primarily due to higher Supplemental Employee Retirement Plan or SERP expense, and a higher incentive compensation cost resulting from the approved profitability.

As a reminder, the SERP costs are results of the normal revaluation of fair value of the SERP liability. These 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 net was the income of \$800,000 in the current first quarter compared to an expense of \$700,000 in the first quarter of the prior year.

This quarter we recognize the bargain purchase gain of \$900,000 related to the Aircom acquisition, which was recorded as non-operating income. The gain was the result of the fair value of the net assets acquired being greater than the total consideration paid. As mentioned earlier, we also recognize SERP income in the current quarter related to the revaluation of fair value of the SERP investments, which are fully funded primarily from employee contributions. Compared to a year ago, we incurred SERP investment losses than the first quarter of last year.

The effect of tax rate for the first quarter was 25.5% compared to 28.5% in the prior year first quarter. Net income in the first quarter of fiscal year 2017 was \$10.1 million compared to \$4.5 million in the first quarter of fiscal 2016. When we exclude the lawsuit income and bargain purchase gain, we ended with adjusted net income of \$6.7 million, which compares to adjusted net income in the prior year quarter of \$4.6 million, which exclude spinoff cost recorded in Q1 of last year.

Diluted earnings per share was \$0.36 in the first quarter of this fiscal year compared to \$0.15 a year ago. After excluding the same items I just mentioned, the adjusted diluted EPS was \$0.24 in the quarter compared to \$0.16 last year. Cash and cash equivalents since September 30, 2016 were \$50 million with strong cash flow provided by our operating activities during the current year first quarter of \$14 million, which compares to a usage of cash from our operating activities of \$500,000 in the first quarter of last year. This quarter's operating cash flow was primarily the result of earnings during the quarter, including the lawsuit settlement proceeds of \$4 million, plus nine cash adjustments.

Borrowings on our credit facilities of September 30, 2016 remain at \$9 million unchanged from June 30. Capital investments in the first quarter totaled \$10.3 million largely related to our investment and new manufacturing equipment to support new product introductions and capacity expansion. During the quarter we also purchased the previously lease facility that housed the former Medivative operation. In addition, \$2.1 million net of cash acquired was use for the acquisition of Aircom Manufacturing during the first quarter.

As Don mentioned, we also repurchased \$6.4 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 \$101 million since September 30. I would like to conclude by saying that 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. Shanice, do we have any analyst with questions in the queue?



## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Herve Francois from B. Riley.

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### Herve Francois - B. Riley - Analyst

I wanted to ask in regards to some of the CapEx that took in regards to the some new manufacturing equipment for new product introduction.

When you look at throughout fiscal 2017, you certainly seem to have several product ramps taking place in the various end markets that you serve. Is this CapEx going to be kind of at this pace to support those new product ramps or are you investing in CapEx ahead of what you see in regards to these new product ramps coming from your different verticals?

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### Donald Charron - Kimball Electronics Inc. - Chairman of the Board, CEO

Now, Herve, I think the answer is really driven by both. Right now, we're still in launch mode with several of these business awards that in some cases awarded more than a year ago to us and so some of that \$10 million in Q1 would be directed at supporting those launches now. As we continue to win new programs, which we have done and did throughout fiscal year 2016, that's driving new CapEx requirements this year in fiscal year 2017 and perhaps early into 2018.

We see the rate of CapEx that we're at right now is really where we've been at. Roughly, the average over the last eight or nine quarters has been roughly at this run rate. We can see that by continuing at this pace at least for a couple of quarters, but we do expect it to subside and come back to something that we think is a little bit more normal for our business, which is CapEx approximating depression. So, there was a few variables left in there that we have to see settled our way out as we're competing very heavily on some strategic pursuits, if you will, for new business, but that's about the best outlook we could give you right now at this point in time.

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### Herve Francois - B. Riley - Analyst

You talked about some ramping receiving approvals from some customers that is going to start ramping in your Romania plan. A couple of things on that, once they are fully ramped -- number one, I guess, how long do you expect it to take for those customers to be fully ramped at industry customer and the auto and the public safety customer? Then, when fully ramped, how much contribution on revenues do you expect that to provide before you guys are on a steady paces?

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### Donald Charron - Kimball Electronics Inc. - Chairman of the Board, CEO

Yes, so as we mentioned, we really just recently received those approvals. It was a bit like the dam broke a little bit as we were waiting for, especially, the automotive approval which as we reported last time was about three months later than where we wanted it to be or where we thought it would be ended up lining up with a couple of other customer approvals, all coming together in a pretty short period of time, but they're all fairly recent.

What's typical for us, Herve, when we get customer approvals and then the next sort of pace is putting together a ramp up plan. A big part of that ramp plan then is placing raw material on order to start production as well as kind of projecting what we think is a fairly well risk mitigated ramp up plan, if you will.

So, typically, when you look at the lead times of raw material, you look at the ramp up, it normally is taking place over a couple of quarters after we receive customer approval. Each customer is unique in that regard. We work through them one by one with the customer and that's exactly what we're doing now that we received approval.

But, the good news is we're working on the ramp up plan and eventually, yes, we will place raw material in order to support that and we'll start production. So, I would say, typically, after receipt of customer approval, it's a two to three quarter kind of ramp up when you include the placing an order of raw material.

So, that, I hope, answers the first part of your question and really until we work through that, it's difficult to say what the contribution will be or what the revenue will be. But, I would say when we constructed our plan to get to a billion in 2018 and we looked at our overall growth opportunities in Europe, we were already contemplating, if you will, our Poland capacity and additional in Romania.

So, really, our road to a billion in 2018 includes utilizing at least a portion of this new capacity we're adding in Romania to support our overall growth plan in Europe.

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**Operator**

Hendi Susanto of Gabelli & Company.

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**Hendi Susanto** - *Gabelli & Company - Analyst*

Don, do you have insight on the strength in automotive such as which markets are major contributors?

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

Well, that's a really good question, Hendi. I think most analyst overall when they look at the worldwide automotive market, I think most of them would say that we're near the top if not at the top of the cycle as automotive as over the years' been cyclical industry, and I don't think they would really discriminate any region from the other in making that statement. Although, there could be a case made that perhaps some regions are a little bit and could be a little bit more stable even in the down cycle that we could see here in automotive.

I think we have taken a pretty conservative outlook ourselves. We also agree being in this business for many, many years that we perhaps are at the top of the cycle and that's obviously being the factored into what we're doing, for example, ahead of us in our own new business development pipeline. But, I think, here in the interim period, in terms of the next few years, I think for a lot of these, it'll be a lot more about what type of content you have on what vehicles and in what region of the world. That, I think, will have a huge impact on what you would see in terms of top line growth and additional growth opportunities from there.

So, as we've said in the past in these calls, we really have worked hard over the years to try to focus our efforts on what we believe to be the content that's going to continue to grow on the automobile itself and where we could and where we can, we have tried to target some of the more popular brands in the world, and some of the more popular vehicles in the world, and try to do our best to put our resources there. So, we like the book of business we have right now in automotive.

Obviously, we had a very strong quarter here in this past quarter and we're optimistic about that book and what it can do even in the beginning of a down cycle. But that being said, it all depends on what happens overall and the overall worldwide market as we get into the next few years of the cycle.

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**Hendi Susanto** - *Gabelli & Company - Analyst*

Don, you mentioned about the beginning of the down cycle and on the other hand there are some increase of electronic contents in automotive, is that the right view?



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

That is right view, Hendi. That is the right view. Yes, I mean, there's no doubt that -- I think, many of the analyst kind of -- they have a common prediction that we would go from somewhere, for example, to 90 vehicles produced worldwide in 2016 to a number close to 100 million in 2020, so a much lower growth rate than what we've just experienced, obviously. But for us that are providing electronic content to those vehicles, the opportunity looks different than that. It's more than 10 million vehicles, because of the increased electronic content per vehicle.

As I was trying to articulate earlier, it's really important that you define the right content on the right vehicles, I think that's pretty critical to the overall strategy, because even though the electronic content per vehicle is growing, it doesn't necessarily mean that you'll grow with it if you don't have the -- if you're not on the right -- if you don't have the right content on the right vehicle.

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**Hendi Susanto** - *Gabelli & Company - Analyst*

I see, and then, Don, do you have any insight into how long softness in public safety may continue?

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

You know, that's our smallest vertical and as I've reported to you before, while the percentages of variation can seem pretty significant from period to period, the real dollars of variation or maybe not as significant. It is our lumpy vertical in terms of the demand, especially that part of the demand that's tied to federal and local government funding. Those purchase orders tend to be a bit lumpy as they come through, and are received, and then the ship dates that are tied to them.

I think we don't see it much different than we see the overall market, growing at maybe 3%, 4%, maybe at the high-end 5%. We kind of look at our public safety, and market vertical, and we kind of think it would probably grow somewhere around the overall market. So, this past period was soft, but when you look at the total dollars that the percentage drop represented, it's pretty small on the big picture for us.

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**Hendi Susanto** - *Gabelli & Company - Analyst*

I see, and then, a question for Mike, the loss associated with the startup of Romania facility, it was like \$1.1 million in Q4 and \$1 million -- sorry, \$1.1 million in Q1 and then \$1 million in Q4, how should we expect that loss to continue in fiscal year 2017 and how should we think of the magnitude of that loss as a function of your utilization?

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

As Don mentioned, as we obtained approval on this programs, we expect to see the ramp up begin, which should begin to offset some of that. But, certainly and probably, I would think we've got a couple of quarters ahead, where we're going to see sort of some more type trends in terms of losses until we get up to a good base of business. So, I think a good way to think about it is kind of look at it where we've been running the last couple of quarters and that would give you a kind of a good indication ahead. But, certainly, we would hope in several quarters out, we'd start to see that subsiding --

(Multiple Speakers)

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**Hendi Susanto** - *Gabelli & Company - Analyst*

So, if my interpretation is correct, the magnitude may stay at that level for a while and that it may see some step up function.



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

Yes, I'm sure that's a good way to look at it.

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**Operator**

(Operator Instructions) Chase Basta with AWH Capital.

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**Chase Basta** - *AWH Capital - Analyst*

Hey, it looks like for the second quarter in a row margins looked a little bit stronger than the levels that you guys had of got into, previously. Can you maybe give us a little bit more color on your outlook in terms of margins going forward?

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

Yes, we're working hard on it. I'll tell you that. It's obviously a priority of focus for management to continue to work on opportunities to improve our efficiencies and find ways to expand our margin.

As Mike mentioned, we do have a mix factor that can help us from period to period as we get through, let's say, some of these ramp ups and get them running in more of a steady state production mode. I think a little bit of what we're starting to see as we go forward is we are getting some of those, let's call them, new product or new business award launches that we did in 2016. After getting a couple of quarters under our belt, those lines are starting to run and start to get -- starting to get pretty close to our quoted run rates on them.

So, therefore, the margin improves with that. We're still, I would say, at about a midpoint of a pretty aggressive new business launch cycle. We've done a lot of that work in 2016. We've got a lot more to do here in 2017, so I would paint a picture for you that for each line we kind of get up and get going at steady state in running out our rates. It's likely we will be launching another new one that we've got to do the same work on to get there.

But, as I've stated to you earlier, it's a priority of focus to management. We got a number of initiatives that we're working on within our operations, using our lean Six Sigma tools, and et cetera, and then even well into the supply chain is what we're doing on some really cost innovative ideas on how to drive improvement there as well.

So, there's a lot of activity going and to the extent that we're successful in bearing fruit earlier in some of that work, it should show up on our margin. But I also would paint for you a picture that we serve our customer base with high expectations around cost innovation and cost improvement sharing.

So, we also have that side of our business that we face as well. In the past calls, we talked about our \$4 operating income target and as a sort of a margin reference point while we're in this period, we would maintain that that's still a pretty good margin reference point for us as we work through this period of pretty high new production introductions getting our acquisitions integrated in terms of Aircom and Medivative and of course getting Romania wrapped up.

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**Operator**

At this time I'm showing no further questions.

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

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

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**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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