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Q1 2019 Kimball Electronics Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 07, 2018 / 3:00PM GMT



CORPORATE PARTICIPANTS

Donald D. Charron *Kimball Electronics, Inc. - Chairman & CEO*
Michael K. Sergesketter *Kimball Electronics, Inc. - VP & CFO*

CONFERENCE CALL PARTICIPANTS

Chase Basta
Michael Morales

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Lisa, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to Kimball Electronics First Quarter Fiscal 2019 Financial Results Conference Call. (Operator Instructions)

Today's call, November 7, 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, 2018, 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 D. Charron *Kimball Electronics, Inc. - Chairman & CEO*

Thank you, Lisa, and 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, 2018. We have posted a financial summary presentation to accompany this conference call. The presentation can be found in our Investor Relations website within the Events & Presentations tab. Or if you're 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.

We achieved solid year-over-year organic growth in 3 of our 4 end market verticals as the ramp-up of new program launches helped to more than offset softness in certain mature programs.

Our sales in China were down double digits when compared to the first quarter of fiscal year 2018, primarily as a result of lower demand from major China domestic automotive customers, likely related to tighter credit from increased regulation on consumer lending practices in China and the U.S. and China trade dispute. While this was a challenging quarter for us, we are cautiously optimistic that our goals of 8% organic sales growth and 4.5% operating income remain within our reach for fiscal year 2019.

The Romania operation continued to progress in its ramp-up and improved its impact on consolidated operating income percent by 30 basis points compared to the prior fiscal year first quarter. We continue to work on yield and throughput improvements on recently launched programs.

Margin expansion and capital efficiency will continue to be priorities of focus for us as we go forward. The market continues to experience component shortages, and we remain focused on doing what's necessary to secure the raw materials in this tight supply market and to maintain the appropriate buffer stock levels to minimize disruptions. We continue to work diligently to prepare for and respond to the changing landscape as it relates to the China tariffs. For the tariffs that have taken effect, it will be critical to get accurate information from our suppliers for us to be able to pass through those costs to our customers.



We continue to leverage our strong balance sheet and cash flow to make investments that would drive further growth in sales and profits. We invested \$4.8 million in capital expenditures in the first quarter of fiscal year 2019 in part to support the launch and ramp-up of new programs.

During the first quarter of fiscal year 2019, we also returned \$5.4 million to our share owners by purchasing 277,000 shares of our common stock, which brings our total to \$49.9 million and 3.5 million shares purchased since October 2015 under our board-authorized share repurchase program. As we stated in 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 finally, we completed the acquisition of GES on October 1, 2018. Headquartered in San Jose, California, GES has business operations in China, India, Japan, United States and Vietnam, and brings us new technologies and capabilities in automation, test and measurement that will open new doors with new and existing customers. GES is the first step in our new platform strategy and our plans to continue our development beyond EMS to a multifaceted manufacturing solutions company.

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 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 the webcast, you can find it in the Downloads tab on the webcast portal.

As shown on Slide 3, our first quarter net sales were \$265.6 million, which was a 5% increase compared to net sales of \$253.2 million in the prior year first quarter.

Slide 4 represents our net sales mix by vertical market. Comparing our net sales by vertical to the same quarter in the prior year, our automotive vertical was up 4% compared to a year ago as demand in North America was up, which more than offset a decline in China, and to a lesser degree, Europe. The increase in North America was largely due to the continued ramp-up of certain programs and new program introductions.

Our medical vertical was up 8% in the current quarter compared to Q1 last year from both the continued ramp-up of certain product launches and increased demand for our existing programs. Our industrial vertical was up 5% from a year ago as a result of an increase in demand for climate control products as well as from the ramp-up of new product launches related to smart metering.

Lastly, our public safety vertical was flat from the prior year first quarter. Our gross margin in the first quarter reflected on Slide 5 was 6.8%, which was down from 7.7% in the first quarter last fiscal year. Our decrease in the gross margin in the current year quarter compared to a year ago was largely related to unfavorable product mix to less mature programs; higher material costs, partially associated with the tightening of component availability; foreign currency headwinds; and higher domestic health care costs.

Selling and administrative expenses, Slide 6 in the deck, were \$11.2 million in the first quarter, which were up \$1.3 million in absolute dollars and up 30 basis points compared to the prior year first quarter. Sequentially, selling and administrative expense was down \$300,000 from the fourth quarter of fiscal year 2018. The increase in selling and administrative absolute dollars compared to the prior year was in part due to a higher salary and related payroll costs, higher noncash stock compensation expense and consulting costs largely related to non-capitalizable onetime information systems implementation costs. Partially offsetting the increase in S&A costs was lower profit sharing incentive bonus expense, which is designed to adjust as profits fluctuate.

Our adjusted operating income for the first quarter, on Slide 7 in the deck, came in at \$6.9 million or 2.6% of net sales, which compares to operating income of \$9.5 million or 3.8% of net sales in the same period a year ago. Other income and expense was a net expense of \$600,000 in the fiscal year 2019 first quarter compared to income of \$1.3 million in the first quarter of fiscal year 2018. The other expense net in the current year first quarter was primarily the result of \$700,000 in net foreign exchange currency losses driven by the

weakening of the currencies in our foreign locations compared to the U.S. dollar and \$400,000 of interest expense, which were partially offset by approximately \$500,000 in foreign government subsidies, largely related to the previous investments in technology improvements and upgrades.

In the prior year first quarter, other income included \$1.1 million of gains related to net foreign currency exchange. The effective tax rate for the current year first quarter was 21.8%, which was relatively flat with the 21.7% effective tax rate in the prior year first quarter. The lowering of the U.S. federal statutory income tax rate to 21% as a result of the Tax Cuts and Jobs Act as well as the recognition of approximately \$100,000 of U.S. discrete tax benefits had favorable impacts on the current quarter effective tax rate. In the prior year first quarter, we benefited more from U.S. discrete tax benefits of approximately \$600,000.

Slide 8 reflects our adjusted net income trend. Our reported GAAP net income in the first quarter of fiscal year 2019 came in at \$5.1 million, which is down from \$8.5 million of net income recorded in the first quarter of fiscal 2018.

Our non-GAAP adjusted net income was \$5.0 million in the current year first quarter, excluding proceeds received from a class action lawsuit, which we were -- of which we were a member.

Diluted earnings per share ended at \$0.19 in the first quarter of this fiscal year, which compares to \$0.31 in the same quarter last year.

Cash and cash equivalents at September 30, 2018, were \$75 million.

Operating cash flow trends are shown on Slide 11. Our cash flow used by operating activities during the current year first quarter was \$10 million as our net income plus noncash items was more than offset by the usage of cash related to an increase in working capital, primarily from an increase in inventories related to increased production volumes, the pushout of customer schedules and to manage through the tightened supply of certain components. Our cash flow used by operating activities in the prior year first quarter were \$200,000.

Our cash conversion days increased 9 days for the 3 months ended September 30, 2018, when compared to the same period in the prior year as a result of the addition of the 15 days for contract asset days recognized as a result of the new revenue recognition guidance that we adopted during the quarter and an increase of 6 days in our PDSOH, or production day sales on hand, which is our inventory metric, which were only partially offset from a 5-day decline in our DSO, or day sales outstanding, which is our receivables metric, and a 7-day increase in our accounts payable days.

The contract asset days are a new metric this quarter and relate to the acceleration of revenue for work performed to date and recognized over time as we manufacture the product. The majority of our contracts and revenue are now recognized over time in accordance with the new revenue recognition guidance. The increase from the addition of the contract asset days should primarily be offset with the reduction in the PDSOH inventory days.

Slide 12 reflects our capital and depreciation trends. Capital investments in the first quarter totaled \$4.8 million, related to the replacement of older machinery and equipment, improvements to our facilities and new manufacturing equipment to increase capacity and support new production awards.

Borrowings on our credit facilities at September 30, 2018, were \$59.3 million, which were up over \$50 million from June 30, 2018. The increase in borrowings during the quarter was largely related to preparing to fund the GES acquisition, which, as mentioned earlier, closed on October 1 as well as for domestic cash needs, including for the repurchase of common stock.

As previously announced, the company's primary credit facility was amended and restated during the first quarter to allow for our \$150 million in borrowings, with an option to increase the amount available up to \$225 million at the company's request and consent of the participating banks. The proceeds from the increased credit facility are expected to be used for working capital and general corporate purposes, which include capital expenditures and acquisitions.

Our short-term liquidity represented as cash and cash equivalents plus the unused amount of our credit facilities totaled \$186 million at September 30, 2018.

I would like to conclude by saying that our balance sheet continues to be very strong and we're well positioned for growth.

With that, I would like to open up today's call to questions from analysts.

Lisa, do we have any analysts with questions in the queue?

QUESTIONS AND ANSWERS

Operator

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

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

Are you still there, Chase?

Operator

Excuse me, the first question is coming from Mike Morales of Walthausen & Co.

Michael Morales

Just to begin with the gross margin compression a little bit, can we maybe quantify some of the compression related to the unfavorable product mix on the ramping of new programs versus have the higher material costs are contributing to that?

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

Yes. So the unfavorable product mix for us relates to programs that are mature, let's say, in production for 2 to 3 years. That's sort of a sweet spot for us in terms of reaching all of the performance factors for those production lines. And then the programs that are more challenging for us are in the first year, let's say, first 18 months of production. And so we, during the quarter, saw a pretty significant shift in that mix. For example, our programs in China were more in that maturity range that I spoke about where it's somewhat of our sweet spot and some of the programs here in North America where we had nice strong growth are more towards that ramp-up phase. So we had good growth contribution from the new program launches. But unfortunately, it offset the sales, but not necessarily the gross margin that we lost on the programs that were in the more mature phase of production. And so that was a significant contributor to the overall gross margin decline. The material storage and the higher material cost issue are obviously connected. We are trying our best to pass on any of those, let's say, increases that we see in the market that are driven purely by short supply. It's not always a given that we're able to do that. It obviously creates a commercial negotiation of sorts. And so we're -- and in some cases, that negotiation can take place over a couple of quarters as we work through the impact of some of the material increases related to the short supply situation. The two of those combined were really the majority of the decline in the gross margin during the quarter. And obviously, we're working through the necessary adjustments on both those items.

Michael Morales

Sure. And would you be willing to give a breakdown between how much of those contributed? Or would that -- would you not be willing to go that granular?

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

Yes. That's a little more granular than we would go, Mike. But again, I would say, those 2 items together made up the majority of the drop in gross margin.

Michael Morales

Sure. And so the expectation would be that the programs that are newer in the United States will continue to show improvement over, let's say, as we get out of that early stage into the past the '18 months where they become more mature programs?



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

Yes. That's certainly our expectation. And our past history would support that expectation.

Michael Morales

Sure. And then I know last quarter you mentioned price negotiations underway. In a broad high-level sense, are you seeing any kind of good progress or pushback in certain end markets? Or is this a mix bag across everything?

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

Yes. I -- It's a mix bag across everything. I think, in general, this short supply market that we've been in on several component categories, unfortunately, is carrying on as we expected throughout calendar year 2018. I think there is some good news coming early in 2019 as new capacity is coming on line with several different component categories. And so we're looking for some relief there in our negotiations with our customers thus far, and we have a number of them that are on the calendar year for the annual price rules that we provide, and I would say, in general, they understand. They're not necessarily willing to accept anything that would look like a price increase. But they understand that some of the cost benefits that we delivered in the past are just not going to be there in this market. And so we're working through that the best we can. Out of all the component categories that are still sort of pretty stretched yet, I would say the MLCCs for us, which we use a lot of them, the multilayer ceramic capacitor, those are still in short supply and driving significant price increases in the market. And that's one that we continue to keep a really close eye on to de-risk both availability and price increases in our operating plan.

Michael Morales

Sure. And I guess, last for me, now that the GES acquisition is closed, can you just remind us of the opportunities that you're expecting from that? And then as you're looking forward, capital allocation priorities on the back of that?

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

Yes. As far as GES, we still -- as we stated in our press release when we closed, we still think the acquisition will contribute about 4% to 6% to our sales growth. Obviously, we also talked a little bit about seasonality there in that business as we see it today. But we're still in that range for contribution to growth. And as far as our earnings, we still believe it'll be neutral to slightly accretive to our earnings. And so, yes, we're busier now in the integration. We obviously have some investments we want to make in the company to shore up some of the needs, let's say, to support the growth that is projected in that company. And so we're doing a lot of the right things right out of the gate to work on the integration. In terms of the capital allocation going forward, as Mike mentioned in his comments, we've got a lot of liquidity that we can put to work and we certainly want to do that. We do intend to continue to be inquisitive, especially as it relates to the -- to our new platform strategy and making more strategic investments in the areas of automation, test and measurement. Having just closed on GES, we want to make sure we get the pace and the sequencing right. And so as we're studying the options that we see in the market, the targets and maybe also some of the pricing or valuations around those targets, we'll certainly keep that in the balance as we discuss those capital allocations. We do think that our core business, EMS, DCMS business, we still believe we'll manage CapEx somewhere around depreciation that'll ebb and flow a little bit depending on new program wins, et cetera. And we've been aggressive, and with our share repurchase program, we've been consistent as well. And so each and every board meeting, the capital allocation discussion is on the agenda and the share owner return portion of that, obviously, is something the board deliberates on very carefully in terms of that piece of the allocation going forward as well. I see us really operating in a similar kind of capital allocation mode that we've been operating in over the past several quarters as we go forward.

Operator

The next question comes from Chase Basta of AW Capital (sic) [AWH Capital].

Chase Basta

Hey, Don and Mike, can you hear me?

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

Yes.



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

Yes, Chase, we can hear you fine.

Chase Basta

Great. I just wanted to ask, you reiterated your revenue and margin guidance for the full year despite pretty challenging quarter. Can you talk a little bit more about what gives you confidence there? What -- are there other parts of your business that you have visibility into that you think you're going to offset this? Or just kind of help us understand what you're seeing.

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

Yes. Well, I'd start by just saying the strength in North America. Again, we're expecting that with the new program wins that we began launching really late last year, ramping up throughout this year. So there are few more increment -- few more increments, if you will, of those new program ramp-ups. And we're pretty confident in those programs, and we're pretty confident in the economy here in the U.S., which is driving the overall demand for those programs. Obviously, we have some very experienced teams here in North America that are dealing with those ramp-ups. So we're placing high expectations on them on how fast we can get those ramp-ups performing to our targeted levels. So the combination of putting some of our very experienced people to work at accelerating the conversion on those new program ramp-ups and the confidence in the end market demand for those new program ramp-ups is the biggest piece to the equation that we're talking about in terms of holding on to the guidance for the full year. Look, I'll tell you, we're watching China very carefully. The -- these tariffs and the trade dispute between U.S. and China has put a lot of pressure, especially on the demand in China, as we reported today, a double-digit drop in our business in China in really over a fair short period of time between the release of List 1, 2 and 3, within 90 days, the bikes started to take a hold in terms of just the overall demand in China. We're at the bottom of that. And might we see a more steadier outlook in China? We're hoping so. We're not expecting a big recovery there either. And so as we look at China and the drop that we've seen here in Q1, we're watching that situation very carefully. If it worsens, that'll put a lot of challenge on us. If it stays where it's at, improves a little, then it's in line with our expectation that the full year -- fiscal year 2019 full year will yield something close to an 8% organic growth rate. So those are the 2 biggest pieces as we look at that -- at holding on to that guidance for the full year really is the impact of the tariffs on the China demand and then just the execution here in North America.

Chase Basta

Okay. That's helpful. And then you talked about the GES acquisition and how you expect that to be neutral to slightly accretive this year, but can you help us understand the longer-term outlook and how that can impact the financial profile, business and just kind of touch on the overall fit to the platform?

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

Yes. It's a technology-rich company, GES, that is a technology-rich company. And they really have been successful partnering with some of the leading technology companies in the world. And so we're really excited about the growth opportunities that they have, medium term, and obviously, we hope that we can help enable some of that growth to occur at even a higher success rate than they've already had in their brief 12 years as a company. So we're excited about the growth opportunities. We want to take the opportunity to invest in that growth. And so we will be adding to the infrastructure of the company. And so short-term profitability might not be as significant as medium-term profitability, but all that being said, in the big picture, their profit profile is higher than, let's say, the profit profile of the EMS business. We can't give you exact numbers yet, but I -- we can say in confidence that their profile or their -- let's call it, their operating income margin would be higher than our core EMS, DCMS business.

Operator

(Operator Instructions) At this time, there are no further questions. I would like to turn the call back over to Mr. Charron for closing remarks.

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

Thank you, Lisa. 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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