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KE - Q1 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****PRESENTATION****Operator**

Good morning, ladies and gentlemen. My name is Saeed, and I'll be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics First Quarter Fiscal 2018 Financial Results Conference Call.

(Operator Instructions)

Today's call, November 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, 2017, and in today's release. The panel for today's call is Mr. Don Charron, Chairman of the Board and Chief Executive Officer; and Mr. Mike Sergesketter, Vice President and Chief Financial Officer of Kimball Electronics. I would now like to turn today's call over to Mr. Don Charron. Sir, you may begin.

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

Thank you, Saeed, 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, 2017. 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'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.

Our sales in the first quarter of fiscal year 2018 were up 5% from the previous quarter and up 12% when compared to the first quarter of fiscal year 2017. Double-digit growth year-over-year in 3 of our 4 end market verticals helped us set a new quarterly sales record for the seventh consecutive quarter and set the pace for us to achieve and exceed our long stated goal of \$1 billion in annual sales in this fiscal year 2018. Over the previous 3 fiscal years, our first 3 years as a newly spawned public company, our compound annual growth rate or CAGR, was approximately 8%, and our goal is to sustain this growth rate over the next few years. Our margins improved sequentially when compared to the fourth quarter of last fiscal year, however, we are below our new operating income target of 4.5%. We are focused on yield and throughput improvements on recently launched new programs and further progress on the ramp up in Romania, to help us make sequential, incremental improvement and achieve our new goal. While we made good progress in fiscal year 2017, we still have work to do to achieve our long-term goal of 12.5% ROIC. Margin expansion and capital efficiency will continue to be priorities of focus for us this fiscal year. We have entered the next phase of ramp-up activity in Romania. 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 operating breakeven point by the end of fiscal year 2018. The impact of the Romania ramp-up on our first quarter fiscal year 2018 operating income was approximately 40 basis points. We continue to make investments that will drive further growth in sales and profits. We invested \$6 million in capital expenditures in the first quarter of fiscal year 2018. Last quarter in our release, we indicated that we expected our [expenditures] to approximate depreciation expense in fiscal year 2018. Due to the stronger than expected forecasted demand from several of our existing customers, we now expect that additional capital expenditures for capacity expansion will increase our total capital expenditures in fiscal



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year 2018 to be closer to the fiscal year 2017 level of \$34 million. We are focused on getting through launch cycles, ramping up production to new forecasted levels and ensuring that the newly deployed capital achieves our expected returns. During the first quarter of fiscal year 2018, we also returned \$3.3 million to our shareowners by purchasing 173,000 shares of our common stock, which brings our total to \$38 million and 2.9 million shares purchased since October 2015 under our board authorized share repurchase program.

And finally, we engaged with a strategy consultant this past year and updated our strategic plan, which was reviewed and approved by our board. The plan looks to first, optimize our EMS business by focusing on capital efficiency, margin expansion, and high quality revenue growth. And second, make new investments that will help us develop our sales beyond EMS to a multifaceted manufacturing solutions company.

Now I'll 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 in our Investor Relations website within the events and 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 a record \$253.2 million, which was a 12% increase compared to net sales of \$226.5 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 a year ago, net sales in our automotive vertical was up by double digits compared to a year ago to a new quarterly record of \$102 million, the first time topping \$100 million in a quarter. The increase from a year ago was largely due to new program introductions and continued steady demand in North America and Europe, which more than offset a decline in demand in China. Our medical vertical was also up by double digits compared to Q1 last year, primarily from new program introductions. Our industrial vertical was up as a result of new product launches relating to smart metering devices and increased demand for climate control products. And our Public Safety vertical was up over 30% from the prior year first quarter from both the ramp-up of new programs and increased demand from existing products.

Our gross margin in the first quarter, reflected on Slide 5, was 7.7%, which was down from 8.1% in the same quarter last year. However, our gross margin did improve sequentially from 7.5% posted in the fourth quarter of fiscal year 2017. Our decline in gross margin in the current year quarter compares to -- compared to a year ago was due in large part to the impact on yields and higher costs associated with the support of new product introductions during the current year quarter. Selling and administrative expenses, Slide 6 in the deck, were \$9.9 million in the first quarter, which were up \$400,000 in absolute dollars, but were down 30 basis points compared to the prior year first quarter from leveraging of higher sales volumes. The increase in selling and administrative absolute dollars compared to the prior year was primarily due to higher employee salaries and related benefit costs. In the prior year first quarter, we recorded other general income of \$4 million related to proceeds we received from a 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 inflated prices and overcharges to purchasers of those components. No other general income was recorded in the current year quarter.

Our operating income came in at \$9.6 million, or 3.8% of net sales, which compares to reported operating income of \$12.8 million or 5.7% of net sales a year ago. However, if you adjust the prior year operating income by excluding the lawsuit income, the non-GAAP adjusted operating income from core operations a year ago was \$8.8 million, or 3.9% as a percent of sales, as shown on Slide 7. Other income expense net was income of \$1.2 million in the fiscal year 2018 first quarter compared to income of \$800,000 in the first quarter of fiscal year 2017. During the current year first quarter, net foreign currency gains as a result of favorable foreign exchange rate fluctuations, which were partially offset by derivative losses, primarily drove the income and other income expense net section of the income statement. The prior year first quarter other income and expense net included \$900,000 of income from a bargain purchase gain recognized on the acquisition of Aircom manufacturing Incorporated. The effective tax rate for the current year first quarter was 21.7% compared to 25.5% in the prior year first quarter. The decrease in the tax rate was largely the result of a \$600,000 discrete item recognized during the quarter related to the excess tax benefit of the difference in the tax deduction and the book expense recognized for performance shares granted during the period. This excess tax benefit was recognized in the current year quarter as a result of the adoption of a new accounting standard to simplify share-based payment accounting, which prospectively requires excess tax benefits to be recognized in earnings. This had a \$0.02 favorable impact to diluted earnings per share for the current quarter.



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Slide 8 reflects our net income trend. Net income in the first quarter of fiscal year 2018 was \$8.5 million compared to our reported amount of \$10.1 million in the first quarter of last year. However, non-GAAP adjusted net income for the prior year first quarter was \$6.7 million after adjusting for the lawsuit proceeds and the bargain purchase gain. Diluted earnings per share was \$0.31 in the current year first quarter compared to \$0.36 in the prior year first quarter. Our non-GAAP adjusted diluted earnings per share of \$0.24 in the prior year quarter, again adjusted for the lawsuit income in the bargain purchase gain. Cash and cash equivalents on September 30, 2017, were \$38.3 million. Operating cash flow trends are shown on slide 11. Our cash flow from operations during the current year first quarter was impacted largely by an increase in inventory and accounts receivable for growing production and sales volumes. As a result, we used \$200,000 of cash from our operating activities in the current quarter compared to \$14 million of cash provided by operations in the first quarter of last year. The prior year first quarter also included the \$4 million of proceeds from the lawsuit settlement. Our cash conversion days increased 1 day for the 3 months ended September 30, 2017, when compared to the same period in the prior year, as our accounts payable days of 62 days declined by one day compared to the prior year quarter. Our PDSOH or production days sales on hand, our inventory metric, and our days sales outstanding, our accounts receivables metric, were both flat with the prior year quarter at 61 and 60 days, respectively.

Slide 12, reflects our capital and depreciation trends. Capital investments in the first quarter totaled \$6.1 million, largely related to our investment in new manufacturing equipment to support new product awards and increased manufacturing capacity. As Don mentioned, we purchased \$3.3 million of our common stock during the quarter. Borrowings on our credit facilities at September 30, 2017, were \$14 million, which were up \$4 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 \$95 million at September 30, 2017.

I would like to conclude by saying our balance sheet is very strong, and we're well positioned for continued growth.

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

QUESTIONS AND ANSWERS

Operator

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

Chase Basta

Noticed buyback seemed pretty strong during the quarter and you guys have historically been a little bit lumpy with how you go about repurchasing shares. Just kind of curious if you can shed a little light on the thought process behind it this quarter.

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

Well, Chase, the timing, the actual numbers of shares repurchased depends on a variety of factors, including price, general business and market conditions and of course, other alternative investment opportunities. So those are the factors that weigh into ultimately what we end up purchasing during any given quarter.

Operator

(Operator Instructions) Gentlemen, I am showing no further questions at this time.



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

Okay, thank you, everyone. 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, this concludes today's conference call. You may all disconnect. And have a wonderful day.

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