Kimball Electronics, Inc.(05 08 2019)
May 08, 2019

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

Participants:
- John Choi; Medina Singh Partners, LLC; Analyst

PRESENTATION

Operator: Good morning, ladies and gentlemen. At this time, I would like to welcome everyone to the Kimball Electronics Third Quarter Fiscal 2019 Financial Results Conference Call.

(Operator Instructions)

Today's call, May 8, 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, 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 Charron: Thank you, Josh, and welcome, everyone, to our third quarter conference call. Our earnings release was issued yesterday afternoon on the results of our third quarter ended March 31, 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 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 I'll turn it over to Mike for the financial overview. After that, we'll answer any questions that you may have.

We delivered record sales, operating income, net income and diluted EPS in our third quarter. Strong double-digit organic growth in our Medical and Industrial end market verticals helped us exceed our 8% organic growth goal and set a new quarterly sales record.

New program launches and ramp-ups more than offset continued softness in certain other programs primarily caused by global macroeconomic conditions and trade uncertainties.

We made excellent progress optimizing our business as we were successful expanding our operating margin by 70 basis points when compared to the third quarter of fiscal year 2018, helping us exceed our goal of 4.5% operating income.

Our acquisition integration work with GES continues as we remain focused on our strategy to become a multi-faceted manufacturing solutions company. We have good momentum, and we are cautiously optimistic that we can begin to consistently achieve our goals of 8% organic growth and 4.5% operating income.

The Romania operation continue to progress in its ramp-up and improved its impact on consolidated operating income percent by 40 basis points when compared to the prior fiscal year third quarter while also achieving another milestone of generating net income for the quarter.

Across all our units, we continue to drive Lean Six Sigma projects and global supply chain initiatives to improve yield and throughput and improve our margins. Margin expansion and capital efficiency will continue to be priorities of focus for us.

In general, the component availability continues to improve, and we are experiencing fewer component shortages. We increased our inventory levels during the prior periods to minimize disruptions. As supply catches up to demand, we expect to work our inventory back down to normal levels.

Our cash conversion days increased to 75 days for the quarter ended March 31, 2019, which is up from 62 days in the same quarter last year, primarily due to these increased inventory levels.

Thus far, we've 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. We are anxiously awaiting the outcome of the U.S.-China trade talks.

We continue to leverage our strong balance sheet to make investments that will drive further growth in sales and profit. We invested $6.9 million in capital expenditures in the third quarter of fiscal year 2019, in part to support the launch and ramp-up of new programs.

During the third quarter of fiscal year 2019, we also returned $4.7 million to our share owners by purchasing 295,000 shares of our common stock, which brings our total to

$67.9 million and 4.5 million shares purchased since October of 2015 under our Board-authorized share repurchase program.

And finally, as I stated earlier, we are working diligently on the integration of GES. The acquisition of GES brings us new technologies and capabilities in automation, test and measurement and is a significant step in our strategy to become a multi-faceted 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. Now I'll turn it over to Mike to discuss our third quarter results in more detail. We will then open the call to your questions. Mike?

Michael Sergesketter: 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 third quarter net sales were a new quarterly record of $313.5 million, which was a 10% increase compared to net sales of $283.9 million in the prior year third quarter. Adversely impacting our net sales for the quarter were foreign exchange rates, which reduced our net sales 3% compared to the third quarter a year ago.

However, offsetting the impact of foreign currency rates were sales resulting from the GES acquisition, which added 2% to our consolidated net sales in the quarter, while the impact from the adoption of the new revenue recognition accounting standards added an additional 1% to consolidated net sales in the 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 down 7% compared to the same quarter a year ago as lower demand in China and, to a lesser degree, Europe, more than offset higher sales in North America largely from the continued ramp-up of new program introductions.

However, when compared sequentially to our second quarter, the Automotive vertical was up by double digits from the growth in all of our geographic markets. Our Medical vertical was up 27% in the current quarter compared to Q3 last year primarily from strong demand for existing programs.

Our Industrial vertical was also up 27% from a year ago as a result of an increase in demand for existing programs, including climate control products and the additional revenue associated with the GES acquisition.

Lastly, our Public Safety vertical was up 5% from the prior year third quarter from both increased demand for existing programs and new product launches. Our gross margin in the third quarter, reflected on Slide 5, was 8.5%, which improved from 8.1% in the third quarter of last year.

Our increase in gross margin in the current year quarter compared to a year ago was largely related to the leverage of higher sales volume, favorable product mix to higher-margin programs and higher new product introduction costs in the prior year third quarter.

Selling and administrative expenses, Slide 6 in the deck, were $12.1 million in the third quarter, which were up approximately $300,000 in absolute dollars and down 30 basis points compared to the prior year third quarter.

The increase in selling and administrative absolute dollars was primarily due to the amortization of finite-lived intangible assets, which were acquired with the GES acquisition, and an increase in the fair value of the supplemental employee retirement plan, or SERP liability.

The revaluation of the SERP liability is exactly offset by gains recorded on the SERP investments during the quarter, which is recorded in other income expense net. These increases were partially offset by lower professional service fees compared to a year ago.

Operating income for the third quarter, on Slide 7 in the deck, came in at a new quarterly record of $14.5 million or 4.6% of net sales, topping our goal of 4.5%. This compares to operating income of $11.1 million or 3.9% of net sales in the same period a year ago.

Other income and expense net was income of $200,000 in this quarter, which compares to income of $2 million in the third quarter of fiscal year 2018.

Other income net in the current year third quarter was primarily the result of approximately $700,000 in foreign currency exchange gains and $600,000 in gains on the SERP investments, which again was offset in the selling and administrative expenses from the increase in the fair value of the SERP liability.

Largely offsetting the foreign currency gains and the SERP investment gains in the quarter was $1.2 million of interest expense, which was the result of increased borrowings on our credit facilities, including the financing of the GES acquisition and for general corporate purposes.

Other income net in the prior year third quarter was primarily the result of $2.1 million in net foreign currency exchange gains. The effective tax rate for the current year third quarter was 19.3% compared to 17.5% in the same quarter last year.

The current year quarter effective tax rate was favorably impacted by approximately $400,000 in discrete tax adjustments primarily related to provision to return true-ups. In the prior year third quarter, approximately $200,000 of discrete tax benefits were recognized.

Slide 8 reflects our adjusted net income trend. Our net income in the third quarter of fiscal year 2019 came in at a new quarterly record of $11.8 million, which compares to a GAAP net income of $10.8 million and adjusted net income of $10.7 million in the third quarter of fiscal 2018. The non-GAAP adjusted net income of $10.7 million a year ago excluded adjustments related to the U.S. Tax Cuts and Jobs Act.

Diluted earnings per share ended at $0.46 for the third quarter of this fiscal year, which was up 15% from the $0.40 reported in the same quarter last year. Cash and cash equivalents at March 31, 2019, were $47 million.

Operating cash flow trends are shown on Slide 11. Our cash flow used by operating activities during the current year third quarter was $14.6 million as an increase in our working capital, largely from an increase in receivables related to higher sales volumes, more than offset cash provided by net income plus noncash items. Our cash flow provided by operating activities in the prior year third quarter was $9.5 million.

Our cash conversion days, or CCD, increased 13 days for the 3 months ended March 31, 2019, when compared to the same period in the prior year, primarily related to an increase in raw material inventories to maintain appropriate buffer stock levels in the current tight supply environment.

Our CCD calculated -- calculation compared to the prior year quarter includes 15 days for contract asset days recognized as a result of the new revenue recognition guidance that we adopted during the first quarter of the current fiscal year; and an increase of 2 days in our PDSOH, or production days sales on hand, our inventory metric, which were only partially offset from a 2-day increase in our accounts payable days and a 2-day improvement in our DSO, or days sales outstanding receivables metric.

The contract asset days are a new metric this fiscal year 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 PDSOH inventory days as inventories relieve when revenue is recognized over time under the new revenue guidance.

Slide 12 reflects our capital and depreciation trends. Capital investments in the third quarter totaled $6.9 million, largely related to manufacturing equipment to support new production awards and to increase capacity. Borrowings on our credit facilities at March 31, 2019, were $127 million, which were up from $8 million at June 30, 2018.

The increase in borrowings during the current year is in large part related to funding the GES acquisition for working capital needs, including for higher inventory levels due to the tight component market and higher receivables related to sales growth and for other domestic cash needs included -- including the repurchase of common stock.

Our short-term liquidity available, represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled $107 million at March 31, 2019.

In conclusion, our Q3 result resulted in record revenue, operating income, net income and earnings per share and were driven by the higher volumes and improved optimization of our operations.

We remain cautiously optimistic that we will begin to consistently deliver on our goal of 8% organic growth and 4.5% operating income. With that, I would like to open up today's call to questions from analysts. Josh, do we have any analysts with questions in the queue?

QUESTIONS AND ANSWERS

Operator: (Operator Instructions)

And our first question comes from John Choi of Medina Singh Partners.

John Choi: My first question is regarding gross margins. Can you help us understand some of the components of the 40 basis point gross margin expansion? I mean how much of it was Romania versus mix versus, say, raw material costs?

Michael Sergesketter: Well, I think in general, a big part of that was mix within the quarter. We commented that our Automotive sales were down a bit, and we were up in our other end markets, Industrial and Medical, and we think that had a big part to do with the shift in the gross margin.

John Choi: Okay. And my second question is regarding the GES acquisition. I know we were expecting, call it, 4% to 6% revenue growth from this acquisition, but it's only been adding about 2%.

So help us understand some of the drivers behind why the revenue contribution has been a little bit less than we initially expected.

Donald Charron: Yes. So the overall number that we provided was sort of to the annual run rate and kind of looking at a 12-month sort of view.

And as we've mentioned on previous calls, there is some seasonality in the GES current portfolio of business. And as we spelled out before in the last webcast, their low season, if you will, has typically been the October, November, December time frame.

And their high season has typically been the April, May, June time frame, and so there is some seasonality there. So the 4% to 6% number we provided was really looking at a full

12-month view of the business, performing somewhat in a similar way as it did in the prior 12 months before our acquisition.

I will say that the business has gotten off to a slower start. I think that we're seeing some cyclicality also with the slower revenue numbers here in our first couple of quarters. Again, their current portfolio of business primarily supports smart mobile device assembly in the semiconductor industry.

And so I think both of those end markets, if you will, are also cycling lower at this point in time. And so we are off to a slower start than we had expected, but we look for that to improve in the future.

Operator: (Operator Instructions)

And I'm not showing any further questions at this time. I would now like to turn the call back over to Don Charron for any further remarks.

Donald Charron: Thank you, everyone, and 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: Thank you. At this time, listeners may simply hang up to disconnect from the call. Thank you, and have a nice day.