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KE.GCZ - Q2 2015 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

Don Charron *Kimball Electronics Inc - Chairman of the Board & CEO*

Mike Sergesketter *Kimball Electronics Inc - VP and CFO*

CONFERENCE CALL PARTICIPANTS

Chuck Murphy *Liberty Park Capital - Analyst*

Hendi Susanto *Gabelli - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Stephanie and I will be your conference call facilitator today. At this time, I'd like to welcome everyone to Kimball Electronics Second Quarter Fiscal 2015 Financial Results conference call.

(Operator instructions).

Today's call, February 12th, 2015, 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 the Kimball's Form 10 declared effective on October 7th, 2014 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 hand the call over to Don Charron. Mr. Charron, you may begin.

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Thank you, Stephanie, and welcome, everyone, to our second quarter conference call.

Our earnings release was issued this morning on the results of our second quarter ended December 21, 2014.

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.

The spin-off from Kimball International was completed on October 31st, 2014. Please keep in mind that our second quarter results include one month as a segment of Kimball International and two months as a standalone public company.

Also, while the legal separation is complete, there are still many ongoing activities to separate the infrastructure and effectively achieve full separation. During this period, we are relying on a parent company for certain services as outlined by the transition services agreement included in our Form 10 filing with SEC.

These are important action steps for us to complete in order to fully complete the spin-off and separation. There are also important and that they will help us lower our cost structure and offset the added cost of becoming a standalone public company.



We are making good progress and expect to complete all the spin-related activities, close out the transition service agreements and achieve full separation by the end of this calendar year.

Our support teams have done a remarkable job staying focused on these spin-related activities and making sure that they do not impact our operations.

Overall, we were pleased with the second quarter results, strong growth in three of our four end market verticals, helped offset a new quarterly sales record for the second consecutive quarter.

We had better than expected growth with a number of our existing customers. Some of the growth came as a result of increased demand that developed during the quarter. This combined with sales growth from new program wins helped us overcome the previously announced decline in sales to JCI.

The JCI build-out is now substantially complete and we continue to work on filling the hole created by the loss of this business and we are encouraged by our progress. While overall, market conditions appeared to be mixed, our new business opportunities pipeline remained healthy and we continue to have good momentum in each of the four end market verticals we serve.

Our business and operations teams remained focused on margin improvement and effective capital utilization. Our Lean Six Sigma projects and our global purchasing initiatives helped us exceed our adjusted operating income goal of 4% for the fourth consecutive quarter. We were pleased with this result as well as the progress we made toward meeting the cost reduction expectations of our customers.

Our solid financial position provides us the flexibility to invest in new initiatives that will drive future growth in sales and profits. The capital to support these initiatives such as the European capacity expansion in Romania and the significant new business wins will in most cases be deployed in advance of the sale growth and therefore put short-term pressure on the targets that we've set for our capital metrics.

Maintaining margin improvement and effective capital utilization will continue to be priorities of focus for us going forward.

Now, I would 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. I'll briefly cover our financial highlights for Q2 and would remind you as Don stated in this opening comments that our quarter does include one month as a segment of Kimball International and two months as a standalone public company. So it does include some corporate allocations as well as spin-related costs.

Starting with sales, our second quarter net sales were \$207.6 million, an increase of 15% from last year, and as Don stated, a new quarterly record for our business.

Our sales growth by vertical compared to the same quarter a year ago shows our automotive vertical up 12% largely on the strength of the China market.

Our medical vertical was up 25% and public safety up 36% both on increased demand from existing products and new customer awards.

Our industrial vertical was flat year-over-year but that vertical remained stable.

The impact on sales from the Johnson Controls' exit was \$12.3 million reduction compared to the same quarter last year, and as Don mentioned, the exit is substantially complete.



Our gross margin improved 90 basis points during the second quarter compared to last year. The improvement resulted primarily from operating leverage due to the higher sales as well as cost productivity from our operations, ongoing Six Sigma and continuous improvement activities.

Selling and administrative expenses increased to \$100,000 compared to a year ago as a percentage of sales showing an admin cost decline of 60 basis points in the second quarter compared to the prior year.

The main contributors to the change in selling and admin included spin-off costs during the quarter of \$1.3 million, reduced cost related to the elimination of the former parent's non-spin-off-related charges and allocations for management fees, I.T. services and so forth which more than offset the increased compensation related to the additional team members brought onboard to support Kimball Electronics as a standalone public company.

The effective tax rate for the second quarter was 29.7%, impacted primarily by a higher mix of foreign earnings during the quarter at lower statutory tax rates compared to the U.S. rate.

Non-deductible spin-off costs during the quarter which had an unfavorable impact on the tax rate partially offsetting the impact of the non-deductible spin cost was a reinstatement of the R&D tax credit in the U.S. for calendar year 2014.

The prior year Q2 effective tax rate was 1.5% and was favorably impacted by \$1.2 million of adjustments related to a decrease in the foreign deferred tax asset valuation allowance and a tax law change in Mexico.

Our consolidated net income in the second quarter of fiscal year 2015 was \$6.2 million compared to \$5.2 million in the second quarter of last year.

Excluding spin-off cost, the net income was \$7.4 million during the second quarter. Diluted earnings per share was \$0.21 in the second quarter of this fiscal year compared to \$0.18 in the prior year quarter. Spin-off cost during the quarter reduced our earnings per share by \$0.04.

Cash and cash equivalents at December 31st, 2014 were \$61.7 million. Net cash distributed to us by Kimball International in connection with the spin-off was \$44 million. And so as previously disclosed, we began operations as an independent public company on October 31st with approximately \$63 million in cash. Cash flow provided by our operations in the second quarter was \$8 million.

Capital investments in the second quarter totaled \$9 million primarily for new machinery and equipment and software. We have no long-term debt as of December 31st, 2014, and our short-term liquidity available represented as cash and cash equivalents plus the unused amount of our credit facilities totaled \$114.3 million.

Our balance sheet is very strong and we think we're well-positioned for growth as a new standalone public company.

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

QUESTIONS AND ANSWERS

Operator

(Operator instructions).

Our first question comes from Chuck Murphy with Liberty Park Capital. Your line is open.

Chuck Murphy - Liberty Park Capital - Analyst

Good morning, guys.



Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Good morning.

Chuck Murphy - *Liberty Park Capital - Analyst*

I just want to get a better understanding of what's going on with JCI. If I look at your end market performance in your press release, it looked like auto was up year-over-year. Could you walk me through what JCI was as a percentage of that auto last year and what it is today and what it might be a year from now?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Yes, we can, Chuck. You know if you go back and look at the 8-K that we released back in December of last year after we learned of JCI's new intentions for the business, we disclosed in that 8-K that the run rate of that business that would be affected was about \$20 million per quarter.

And so that was roughly the run rate of the business, and we're tracking relatively close to the forecast, you know, since that 8-K released last December up until now. So in our press release when we refer to the fact that our business was down \$12.3 million year-over-year, that gives you an idea of how much of that business was actually lost compared to the same period of last year.

Chuck Murphy - *Liberty Park Capital - Analyst*

Got you. But -- so will it eventually be that full \$20 million that will have been lost?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Yes, it will approach that full -- that full \$20 million for quarter run rate.

Chuck Murphy - *Liberty Park Capital - Analyst*

Got you.

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Once -- and as we stated in the press release, the build-out is substantially complete. So going forward from this quarter, you know, it's that \$20 million run rate is approaching zero.

Chuck Murphy - *Liberty Park Capital - Analyst*

Got you. Okay. And so given that auto was up year-over-year, how were you able to fill, you know, a decent sized hole?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Yes, we were very pleased with the results. And as I mentioned in my comments, some of that demand developed even within the quarter. We did see, you know, strong demand from China which was one of the pleasant surprises. But overall, our book of business performed very well in the automotive piece despite that drop in JCI sales, so we were very pleased...

Chuck Murphy - Liberty Park Capital - Analyst

Got it.

Don Charron - Kimball Electronics Inc - Chairman of the Board & CEO

... with the results.

Chuck Murphy - Liberty Park Capital - Analyst

Okay. And then one of your other large auto customers was TRW and they got acquired as well by ZF. Can you kind of give us an update on what's going on with ZF? You know, so you had that press release about Gentex. Is that ZF's contract manufacturer or -- can you just give an update there?

Don Charron - Kimball Electronics Inc - Chairman of the Board & CEO

Sure, sure, let me handle a little separately. Yes, TRW is a customer and they are being acquired by ZF. I believe that transaction is expected to close sometime early this calendar year.

You know, like any change in ownership like that, we always realize and recognize that we -- you know, we need to, you know, widen the relationship, if you will, to include members of the new ownership.

But we feel at this point with our relationship with TRW and the fact that we've been doing business with them for many years, 30 years or so, that we would have the opportunity to continue to be an important supply partner to them and, of course, we have to earn it.

Our performance has to remain strong and our scorecard, if you will, of course, performance with them has to remain in very good standing. And we'll -- and we should be able to continue on.

So, you know, more to come on that after the -- after the transaction itself closes with ZF. I'm sure we'll learn more about it but at this point, we feel like we've got a good opportunity and good firm standing with TRW and we've got a good chance for that to continue on.

Chuck Murphy - Liberty Park Capital - Analyst

Got it, okay.

Don Charron - Kimball Electronics Inc - Chairman of the Board & CEO

In terms of the Gentex relationship, you know, you are referring to it as well as the press release, we are excited about the development there that we're working with Gentex on. It is one of our largest automotive customers that has given us the new business awards, that we're -- you know, that we're preparing for with this new advanced automation that we're developing with Gentex.

We did not name who that development is for in terms of our automotive customer that for market competitive reasons, we are not disclosing that, but it is an automotive customer and it's a significant award.

As you can see from the press release, you know, there is multiple programs over multiple years and going out significantly into the future. So that's a very important development for us and as I mentioned in my opening comments, it's the challenge for us in many cases with those new significant business wins is that we're deploying capital, you know, in advance of the actual sales growth, not incumbent at all in the automotive business to



have to deploy capital as much as 18 to 24 months before you start serious production as you're going through the development phase and the validation phase of the program.

Chuck Murphy - *Liberty Park Capital - Analyst*

Got it. If I could just ask one follow-up on the TRW. I mean I guess kind of what sort of the situation with JCI that, you know, basically made it difficult for you to hold on to that business and what might be different with your relationship with TRW that would allow you to hold on to it as opposed than being acquired?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

That was a really good question. I think I would just maybe point out some of the specifics on the Johnson Controls' decision that came about last year in December.

You know, they, you know, at the very beginning of that decision were really pointing that the reason of the decision adds from underutilized capacity that they had internal to their operations. Later, of course, we learned that, you know, they also made a key strategic decision to basically put that business up for sale, the automotive electronics division of Johnson Controls up for sale. But I think that there were contributing factors there that also played in to the decision.

We were in very good standing with JCI. In fact, we had won a supplier award from them for our performance and, you know, obviously, it was a surprise to us last year in December when we learned of their new direction, but we were in very good standing with them and so we were able to develop a wind down plan that I think, you know, supported their decision very well but also helped us transition and have a chance to really fill the hole.

So, you know, I think that that's, you know, to us is the result of the strong partnership with them. We have the same strong partnership with TRW and I think again, we would -- we would hope that we have the opportunity to continue on with them even after the transaction closes with ZF.

Chuck Murphy - *Liberty Park Capital - Analyst*

Yes, okay. Sounds good. Thanks for the help.

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Thanks, Chuck.

Operator

Again, ladies and gentlemen, to ask a question, please press star-1 on your dial pad. Our next question comes from Hendi Susanto with Gabelli. Your line is open.

Hendi Susanto - *Gabelli - Analyst*

Don and Mike, good morning and congrats on strong top-line growth.



Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Thanks, Hendi.

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

Thank you.

Hendi Susanto - *Gabelli - Analyst*

Yes. First, would you be able to share some insight on what products drove strong sales in your three major verticals and out of sales in China?

And second, how should we think of sales growth expectation for your second half given that you're seeing the double-digit growth in the first half?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Hendi, first of all, you know, in terms of specific products that drove growth, we don't disclose that for market competitive reasons. I can just say to you that, you know, the growth was coming from multiple different product categories, and as you can see, from three of our four verticals.

So, you know, in addition to having, you know, growth that was pretty wide, it was also pretty deep in a couple of cases. So that -- that was a very -- a very pleasant surprise for us in many ways.

You know, I can share with you that we have pretty disciplined processes whereas by we go through sales and operations planning with our customers each month and, of course, in those meetings, they're giving us their forecasts for what they expect would be the requirements in the upcoming months.

And as I mentioned in my opening comments, you know, much of the demand that we saw -- the increases we saw came as a result of developments during the quarter which would -- and said another way, would mean that it was demand that even in many ways surprised our customers because they simply were not forecasting it at the beginning of the quarter.

So that being said to answer the second part of your question, you know, we're not so sure what to expect, you know, in the -- in the upcoming quarters or the second half of our year. We do know that, you know, our business relationships are strong, our customers, you know, remained well-positioned in the markets they serve.

And so, you know, we're consciously optimistic, but at the same time, we know and we can see that there are several different sources of potential headwinds, and so yes, we're taking each quarter by quarter with what we can feel and see in the marketplace.

Hendi Susanto - *Gabelli - Analyst*

And then you mentioned some surprise upsides in the quarter. Was that like a one-time event or do you expect that to continue spilling into the current quarter?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Really hard to say, Hendi, really hard to say. You know, obviously, the quarter turned out stronger as a result of the stronger requirements that developed in the quarter. And, you know, in many cases, that was a surprise to our customers.



As you know, we don't give guidance so we really aren't in a position to talk about what to expect in the future, but it was a surprise this quarter to many of our customers in terms of demand that we saw.

What we thought we were going to have as the requirements at the beginning of the quarter and to develop during the quarter, well, we ended up at the end of the quarter.

Hendi Susanto - *Gabelli - Analyst*

Okay. And then Mike, you mentioned that capacity expansion in Romania will likely add cost to your cost structure. How significant will that be and what are drivers of your operating margin performance in the next several quarters? Should we -- is it reasonable to assume some margin expansion?

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

While the Romania project is just launching, you know, the way those projects typically work, you know, the costs, they sort of ramp up over the quarters and so we do -- we would expect to see as we bring that capacity online that there would be a short-term impact on margins.

In terms of what it is, you know, that will be driven by the cost that we incur and how quickly we can get that capacity online. So it's kind of hard to say at this point.

Hendi Susanto - *Gabelli - Analyst*

Okay. And then last question from me, should we anticipate some like ForEx impact?

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

Yes. You know, in terms of the ForEx impact, obviously, that's an area that we have been watching very closely with all the movement in the exchange rates.

And in terms of Q2, we think a minimal impact on our results. You know, we have a pretty diligent process internally. We focus heavily on trying to make sure we have natural hedges in place in our foreign jurisdictions whereby we're matching our sales dollars with our sales currencies with our cost in currencies, but it's not a perfect process, so we do have the hedging process that hedges the cash flows as well.

And we think that serve us well today in terms of managing the ForEx risk. You know, going forward, it's something we'll have to keep a close eye on with the more pronounced movements that we've seen in the exchange rates here of late.

Hendi Susanto - *Gabelli - Analyst*

Okay. May I ask please one more question? How should I think of seasonality in your business?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

I'm sorry, Hendi, could you repeat that question?



Hendi Susanto - *Gabelli - Analyst*

How should I think of seasonality in your business?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Seasonality, okay, how should we -- how should you think of seasonality in our business?

Hendi Susanto - *Gabelli - Analyst*

Yes.

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Well, you know, I think for the most part, we have a pretty diversified book of business. I would just state that, you know, our sales year-to-date have been spread across 70 active customers in those four verticals that we serve.

So I think for the most part, you know, the seasonality effects have been somewhat muted by that diversification and spread across the customer base that we have.

I would just note that in the automotive vertical that, you know, typically still here in the U.S., there's a model year changeover that occurs in the summer months, typically in July. And sometimes, you know, the demand in that period for the U.S. automotive market can be somewhat lower as that model year changeover occurs.

And while it's not exactly the same in Europe, there certainly is a similar phenomenon in Europe that occurs in the month of August. So those -- those two months typically have the greatest impact on our automotive vertical.

But again, I would not say that -- I would say that the diversification that we've had over the years has really gone a long way to mute any seasonality effect as a result of that.

Hendi Susanto - *Gabelli - Analyst*

Thank you.

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Thank you, Hendi.

Operator

Our next question is a follow-up from Chuck Murphy with Liberty Park Capital Management. Your line is open.

Chuck Murphy - *Liberty Park Capital - Analyst*

Hello again, guys.



Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Hello, Chuck.

Chuck Murphy - *Liberty Park Capital - Analyst*

Just a follow-up on JCI, when you said it was the \$20 million per quarter that was winding down, was that for all of JCI or just a portion that Visteon acquired?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Yes, it's a good question, Chuck. You know, it was just a portion that was affected by JCI's decision in that -- surrounding that product category. And so, you know, if you look at our disclosure on JCI as a percent of our total sales, you'd have a difficult time matching that up because they were products outside those product categories that were affected by the JCI decision to in-source and the products that were going end of life.

And so, ultimately in the end, after JCI went through the selling process of that division, they ultimately ended up unbundling that, if you will, and selling it to two different buyers, Visteon being one and then the other one being Gentex. And so part of that business continues on today with us.

Chuck Murphy - *Liberty Park Capital - Analyst*

And so how much -- can you say how much is left for like Gentex?

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

No, I cannot, Chuck, sorry about that.

Chuck Murphy - *Liberty Park Capital - Analyst*

Okay. All right, that's all I had, thanks.

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Thank you, Chuck.

Operator

Again, ladies and gentlemen, to ask a question, please press star-1 on your dial pad. I am showing no further questions. I will now turn the call back over to Don Charron for closing remarks.

Don Charron - *Kimball Electronics Inc - Chairman of the Board & CEO*

Thank you, Stephanie. 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 may simply hang up to disconnect from the call. Thank you and have a nice day.

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