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KE - Q3 2016 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

Don Charron *Kimball Electronics - CEO, Chairman*

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CONFERENCE CALL PARTICIPANTS

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

Hendi Susanto *Gabelli & Company - Analyst*

Austin Hopper *AWH Capital - Financial Advisor*

John Rakoto *Claret Asset Management - Analyst*

PRESENTATION

Operator

Good morning ladies and gentlemen. My name is Ronya and I'll be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics Third Quarter Fiscal 2016 Financial Results Conference Call.

All lines have been placed on listen-only mode to prevent any background noise. After the Kimball speaker's opening remarks, there will be a question and answer session period where Kimball will respond to questions from analysts. Analysts can ask questions during the question and answer session segment by simply pressing the star and the number one key on your telephone keypad and questions will be taken in the order that they are received.

Today's call, May 5, 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 10-K for the year ended June 30, 2015 in today's release.

Our panel for today's call is Don Charron, Chairman of Board and Chief Executive Officer and Mike Sergesketter, Vice President and Chief Financial Officer of Kimball Electronics. I would now like to turn the call over to Mr. Don Charron. Mr. Charron, you may begin sir.

Don Charron - *Kimball Electronics - CEO, Chairman*

Thank you, Ronya, and welcome everyone to our third quarter conference call. Our earnings release was issued yesterday afternoon on results of our third quarter ended March 31, 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 download's tab on the webcast portal.

I will begin by making a few remarks on the overall quarter and then I'll turnover to Mike for the financial overview. After that, we will answer any questions that you may have.

Our sales in the third quarter of fiscal year 2016 improved slightly over both the previous quarter and the same quarter last year. Led by a double-digit increase in China and further strengthening in Europe, sales in our automotive end market protocol were up 14% when compared to the same quarter last year.

We completed the launch and transition from a current to next generation product for one of our largest customers, which helped increase the sales in our medical vertical by 10% when compared to the third quarter of fiscal year 2015. Our sales in our public safety end market vertical were

down 8% year over year on lower demand and our sales in the industrial end market vertical were down 11% when compared to the third quarter of fiscal year 2015. However, we were encouraged by the sequential increase in our sales in the industrial end market vertical, which were up 7% from the second quarter.

We are making good progress on the launches of a number of new business awards with both existing and new customers. We are expecting sales from these launches starting in the fourth quarter of this fiscal year. Now, our new business opportunities pipeline remains healthy and we continue to work diligently to achieve our medium range goal of \$1 billion in annual sales by fiscal year 2018.

As we updated previously over the last few quarters and continuing in this quarter, our operating margin is under pressure due to incremental cost related to the Romania Greenfield start-up and capital deployments for new customer programs in advance of revenue. Margin improvement to cost control and productivity improvements continues to be a high focus area for us as we remain committed to our 4% operating income goal.

We continue to make excellent progress in Romania. Since completing the construction of a new facility in November 2015, we went live with our ERP System and passed our ISO quality management system certification audit. We also hosted several customer audits and during this past quarter, we received approval from one of our industrial customers to begin production. Also during this past quarter, we produced validation units for one of our automotive customers.

Once we received the customer approval, we expect a steady ramp up of revenue over a multi-quarter period. We continue to take advantage of the flexibility provided by our strong balance sheet and making investments that would drive future growth in sales and profits. After investing \$37 million in capital expenditures in fiscal year 2015, we are on pace and expect to invest slightly more than that in capital investments in fiscal year 2016 with the largest portion of these capital expenditures directly supporting new business awards. We are focused on getting to the launch cycle, ramping up production and ensuring that these new programs and the newly deployed capital that supports them achieved our expected returns.

During the third quarter of fiscal year 2016, we also return \$4.4 million to our share owners by purchasing 402,000 shares of our common stock, which brings our total to \$8.2 million and 745,000 shares purchased under the \$20 million share repurchased program approved by our board in October of 2015.

And finally, we are excited about the Medivative acquisition, which we closed on May 2nd and was disclosed in our Form 8-K yesterday. Medivative adds capabilities in mechanical design, precision plastics, combination devices, instruments and complex system assembly to our overall package of value and positions us to better serve both existing and new customers in our medical end market vertical.

Medivative has been successful building long-term relationships with a number of well-known medical and bioscience customers and we look forward to growing these relationships in the future as Medivative becomes a unit of Kimball Electronics.

Now, I will turn it over to Mike to discuss our third quarter results in more detail. We will then open the call to your questions. Mike?

Mike Sergesketter - Kimball Electronics - VP, CFO

Thanks, Don. I'll briefly cover our financial highlights for the third quarter and as Don mentioned we'll open the call for your questions.

Our third quarter net sales were \$214.1 million, which was a 4% increase compared to the net sales of \$206.9 million in the prior third quarter. Comparing our net sales by vertical to the same quarter a year ago, our automotive vertical was up driven by higher demand in all markets with China leading the way. Our medical vertical was up on an increased demand from existing customers and as Don mentioned the successful launch of the next generation product for one of our largest customers. Our industrial vertical was down as a result of lower end market demand largely for climate control products and our public safety vertical was down from lower demand in certain government programs.



Our growth margin in the third quarter was 7.6%, which was down from 9.2% in the same quarter last year. Margins are tied or partly the result of contracted customer price reductions running slightly ahead of productivity improvements. Product mix, foreign exchange fluctuations and cost associated with new product introductions have also impacted margins.

Selling and administrative expenses were \$9.1 million in the third quarter, which were up almost \$1 million or 30 basis points compared to the prior year third quarter. Selling and administrative expenses in the current year quarter included incremental cost of \$700,000 related to our Greenfield start-up in Romania.

Cost related to the spin-off in the third quarter a year ago were \$300,000. No spin-off costs were incurred in the current year third quarter. As we mentioned in our call last -- the last couple of quarters, the spin-off is substantially complete.

Other income expense, net income of \$200,000 in the fiscal year 2016 third quarter compared to an expense of \$900,000 in the third quarter of fiscal year 2015. Included in other income and expense during the current year third quarter are net gains of \$300,000 related to foreign currencies and derivatives as a result of exchange rate fluctuations. The prior year third quarter included net losses of \$900,000 related to foreign currencies and derivatives.

The effect of tax rate for the current year third quarter was a -2.3% as a result of the \$1.8 million discrete foreign tax benefit we recognize during the quarter resulting from a favorable tax ruling related to the capitalization of our Romania subsidiary. The effect of tax rate for the prior year third quarter was 27.6%.

Net income in the third quarter of fiscal year 2016 was \$7.5 million compared to \$7.2 million in the third quarter of last year. Adjusted net income excluding spin-off cost was \$7.5 million in Q3 of last year. Diluted earnings per share was \$0.26 in the third quarter of fiscal year -- this fiscal year compared to \$0.25 in the prior year quarter.

Cash and cash equivalents at March 31, 2016 were \$59.8 million. We had strong cash flow provided by our operations during the current year third quarter of \$11.7 million compared to \$7.7 million provided in the third quarter last year. The strong operating cash flow during the quarter was primarily the result of the earnings plus non-cash adjustments and an increase in accounts payable.

Capital investments in the third quarter totaled \$8.6 million partly related to our investment in new manufacturing equipment to support new product introductions, capacity and our new Romania operation. As Don mentioned, we also repurchased \$4.4 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 a \$116.5 million.

Don mentioned the Medivative acquisition, which we closed earlier this week. The acquisition price was \$8.3 million in cash subject to post-closing working capital adjustments and was funded with available liquidity. The acquisition is expected to add approximately 2% to our sales run rate with further upside potential three to four quarters out. We anticipate Medivative to be neutral to slightly accretive to our earnings in the next fiscal year.

Our balance sheet continues to be very strong and we think we're well positioned for growth. With that, I would like to open up today's call for questions from the analysts. Ronya, do we have any analyst's questions in the queue?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Herve Francois from B. Riley.



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

Just in regards to the start-up cost in Romania, how much further -- I guess how many more quarters do you expect that to take place or you're pretty much rounding. I think you said you're coming to an end on that and then going forward since you received the tax benefit in the quarter because of the Romania operations, how do you see your tax rate corporate wise going forward.

Don Charron - *Kimball Electronics - CEO, Chairman*

Okay, maybe I'll take the first part of that question, Herve, this is Don Charron and then I'll let Mike take the part about the tax -- the part related to the tax question.

In terms of Romania and where we are in the -- in the process of getting customer approval and certification in place to start production, I mentioned we received approval from one of our industrial customers and that's a huge milestone for us to achieve. It allows us to begin to ramp up production for that customer and certainly will pave the way for other industrial customers and it's a little bit more difficult in terms of getting qualified and certified for automotive, which is the next step and we have built validation units, but we've not yet cleared the validation testing protocols and received customer approval to begin production and we expect that to happen in this quarter that we're in, but there's still a variable that we don't -- we have not been approved so we're not approved until we are approved, but once that happens, we expect it as I mentioned to be a multi -- a multi-quarter ramp up.

Normally, the risk mitigation strategy around a start-up like this involves dual production for a period of time so that's -- that's why we're saying it to be a multi -- a multi-quarter ramp up of this next program, so we got a ways to go yet with Romania in terms of getting it ramp to profitability of at least several quarters for us, but we're making that excellent progress.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

I think regarding your question on the tax rate, the tax benefit that we received related to the start-up in Romania was really a one-time tax benefit and going forward, we would expect our tax rate to sort of continue to settle in somewhere in the mid 20%, 25% somewhere in that range.

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

Got it. That's helpful and if I can have a follow-up. Then if you think about the gross margins based off of what you said could be a multi-quarter ramp, so do you expect that to continue to have pressure on your gross margins over the next several quarters as well as you ramp not only with this new industrial customer, but you are also waiting to get the validation protocols from the -- on the auto side.

Don Charron - *Kimball Electronics - CEO, Chairman*

Yes, we expected to impact our margins over the next several quarters at least -- at least three to four quarters out from where we are and again the variable there is we've not yet received automotive approval and so we hope to have some good news on that soon, hopefully maybe our next conference call in terms of actually achieving that approval and I think once that happens we'll be able to build a little bit more predictable path to at least where Romania has been neutralized or contributing to our -- to our operating profit, but it's at least three or four quarters out.

Operator

(Operator Instructions) Hendi Susanto from Gabelli & Company.



Hendi Susanto - *Gabelli & Company - Analyst*

Would you be able to show some color on the weaknesses in public safety and industrials? What were the corresponding end markets that resulted in your year over year decline? Does that reflect your customers, their markets or both?

Don Charron - *Kimball Electronics - CEO, Chairman*

Yes, I'd start with public safety that end market vertical is our smallest vertical so any movement there can look larger in the percentages than obviously the absolute dollar movement and that particular end market vertical for us Hendi is probably the most lumpy in -- from quarter to quarter in terms of just how demand flows through the system. I don't know that, other than -- as Mike mentioned, we did see a few programs that are more tied to government spending that seemed to slow in the quarter. When you say that that's the trend, it may correct itself in the upcoming quarters. It's just the nature of that business tends to be a little more lumpy in the way he comes through to fulfillment.

On the industrial and market vertical as we've reported in the last couple of calls, we -- it's been sluggish in a number of areas within our end-market vertical there. Mike mentioned climate controls, that's been an area. It's been a little [fact] when you compare the revenue for this quarter to last year at same time but it's not just that one subcategory, if you will, that we look across the board at our industrial and market vertical, and we -- which has been sluggish in a number of areas.

Now, I think, at least with the sequential growth there being up 7% over the prior quarter, we're hopeful that maybe we've seen the bottom and maybe we'll start to see gradual improvement in the upcoming quarters on our industrial vertical. Because we really have to -- some really good customers that we support in that end-market vertical because frankly they're market leaders. And so we think once the overall end-market improves, we'll see that pretty quickly in our demand because of the quality of those customers we have in that vertical.

Hendi Susanto - *Gabelli & Company - Analyst*

Okay. And then question for Mike. So, let's say excluding the Romania startup costs. Do you have any estimate on the gross margin? In other words, how much impact the Romanian startup costs on gross margin and then how much further upside if the Romanian facility has fully ramp up in the future?

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Well, Hendi, on the impact of Romania, right now the startup costs are pretty much all flowing through S&A. As we start production, we'll see those costs move but in the short run, there's really very little impact on gross margin. It's all on the S&A lines. So, we'll see that start to shift over the next couple of quarters as we ramp up production and revenue.

Operator

(Operator Instructions) Austin Hopper from AWH Capital.

Austin Hopper - *AWH Capital - Financial Advisor*

You've talked a fair amount about Romania. I just was hoping, can you maybe help us understand kind of expectation on the revenue -- specifics on the revenue ramp for Romania over the next few quarters?

Don Charron - *Kimball Electronics - CEO, Chairman*

Yes. So, I think we've got a couple of comments maybe it will help you understand what we're facing there. So, coming back all the way to, I guess, the primary driver in terms of that -- making that investment in Romania was driven by the fact that we were approaching full capacity in Poland -- in our Poland operation, and so the expanding Romania was driven primarily by capacity needs, and so in the first phases of what we're doing in terms of establishing revenue in the facility is actually programs that are currently run in our Poland operation and identified as candidates to be moved to free-up capacity in Poland and obviously start revenue in Romania.

So, that part of our plan is fairly predictable and that we're in control of everything except validation and customer approval process, that's where the variability comes in. And, again, I think it's very positive that we got the approval on the first project on the industrial side. We are now starting to ramp revenue there. And then the next big step for us is getting our automotive approvals and so until we have our automotive certification quality system certification and approval from the first customer. It's difficult to build a predictable path to when we can see that revenue ramp at least get to us to the breakeven point for the operation.

But we have a number of programs that are lined up behind both of these initial projects that I'm speaking about. So, we really hope that, you know, once we get the automotive approval like we have the industrial approval that we'll see projects fall in line right after that and we'll start to be able to build a more predictable path on that ramp up. So, that's really -- it's really key for us right now in this particular quarter as we -- as I stated in the -- in my comments that we built the validation units. We've had the customer on-site, we're going to testing as we speak on those validation units. So, we are hopeful that we'll received word this quarter. I think that's a pretty key piece for us then as we move forward with our plan for ramp up.

Austin Hopper - *AWH Capital - Financial Advisor*

Okay. And the revenues that you are talking about, are they additive to the Company or are they revenues basically coming from your other facility?

Don Charron - *Kimball Electronics - CEO, Chairman*

Well, they -- in the end -- they are additive. The programs that are transferring from Poland will be backfilled with new business awards that are targeted for our Poland operation. So, we continue to have good traction in Europe overall with our growth plans there. So, yes, while we are transferring a couple of programs from Poland and the new business opportunity pipeline I spoke of for the whole Company is also very healthy in Europe. So, yes, in the end, it will be additive growth to the Company.

Austin Hopper - *AWH Capital - Financial Advisor*

Okay. So you said that -- what was the \$700,000 costs associated, was that come with Romania cost in the quarter or?

Mike Sergesketter - *Kimball Electronics - VP, CFO*

That was Romania, yes.

Austin Hopper - *AWH Capital - Financial Advisor*

Okay. Okay. And so that's in the S&A line, I think, you mentioned.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

That's correct.



Austin Hopper - *AWH Capital - Financial Advisor*

So, as you ramp on revenues, do you -- I was just trying to [see] the nature of that. The ramp up revenues, do you have additional cost associated with that? As you ramp on revenue is that 700,000 on that basis go down or it is additional cost as well?

Don Charron - *Kimball Electronics - CEO, Chairman*

Yes. So, let me talk a little bit about that. So, as we're talking about this heavier than normal period wherein in terms of new product introduction, typically what we see in our business especially with the automotive end-market vertical is that we're deploying capital and adding resources in advance of the revenue. The launch cycle typically is anywhere from 18 months to 24 months.

And so as we get closer to building validation units in that cycle, we're deploying the capital and certainly as I mentioned, we're adding resources that would in part be found in S&A line but also in part found in the cost of goods sold line and it's in advance of the revenue developing. Once the revenue begins, then we go through a period where we're ramping up and in some cases if it's a multivehicle platform that we're supporting, there's a stagger that exist in the -- each vehicle platform that's introduced. So, we may go through a six-month or nine-month sort of ramp-up of each of those vehicle platform even after we're approved for series production.

So that period, we're in the middle of that right now with a couple of very large automotive programs, and so when we talk about the impact on our margin, it's just for that reason. It's the capital we've deployed and the resources we've already added to support those programs and, again, it's an advanced revenue developing.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

I think just a little clarification on Romania being a start up, all the cost in S&A until production begins and once production ramps up, a lot of those costs will move in the cost of goods sold. So, those costs aren't all -- there are some added cost that though it's not -- the 700,000 some of that will move above the line and will be then offset with the revenue and so forth this week as we launch that operation.

Operator

(Operator Instructions) Herve Francois from B. Riley.

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

And so just a follow-up, on the -- I guess once you include both the Medivative acquisition that closed earlier this week and then I guess when you talk about getting to a full ramp within Romania. How do you think your margins -- your gross margins -- even potentially your operating margins are going to look like at the corporate level?

Don Charron - *Kimball Electronics - CEO, Chairman*

Yes. I would start with just our goal of getting back to the 4% operating income. Obviously with where we're at right now in the gross margin line -- and where we're at with SG&A, we're off of that by a margin coming at 3.3% this quarter versus our 4% goal. So, we're focused on getting back to that 4% operating income level on a consistent basis. Obviously, Romania is a key part of that, continuing to ramp these NPIs that I spoke of is a key part of that.

We do expect in this quarter to start to see some measurable revenue from those NPIs as I mentioned in the webcast earlier. So, we hope that we are on a path to start seeing some consistent improvement back towards our goal of a 4% operating income, but we recognize that getting to the

Romania ramp-up is really critical and these next two quarters really in terms of the NPIs, we're working on are going to be also very critical to help give us firm footing on the way back to that 4% number.

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

Okay. And just to clear, the NPI ramps, are you talking about -- is that across the sectors and across your Company or is that predominantly for Romania, the NPIs.

Don Charron - *Kimball Electronics - CEO, Chairman*

Well, it's across the Company, all four verticals and really with the addition of Medivative eight facilities. All of which have some level NPI activity going on.

I would say by vertical though, it's heaviest in the automotive end-market vertical for us and so, you know, the activity is highest there. But really it's beyond just Romania's NPI. Its NPI's -- if you look at our CapEx, I think it's a pretty good indication of -- when I said heavier than normal, activity in this area, I think if you look at our historical results, our CapEx would be more normalized around the rated [appreciation], may be slightly higher than that.

And if you look at what we did, last year on CapEx at \$37 million and being on track for this year to be slightly higher than that with the majority of those expenditures really going to equipment to support these new product introduction, you get a sense, we're just -- how heavy that period is for us and how heavy it's been for us. That rate would be nearly twice depreciation -- current depreciation. So, it's pretty heavy activity for us activity for us across Board, all four verticals and now at Medivative, all eight plans.

Operator

[John Rakoto] from Claret Asset Management.

John Rakoto - *Claret Asset Management - Analyst*

So, just a question from me; I wanted to go back to the industrial piece of business. I was wondering if you can give us more color about the climate control [something sale] during the quarter. Any thoughts will be helpful in terms of the context or the dynamics you're seeing there. Thanks.

Don Charron - *Kimball Electronics - CEO, Chairman*

Yes. So, we have a couple of very large customers that make up the majority of that sort of sub-vertical of the industrial vertical of our business. One based in Europe and one based in the U.S., and so in general, we would say that we see the softness in both areas. So, one primarily serving the European Eurozone, let's say, and the other one serving NAFTA.

We don't really see too much difference from the markets from a geographic standpoint. It just seems like there's just been a general slowing in spending in those areas that is affecting the overall end-market demand. I think obviously, when you're talking climate controls, there's a lot of things that can impact that overall end-market demand, spending levels being one but also the weather patterns and others obviously contributing to that, and then you also have, in some cases, legislation that is contributing to that in terms of energy efficiency requirements and what the OEMs in that space have to face going forward to be able to hit or manage their business to those requirements

There's a number pieces to the puzzle to try to figure out what's really going on. Yes, as I said before, we've been looking at now a multiple quarter sort of softness here, and we're at least encouraged by the fact that we kicked up a little bit this quarter when compared to last quarter a little being 7%, and so we're hopeful that maybe the bottoms [find us].



Operator

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

Don Charron - Kimball Electronics - CEO, Chairman

Thank you, Ronya. 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 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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