Kimball Electronics, Inc.(Q3 2020 Results)
May 05, 2020

Corporate Speakers:

- Don Charron; Kimball Electronics, Inc.; Chairman & CEO
- Mike Sergesketter; Kimball Electronics, Inc.; VP & CFO

Participants:

- Anja Soderstrom; Sidoti & Company, LLC; Analyst

PRESENTATION

Operator^ Good morning, ladies and gentlemen.

(Operator Instructions)

At this time, I would like to welcome everyone to the Kimball Electronics Third Quarter Fiscal 2020 Financial Results Conference Call.

(Operator Instructions)

Today's call, May 5, 2020, 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 the forward-looking statements can be seen in Kimball's annual report on Form K -- 10-K for the year ending June 30, 2019, and other filings with the Securities and Exchange Commission, the SEC, 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 Campbell Electronics.

I would now like to turn today's call over to Don Charron. Mr. Charron, you may begin.

Don Charron^ Thank you, Angel. 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, 2020. 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 follow along by advancing the slides or download them from the Downloads tab on the webcast portal.

I will begin by making a few remarks on the overall order, and then I will turn it over to Mike for the financial overview. After that, we will answer any questions that you may have.

We are pleased with the results we delivered in the third quarter of fiscal year 2020, despite the interruptions and challenges caused by the COVID-19 pandemic. The safety and health of our employees, customers, suppliers and communities are paramount.

We are making every effort to keep our facilities safe following current guidelines suggested by applicable country authorities. Because of the variety of critical medical device assemblies we manufacture around the world, our facilities are classified as essential businesses. And so all are currently operational, but have been affected to varying degrees by COVID-19.

We serve a diversified portfolio of markets, geographies and customers. In our third quarter, we experienced a double-digit decline in sales to customers in our medical vertical, which was primarily unrelated to COVID-19. However, we are seeing a significant increase in demand for medical assemblies for the near future, specifically those related to respiratory care and patient monitoring products.

We have customers whose products are essential to the health and safety of people around the globe. We are proud of what we do for the world, and we're proud of our people and their extraordinary efforts and contributions during this challenging time. I feel honored and privileged that our company can play such an important role to help in this pandemic.

In our automotive vertical, we started to see the impact of COVID-19 in our third quarter results, although the severity of the impact from the extensive automotive plant shutdowns in North America and Europe will not be reflected in our results until our fiscal fourth quarter. We are, however, encouraged by the recent announcements of several of our domestic automotive customers and their plans to restart production on May 18. We also are pleased with the return of our production output in China to near pre-COVID-19 run rates.

We continue to ramp-up of several new programs, including a large program for an existing customer, who supports a vehicle OEM that specializes in fully electric vehicles. We anticipate our overall run rates for our automotive vertical will return to a new normal. And when added to the ramp-up of these new programs, will return us to middle single-digit growth rates in the first half of fiscal year 2021.

Within our medical vertical, we have been working hard to respond to the significant increases in demand from our existing customers for their respiratory care and patient-monitoring products. These increases are immediate, and our customers expect that they will continue over the next several quarters, as the world deals with the pandemic and the shortages of the medical equipment in these product categories. These COVID-19-related increases, when added to our base medical business will help us generate strong double-digit growth in our medical vertical in the fourth quarter of fiscal year 2020 and the first half of fiscal year 2021.

We continue to gain traction in the new business opportunities pipeline for our GES business. The recent new orders for machines, I mentioned on our last quarter call, are on schedule to be delivered in the fourth quarter of fiscal year 2020.

We are also excited about the role GES is playing in our digital and Industry 4.0 strategy, as we work to roll out EM Tab, a GES-developed software solution in all our global facilities in 2020. We are working diligently to respond to the volatility in demand and change in the mix of our overall business. We continue our relentless pursuit to achieve our operating margin and return on invested capital goals.

We are doubling down on execution across all of our units as we continue to drive Lean Six Sigma projects and global supply chain initiatives to improve yield and throughput and drive improvement in our margins. Margin expansion and capital efficiency will continue to be priorities of focus for us.

Our cash conversion days for the quarter ended March 31, 2020, were 81 days, up from 75 days in the quarter ended March 31, 2019, and from 76 days in the second quarter of fiscal year 2020. While the volatility in demand has made it difficult for us to achieve our inventory objectives and thus, our cash conversion days objectives, we remain committed to our inventory reduction goals and actions.

We invested $5.7 million in capital expenditures in the third quarter of fiscal year 2020. The majority of these capital investments were for capacity expansion and to support the launch and ramp-up of new programs.

During the third quarter of fiscal year 2020, we also returned $2.7 million to our shareowners by purchasing 214,000 shares of our common stock, which brings our total to $76.7 million and 5.1 million shares purchased since October 2015 under our Board-authorized share repurchase program. As a result of the COVID-19 environment, our plan has been temporarily suspended until further determination by our Board.

And finally, as I stated earlier, I am so proud of our people around the world and our collective response to the COVID-19 pandemic. Our strong company culture and core values have and will continue to help us get through this together. Our number one priority will continue to be keeping our employees healthy and safe. We will continue to deliver on our promises to our customers. The company is in a solid position, and we are committed to build success in the future.

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^ Thank you, Don.

Before I get into my normal discussion on our financial results, I wanted to stress that our financial condition continues to be strong. We believe we are in a solid position to be able to support the increased demand in the medical market relative to the COVID-19 pandemic and to do our part in helping solve the shortage of critical medical devices necessary to help save lives.

Our short-term liquidity available represented as cash and cash equivalents on the unused amount of our credit facilities totaled $122 million at March 31, 2020. We have the ability to increase the borrowing capacity on our primary credit facility by an additional $75 million of fund request, subject to consent of the participating lenders as well as other options to enhance our liquidities.

Now regarding our Q3 results, I will be referring to the slide deck Don mentioned, which can be found on our Investor Relations website within the Events and Presentations tab. Or if you're listening via the webcast, you can follow along by advancing the slides on the webcast portal. As shown on Slide 3, our third quarter net sales were $293.9 million, which was a 6% decrease compared to a very strong third quarter of fiscal year 2019 with net sales of $313.5 million (technical difficulty).

Operator^ Ladies and gentlemen, please hold.

Mike Sergesketter^ I'll continue with our sales results. So as shown on Slide 3, our third quarter net sales were $293.9 million, which was a 6% decrease compared to a very strong third quarter of fiscal year 2019 with net sales of $313.5 million. The decline in net sales was largely the result of overall lower demand compared to the prior year, particularly in the medical vertical, which was primarily unrelated to COVID-19. Foreign exchange rates reduced our consolidated net sales by approximately 1% compared to the third quarter a year ago.

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 2% compared to the same quarter a year ago, driven largely by lower demand of existing products, including the negative impact to demand from COVID-19 starting in the last part of the quarter, which was partially offset by the ramp-up of certain programs for fully electric vehicles and new product introductions. As Don mentioned, we started to see the COVID -- the impact of COVID-19 on the automotive industry and our third quarter results, although the severity of the impact will not be reflected in our results until our fiscal fourth quarter.

Our medical vertical was down 12% in the current quarter compared to the prior year third quarter, resulting from lower overall demand that was partially offset by the ramp-up of certain products. We anticipate growth of sales to customers in the medical market in the upcoming quarters as we are currently experiencing a significant increase in demand from medical assemblies, specifically those related to respiratory care and patient monitoring products as a direct result of the COVID-19 pandemic and related global shortage of respiratory equipment.

Our industrial vertical was down 3% from a year ago as lower end market demand for climate control products and the phase out of certain programs were partially offset by increased demand for smart metering products.

Lastly, sales in our public safety vertical were down 18% from the prior year third quarter as a result of the continued phase out of certain programs and lower overall demand.

Our gross margin in the third quarter, reflected on Slide 5 was 6.9%, which was a decline of 160 basis points from the 8.5% in the third quarter of last year. However, our gross margin did improve 20 basis points sequentially from the second quarter of fiscal year 2020. Our decrease in gross margin in the current year compared to a year ago was primarily due to lower volumes and unfavorable product mix, which partially were offset by lower profit sharing bonus expense.

Selling and administrative expenses, Slide 6 in the deck, were $9.6 million in the third quarter which was down approximately $2.4 million in absolute dollars and is down 60 basis points as a percent of net sales compared to the prior year third quarter. The decrease in selling and administrative absolute dollars was largely due to changes in the fair value of the Supplemental Employee Retirement Plan or SERP liability, which accounted for 50 basis points of the decrease compared to the prior year third quarter. The revaluation of the SERP liability is exactly offset by gains or losses recorded in the SERP investments during the quarter, which is recorded in other income and expense net, and as a result, has no impact on net income.

Operating income for the third quarter on Slide 7 in the deck, came in at $10.6 million or 3.6% of net sales. This compares to operating income of $14.5 million or 4.6% of net sales in the same period a year ago, driven by the decline in our gross profit percent previously mentioned, which was partially offset by the favorable impact of the comparison to the prior year quarter relating to changes in the fair value of the SERP liability.

Sequentially, compared to our second quarter, our operating income as a percent of sales improved by 80 basis points on the revaluation of SERP liability and the improvement in gross profit. Other income and expense net was an expense of $1.9 million in the third quarter, which compares to income of $200,000 in the third quarter of fiscal year 2019. Other expense net in the current year third quarter includes $900,000 in losses on the SERP investments and $1.2 million in interest expense, partially offset by $200,000 from favorable exchange rate fluctuations and other items. Other net income net in the prior year third quarter included $800,000 from favorable exchange rate fluctuations and other items and $600,000 in gains on SERP investments, which were largely offset by $1.2 million of interest expense.

The effective tax rate for the current year third quarter was 28%, which compares to 19.3% in the prior year third quarter. The current quarter rate is slightly above our expected effective tax rate of the mid-20% range, primarily due to a change in mix of earnings among our various tax jurisdictions. The prior year third quarter effective tax rate was favorably impacted by discrete tax benefits related to provision to return adjustments.

Slide 8 reflects our adjusted net income trend. Our net income in the third quarter of fiscal year 2020 came in at $6.3 million. This compares to our quarterly net income of $11.8 million in the third quarter of fiscal 2019.

Diluted earnings per share were $0.25 for the third quarter of this fiscal year, which compares to diluted EPS of $0.46 reported in the same quarter last year, which was also a record quarter for our diluted EPS for us. Cash and cash equivalents at March 31, 2020, were $58.3 million.

Operating cash flow trends are shown on Slide 11. Our cash flow provided by operating activities during the current year third quarter was $12 million, which was driven by net income plus noncash items, only partially offset by changes in operating assets and liabilities. In the prior year third quarter, operating activities used $14.6 million of cash. Our cash conversion days, or CCD, was up 6 days for the 3 months ended March 31, 2020, when compared to the same period in the prior year. And sequentially to the second quarter of fiscal year 2020, our CCD increased 5 days, driven by an increase in our CAD or contract asset days.

Slide 12 reflects our capital and depreciation trends. As Don mentioned, our capital investments in the third quarter totaled $5.7 million, largely related to manufacturing equipment to support new production awards and to increase capacity. Borrowings on our credit facilities at March 31, 2020, were $122 million, which were down $4 million from our borrowings at June 30, 2019.

In conclusion, our financial condition continues to be strong, and we believe we're in a solid position to be able to support the increased demand in medical market related to the COVID-19 pandemic. And to do our part in helping to solve the shortage of critical medical devices necessary to help save lives. As Don mentioned, we're very proud of the work our teams are doing to support the efforts to combat this disease on a global scale.

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

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions)

And your first question comes from Anja Soderstrom from Sidoti & Company.

Anja Soderstrom^ If you could first give me some more color on the auto segment. It seems like even though there might be a drop-off among the auto manufacturers, you're going to be helped by new program ramps there. Is that correct?

Don Charron^ That's correct. So maybe I can (inaudible) on you.

Anja Soderstrom^ Yes. And just how -- if there's going to be a more severe slowdown among the -- in the industry, how is that going to affect your new program ramps, you think, in the next coming quarters?

Don Charron^ Yes. So I think as you said in the script, on, yes, I would start with the fact that at least now, we have for North America and Europe, a restart date of May 18. and that affects the majority of our customers. And so we basically have been down for the month of April. And yes, for basically the first half of May. So -- but we have a restart date.

That's the good news, and we expect that once the restart happens, it'll take a few weeks for the value chain that supports those OEMs to crank back up to the pre-COVID run rate. But we expect towards the end of Q4 and the month of June, we'll start to approach those pre-COVID-19 run rate. So Q4 to us looks like China at something near pre-COVID-19 run rate. And North America and Europe essentially exiting the quarter somewhere around that level. But of course, the lost production essentially equal to happen (inaudible).

Anja Soderstrom^ Okay. That was helpful additional color. And then in the medical segment, it seems like you are helped by the covered related production. But there's weakness in your other production? What are those? And what do you see there in terms of a turnaround?

Don Charron^ Yes, separate product categories, obviously, then respiratory care and patient monitoring. We had some of our customers that are supporting the drug delivery device by category that are going through some significant changes in their go-to-market strategy. And so that resulted in a year-over-year change, if you will, that made up the majority of the shortfall.

I think the good news there is that we expect that, that go-to-market change will be successful for them, and their strategy will be successful. It may take a few quarters for them to get back to the level of business we enjoyed with them. But I think, overall, it's good news, but it did impact the Q3-to-Q3 comparison because of the change going into effect before this most recent reported quarter.

Anja Soderstrom^ Okay. So sort of that weakness from that is expected to go on for a couple of more quarters, but we offset them at least partially by the COVID-19-related production?

Don Charron^ Yes. So again, I would say, relative to the comments in the script, Anja, I would say we're expecting strong double-digit growth. And as I mentioned, the demand for the respiratory care and patient-monitoring product is immediate. And so while through -- while we're working through capacity and supply chain or component availability issues, we expect the ramp-up of the COVID-19-related business to occur immediately in the quarter we're in and as I mentioned, over the next several quarters.

Anja Soderstrom^ Okay. And then just in terms of overall demand, have you seen like the sort of any impact from potential prolonged economic slowdown on your order book?

Don Charron^ The demand overall that our customers are relaying to us has been impacted by the shutdown. So in places where government restricted mobility and availability of workers, that clearly has been an impact. It's difficult to determine when those restrictions now as they're being lifted, both here in North America and Latin America and also in Europe, how fast we will get back to some run rates that we were at pretty COVID-19. But I will say that we're starting to see signs of the value chains that we're in, the value chains that we're in, where these restrictions are being lifted.

Our customers are placing demand on us that's ramping us up fairly quickly to run rates we were at or near the run rates we were at pre-COVID-19. But definitely, I would say, in the short-term here, with the month of April, seeing significant restrictions and shutdowns and other related kinds of interruptions to the normal production flow. Q4 impact certainly will be there, but we're optimistic -- cautiously optimistic about how fast the value chain will ramp up once these restrictions are lifted, and we get back to work.

Anja Soderstrom^ Okay. Just on capacity, how -- what would you say you're running off now overall?

Don Charron^ That's a really difficult and complicated question to answer, but let me give you my best shot at it. I would say our automotive line literally in North America and Europe were shut down for the month of April and for the first half of May. So the utilization calculation is pretty easy for that 6-week period. And then as we ramp-up in those areas growing automotive lines, we expect them to get back to the utilization run rate we were at the pre-COVID-19. Our medical line with the increases that have been placed on us, they will run a very high utilization rate.

And as Mike mentioned, we've even had to add some capital equipment to meet the demand over the next several quarters. And the good news is we've been able to utilize some of the capacity freed up on our automotive line to support those ramp-ups. So it's the -- the lower utilization in automotive is not totally at a loss at this point because we are able to use a portion of that capacity to support the medical -- the increase in the medical demand.

Anja Soderstrom^ Okay. And therefore, other EMS have noted the supply chain challenges. How is that affecting you?

Don Charron^ Well, it's a challenge for us as well, especially as the pandemic spreads, it took some time, but the value chain that includes the component suppliers boosted on the other side of us. They were also impacted with the restrictions and the shutdown. And so

-- and just availability of workers, even after the restrictions were lifted and people are coming back to work.

And so yes, it is a challenge. It's been a challenge for us to get to the ramp-up levels, for example, on those medical product increases, for respiratory care and patient monitoring. We're making great progress there. Our teams are working really hard. Our supply partners are working really hard, and we're making great progress there. But that certainly is the challenge here in the short term.

On the automotive side, it was different in that there was a shutdown. And so now, we're going back to work, and we're restarting here this week and next week. So yes, with a different kind of scenario there, we're not necessarily dealing with rapid increases. We're trying to return to run rates we were at, let's say, pre-COVID-19. So I'm not anticipating as many issues there, although our supply base for our automotive customers is global. And every region has responded differently in this pandemic in terms of how they dealt with the restrictions. And I would say how they're dealing with the [restudy].

Anja Soderstrom^ Okay. And then in terms of the GES business, I know you have diversify that. But now it seems like semi-cap is coming back. Do you see an improvement there in terms of the GES business and that's helping the industrial segment? Or...

Don Charron^ Yes. We -- the -- our GES business unit supports both the smart mobile device end market, the manufacturing market for the smart mobile devices and also, as you mentioned, the semiconductor area. And we've been getting some nice traction starting last quarter, which we were surprised that, that held up in Q4 so far in terms of demand for those machines. We're on schedule to deliver them, as I mentioned in the script.

So we'll see how that develops. And yes,. The semiconductor guys are coming back too. We are seeing some signs of positive momentum forming there. So we're in a good position to take advantage of that when that demand comes back. And we're looking forward to seeing the quarter here firm up with those machines we already accepted all these for.

Operator^ (Operator Instructions)

And now I'd like to turn the call back over to Don for closing remarks.

Don Charron^ Thank you, Angel. 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. Have a great day.

Operator^ 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.

(Operator Instructions)

Thank you. Have a nice day.