



Kimball Electronics, Inc.

First Quarter Fiscal 2023 Earnings Conference Call

November 8, 2022

C O R P O R A T E P A R T I C I P A N T S

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C O N F E R E N C E C A L L P A R T I C I P A N T S

Max Michaelis, *Lake Street Capital Markets*

Anja Soderstrom, *Sidoti & Co.*

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P R E S E N T A T I O N

Operator

Good morning, ladies and gentlemen. Welcome to the Kimball Electronics First Quarter Fiscal 2023 Earnings Conference Call.

Today's call, November 8, 2022 is being recorded.

At this time, I would like to turn the call over to Andy Regrut, Vice President, Investor Relations. Mr. Regrut, you may begin.

Andy Regrut

Thank you, Darius. Good morning, everyone. Welcome to our first quarter conference call.

With me here today is Don Charron, our Chairman and CEO, and Jana Croom, Chief Financial Officer.

We issued a press release yesterday afternoon with our results for the first quarter of Fiscal 2023. To accompany today's call, a presentation has been posted to the Investor Relations page of our Company website.

Before we get started, I'd like to remind you that we will be making forward-looking statements that involve risk and uncertainty and are subject to our Safe Harbor provisions as stated in our press release and SEC filings. Actual results can differ materially from the forward-looking statements.

Our commentary today is focused on adjusted non-GAAP results. Reconciliations of GAAP to non-GAAP amounts are available in our press release.

One additional housekeeping item, as a reminder, starting in Q1 we have combined the reporting of results for our industrial and public safety vertical markets. Reclassified amounts for prior periods are available in our press release and SEC filings.

This morning, Don will start the call with a few opening comments. Jana will review the financial results for the quarter and guidance for Fiscal 2023, and Don will complete our prepared remarks before taking your questions.

I'll now turn the call over to Don.

Donald Charron

Thanks, Andy. Good morning, everyone.

I'm pleased with our results in Q1 and the strong start to the new fiscal year. For the third consecutive quarter, net sales surged to a record-breaking level, setting another all-time high for our Company, and operating margin improved compared to the same period last year. This was in line with our estimates as we ramp up production on new and existing programs and leverage our facility expansions in Thailand and Mexico. These investments, however, increased fixed costs that were not fully absorbed when comparing the operating margin rate to Q4 of Fiscal Year 2022.

New customers and product start-ups generally cause margin dilution early in the life cycle, which are recovered as the program matures. We expect sequential quarterly increases in a stair stepped Fiscal Year 2023, and we are affirming our guidance for the full year with results expected at the high end of the range for sales and operating margin.

Today's operating environment remains challenging, filled with uncertainty from geopolitical events, the pandemic, global supply chain disruptions, part shortages, inflation and a looming economic downturn. Our team continues to navigate these unprecedented circumstances by focusing on what we can either control, or at least positively influence. For us, this starts with the health and safety of our people, and not just their physical well-being, mental health is as important as ever.

In terms of the global supply chain, I'm encouraged to report there are signs of a gradual recovery from the pandemic, but the progress is slow with only modest improvements occurring at a measured pace. Addressing part shortages has become a constant priority as we look to better align production forecast with material availability and manufacturing capacity. When it comes to microchips, it's important to note that not all of them are created equal, so to speak, and the higher grade chips needed in the applications we support are still in short supply. As costs rise, we are leveraging productivity improvements and partnering with our customers to maintain competitiveness.

For the first quarter, net sales were \$406 million, a 39% increase compared to Q1 last year and 9% better than Q4. Not only was this a record high for our Company, it was the first time we eclipsed the \$400 million mark—threshold in a quarter. All three vertical end markets we serve reported large increases with automotive posting a record high of \$185 million. This represents a 43% increase compared to Q1 last year and 46% of total Company sales in the quarter. It is also a 21% sequential step-up from Q4. We continue to see growth opportunities in this vertical market, particularly as applications such as advanced driver assistance systems are more widely adopted.

Our support will enable further advances in areas such as battery management, electronic steering, electronic braking, motor controls and redundant safety systems. With over 37 years of experience producing high-quality electronic assemblies that meet the stringent regulatory requirements of the automotive industry, we are ideally positioned to assist as the electrification of vehicles evolves.

Net sales in Medical were \$115 million, a 35% increase compared to Q1 last year and 28% of total Company sales. This is the second consecutive quarter for this business to post gains in excess of 30% versus the same period in the prior year. Our Medical customers also have stringent standards for their products. Our capabilities are uniquely tailored to meet the requirements and challenges of the Medical market. Since 1999, we have manufactured millions of medical electronics, drug delivery systems and single-use medical devices. Our launch of Kimball Medical Solutions highlights our full service of capabilities so that when customers consider the whole package of value, it's clear, our offering extends beyond electronics.

Net sales in our industrial vertical totaled \$101 million, a 35% increase over the recasted first quarter of last year and 25% of total Company sales. As a reminder, public safety is now included in our industrial vertical results. In this dynamic and evolving market, we collaborate with our customers on products that support smart cities, energy efficiency and energy management, as well as industrial devices and applications focused on public safety. Recent advances in electronics and mobile technology, combined with lifestyle changes coming out of the pandemic, are producing growth opportunities for our unique manufacturing capabilities.

In summary, a very good quarter with record setting sales and momentum that will continue throughout Fiscal Year 2023.

I'll now turn the call over to Jana to provide more detail on the financial results for Q1 and our guidance for the full year. Jana?

Jana Croom

Thanks, Don. Good morning, everyone.

As Don highlighted, total net sales in the first quarter were \$406 million, a 39% increase over Q1 last year and an all-time record high for our Company. Foreign exchange adversely impacted sales by 5% in the quarter. At historical rates, the growth would have been even more impressive. The gross margin rate in Q1 was 7.2%, a 190 basis point improvement compared to the first quarter of Fiscal 2022, with our record sales driving a higher level of absorption this year versus a year ago when production was more significantly curtailed by part shortages.

Adjusted selling and administrative expenses in the quarter were \$16 million, compared to \$12.3 million in Q1 last year. The increase resulted from higher salary and related payroll costs, stock-based compensation, factoring fees associated with our accounts receivables and travel expense. When measured as a percentage of net sales however, adjusted selling and administrative expenses were 3.9%, a 30 basis point improvement compared to Q1 last year.

Adjusted operating income for the first quarter was \$13.3 million or 3.3% of net sales, which compares to last year's Q1 adjusted results of \$3.3 million or 1.1% of net sales. While adjusted operating income was outside of our guidance range, it did meet our expectations for stair steps fiscal year as we ramp up new productions and grow into our close, with new expansions in Thailand and in Mexico. We fully expect OI margin to improve over the remainder of the year.

Other income and expense increased slightly with expense of \$1.4 million in the first quarter of this year versus expense of \$1.2 million in Q1 of Fiscal 2022. The effective tax rate in Q1 was 21.9% compared to 27.4% in the first quarter last year.

Net income in the first quarter of Fiscal of 2023 was \$9.5 million or \$0.38 per diluted share, compared to adjusted net income in Q1 of last year of \$1.5 million or \$0.06 per diluted share.

Now turning to the balance sheet. Cash and cash equivalents at September 30, 2022, were \$19.7 million. Cash flow used by operating activities in the quarter was \$60.2 million, and cash conversion days were 99 days, up from 73 days in the first quarter of last year. Our cash flow and CCD results were driven by increase in inventory, which was up \$187.4 million from a year ago and \$53.9 million from last quarter. We continue to purchase materials not impacted by the part shortages so that we can fulfill customer orders once the components in short supply are received. It is also important to highlight, however, that the increase in inventory is heavily concentrated in Mexico and Thailand, the facilities where recent expansions have doubled our footprint and manufacturing capacity.

We expect inventory turns, measured as production-based sales on hand, to normalize as the part shortage abates and our expansions continue to ramp. The absolute dollar level of inventories will likely be higher than levels in the past to support stepped-up production volume.

Capital expenditures in the first quarter were \$19 million, largely in support of our facility expansion in Poland, equipment for the recently completed expansion in Mexico, and capital deployed to support the healthy funnel of new product introduction and equipment with leading-edge technologies and capabilities. Borrowings on our credit facilities at September 30, 2022 were \$232.5 million compared to \$72.6 million a year ago and \$180.6 million at the end of Fiscal 2022. Our short-term liquidity available, represented as cash and cash equivalents, plus the unused amount of our credit facilities, totaled \$113.4 million at September 30, 2022.

There were no shares repurchased in the first quarter of Fiscal 2023. Since October 2015, under our Board authorized share repurchase program, a total of \$88.8 million has been returned to our shareowners by purchasing 5.8 million shares of common stock. We have \$11.2 million remaining on the repurchase program. We do anticipate some share repurchase in the fiscal year, equal to the stock-based compensation in order to keep our share count flat.

As Don noted, we are affirming our guidance for Fiscal Year 2023 and expect full year results to be at the high end of the range, with net sales of \$1.6 billion to \$1.7 billion, a 19% to 26% increase year-over-year. Operating margin of 4.6% to 5.2% and capital expenditures totaling \$80 million to \$100 million. Just to reiterate a point made in Don's opening remarks, new customers and product start-ups can cause margin dilution early in the life cycle. As programs mature and volumes ramp, cost efficiencies are gained. With the increased launch activity due to facility expansions over the last 12 months, there has been near-term pressure to profitability, but we fully expect this to be recovered. As a result, our guidance anticipates sequential improvement in Fiscal 2023, with each quarter expected to improve over the previous one.

With that, I'll now turn the call back over to Don.

Donald Charron

Thanks, Jana. In closing, we're very proud of our accomplishments in Q1. This includes not only the financial results, but also other achievements, honors and distinctions in the quarter.

For example, we were awarded a silver medal for Corporate Social Responsibility and Business Sustainability from EcoVadis, the world's largest and most trusted provider of business sustainability

ratings. The silver medal places our Company in the top 25% of the 90,000 plus companies that EcoVadis rates, and demonstrates how we live our guiding principles through awareness and respect for sustainability, business ethics, the environment and human rights. This achievement is a credit to our teams worldwide.

With an outlook for Fiscal 2023 that includes record results in certain financial metrics, including top line growth, we are very bullish on the long-term prospects for the Company. We're forecasting sequential quarterly increases for the balance of Fiscal 2023, with emphasis on aligning production forecast with material availability and manufacturing capacity, increasing cash flow through inventory management and driving additional and sustainable operating leverage at even higher levels of revenue in a quarter.

The \$2 billion annual revenue milestone is clearly in our sights and with plenty of recent experience expanding facilities, our manufacturing capacity is being carefully evaluated at each location to support the higher level of production needed to reach this milestone.

Partnership with all members of the value chain is critical in this exercise as we believe our customers' growth becomes our growth.

Finally, I'd like to take a moment to welcome Tom Vadaketh to our Board of Directors. Tom was appointed a new Director at our Board meeting in September and will stand for election to a full term at the Annual Meeting of Shareowners later this week. It is an honor to have Tom join us with his well-rounded financial expertise, vast experience with major multinational organizations and demonstrated leadership in a variety of global businesses, driving both organic growth and strategic acquisitions. He further enhances our Board's distinct and valuable skillsets as we continue to build lasting relationships and global success with our stakeholders. We expect to learn a lot from Tom so that we become an even better Company while creating quality for life.

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I would now like to open the lines for questions.

Operator

Thank you. First question comes from Max Michaelis from Lake Street Capital Markets. Please go ahead Max.

Max Michaelis

Hi, guys. Good morning and congrats on the quarter.

My first question here, I want to touch on the margins. You were down to a gross margin of 7.2% in the quarter, and you did note that you were going to see sequential improvement throughout the year. Is this gross margin—is this a snapback to levels like we saw in Q4 at around 9.2% or is this a gradual improvement? I'm just trying to get a good sense on how we get to the higher end of guidance for operating margin.

Donald Charron

Yes. We wouldn't describe it as a snapback, but a gradual improvement with each quarter throughout the fiscal year in a stair step fashion improving over the previous quarter and getting back to those levels,

Max, that we were at before in that 9% range. That's how we think about it as we go through the rest of the fiscal year.

Max Michaelis

Okay. Then are you going to see any tick down in Opex at all throughout the year?

Donald Charron

Say that again, to make sure I understand your question.

Max Michaelis

Yes. basically, I'm trying to get an idea of how we get to the higher end of that operating margin range and if we're not seeing a snapback in gross margin, I'm trying to figure out, are we seeing a tick down in operating expenses?

Donald Charron

No, I think with the new footprint, especially expansions in Mexico and Thailand ramping up those new production capabilities and capacities that were put in place in those expansions as well as other new programs. Improving that absorption rate, improving the utilization, driving the improvements in those new program introductions, that's really where the bulk of that margin improvement will come from.

Jana Croom

Max, you're going to also see—it's twofold. It's the dynamic of improving revenue that also stair steps while the margin stair steps. As you get to the back half of the year and the revenue was higher, it also has higher margin, and taking the cumulative effect of that over the year is how you get there. Is that helpful?

Max Michaelis

Okay. Thank you. Yes, and you're not going to see like a mix change where you're going to have higher revenue—higher margin revenue at the end of the year. Are you having any expectations in changes in mix?

Donald Charron

That won't be significant, not nearly as the improvement in absorption. As Jana said, as we ramp up revenue into a footprint that's essentially already there.

Max Michaelis

Okay. Thanks, guys. Then I wanted to shift to supply chain. Is there any way you can quantify how much revenue you did not ship in the September quarter?

Donald Charron

We were still constrained in the September quarter. I think, if you think about our updated full year guidance being towards the upper end of the range, think about stair steps throughout the fiscal year. Yes, we're talking about pretty big numbers that we're still missing. Somewhere, if I had to ballpark it,

maybe as much as 10%, if we had all the parts that we needed. That's a ballpark number, Max, but it's significant still.

The point I want to make is, the constraint is still significant. As we anticipate availability of components improving throughout the fiscal year and you start to put those stair steps in place, you can see where Q4 is going to be running—the rough range where Q4 is going to be running for us to finish the full year near the upper end of the range of our guidance.

Max Michaelis

Thank you. Then just the last one, and then I'll jump back in the queue. Where does backlog currently stand? I know you were greater than \$1 billion last quarter. Then if you could touch on the mix of that? Or is it pretty similar to the mix in revenue this quarter?

Donald Charron

The mix is pretty similar. It fluctuates from customer to customer, more so than it does from vertical to vertical. The dynamic there, Max, that's important to note, is as lead times improve, backlog softens, or it decreases in a commensurate fashion. It takes time. It doesn't happen immediately. We are seeing lead times improve in several areas. We're still monitoring that very closely. Open order backlog was down a bit from the prior period, but still at very, very high levels for us. Again, it's stuff we should have already shipped. It's got a lead time dynamic to it, and of course, our new program wins.

Max Michaelis

Okay. Thanks, guys. That's it from me. Great quarter.

Donald Charron

Thank you. Take care. Have a good day.

Operator

The next question comes from Anja Soderstrom from Sidoti. Anja, please go ahead. Anja, your line is now open.

Anja Soderstrom

Hi, can you hear me?

Donald Charron

Yes.

Anja Soderstrom

All right. Thank you for taking my questions. My first question is, have you seen any changes to the sentiment of your customers given the uncertain economic environment?

Donald Charron

Certainly, it's added an additional rigor to the monthly sales and operations planning process, as they look at their forecast going out further on to the horizon. They're factoring in, certainly, what would be an anticipated economic downturn. It certainly has not shown up in their forecasted demand to us. Demand remains very strong. If you start with the automotive vertical, inventories are still very low, especially in the U.S. but around the world. There's a backlog component there that's adding a lot of stability, and I would say, firmness to the demand. It's not backed off at all. Very strong demand there.

We're still recovering in the medical vertical from the pandemic and areas of that business that were impacted negatively by the pandemic. That's also an added factor to, let's say, bullishness to the outlook. Frankly, our industrial vertical with the customers we serve in that space, they also are working to replenish inventory levels, as they've been constrained by component availability in their end markets, especially in climate control. For us, in the three verticals, three end market verticals that we support, we would say the sentiment has not changed, and backlog remains very strong and demand remains very strong.

Anja Soderstrom

All right. Thank you. Which end markets do you see most potential growth within?

Donald Charron

Just like this quarter proved out in terms of the growth by each end market vertical, you really can't pick out one. Obviously, automotive being the strongest, but very strong double-digit growth in both medical and industrial. We see a very similar picture going forward. Demand in all three verticals remains very strong. Certainly, our automotive vertical, you may have recalled in past earnings releases and webcast, we talked about winning a large electronic braking program—next-generation electronic braking program. That program has since launched and certainly factored into the automotive growth that we saw in Q1. Really we've seen strong demand in all three end market verticals and again, we would expect it going forward.

Anja Soderstrom

All right. Thank you. Do you see any changes at all in the competitive environment?

Donald Charron

I think the entire industry is doing very well, recovering from the pandemic and working on backlog, working through supply chain, material shortage issues. Certainly, we're all going about that in slightly different ways. I do think the industry overall is still in recovery mode from part shortages, pandemic caused part shortages. I do think that as we start to get back to more normal operating conditions and have really effectively dealt with the inflation, especially in raw materials. I do think that it's going to put pressure on Companies like ours to continue to innovate and be competitive and find productivity, especially variable cost productivity. Those that do, I think, will fare better than those that don't.

Anja Soderstrom

All right. Thank you. I guess the last one for me is where do you see the most challenge to secure components?

Donald Charron

We mentioned it in the script today, many of the component types, component categories and certainly part numbers with a higher grade material or a higher level of reliability expectations are still in short supply. I think those components that are a little behind in the technology life cycle, those will be in short supply. Capacity is being added at the front end of the technology curve. As that comes online, it will continue to free up other capacity to address the lagging technologies.

Really, we still see power semiconductors as being a big challenge and automotive grade components in general, still being a big challenge going forward. Again, the good news is it's improving, but at a relatively slow pace. Yes, we're going to be constrained still for the next couple of quarters, but we do see improvement, and I think that's the good news.

Anja Soderstrom

All right. Thank you so much. I'll jump back in the queue.

Donald Charron

Okay. Thank you.

Operator

The next question comes from Hendi Susanto from Gabelli Funds. Please go ahead.

Hendi Susanto

Good morning, Don, Jana and Andy.

Donald Charron

Hello Hendi.

Jana Croom

Good morning.

Hendi Susanto

My first question, given the capacity ramp up in the next several quarters, how should we think about seasonality from one quarter to another on the top line and then the revenue growth driven by capacity ramp up? Should we expect that the capacity ramp up would over shadow the historical seasonal pattern?

Donald Charron

Yes. We've stated in the past, the seasonality in our business is really not material, not as measurable. I wouldn't really expect anything different this fiscal year. Certainly, it would be very small in comparison to the ramp-up of new business and recovery of backlog on existing programs. That's really where these stair steps are coming from. Things we should have already shipped if we had parts and new programs that are ramping up to run at rate volumes. That's where the stair steps are going to come from. That's really the significance of the story.

In terms of the second part of your question, for us, we feel like the return to our targeted operating margin levels will come from better absorption in our newly added capacity. That's where we're focusing our time and our energy. That's not new to us. I think we're good at that. It is challenging in the sense of the sheer size or magnitude of the growth that we're facing into. That's what we're focused on, getting those programs up to their quoted run rates and getting the bugs worked out of those new production lines that are going into place. That's where we're spending our time and our energy.

Hendi Susanto

I see. Then, Don, given the cost adoption of the new facility and the new early products in its lifecycle—would you be able to share like how long the cost absorption process may take place? Or in other words, how many quarters would it need before reaching out the 9% gross margin range again?

Donald Charron

Yes. We're expecting to have improvement each quarter on a sequential basis. Q2 will be better than Q1, Q3 better than Q2 and Q4 better than Q3. Certainly, by the time we exit the fiscal year, we expect to be again, well within our normal operating margin and gross margin range. Again, the full year operating income margin would be towards the upper end of our guidance for the full year.

Hendi Susanto

That's helpful.

Donald Charron

Two or three quarters, Hendi. That's in a gradual step up each quarter.

Hendi Susanto

That's fast by the way. Yes. That's all. Thank you so much, Don. Jana and Andy.

Donald Charron

Thanks, Hendi.

Andy Regrut

Take care, Hendi.

Jana Croom

Thank you.

Operator

It appears we have no questions at this moment. I'm going to hand back to Don for any final remarks.

Donald Charron

Thank you, Darius. That brings us to the end of today's call. We appreciate your interest and look forward to speaking with you in the near future. Thank you.

Operator

At this time listeners should hang up to disconnect from the call. Thank you, and have a nice day.