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KE - Q4 2016 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

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Mike Sergesketter *Kimball Electronics - VP, CFO*

CONFERENCE CALL PARTICIPANTS

Zach Cummins *B. Riley - Analyst*

Hendi Susanto *Gabelli & Company - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Ashley and I will be your conference call facilitator today.

At this time I would like to welcome everyone to the Kimball Electronics Fourth Quarter Fiscal 2016 Financial Results Conference Call.

(Operator Instructions)

Today's call August 4th, 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 outcomes of the forward-looking statements can be seen in Kimball's annual report on Form 10k for the year ended June 30th, 2015 and in today's release.

The panel for today's call is Don Charron, Chairman of the Board and Chief Executive Officer and Mike Sergesketter, Vice-President and Chief Financial Officer of Kimball Electronics.

I would like to turn the call over to Don Charron. Mr. Charron, please go ahead.

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Thank you, Ashley. And welcome, everyone, to our Fourth Quarter Conference Call.

Our earnings release was issued yesterday afternoon on the results of our fourth quarter ended June 30, 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 Event and Presentations tab. Or if you are listening via the webcast you can find it in the downloads tab on the webcast portal.

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

Our sales in the fourth quarter of Fiscal Year 2016 improved slightly over the previous quarter and were up sharply when compared to the fourth quarter last year. Continued strength in the automotive end market vertical, combined with sales from new program launches, helped us set a new quarterly sales record in the fourth quarter and a new annual sales record in Fiscal Year 2016.

Sales in our medical end market vertical were up double digits when compared to the fourth quarter of last year. However they were relatively flat when compared to the previous quarters. We are encouraged by the back-to-back sequential quarterly increases in our sales in the industrial end market vertical which were up 6% from the quarter, which followed a 7% sequential quarterly increase posted in the third quarter.

Industrial end market sale were up 8% when you compare the fourth quarter of Fiscal Year 2016 to the same period last year. However for the full Fiscal Year 2016 our industrial end market vertical sales were down a disappointing 7% when compared to Fiscal Year 2015.

Our sales and our public safety end market vertical were relatively flat quarter over quarter, and year over year and remained stable at approximately 7% of our total book of business.

We continue to make good progress on the launches of a number of new business awards with both existing and new customers. As expected after several quarters of development we begin to see sales from the ramp-up of some of these programs which contributed to our record breaking fourth quarter sales. Our new program launch activity was approximately twice the normal level in Fiscal Year 2016, and we expect Fiscal Year 2017 to be at a similar level.

Our new business opportunities pipeline remains healthy and we continue to work diligently to achieve our goal of $1 billion in annual sales by Fiscal Year 2018. We set this goal two years ago and despite the subsequent currency exchange reset caused by the stronger U.S. dollar in a weakening global economic environment, we believe that the goal is still within our reach.

We were pleased to have achieved our goal of a 4% operating income in the fourth quarter of Fiscal Year 2016. But it is important to know that we continue to experience pressure on our margins. We still have work to do in order to consistently achieve our 4% operating income goal.

Margin improvement will continue to be a priority of focus for us going forward as we drive variable cost productivity to our Lean, and Six Sigma, and global supply chain initiatives, and as we look for enterprise-wide productivity improvements in our office support areas.

Fiscal Year 2017 will be a pivotal year for us as we work through another year of significant programs launches, the ramp up of our new operation in Romania, and the integration of our recent Medivative and Aircom acquisitions.

We continue to make excellent progress in Romania. Production for our first industrial customer continues to ramp as planned and we are working on validation of plans for additional industrial customers that we expect will launch and ramp over the next several quarters.

However, we did not receive approval to begin production from our first automotive customer. It was determined by our customer that additional validation testing is required causing a three to four month delay to our previous plan-started production. We now expect to get customer approval to start production in the October to November timeframe.

Getting approval to start automotive production is a very important step and requires for us to be able to build a more predictable path to profitability in Romania.

We are excited about the recent Medivative and Aircom acquisitions. Aircom, the former parent of Medivative is a key supplier to Medivative. The combination of the two companies adds capabilities and expertise in mechanical design engineering, metal fabrication, injection molding, combination devices, medical instruments and complex system assembly, all to our package of value.

As previously announced Medivative is expected to be neutral to slightly accretive to our Fiscal Year 2017 results. Aircom is expected to be slightly dilutive to our Fiscal Year 2017 results. While these acquisitions will add to our near-term margin challenge we believe it is an appropriate value creating risk to take it this time.

Our plan to leverage our platform to enable more business opportunities for both Medivative and Aircom have already been kicked off. And we were recently two new strategically important programs from two different medical customers that will help us solidify our business plans for these two new additions to our footprint.

We are also looking at some [make] versus buy opportunities to improve the short-term utilization of the Aircom operation.

And finally we continue to take advantage of the flexibility provided by our strong balance sheet making investments that would drive future growth in sales and profits. After investing $37 million in capital expenditures in Fiscal Year 2015, we invested $35 million in capital expenditures in Fiscal Year 2016, which was slightly below what we expected as we were able to defer a portion of the expenditure to the first quarter of Fiscal Year 2017.

It is important to remind you that a large portion of these capital expenditures directly support new business awards. We are focused on getting through the launch cycle, ramping up production, and ensuring that these new programs and a newly deployed capital that supports them achieve our expected returns.

In addition to the $35 million in capital expenditures in Fiscal Year 2016 we also invested more than $10 million to complete the Medivative and Aircom acquisitions which has strategically positioned us to open new doors for future growth in sales and profit.

During the fourth quarter of Fiscal Year 2016, we also returned $5 million to our share owners by purchasing 400,000 shares of our common stock, which brings our total to $13.2 million and 1.2 million shares purchased under the 22 million shares repurchase program approved by our Board in October, 2015.

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

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Thanks, Don.

Our fourth quarter net sales were $220.4 million which was a 10% increase compared to net sales of $201.1 million in the prior year fourth quarter.

If we exclude incremental sales in the fourth quarter from the Medivative acquisition, net sales were up 8% from last year.

Comparing our net sales by vertical to the same quarter a year ago our automotive vertical was up driven by a continued strong demand and new program introductions beginning to ramp in the period. We generally saw increased demand globally for automotive products.

As Don mentioned our medical vertical was up double digits from last year and flat compared to Q3. However, when excluding sales from the Medivative acquisition the medical net sales were up in the high single digits from a year ago, and down in the low single digits from the third quarter.

The increase from a year ago was related to both demand from existing customers and new program launches.

Our industrial vertical was up as a result of increased customer demand in the lighting and industrial pumps and new program launches related to smart metering. And our public safety vertical was down just slightly from a year ago.

Our gross margins in the fourth quarter was 7.7% which was down from 8.8% in the same quarter last year. Margins are under more pressure partly as a result of contracted customer price reductions. In addition cost related to the ramp up of the remaining operation and new product introductions have also impacted margins as have product mix.

Selling and administrative expenses were $8.2 million in the fourth quarter which were down almost $500,000 or 60 basis points as a percent of sales compared to the prior year fourth quarter.

The decline in selling and administrative costs compared to the prior year was largely due to lower profit base incentive compensation costs which are designed to fluctuate with changes in earnings.

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Our income expense net was expense of $700,000 in the Fiscal Year 2016 fourth quarter, compared to an expense of $400,000 in the fourth quarter of 2015.

Foreign currency losses during the current year fourth quarter as a result of unfavorable exchange rate fluctuations, which were only partially offset by derivative gains primarily drove the larger expense in the other income and expense net section of the income statement.

The effect of tax rate for the current year fourth quarter was 28.4% compared to 15% in the prior year of fourth quarter. The increase in the tax rate was largely the result of a change in the mix of taxable earnings within the jurisdictions in which we operate.

And in the prior year fourth quarter we had a benefit from the [true-up] of the estimated annual effective tax rate to deploy the full year rate, which further lowered the prior year Q4 rate.

The [full-year fiscal] to 2016 rate ended at 20.3% which was a little low due to the $1.8 million discreet foreign tax benefit we received in the third quarter as a result of a favorable tax ruling related to the capitalization of our Romanian subsidiary.

Net income in the fourth quarter of Fiscal 2016 was $5.8 million compared to $7.4 million in the fourth quarter of last year.

Diluted earnings per share was $0.20 in the fourth quarter of this fiscal year compared to $0.25 in the prior year fourth quarter.

Cash and cash equivalents at June 30th, 2016 were $54.7 million. We had strong cash flow provided by our operations during the current year fourth quarter of $8.8 million. However that compares to a very strong $16.8 million provided in the fourth quarter of last year. The operating cash flow during the quarter was primarily the results of the earnings plus nine cash adjustments.

Capital investments in the fourth quarter totaled $6.5 million largely related to our investment in new manufacturing equipment to support new product introductions and capacity adjustments.

In addition $8.3 million in cash reduced for the acquisition of the Medivative Technologies during the fourth quarter.

As Don mentioned we also repurchased $5 million of our common stock during the quarter. During the quarter we did draw down $9 million on our primary credit facility to help fund our domestic needs including the stock repurchases and the Medivative acquisition, while we also paid back the $3 million on our China revolver that was outstanding at the end of the third quarter.

Our current short-term liquidity available represented as cash and cash equivalents, plus the unused amount of our credit facilities totaled $105 million.

Don mentioned the Aircom acquisition which closed on July 18th. The acquisition price was approximately $3.5 million and included an 80,000 square foot facility on a northeast side of Indianapolis, along with trade recievables, inventory and manufacturing equipment. In addition as part of the acquisition we assumed certain liabilities.

We also welcomed approximately 100 Aircom employees into the Kimball family.

I would like to conclude by saying that our balance sheet continues to be very strong and we believe are well positioned for growth. With that I would like to open up today's call to questions from the analysts.

Ashley, do we have any analysts with questions in the queue?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Herve Francois of B. Riley Capital. Your line is open.

Zach Cummins - *B. Riley - Analyst*

Hi, good morning, this is actually Zach Cummins in for Herve today. But I guess will just start out with -- can you give me some of your expectations in your auto segment in both China and the US especially given some of the weakness in auto sales mentioned by Ford last week?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Hello, Zach. Yes, I can add a little bit of color around our automotive business. You know, I think that, you know, this past year was a very strong year for us.

And as Mike mentioned, the fourth quarter overall was strong in all three regions. And so, you coupled that with some of our new product wins which, you know, have been certainly significant in our automotive end market vertical.

We talked in a script today about the new product introductions that we're working on and a significant portion of those are automotive. And so, you know, we will get a lift from that activity. And, you know, the market overall is expected to start to slow down a little bit and I think especially China which has been, you know, very strong for us.

We are anticipating that the market will eventually begin to level out there a little bit. And as you mentioned Ford and other car makers are lowering their forecasts for auto sales in the near term. But again, I think with our automotive book of business, where we're situated today we have a significant amount of our new [product care] reduction activity is concentrated on automotive, which will help us I think stay strong in that end market vertical going forward.

Zach Cummins - *B. Riley - Analyst*

That's great. That's really helpful. And you did mention there was some start-up costs for your Romanian plant in this quarter. Do you expect any additional costs in the coming quarters?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Yes. You know, our facility has been, you know, readying for a production and ramp-up of additional production, you know, over the past several quarters now.

And so, you know, we had a net loss impact of a $1 million as a result of our Romanian facility this past quarter. And we would continue to expect to have that kind of impact to our earnings. And as I said today, you know, it's critical for us to get approval to start automotive production there and ramp up production in automotive so that we can build a more predictable path to profitability.

Zach Cummins - *B. Riley - Analyst*

And I guess going straight more about that delay in your automotive production do you anticipate that having a pretty meaningful headwind until you are able to get approvals sometime in October?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Well. Certainly at the level that we saw in Q4 continuing on at that level in terms of impact to our earnings we would expect to be in that range, maybe even slightly deeper as we work to gain approval to start automotive production and then ramp up on automotive production.

Zach Cummins - *B. Riley - Analyst*

Okay, fantastic. And then just one more question for me, however your expectations for gross margin and operating margin throughout Fiscal Year '17.

I mean you have stated that you have kind of a 4% operating margin goal, can you give -- do you have kind of a target that you're shooting for, for gross margin? And then can you kind of explain how you think your margin profile will look throughout each quarter in the year? That might be a bit difficult but just kind of an overview of what to expect from a modeling standpoint.

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Yes, you know, as we mentioned we expect to continue to have margin pressure going forward. You know, if you look at the quarter we just finished 7.7% on the gross margin line.

You know, that's a pretty good quarter for us given the headwinds we have right now with Romania and all this [MPI] activity we're working on and of course the two new acquisitions that we're working to integrate.

So, you know, we're maintaining our target of 4% operating income. You know, we achieved that in Q4 but actually when you look at Q4 compared to the previous two quarters we read 3.3% in each of the previous two quarters to our fourth quarter. In other words second quarter and third quarter of Fiscal Year 2016 were 3.3%.

You know, I think when you look at our business going forward really Q4 is a little bit more of an outlier in terms of finishing up 4% off income. I think our business is performing a little bit closer to the 3.3 range that you saw in Q2 and Q3. And again, while we have these headwinds from Romania and the new product introductions and the acquisitions, you know, we got to work our way back to a consistent performance level of 4% up income.

Zach Cummins - *B. Riley - Analyst*

Great. Thank you for taking my questions.

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Thanks, Zach.

Operator

(Operator Instructions)

Our next question comes from Hendi Susanto of Gabelli & Company. Your line is open.

Hendi Susanto - *Gabelli & Company - Analyst*

Good morning, Don and Mike.

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Hello, Hendi.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Hello.

Hendi Susanto - *Gabelli & Company - Analyst*

Your goal of $1 billion of sales in Fiscal Year '18 is two years away, how should we see the path toward that goal?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Yes, so, you know, it is approaching us, Hendi. So we got Fiscal Year 2017 that we started, and we are going to be in the 2018. You know, I think our four quarter ending a $220 million and being a new record for in the fourth quarter is a good sign.

As I mentioned we were able to set that record because we did have [reach] on automotive sales and we got that lift we had been anticipating from the new product introductions. So we have more new product introductions, a pretty heavy slate ahead of us in Fiscal Year 2017. And as those programs begin to ramp towards the end of 2017 I think that will position us for a run-rate that would a billion in 2018.

Hendi Susanto - *Gabelli & Company - Analyst*

So that goal assumes no more acquisitions. Is that correct?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Yes, that's right, Hendi. We believe that the billion dollar target, that target is achievable with what we can see right now in our current book of business. And of course it does include the acquisitions of Medivative and Aircom now included in those revenue figures.

Hendi Susanto - *Gabelli & Company - Analyst*

Got it. And then, Don, may I know the main reason why you did not approve from your first out of customer for production in Romania?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Yes, that's a good question, Hendi, I think that, you know, basically in these validation testing scenarios and protocols there can be some variation that's introduced as a result of the carmakers and our customer who is the tier 1 -- you know, shifting if you will their plans for what products they want to validate in the new production facility.

In some cases, the car makers themselves can add additional testing requirements depending on the criticality of the part and what they believe to be the risk profile. And in this case there were no failures that caused the delay, rather additional testing that the customer wanted to see done.

In other words adding more cycles if you will to the testing just to validate that the new process, the new facility is working properly, it can build reliable parts.

And so, in this case our customer and our customer's customer added another three months approximately to the testing cycle, the validation testing cycle and that's the reason for the delay.

Hendi Susanto - *Gabelli & Company - Analyst*

Okay. And then, Don, may I know where we are in terms of the Kimball Electronics trying to get a second auto customers for production in Romania?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

: Yes, so I think we continue to work our plan there, Hendi. You know, the first automotive customer is committed. We have parts in validation testing.

We do have the second and third automotive customers identified and they also are in agreement with production for our Romania facility.

You know, obviously it's important that we get the first customer through the testing cycle and improve it for production. And then I think we feel quite confident that the next two customers will follow.

Hendi Susanto - *Gabelli & Company - Analyst*

Yes. And that how far behind...

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Yes, Hendi?

Hendi Susanto - *Gabelli & Company - Analyst*

How far behind are the second and third potential customers?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

They ramp up...

Hendi Susanto - *Gabelli & Company - Analyst*

In terms of time frame?

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Yes, within the next couple of quarters after the first approval.

Hendi Susanto - *Gabelli & Company - Analyst*

Got it. Yes. And then one question for Mike.

With regards to the operating margin target of 4% in Fiscal Year 2017, how should we assume that operating margin will be in quarters throughout the fiscal year should we expect like a more back end-loaded one, or should we expect like more linear progression?

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Yes, I think, Hendi, if you look at kind of last year and how it played out, you know, we are going to see more margin pressure I think initially coming out of the gate because of what Don talked about with the new product introductions and capital deployed and so forth.

So, I think if you kind of look at the profile from last year it would give you kind of a directional feel for how we would see the margins playing out in '17 as well. Although you have to keep in mind that we have additional headwinds that we're talking about with some of the delays in Romania and then also with the addition of Aircom, those are going to put a little more pressure on our margins I think in the early part of Fiscal '17.

Hendi Susanto - *Gabelli & Company - Analyst*

Thank you.

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Thanks, Hendi.

Operator

(Operator Instructions)

I'm not showing any further questions in queue at this time. I'd like to turn the call back over to Don for any further remarks.

Don Charron - *Kimball Electronics - Chairman of the Board, CEO*

Thank you, Ashley. And that brings us to the end of today's call.

We appreciate your interest and look forward to speaking with you on our next call. Thank you and have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone have a wonderful day.
