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KE - Q3 2017 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

Don Charron *Kimball Electronics, Inc. - Chairman and CEO*

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

CONFERENCE CALL PARTICIPANTS

Austin Hopper *AWH Capital, LP - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, my name is Leigh-Anne and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics Third Quarter Fiscal Year 2017 Financial Results Conference Call.

(Operator Instructions) Today's call May 2, 2017 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, 2016 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 now like to turn the call over to Don Charron. Mr. Charron, you may begin.

Don Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Thank you, Leigh-Anne, 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, 2017. We have posted a financial summary presentation to accompany this conference call. The presentation can be found in our Investor Relations website within the Events & 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 third quarter of fiscal year 2017 were slightly higher than the previous quarter and up nicely when compared to the third quarter of last year. Continued strength in our automotive end market vertical in both North America and Europe more than offset a decline in China.

Double-digit growth in our industrial and public safety end market verticals compared to the prior year quarter help to set a new consolidated quarterly sales record for the fifth consecutive quarter. Sales in our medical end market vertical were down a disappointing 9% when compared to the same period last year. Despite being assisted by our Medivative and Aircom acquisitions.

Our sales in our public safety end market vertical were up significantly in the third quarter of fiscal year 2017, when compared to the third quarter of fiscal year 2016 as a result of the ramp up of a new customer and increased demand from existing customers.

Our new program launch and ramp-up activity remained high as we continue to work diligently to achieve our goal of $1 billion in annual sales in fiscal year 2018.

We continue to face margin pressure and while we still have work to do to achieve our goal of 12.5% ROIC, we are encouraged by our progress and that both our third quarter and year-to-date gross margins and operating margins have improved over the prior year.

Margin expansion and capital efficiency will continue to be priorities of focus for us as we close out this pivotal year. We remain focused on our new program launches, the continued ramp up of our new Romania operation and the integration of the Medivative and Aircom acquisitions.

We continue to make good progress in Romania. After receiving approval last quarter from our second automotive customer, we now have production ramping for two automotive customers, two industrial customers and one public safety customer. This positions us well to make sequential incremental improvements each quarter as we expect to approach our breakeven point next fiscal year.

We also continue to make good progress on the integration of the Meditative and Aircom acquisition. This combination of the two companies adds capabilities and expertise in mechanical design, machining and metal fabrication and plastic injection molding to our package of value. These new capabilities have strategically positioned us to open new doors for future growth in sales and profit.

Since the acquisitions, two new programs from existing medical customers have been awarded and once they are fully ramped, they are expected to add an additional 3% to 4% to our sales run rate.

And finally, we continue to take advantage of the flexibility provided by our strong balance sheet making investments that will drive future growth in sales and profit. In addition to the $35 million in capital expenditures in fiscal year 2016, we have invested $26 million in capital expenditures in the first nine months 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 the newly deployed capital that supports them, achieve our expected returns.

During the third quarter of fiscal year 2017, we also returned $3 million to our shareowners by purchasing 191,000 shares of our common stock which brings our total to $29.9 million and 2.4 million shares purchased under the original $20 million shares repurchase program approved by our board in October of 2015 and then later increased by an additional $20 million with no expiration date by a board approval in September of 2016.

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

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

Thanks, Don. Beginning with sales, our third quarter net sales were $232.9 million, which was 9% increase compared to net sales of $214.1 million in the prior year third quarter. And as Don mentioned, this was our fifth consecutive quarterly sales record.

Comparing to changes in our net sales by vertical to the same quarter last year, our automotive vertical remained strong as it was up again by double-digits in the third quarter compared to the same quarter last year driven by strong demand in the US and Europe as well as new program introductions in those same markets.

Net sales in our medical vertical was down 9% from prior year, which was the result of reduced demand from several of our largest medical customers. Our industrial vertical revenue was up 18% from a year ago, largely as a result of increased customer demand for climate control products and new product launches related to smart metering and net sales in our public safety vertical was up 47% from a year ago, setting a new quarterly record for this vertical.

Our gross margin in the third quarter was 8%, which was up 40 basis points from the same quarter last year. The increase in margins was assisted by the leverage from the higher sales volume, favorable product mix and cost productivity. But it was also partially offset by cost related to new product introductions and the continued ramp up of the Romania operation.

Selling and administrative expenses were $9.2 million in the third quarter which were up in absolute dollars by less than $100,000 but was down by 40 basis points when compared to the prior year third quarter. Selling and administrative cost related to our Supplemental Employee Retirement Plan or SERP increased by $400,000 compared to third quarter last year.

As a reminder, the SERP cost are the result of the normal revaluation to fair value of the SERP liability. These cost classified as selling and administrative costs are exactly offset by income from the revaluation to fair value of the SERP investments, which is recorded in other income and therefore has no impact on the company's net earnings during the period.

In the prior year quarter, selling and administrative expenses included incremental cost of $700,000 related to the startup of the Romania facility. Other income and expense net was an income of $300,000 in the current year third quarter compared to income of $200,000 in the third quarter of prior year. The current quarter income was driven by a $400,000 gain in the SERP investments, which as I mentioned is exactly offset in selling and administrative expense.

The effective tax rate for the third quarter increased to 17.8% compared to a negative effective tax rate or benefit of 2.3% in the prior year third quarter. We recognized a $1.8 million discrete foreign tax benefit related to the capitalization of our Romania subsidiary in the prior year third quarter. In the current year quarter, we recognized approximately $500,000 of discrete tax benefits from foreign and domestic provisions to return true-ups.

Net income in the third quarter of fiscal year 2017 was $8.1 million compared with $7.5 million in the third quarter of fiscal 2016.

Diluted earnings per share was $0.30 in the third quarter of this fiscal year, compared to $0.26 in the same quarter last year.

Cash and cash equivalents at March 31, 2017 were $40.1 million. Cash flow provided by our operating activities during the current year third quarter was a solid $8.7 million. However, it was down from cash flow provided by operating activities of $11.7 million in the third quarter of last year. This quarter's operating cash flow was primarily the result of the earnings during the quarter plus non-cash adjustments, which were partially offset by an increase in receivables and inventory driven by the higher volumes.

Borrowings on our credit facilities at March 31, 2017 were $6.5 million, which were down $2.5 million from June 30.

Capital investments in the third quarter totaled $6.3 million, largely related to our investment in new manufacturing equipment to support new product introductions and capacity expansion. As Don mentioned, we also repurchased $3 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 $93.9 million at March 31.

I would like to conclude by saying that our balance sheet is very strong and we continue to focus on margin improvement and capital efficiency. With that, I would like to open up today's calls to questions from analysts. Leigh-Anne, do we have any analyst with questions in the queue?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Austin Hopper with AWH Capital. Your line is open.

Austin Hopper - *AWH Capital, LP - Analyst*

Nice quarter. Something maybe on automotive, can you just talk about the strength you saw in North America versus -- and just compare that with what you saw in China?

Don Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Yes, overall, the total vertical was up 10% when compare this quarter Q3 to Q3 last year, but we were up in both Europe and North America, but down in China. So there's a number of factors there Austin, I think first and foremost, has to do with the launch and ramp activity as well as end market demand.

So I think we have new programs, for example, that we're launching and ramping in both Europe and North America and those end markets are pretty stable growing a little. China for us has been an end market that from a geography standpoint, it's been very strong. So this is sort of the first time that we've seen some softness there and a tough comparable last year. At this time, we had a lot of activity going on relative to ramp-ups of new programs, which have settled down now.

So overall, we would expect that our end market vertical in automotive would continue to remain strong dependent more upon the actual demand within geography. We still have a number of new programs that we're launching. But as we reach towards, I would say more of a normal launch activity, our overall demand in those end markets will depend more and more on the end market demand within that region.

Austin Hopper - *AWH Capital, LP - Analyst*

Okay, thank you. And then [kind of some] more medical, it sounds like you have some new business coming on but maybe some weakness in some of your bigger accounts. Can you give some color on that? That's all I had. Thank you.

Don Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Yes. We did see some general softness, obviously, it was unexpected for us. As Mike mentioned, as we looked at our existing customer base, three of our largest customers for example which would represent a number of different product categories as well as regions of the world, we're all down year-over-year in comparison. And so not sure we really have a [cause] on that yet, just general softness.

We are excited about the upcoming period given the new programs that we're ramping. I mentioned the two existing customers that we've gotten new program awards that we'll be ramping within our new business unit in Indianapolis that are medical-related, which we're really excited about and we're hoping to see some firmness return back within our existing customer base. Again, given that there was really no specific [causal] to that general softness we saw. We're hoping that we'll return to maybe more normal run rates out ahead of us here in the future.

Operator

(Operator Instructions) And I'm not showing any further questions at this time, I would like to turn the call back over to Don Charron.

Don Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Thank you, Leigh-Anne, 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

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