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CORPORATE PARTICIPANTS

Donald D. Charron *Kimball Electronics, Inc. - Chairman and CEO*

Michael K. Sergesketter *Kimball Electronics, Inc. - CFO and VP*

CONFERENCE CALL PARTICIPANTS

Chase Basta

Hendi Susanto

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Geronimo, 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 2017 Financial Results Conference Call.

(Operator Instructions)

Today's call, August 3, 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, 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 now like to turn today's call over to Don Charron.

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Thank you, Geronimo, and welcome, everyone, to our fourth quarter conference call. Our earnings release was issued yesterday afternoon on results of our fourth quarter ended June 30, 2017. 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 Downloads tab on the webcast portal.

I will begin by making a few remarks on the overall quarter, and then I'll 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 2017 were up 4% from the previous quarter and up 9% when compared to the fourth quarter of fiscal year 2016. Year-over-year growth in all 4 of our end-market verticals, including double-digit growth in 2 of our end-market verticals, helped us set a new quarterly sales record for the sixth consecutive quarter and provided a strong finish to a record-setting fiscal year 2017. New program launch and ramp-up activity combining with the successful integration of our recent acquisitions has created significant momentum and positioned us well to achieve our goal of $1 billion in annual sales in fiscal year 2018.

We continue to face margin pressure as we absorb the costs associated with our next phase of the ramp-up in our new Romania operation and another large wave of new program launches. In the just-completed fourth quarter, we also experienced higher-than-expected healthcare costs in the U.S., which negatively impacted our margins. However, our bottom line was assisted during the quarter by favorable foreign exchange tailwinds.

While we made good progress in fiscal year 2017, we still have work to do to achieve our long-term goal of 12.5% ROIC. Margin improvement and capital efficiency will continue to be priorities of focus for us in fiscal year 2018.

Our new operation in Romania is entering the next phase of ramp-up activity. We ended the fourth quarter of fiscal year 2017 having received approval to begin shipments to 5 customers, and we expect to gain approval from 2 additional customers during fiscal year 2018. We expect the sales run rate to more than double from the fourth quarter of fiscal year 2017 and to approach our operating breakeven point by the end of fiscal year 2018.

We continue to make good progress on the integration of our recent acquisitions. We have successfully added plastic-injection molding and metal fabrication to our value proposition, and we continue to take advantage of these new capabilities to win new business. As reported last quarter, the 2 new programs from existing medical customers that were awarded after the acquisitions had been completed have been launched and are ramping up nicely. For the fourth quarter of fiscal year 2017, these programs helped our 2 newly acquired units combined to become accretive to our earnings for the first time.

And finally, we continue to make investments that will drive further growth in sales and profits. In addition to the $35 million in capital investments in fiscal year 2016, we invested another $34 million in capital expenditures in fiscal year 2017. It's 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 fourth quarter of fiscal year 2017, we also returned $5.1 million to our shareowners by purchasing 300,000 shares of our common stock, which brings our total to over $35 million and 2.7 million shares purchased, under the original $20 million share repurchase program approved by our board in October 2015, and then with later increase by an additional $20 million with no expiration date by a board approval in September of 2016.

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

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

Thanks, Don. During my comments, I'll 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 find it in the Downloads tab on the webcast portal.

As shown on Slide 3, our fourth quarter net sales were $241.3 million, which was a 9% increase compared to net sales of $220.4 million in the prior year fourth quarter. Incremental net sales related to acquisitions within the previous 12 months did not materially contribute to our consolidated net sales in the fourth quarter of fiscal year 2017.

Slide 4 represents our net sales mix by vertical. Comparing our net sales by vertical to the same quarter a year ago, our automotive vertical was up by double digits, driven by steady demand in North America and Europe, and new program introductions, including the ramp-up of programs in our new Romania facility, all of which more than offset declining demand in China.

Our medical vertical was up in the mid-single-digit range, compared to Q4 last year, as a new program introduction and contributions from our acquisitions within 12 months more than offset a reduction in demand from several of our largest medical customers. Sequentially, compared to the third quarter, our medical vertical sales were up by double digits, primarily as a result of the new program introduction.

Our industrial vertical was up as a result of new product launches and increased demand for climate-control products, which more than offset a decline in demand for components for industrial pumps.

And our public safety vertical was up almost 40% from the prior year quarter, largely from the ramp-up of a couple of new programs.

Our gross margin in the fourth quarter, reflected on Slide 5, was 7.5%, which was down slightly from 7.7% in the same quarter last year. Our gross margin in the current year quarter was adversely affected by increased costs related to our domestic self-insured healthcare benefit program, due to a significant increase in high-dollar claims.

Selling and administrative expenses, Slide 6 in the deck, were $9.5 million in the fourth quarter, which were up $1.4 million, or up 30 basis points, as a percent of sales, compared to the prior year fourth quarter. The increase in selling and administrative costs compared to prior year were partly due to an unfavorable comparison in the bad debt expense, which was primarily the result of a recovery recognized in the prior year fourth quarter of a previously written-off receivable. Also contributing to the increased S&A costs were increased salaries and related benefits. Other income and expense was a net income of $1.1 million in the fiscal year 2017 fourth quarter, compared to an expense of $700,000 in the fourth quarter of fiscal 2016. Net foreign currency gains during the current year fourth quarter as a result of favorable exchange rate fluctuations, which were partially offset by derivative losses, primarily drove the income in other income and expense in that section of our income statement.

The effective tax rate for the current year fourth quarter was 15.1%, compared to 28.4% in the prior year fourth quarter. The decrease in the tax rate was the result of a change in taxable earnings in our lower tax jurisdictions, favorable discrete tax items primarily related to state R&D credits, and a benefit from the true-up of the estimated annual effective tax rate to the full year rate, which further lowered the current year Q4 rate. The full year fiscal 2017 rate ended at 22.8%, which is on the low end of our expected range, largely due to current year favorable discrete items.

Slide 8 reflects our net income trend. Net income in the fourth quarter of fiscal year 2017 was $8.1 million, compared to $5.8 million in the fourth quarter of last year. Diluted earnings per share was $0.30 in the fourth quarter of this fiscal year, compared to $0.20 in the prior year fourth quarter. Cash and cash equivalents at June 30, 2017, were $44.6 million.

Operating cash flow trends are shown on Slide 11. We had strong cash flow provided by our operations during the current year fourth quarter of $12 million, compared to $8.8 million provided in the fourth quarter of last year. The operating cash flow during the quarter was primarily the result of earnings during the quarter plus noncash expense, which were partially offset by an increase in accounts receivable.

Slide 12 reflects our capital and depreciation trends. Capital investments in the fourth quarter totaled $8.3 million, largely related to investment in new manufacturing equipment and to support new product introductions and increase manufacturing capacity.

As Don mentioned, we also repurchased $5.1 million of our common stock during the quarter. Borrowings on our credit facility at June 30, 2017, were $10 million, which was up $3.5 million in the quarter and up just $1 million from June 30, 2016. Our short-term liquidity available, representative cash and cash equivalents, plus the unused amount of our credit facilities, totaled $105 million.

I would like to conclude by saying our balance sheet is very strong and we're well positioned for continued growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions).

The first question comes from Hendi Susanto of Gabelli & Company.

Hendi Susanto

So, looking back into the last 4 quarters, can you share some insight on the ups and downs of your 4 major markets' sales growth? When I look into it, like, medical, for the year, grew 3%, public safety had strong second half, auto sales were strong throughout the year, and industrial grew 10%

in fiscal year '17. So I'm wondering whether you can share your perspective looking back into fiscal year '17 and what we should expect for fiscal year 2018.

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Yeah, Hendi, that's -- it's a good topic to start the questions with today. Our overall demand and our growth for the year, when it's all put together at a double-digit growth rate, is something we're pretty pleased with. I think when you look at our diversification strategy, to diversify across these 4 end-market verticals, it's working. I mean, from our point of view, it's working. And we've seen this over the last few years, actually, where maybe when we see some sluggishness in one end-market vertical, we see some pick-up in others. And so when you look at the full year, fiscal year '17, obviously, automotive remained very strong for us. And actually, we have arguably the most visibility when it comes to automotive, because the programs are typically awarded a couple of years in advance of the start of production, and so the biggest variable there really ends up being not so much the start of production, but what will the actual volume be on the new programs we launch? So we have more visibility there, and as we've said in the past calls, we feel like our automotive vertical will remain strong based on the business we have and the business we've been awarded and the business that's left to be launched. When you look at the other verticals, we don't have as much visibility. We know the business that we have, and the ups and downs are really more related to the actual end demand and market demand. And obviously, starting with public safety being our smallest vertical of the remaining 3, that's probably our lumpiest. I don't know if you could look at 4 quarters and make any sort of determination of what's really happening there, because it is pretty lumpy in general in terms of how the business comes to us from our customers. Large purchase orders maybe 1 quarter, smaller purchase orders or no purchase orders the next. It's a little lumpier for us. Industrial and medical tend to be more end-market-related. Just how is the demand that our customers are facing being generated with real consumption? And there's not a lot of inventory in the pipeline, so if there is a reduction in true demand, it's reflected in our sales pretty quickly. But overall, I think our diversification strategy is working. We're a little bit disappointed in the growth in our medical end-market vertical this year. The other 3 end-market verticals ended up a little closer to where we thought they would. But we also really like the traction we have in our medical end-market vertical. As I stated, our acquisitions that we did last year have been successfully integrated. Those were largely in support of our medical end-market vertical. And we're really seeing some really nice traction there as we look into fiscal year 2018. And we have other existing medical customers that have awarded us new programs, and so our outlook for medical is still bullish. And certainly, as we stated in FY '17, it was a little bit lighter than we thought it would end up. But overall, we're pleased with where we ended the year, the diversification strategy is working, and we feel like we've got a solid portfolio of business to move forward with.

Hendi Susanto

Okay. And then, any insight into your outlook for fiscal year 2018, Don?

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Well, we reiterated the fact that we believe we're positioned to hit our long-stated goal of $1 billion in annual sales in fiscal year '18, and so finishing this year at $931 million, that's obviously a pretty nice step up in growth again, to reach $1 billion in fiscal year '18. And so, I think we've put that goal out there, Hendi, maybe more than 2 years ago now, and we've been tracking to it, and yeah, we as a management team feel confident that we've got a good -- we're positioned well to achieve that $1 billion goal in 2018.

Hendi Susanto

Yeah. And then Mike, can you talk about the Romanian facility, where we are, what we should expect in 2018 with respect to the transition and the impact on the gross margin?

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

Well, I think Don commented on it in his part of the discussion. We do expect to achieve operating breakeven by the end of the fiscal year. We're expecting to see some significant growth there. In the current quarter, I think, quarter-over-quarter, we're seeing kind of similar results to what we've seen in the prior quarters. So we're kind of right on the cusp of where we see, as volumes ramp up, we're going to see some improvement in those results over the next 4 quarters.

Hendi Susanto

Okay. And then, can you quantify a bit on the gross margin level, how that operating breakeven may translate?

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

That would be a bit of a challenge.

Hendi Susanto

I see.

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

We do believe by the end of the year we'll be at breakeven operating income. That 's --

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Hendi Susanto

Okay. So, by exiting the Q4 of fiscal year 2018?

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

Yes.

Hendi Susanto

Yeah, okay.

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

That's correct.

Hendi Susanto

And then, the press release mentioned that there's some higher healthcare costs in Q4. Should we expect them to continue?

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Well, we don't know that we can really answer that question. There's lots of variables there, Hendi, that makes that unpredictable. I'll just reiterate the fact that we -- it was, in the fourth quarter, higher than we expected, and we have historical data that we certainly can look at. It's not necessarily a predictor of the future in terms of our healthcare costs, but we would tell -- we'd want to reiterate the fact that the fourth quarter was higher than we expected, and it was pretty significant. It was 50 basis points on our operating income line. So that will just give you an idea of the size of the impact that was beyond what we would have expected. And so, we hope that it would return back to something that's more normalized, but we really can't say that.

Hendi Susanto

I see. Okay, thank you, Don, thank you, Mike, and all the best reaching the $1 billion goal.

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Thank you, Hendi.

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

Thank you.

Operator

Thank you. (Operator Instructions).

Our next question comes from the line of Chase Basta of AWH Capital.

Chase Basta

Hi, Don, Mike. Thanks for taking my questions.

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Hello, Chase.

Chase Basta

You talked about margin pressures that you're facing in Romania and still being in the ramp-up phase, as well as new program launches, and I think you touched on the healthcare. Can you just kind of break down where those costs are being reflected in terms of being in the confine of the S&A line?

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

Well, most of, like, the Romania costs are primarily reflected in the COGs line. That's where we're seeing those. Healthcare costs are same, yeah. It's -- we have a large indirect workforce in the U.S., and so most of those costs are related more directly to production, so they're showing up in COGs as well.

Chase Basta

Okay. So it sounds like healthcare was a big contributor to the decline in gross margin during the quarter. You touched on the ramp-ups also being a contributor, but I know this has kind of been the case for the last several quarters. Does this kind of indicate that the level of new business ramping has accelerated during the quarter?

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

I would say it remains at a pretty high level. It's supporting basically a double-digit growth rate, which is pretty significant. We would consider that, from a new product introduction standpoint, that it would be 1.5x, maybe as much as 2x the normal activity for our business when we look back over a several-year period. So as we add those costs to support those launch activities in advance of the revenue, we get a little bit bigger drag that tends to normalize a little bit once we get to a more normalized run rate of new program launch activity. Look, we're really happy with the new program wins, the new business wins. We -- it's exceeded our expectations in terms of the successes we've had in winning new business. And so we feel like we've got to continue to get better through the launch cycle, and we're working on those kinds of things, and try to improve, if you will, the performance between the receipt of the award and actually getting the product up into production and generating sales and profits. So we've got plans to improve that cycle, and in terms of its impact on our earnings, but I would want to say we're very pleased with the win rate right now, the addition of new business awards. It's -- we would consider it to be maybe, as I said, maybe 1.5x to 2x at, like, a normalized run rate for us. To just maybe to add a little bit more color on the -- I think, in terms of our future performance, we are very focused on Romania in this next phase of the ramp-up in Romania. We're very pleased with Phase 1, getting the customer approval, starting revenue. We are now shipping a measurable amount of revenue out of Romania on a quarterly basis. And as I mentioned, we expect that rate that we finished in fiscal year 2017 fourth quarter to double throughout the fiscal year 2018. And so we've got to make that happen, and as we make that happen and approach our breakeven point for Romania, that's going to have a significant impact on our earnings results.

Chase Basta

Okay. And then, did you guys say what the profitability drag was this quarter out of Romania?

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

It's -- we didn't say this quarter. I think if you go back to last quarter, it's very similar to the Q3 report that we gave you, somewhere around $1 million on the operating line. But if you go back to our last quarterly report, it -- the Q4 drag was pretty similar to the Q3 drag we reported in Q3.

Chase Basta

Okay. Great. Thanks, guys.

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Thanks, Chase.

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

Thank you.

Operator

Thank you. (Operator Instructions).

And we have a follow-up question from the line of Hendi Susanto.

Hendi Susanto

Hi, Don. Looking into fiscal year '18, is there any plan to enter new markets?

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Well, we're in the process, Hendi, of updating our strategic plan, as we do each and every year. And there's obviously those types of considerations that are on the table at that point in time. Certainly, we don't have anything we're ready to announce at this point in time. I think the good news is, we see continued growth in the 4 end-market verticals that we're focused on, and so I would tell you that we're not going to get too far off of that path, not going to distract ourselves too much from those 4 verticals while we're seeing pretty good growth opportunities there. But as we look further out and we start to set new growth goals beyond $1 billion, that certainly will come into the realm of a possibility.

Hendi Susanto

Got it, yeah. And then, Mike, how should we think about capital allocation and share repurchase for fiscal year 2018?

Michael K. Sergesketter - *Kimball Electronics, Inc. - CFO and VP*

We've been running, and we've talked about this in several of our past calls, we've been running at a rate that's higher than what we would normally target, and we're looking for an opportunity to sort of normalize our capex. And somewhere around the annualized depreciation is really what we're targeting.

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

As far as the share repurchase program, Hendi, we're, as reported, we're $15 million into the second $20 million, if you will, or $35 million into the $40 million that our board has approved, and so we have that on the agenda in the August meeting. We'll decide for the upcoming year what the final capital allocation will be. But we don't have any further information to share at this time.

Hendi Susanto

Okay, got it. Thank you.

Operator

Thank you. And I'm showing no further questions at this time. Mr. Charron, please proceed with any closing remarks.

Donald D. Charron - *Kimball Electronics, Inc. - Chairman and CEO*

Thank you. And that brings us to the end of today's call. We appreciate your interest and look forward to speaking with you in our next call. Thank you and have a great day.

Operator

(Operator Instructions). Thank you and have a nice day.