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KE - Q2 2018 Kimball Electronics Inc Earnings Call

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Chase Basta

Hendi Susanto *G. Research, LLC - Research Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Michelle, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics Second Quarter Fiscal 2018 Financial Results Conference Call. (Operator Instructions)

Today's call, February 8, 2018, will be recorded and may contain forward-looking statements as defined under the Private Security Litigation Reform Act of 1995 (sic) [Private Securities Litigation Reform Act of 1995]. Risk factors may -- 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, 2017, 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 the call over to Don Charron. Mr. Charron, you may begin.

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

Thank you, Michelle, and welcome, everyone, to our second quarter conference call. Our earnings release was issued yesterday afternoon on the results of our second quarter ended December 31, 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 & 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 second quarter of fiscal year 2018 were up 2% from the previous quarter and up 12% when compared to the second quarter of fiscal year 2017. Double-digit year-over-year growth in our automotive and medical end market verticals helped us set a new quarterly sales record for the eighth consecutive quarter and kept us on pace to exceed our long-stated goal of $1 billion in annual sales in this fiscal year 2018.

As we stated last quarter, our compound annual growth rate, or CAGR, was approximately 8% over the past 3 fiscal years, and our goal is to sustain this growth rate over the next few years through fiscal year 2020, as we look to grow the company beyond $1 billion in annual sales.

Our margins improved slightly in the second quarter of fiscal year 2018 when compared to the first quarter of this fiscal year. However, we are still below our new operating income target of 4.5%. We expect to make sequential, incremental improvement toward achieving our new goal as we continue to drive actions to improve our yields and throughput margins on recently launched new programs.

Our next phase of ramp-up activity in Romania is on track. We expect our sales run rate to more than double from the fourth quarter of fiscal year 2017 to the fourth quarter of fiscal year 2018, and we expect to approach our operating income breakeven point by the end of fiscal year 2018. The impact of the Romania ramp-up on our second quarter fiscal year 2018 operating income was relatively flat with the same period last year.

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 expansion and capital efficiency will continue to be priorities of focus for us this fiscal year.

We continued to make investments that will drive further growth in sales and profits. We invested $8.7 million in capital expenditures in the second quarter of fiscal year 2018, bringing our fiscal year 2018 total to $14.8 million. As we stated on our first quarter call, due to stronger-than-expected forecasted demand from several of our existing customers, we expect fiscal year 2018 capital expenditures to approximate the fiscal year 2017 level of $34 million. We are focused on securing raw materials, getting through launch cycles and ramping up production to new forecasted levels. We remain focused on ensuring that the newly deployed capital achieves our expected returns.

During the second quarter of fiscal year 2018, we also returned $3 million to our shareowners by purchasing 152,000 shares of our common stock, which brings our total to $41 million and 3 million shares purchased since October 2015 under our board-authorized share repurchase program.

And finally, as we stated on our last call, our work has begun on the implementation of our board-approved updated strategic plan. We are committed to optimizing our EMS business by focusing on capital efficiency, margin expansion and high-quality revenue growth. And we are committed to making new investments that will help us develop ourselves beyond EMS to a multifaceted manufacturing solutions company. We are also exploring opportunities that would establish new platforms and create optionality for us in the future.

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

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

Thanks, Don. During my comments, I will be referring to the slide deck Don mentioned, which can be found on our Investor Relations website within the Events & 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 the Slide 3, our second quarter net sales were a record $258.2 million, which was a 12% increase compared to net sales of $230.3 million in the prior year second quarter. Partially assisting in the increase from a year ago was a favorable exchange rate movement, which affected our net sales growth by 3%.

Slide 4 represents our net sales mix by vertical market. Comparing our net sales by vertical to the same quarter a year ago, net sales in our automotive vertical were up over 20% compared to a year ago to a new quarterly record of $116.4 million. The increase from a year ago was largely due to the ramp-up of our new program introductions and strong demand in North America and Europe. While our China automotive sales were down year-over-year, we did see a nice improvement sequentially from the prior quarter.

Our medical vertical was up by double digits compared to Q2 last year, primarily from the ramp-up of new programs.

Our industrial vertical was up from a year ago, as a result of the continued ramp-up of new product launches related to smart metering devices as well as increased demand for climate control products.

Lastly, our public safety vertical was down by double digits from the prior year second quarter as a result of lower overall demand.

Our gross margin in the second quarter, reflected on Slide 5, was 8.1%, which was down from 8.9% in the same quarter last year. However, our gross margin did improve sequentially from 7.7% posted in the first quarter of this fiscal year. Our decline in gross margin in the current year quarter compared to a year ago was due in part to the impact on yields and higher costs associated with the support of new product introductions as well as higher domestic health care costs during the current quarter.

Selling and administrative expenses, Slide 6 in the deck, were $10.8 million in the second quarter, which were up $2.5 million in absolute dollars and up 60 basis points compared to the prior year second quarter. The increase in selling and administrative absolute dollars compared to prior year was in part due to higher stock compensation, which accounted for a 20 basis point increase. Also contributing to the S&A increase are increases in employee salaries and related benefit costs, mostly associated with higher employee count and expense related to the normal revaluation of the Supplemental Employee Retirement Plan, or SERP, liability.

As a reminder, the expense related to the revaluation of the SERP liability recorded in selling and administrative expenses is exactly offset by a gain in the investment in the SERP that is recognized in other income and expense net. Therefore, the impact from the revaluation of the SERP is neutral to net income.

Our operating income, on Slide 7 in the deck, came in at $10.2 million or 3.9% of net sales, which compares to operating income of $12.2 million or 5.3% of net sales a year ago.

Other income expense net was an income of $400,000 in the fiscal year 2018 second quarter compared to an expense of $1 million in the second quarter of fiscal year 2017. During the current year second quarter, other income expense net includes a $300,000 gain on the fair value of investments in the SERP. The prior year second quarter other income and expense net was primarily the result of net foreign currency exchange losses, driven by the strengthening of the U.S. dollar a year ago.

Our effective tax rate for the current year second quarter was significantly impacted by enactment during the quarter of the U.S. Tax Cuts and Jobs Act, the tax reform. The tax reform lowered the U.S. corporate federal tax rate from 35% to ultimately 21%. However, as we are a June 30 fiscal year-end, our current fiscal year blended federal statutory rate will be 28.1%, with the new 21% rate kicking in for our fiscal year 2019. While we applaud this move of lowering the corporate federal tax rate and believe this is positive for U.S. businesses and expect in the long run, it will improve the competitiveness of U.S. businesses in the global market, it did have a significant unfavorable impact for us during the current quarter.

The tax reform imposed a onetime deemed repatriation tax on accumulated unremitted foreign earnings of 15.5% for the accumulated unremitted foreign earnings held in cash and other liquid assets and 8% of the residual accumulated unremitted foreign earnings. We estimated and recorded in the current quarter approximately $12.8 million of tax expense for the deemed repatriation tax, which is payable over an 8-year period.

In addition, as a result of the change in the U.S. statutory rates, we were required to revalue our deferred tax assets as of December 31, 2017, using the new rates, which resulted in the recording of additional tax expense in the current quarter of approximately $3.8 million. These discrete tax items had a $0.62 unfavorable impact to diluted earnings per share for the quarter.

Slide 8 reflects our net income trend. In the second quarter of fiscal year 2018, we recognized an $8.3 million net loss as a result of the tax reform. However, our non-GAAP adjusted net income for the current quarter, excluding the discrete tax items related to tax reform, was $8.2 million, which compares to net income of $7.8 million recorded in the prior year second quarter.

We recognized a diluted loss per share of $0.31 in the current year second quarter, while our non-GAAP adjusted diluted EPS was income of $0.31, which excludes the $0.62 impact from the discrete tax reform items. Diluted EPS in the prior year second quarter was $0.28.

Cash and cash equivalents at December 31, 2017, were $35.6 million. Operating cash flow trends are shown on Slide 11. Our cash flow from operations during the current year second quarter was a strong $11.6 million, as our net loss adjusted for depreciation, income tax charges related to tax reform and an increase in accounts payable more than offset usage of cash related to an increase in inventory. Our cash flow from operating activities in the prior year second quarter was $12.1 million.

Our cash conversion days increased 1 day for the 3 months ended December 31, 2017, when compared to the same period in the prior year as our PDSOH, or Production Days Sales On-Hand, which is our inventory metric, increased by 6 days to support increased volumes and new introductions and implementation of new inventory management program for one of our largest medical customers, which more than offset an increase in our accounts payable days compared to the prior year quarter and a reduction in our days sales outstanding receivables metric.

Slide 12 reflects our capital and depreciation trends. Capital investments in the second quarter totaled $8.7 million, largely related to our investment in new manufacturing equipment to support increased manufacturing capacity and new product awards.

As Don mentioned, we repurchased $3 million of our common stock during the quarter. Borrowings on our credit facilities at December 31, 2017, were $11 million, which was up $1 million from June 30 of 2017.

Our short-term liquidity available, represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled $96 million at December 31, 2017.

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

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) I'm showing we have a question from Hendi Susanto with Gabelli & Company.

Hendi Susanto - *G. Research, LLC - Research Analyst*

First question. It's good to see strength in automotive, and you mentioned there is some ramp-up of new product introductions. Where are we in terms of the ramp-up? Do we still have some leg for further ramp-up for the next several quarters or the ramp-up may have reached some kind of the final stage?

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

We still have programs that are launching for the remainder of this fiscal year, Hendi. So we're quite busy in launch mode. I would say though pretty similar activity level as we've had over the last 4, 5 quarters. So we still have 2 or 3 quarters ahead of it. So it'll look a lot like the last 4 or 5 quarters in terms of ramp-up activity in automotive.

Hendi Susanto - *G. Research, LLC - Research Analyst*

So will that imply that further sequential growth every quarter?

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

Well, Hendi, we don't give guidance, as you know, on our sales projections. But certainly, as we ramp up new programs in automotive, and we launch those programs, there's a certain amount of visibility and predictability that we do have given just the characteristics of that end market vertical. So yes, we expect continued strength in automotive because of our existing base combined with the new program launches that we have going on ahead of us yet.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Okay. And then, Mike, you mentioned that the 21% tax rate will kick in 2019. Is it fiscal year 2019 or calendar year 2019?

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

I mean, fiscal year 2019, Hendi.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Okay. So Q4 we will still see the same tax rate as in Q3?

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

Similar, yes.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Okay. And then, how much a drag now to ramp up of your Romanian facility?

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

How much was the impact?

Hendi Susanto - *G. Research, LLC - Research Analyst*

Yes. On the operating margin?

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

It's been running around 40 to 50 basis points on our operating income line, Hendi. And as I said today in the webcast, we believe our -- the phase of ramp-up that we're in is on track, and that we will be approaching our breakeven on the operating income line in the fourth quarter of this fiscal year.

Hendi Susanto - *G. Research, LLC - Research Analyst*

And would you be able to tie up -- when you said breakeven, how much utilization, let's say, like qualitatively?

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

Can you repeat that, Hendi? I don't if I caught your question.

Hendi Susanto - *G. Research, LLC - Research Analyst*

When you said that you are targeting breakeven in your Romania facility by the end of fiscal year 2018, how should we relate that to, let's say, the utilizations?

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

The utilization of the operation?

Hendi Susanto - *G. Research, LLC - Research Analyst*

Yes.

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

Yes. So we would put our utilization somewhere in the 55% to 65% range at that point in time, and again, that would be for the Phase 1 of the Romanian facility. So we would still have our further expansion plans available to us, which is important to our European customer base. But the current structure would be somewhere between 55% and 65% utilized as we exit the fourth quarter of this fiscal year.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Okay. And then Don, can you share what kind of business insights for every vertical that you are expecting for the March quarter?

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

Can you ask that again, Hendi? I want to make sure I understood your question.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Okay, like the business environment for your different verticals for the March quarter?

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

Yes. I think we exited Q2 with, obviously, some pretty good momentum with 12% overall growth, and of course, automotive and medical both together leading the way with very strong growth. We feel that momentum coming with us into the third quarter of our fiscal year. So yes, I would say across all 4 end market verticals, we're seeing some good momentum, maybe with the exception of public safety, which is a little bit lumpier for us. It's our smallest vertical. But when we look at automotive, medical and industrial, we -- we're -- we carried some good momentum with us out of the second quarter of our fiscal year 2018 into this quarter that we're currently in.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Okay. And then last question from me. How should we think about share buyback in fiscal year 2018? You did a lot of share buyback of, like, $22 million in fiscal year 2017. Should we expect like a similar magnitude?

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

Well, there's a number of factors that play into the buyback program. Obviously, the market conditions, other options of investments that we have available to us, our current operating environment, a number of factors that will weigh into it. We have approximately $19 million left on the board-authorized buyback program. And so we certainly will continue to keep return to our shareowners through the buyback as part of our short list of priorities for capital allocation as we go forward. As I mentioned in my closing, we're really excited about our board-approved updated strategic plan. And we do see ourselves looking at making future investments to support that updated strategic plan. And so certainly, as we think about capital allocation and priorities going forward, some of the things we want to do relative to our updated strategic plan will be priority items on that list.

Operator

And our next question comes from the line of Chase Basta with AWH Capital.

Chase Basta

Can you help us understand the cash implications of the deemed repatriation tax charge?

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

Sure. I can talk a little bit to that. The deemed repatriation calculation, as we mentioned, that -- it was a pretty significant expense that we booked in the quarter. But the payment schedule on that to the government is over an 8-year period. So the first 5 years, 8% of the balance is due and then in the last 3 years, it goes to 15%, 20% and then 25%. So it's kind of a backloaded effect. And -- so we'll see that effect in our cash flow over the next 8 years.

Chase Basta

Okay. That's helpful. Then, you guys -- you mentioned that the Romania headwind in terms of its impact on the gross margin was around 40 to 50 basis points a quarter. What needs to happen to get to breakeven? Do you need new customer wins or is that order book built? Or -- I mean, what needs to happen along the way to kind of ramp to breakeven in Q4?

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

Yes, it's top line growth. And I think the good news we had report there is that we feel like we've got good visibility to that growth in Q3 and Q4 this fiscal year. As you may recall from previous quarters, we talked about how critical it was to get customer approvals and to get to validation protocols, and therefore, have a predictable ramp ahead of us. We've done that for the most part. We've got a very predictable ramp ahead of us. That's what gives us confidence to say that we're on track as we ramp up Q3 and Q4 to approach our breakeven point on the operating income line during -- in the fourth quarter of this fiscal year.

Chase Basta

Okay. So you hit breakeven in Q4, if Romania goes from being a negative 40 to 50 basis impact on operating margin, but how should we think about how additive that could be, kind of, once you're on the other side of breakeven?

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

Yes, it's hard to say because on the other side of that, we've got more work to do to secure more business wins and to continue to ramp up in Romania. But as we look at the quarter, we just finished at 3.9% operating income. We feel like with the work we're doing, getting Romania to operating income breakeven in the fourth quarter this fiscal year, basically, holding serve everywhere else in our company, in our footprint, that we could be approaching our goal of 4.5% operating income at the same time we get Romania to breakeven.

Operator

(Operator Instructions) And I'm showing no further questions at this time. And I would like to turn the conference back over to Mr. Don Charron for any closing remarks.

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

Thank you, Michelle. 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 great day.