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KE - Q4 2018 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Chase Basta

PRESENTATION

Operator

Good morning, ladies and gents. My name is Tawanda, 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 2018 Financial Results Conference Call. (Operator Instructions)

Today's call, August 2, 2018, 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, 2017, and in today's release.

The panel for today's call is Don Charron, Chairman of the Board of -- 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, Tawanda. 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, 2018. We have posted a financial summary presentation to accompany this conference call. The presentation can be found on our Investors Relation 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 fourth quarter of fiscal year 2018 were down 3% sequentially from the previous quarter, up 15% when compared to the fourth quarter of fiscal year 2017. Very strong growth in our automotive and medical end market verticals helped us achieve the double-digit year-over-year growth for the fourth consecutive quarter and to exceed our longtime goal of $1 billion in annual sales in fiscal year 2018. As we stated last quarter, our compound annual growth rate, or CAGR, was approximately 8% over the previous 3 years, and our goal is to sustain this growth rate going forward on an organic and annual basis as we look to grow the company beyond $1 billion in annual sales.

We are pleased to have improved our operating income margin by 60 basis points from the prior year quarter and 20 basis points sequentially when compared to the third quarter. The much anticipated progress in Romania came through in the fourth quarter, helping to drive the improved overall performance, and we look forward to their continued growth and positive contributions in fiscal year 2019.

Partially offsetting the improved operating performance in the fourth quarter were expenses directly associated with our pending acquisition of GES. We remain focused on achieving our midrange goal of 4.5% operating income.

We were disappointed that we did not make progress in fiscal year '18 toward our long-term goal of 12.5% ROIC. We still have work to do to achieve this important goal. Margin expansion and capital efficiency will continue to be priorities of focus for us.

We continue to leverage our strong balance sheet and cash flow to make investments that would drive further growth in sales and profits. We invested $4.4 million in capital expenditures in the fourth quarter of fiscal year 2018, bringing our fiscal year 2018 total to $26.5 million.

We remain focused on doing what's necessary to secure the raw materials in this tight supply market and to maintain the appropriate buffer stock levels to minimize disruptions. We also have been working diligently to prepare for and respond to the changing landscape as it relates to the China tariffs. We were given an opportunity to testify last week in a public hearing on tariffs before the U.S. Trade Representative Committee to voice our concerns and help persuade the U.S. administration to remove certain electronic components from the proposed list of the next round of tariffs. In addition, we are applying for an exemption for certain components for which the tariffs went into effect on July 6. For the tariffs that had taken effect, it will be critical to get accurate information from our suppliers for us to be able to pass through the cost to our customers.

During the fourth quarter of fiscal year 2018, we also returned $3.1 million to our share owners by purchasing 163,000 shares of our common stock, which brings our total to 44.5 million and 3.2 million shares purchased since October 2015 under our board-authorized share repurchase program.

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 finally, we are in the process of obtaining the necessary government approvals for our pending acquisition of GES, and we believe it is still on track to close during this quarter -- first quarter of fiscal year 2019. Last Friday, July 27, in anticipation of finalizing the GES acquisition, our primary credit facility was amended and restated to allow for borrowings to $150 million with an option to increase the amount available for borrowing to $225 million upon request. When closed, GES will be the first step in our new platform strategy and our plans to continue our development beyond EMS to a multifaceted manufacturing solutions company.

Now I'll turn over to Mike to discuss our fourth 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'll 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 webcast, you can find it in the Downloads tab on the webcast portal.

As shown on Slide 3, our fourth quarter net sales were $276.8 million, which was a 15% increase compared to net sales of $241.3 million in the prior year fourth quarter. Favorable foreign currency fluctuations accounted for approximately 4% year-over-year growth.

Our net sales mix by vertical market is depicted on Slide 4. Comparing our net sales by vertical, our automotive vertical was up 20% from a year ago, driven largely by new product introductions, including the continued ramp-up of programs in our Romania facility. We did see some softness in the industry during the quarter as our automotive vertical sales were down 16% sequentially compared to a record quarterly sales in our third quarter. Our medical vertical was up in the mid-20% range compared to the fourth quarter of last year from strong demand across the board from our largest existing medical programs. Sequentially, compared to the third quarter, our medical vertical sales were up by double digits. Our industrial vertical in Q4 was up by double digits from the prior year primarily as a result of increases in industrial pumps, smart metering and other existing programs, which more than offset the effects of the exit of other certain programs. And our public safety vertical was down 20% primarily as a result of lower overall demand and programs reaching end of life. However, when compared sequentially to the third quarter, we are encouraged that public safety was up double digits largely from an uptick in demand and a new product introduction.

Our gross margin in the fourth quarter reflected on Slide 5 was 8.2%, which was up nicely from 7.5% in the same quarter last year. Gross margin improvement in the current year quarter compared to a year ago included contributions from improvements at Romania, as Don mentioned, and as they leverage their continued ramp-up in sales volumes and improved efficiencies. In addition to Romania, the Romania improvement, leverage of higher sales volumes in other units, favorable mix and lower cost related to our domestic self-insurance health care benefit program also contributed to the gross margin improvement from the prior year fourth quarter.

Selling and administrative expenses, Slide 6 in the deck, were $11.5 million in the fourth quarter, which were up $1.9 million or 10 basis points compared to the prior year fourth quarter. As Don mentioned, selling and administrative cost in Q4 included costs incurred directly related to the pending acquisition of GES, which amounted to approximately $600,000 or approximately 20 basis points. The remaining increase in S&A costs was larger largely related to increased employee costs, including salary expense and related benefits; and incentive compensation costs, which include noncash stock compensation expense.

Other income and expense, net, was expense of $1.1 million in the fiscal year 2018 fourth quarter compared to income of $1.1 million in the fourth quarter of fiscal year 2017. Net foreign currency losses during the current year fourth quarter, as a result of unfavorable exchange rate movements, were largely -- were partially offset by derivative gains, primarily drove the loss to the other income expense net section of the income statement.

The effective tax rate for the current year fourth quarter was an inflated 43%. The significantly higher current quarter rate was largely the result of measurement period adjustments related to tax reform partly from subsequent guidance released by the IRS during the quarter as well as the valuation allowance recorded related to state tax credit. The prior year fourth quarter effective tax rate included favorable adjustments primarily related to state credits and a benefit from the true-up of the estimated annual effective tax rate to the full year rate, which further lowered the prior year Q4 rate. The full year fiscal 2018 rate ended at 63%, which was significantly impacted by tax reform, accounting for approximately 40% of pretax income.

Slide 8 reflects our adjusted net income trend. Net income in the fourth quarter of fiscal year 2018 was $5.8 million compared to $8.1 million in the fourth quarter of last year. Non-GAAP adjusted net income for the current quarter, excluding the impact from the tax reform adjustments, was $7.2 million. The last slide of the deck provides a reconciliation of non-GAAP metrics to GAAP metrics.

Diluted earnings per share was $0.22 in the fourth quarter of this fiscal year compared to $0.30 in the prior year fourth quarter. When adjusting for tax reform in the current year fourth quarter, non-GAAP adjusted diluted earnings per share was $0.27.

Cash and cash equivalents at June 30, 2018, were $46.4 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 $19.3 million compared to $12 million provided in the fourth quarter of last year. The operating cash flow provided during the quarter was primarily the result of the earnings during the quarter plus noncash expenses and a reduction in receivables, which were partially offset by uses of cash from an increase in inventories and a reduction in accounts payable.

Slide 12 reflects our capital and depreciation trends. Capital investments in the fourth quarter totaled $4.4 million, largely related to our investment in new equipment for increased manufacturing capacity and to support new product introductions. Capital investments for the full fiscal year 2018 amounted to $26.5 million, which approximated our depreciation expense for the year and was in line with our outlook provided a year ago. We also returned capital to our share owners through the repurchase of our common stock amounting to $3.1 million during the quarter.

Borrowings on our credit facility at June 30, 2018, were $8.3 million, which were down $8 million from March 31 and down $1.7 million from June 30, 2017. As of June 30, our short-term liquidity available, represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled $109 million. As Don mentioned, our primary credit facility has subsequently been amended and restated for an additional 5 years, increasing the amount of the facility from $50 million to $150 million with an additional $75 million available upon request. The facility is expected to be used for working capital and general corporate purposes, including acquisitions. This increases our short-term liquidity available, which is expected to be partially used to fund the GES acquisition.

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 to questions from analysts. Tawanda, do we have any analyst with questions in the queue?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Chase Basta of AWH Capital.

Chase Basta

You had pretty nice sequential and year-over-year growth in the medical vertical. Can you give us some additional color on what drove that and the outlook you're thinking for that vertical in 2019?

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

Yes, we really thought of the growth in multiple areas across the portfolio of business we have there, which is, I think, a really positive sign. And we continue to ramp programs, relatively new programs such as the programs that we picked up in our acquisition in Indianapolis a couple of years ago, which had a nice contributing factor to our overall growth, and so pretty widespread. We're pleased with it in some way. That's a little bit unexpected, stronger than I think we would have thought going in to the quarter and really for the full fiscal year. But we have good momentum, and the strength looks to be, as I said, widespread. So we're hoping that it can continue for us going into the new fiscal year.

Chase Basta

Okay. And then there's a little bit of sequential softness in automotive segment you touched on. Is there an element of seasonality there? Or what kind of explains that?

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

Yes, I don't know the seasonality would explain all of that. That's really hard for us to get our heads around what really happened between Q3 and Q4. I mean, essentially, you have the same programs in production; so yes, seasonality. Maybe some softness in the market in some regions contributed to that. We've had this short supply and component shortage situation that's been impacting inventory levels, buffering levels throughout the supply chain. That also could have had some impact. I think when you look at the numbers, we had a hard time explaining why Q3 was so high. So the sequential drop is just as hard to explain, but it's essentially the same book of business in play in both quarters. So we'll see. We'll see how the rest of the calendar year shapes up. And as we go into fiscal year 2019, we expect it to remain pretty strong. Just given the programs, we still have in front of us to ramp, namely new programs. But the current programs that we've got in production will depend really on how the overall market does.

Chase Basta

Okay. And then regarding the tariff discussion, can you talk a little bit more about your ability to pass on price to customers and just kind of help us understand the switch of conversations you're having in that regard?

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

Yes, that's a really good question and one that's, I'm sure, being answered by a lot of CEOs and CFOs nowadays in terms of how this ripple effect is going to be managed. The first thing I would say, it's going to be an aggravation for everyone in the value stream. And at the end of the day, I think the pass-through concept is going to have to be embraced by everyone, or it's going to create disruption and issues. We -- there's no way that we could absorb tariffs on parts that we buy from China that, let's say, come into our U.S. manufacturing plants. We don't have the ability to absorb those costs. So we definitely will have to pass them through to our customers. We've already started that dialogue, especially with several parts on List 2 that could impact us. So we've opened up the dialogue with our customers. We've given them specifics, at least what we know today. The list is never final until it's final. List 1 didn't get finalized to the very end after the hearing. So we'd expect the same for List 2. But at the end of the day, we have to pass it through. We've been talking to our customers about that, and it's probably going to end up being a pretty tough negotiation at the end of the day, as I said, an aggravation. But our plans are to pass it through, and we think we have all of the room, contractually, to pass it through that we need. So that's about the best I could describe that, Chase. I don't know if you have any follow-on questions to it.

Chase Basta

No, that's helpful. And then on the GES acquisition, is there anything more you can tell us about that acquisition or impact on your fiscal 2019 numbers or anything like that?

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

Not at this time. I just reiterate what we talked about in our press release in terms of the cash allocation or the purchase price at $50 million. We're getting down to the final government approvals, and we hope to get something out to our investors. As soon as we can gain approvals we need to close the transaction and we'll be able to add more about what the impact will be to fiscal year '19 from the top line and most likely EPS range standpoint.

Operator

(Operator Instructions) Our next question comes from the line of [Mike Ralph] with [Wolfson and Company].

Unidentified Analyst

As we think about some of the new programs that we have ramping throughout fiscal '19, I'm interested in the component supply situation. Have we gotten any additional insights from our suppliers on when we might be able to expect this to kind of turn over and have this component-constrained environment that we're in kind of blip?

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

Yes, a really good question. First of all, on the new programs that we're ramping this year, we've actually been working for over a year on securing supply for those programs. And so we feel like we derisked that part of the ramp-up. I mean, it's tight. The supply is tight, but we believe that we've got the material lined up that we need to ramp those programs this summer into the fall time frame. Most of the component shortages and the manufacturer of those components are telling us -- give us an answer today that it sort of depends. It depends on the demand profile that we'll see in the second half of this calendar year. There's been reports of some softening in demand in some end markets that's making more material available. And so we -- it can improve definitely throughout the year if the demand truly softens. If it's just a blip, then we get back to some of the growth rates that we, as an industry and really the industry overall, has seen in the -- let's say, the first half of 2018. They're telling us that it could be the end of 2019 before they truly get capacitized to handle, let's say, the new run rate, especially the manufacturers of some component categories are really tight. For example, the multilayer ceramic capacitor guys are telling us that the short supply situation could last to the end of 2019 in certain demand profile scenarios. So we'll see. They're adding new capacity. They've been working hard to add that new capacity. There's new capacity coming on line, for example, in companies like [Marada] by the end of this year. So they -- in some cases, we'll see some catch-up towards the end of the year. The automotive supply is a tougher one in that it's -- the automotive components are an automotive grade. And so our -- some of our ramp-ups, for example, in the automotive space, we pay particular attention to because we depend on that capacity and not the overall capacity, which include commercial grade.

Operator

(Operator Instructions) I'm showing no further questions at this time. I would now like to turn the call back over to Don for closing remarks.

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

Thank you, Tawanda. 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, you may simply hang up to disconnect from the call. Thank you, and have a nice day.
