Kimball Electronics, Inc. (Q2 2020 Results)
February 06, 2020

Corporate Speakers:

- Don Charron; Kimball Electronics, Inc.; Chairman & CEO
- Mike Sergesketter; Kimball Electronics, Inc.; VP & CFO

PRESENTATION

Operator^ Good morning, ladies and gentlemen. My name is Josh, 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 2020 Financial Results Conference Call.

(Operator Instructions)

Today's call, February 6, 2020, 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, 2019, 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. Mr. Charron, you may begin.

Don Charron^ Thank you, Josh. 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, 2019. 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 follow along by advancing the slides or download them from 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. We delivered solid growth results in the second quarter of fiscal year 2020, despite the impact from the strike at General Motors and the continued softness in the overall market. We expect softness and fluctuations in the overall market to continue near-term as our customers review and revise their outlook over the next few quarters.

However, we remain cautiously optimistic that we will achieve our goal of 8% organic growth for fiscal year 2020. We continue to monitor the uncertainties facing our customers and the corresponding impact on the production demand that they ultimately place on us as their supply partner. The signing of the Phase I China trade agreement and

USMCA, provide us with renewed optimism as we further develop our long-term business plans for those geographies.

We also continue to monitor the unexpected and unfortunate coronavirus outbreak in China, and its negative impacts on our operations in our two China facilities, including the effect on shipments in and out of China, the availability of critical components and the health and availability of our workforce.

The close relationships that we have with our customers, our suppliers, and our employees will help us manage through the difficult issues resulting from the coronavirus. We're gaining stability in our base business, and the ramp-up of new business wins will be essential to helping us achieve our goal of 8% organic growth in fiscal year 2020.

We are pleased with the results of our efforts to minimize the operating margin impact of the strike at GM. It is worth mentioning that the impact of the strike at GM would have been far greater without the progress that we've made in our diversification strategy over the past decade or so.

The lost production and sales caused by the strike were offset by sales related to certain contracts with customers beginning to meet the criteria for -- to recognize revenue over time during the period and the ramp-up of new programs, including programs for fully electric vehicles.

We continue to gain some traction in the new business opportunities pipeline for our GES business. We are encouraged by the recent new orders for machines with expected delivery dates later this fiscal year. Our integration work with GES continues as we have now identified a dozen or so value-creating automation, optical inspection and artificial intelligence projects that will eventually improve the productivity of our own existing manufacturing facilities.

We are also excited about the role GES is playing in our digital and Industry 4.0 strategy as we work to roll out EM tab, a GES-developed software solution in all our global facilities in 2020. We are working diligently to respond to the volatility in demand and change in the mix of our overall business.

We continue our relentless pursuit to achieve our operating margin and return on invested capital goals. We are doubling down on execution across all of our units as we continue to drive Lean Six Sigma projects and global supply initiatives to improve yield and throughput and drive improvement in our margins. Margin expansion and capital efficiency will continue to be priorities of focus for us.

Our cash conversion days for the quarter ended December 31, 2019, were 76 days, flat to the quarter ended December 31, 2018, and up from 73 days in the first quarter of fiscal year 2020.

While the volatility in demand has made it difficult for us to achieve our inventory objectives, and thus, our cash conversion days objectives, we remain committed to our inventory reduction goals and actions.

We invested $10.4 million in capital expenditures in the second quarter of fiscal year 2020, the majority of these capital investments were for capacity expansion and to support the launch and ramp-up of new programs.

During the second quarter of fiscal year 2020, we also returned $2.6 million to our shareowners by purchasing 180,000 shares of our common stock, which brings our total to $74 million and 4.9 million shares purchased since October of 2015, under our board-authorized share repurchase program.

And finally, as I stated earlier, we are making good progress on the integration of GES. The acquisition of GES brings us new technologies and capabilities in automation, test and measurement, in industrial applications and is a significant step in our strategy as a multifaceted manufacturing solutions provider.

We are excited about the opportunities to present the GES capabilities to our existing customers and to deploy these technologies and solutions in our own manufacturing facilities as part of our overall digital and Industry 4.0 strategy. Now I'll turn it over to Mike to discuss our second quarter results in more detail. We will then open the call to your questions. Mike?

Mike Sergesketter^ 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 follow along by advancing the slides on the webcast portal.

As shown on slide three, our second quarter net sales were $307.1 million, which was an 8% increase compared to net sales of $284.1 million in the prior year's second quarter. Favorably impacting our consolidated net sales by 2% for the quarter was the acceleration of revenue for certain contracts with customers, which began to meet the criteria to recognize revenue over time during the current quarter.

Partially offsetting the impact of the transition in revenue treatment for these certain contracts were foreign exchange rates, which reduced our consolidated net sales by approximately 1% compared to the second quarter a year ago.

Slide four represents our net sales mix by vertical market. Comparing our net sales by vertical to the same quarter in the prior year, our automotive vertical was up 20% compared to the same quarter a year ago, largely driven by improved demand in China compared to the second quarter of 2019.

Negative impacts of the GM strike were largely offset by an increase in revenue from certain contracts, which -- with customers beginning to meet the criteria to recognize revenue over time during the current quarter.

Our medical vertical was flat in the current quarter compared to the prior year second quarter, resulting from mixed demand. Our industrial vertical was up 7% from a year ago as a result of increased demand and new product introductions and smart metering programs, which more than offset decreases in demand for climate control programs.

Lastly, sales in our public safety vertical were down 18% from the prior year second quarter as a result of the phase out of certain programs.

Our gross margin in the second quarter reflected on slide five was 6.7%, which declined 50 basis points from 7.2% in the second quarter of last fiscal year.

Our decrease in gross margin in the current year quarter compared to a year ago was a result of unfavorable product mix and the unfavorable impact from the decline in sales to our customers that support GM due to the UAW labor strike, which more than offset any leverage gain on higher revenue.

Selling and administrative expenses, slide six in the deck, were $11.8 million in the second quarter, which was up approximately $1.6 million in absolute dollars and is up 30 basis points as a percent of net sales compared to the prior year second quarter.

The increase in selling and administrative absolute dollars was largely due to changes in the fair value of the Supplemental Employee Retirement Plan or SERP liability, which accounted for a 40 basis point increase compared to the prior year second quarter. The revaluation of the SERP liability is exactly offset by gains or losses recorded in the SERP investments during the quarter, which is recorded in other income expense net, and as a result, has no impact on net income.

Operating income for the second quarter, on slide seven in the deck, came in at $8.7 million or 2.8% of net sales. This compares to operating income of $10.2 million or 3.6% of sales in the same period a year ago.

As I previously mentioned, the impact of the comparison to the prior year quarter relating to changes in the fair value of the SERP liability was 40 basis points. Other income expense net was income of $100,000 in the second quarter, which compares to expense of $1.6 million in the second quarter of fiscal year 2019.

Other income net in the current year second quarter includes $800,000 from favorable exchange rate fluctuations and $500,000 in gains on the SERP investments, which were largely offset by $1.1 million in interest expense. Other expense net in the prior year's second quarter included $1.1 million of interest expense and $600,000 in losses on SERP investments.

The effective tax rate for the current year second quarter was 25.1%, which compares to 17.4% in the prior year second quarter. The difference in the effective tax rate compared to the prior year was primarily related to changes in the valuation allowance on state R&D tax credit carryforwards.

Slide eight reflects our adjusted net income trend. Our net income in the second quarter of fiscal 2020 came in at $6.6 million. This compares to GAAP net income of $7.1 million and non-GAAP adjusted net income of $6.9 million in the second quarter of fiscal 2019. The non-GAAP adjusted net income in the prior year excludes adjustments to the provision for income taxes related to tax reform.

Diluted earnings per share was $0.26 for the second quarter of this fiscal year, which compares to a GAAP diluted EPS of $0.27, and non-GAAP adjusted diluted EPS of $0.26 reported for the same quarter last year.

Cash and cash equivalents at December 31, 2019, were $52.2 million. Operating cash flows are shown on Slide 11. Our cash flow used by operating activities during the current year second quarter was $300,000, which was driven by changes in operating assets and liabilities, largely from increases in accounts receivable and contract assets, which more than offset cash provided by net income plus noncash items.

In the prior year second quarter, operating activities provided $5.6 million of cash. Our cash conversion days, or CCD, was flat for the three months ended December 31, 2019, when compared to the same period in the prior year. However, compared sequentially to the first quarter of fiscal year 2020, our CCD increased three days, driven by an increase in our DSO or days sales outstanding.

Slide 12 reflects our capital and depreciation trends. As Don mentioned, our capital investments in the second quarter totaled $10.4 million, largely related to manufacturing equipment to support new production awards and to increase capacity.

Borrowings on our credit facilities at December 31, 2019, were $119 million, which were down $7 million from our borrowings at June 30, 2019.

A portion of our cash provided by operating activities during the six months ended December 31, 2019, was utilized to partially pay down our current debt.

Our short-term liquidity available represented as cash and cash equivalents, plus the unused amount of our credit facilities, totaled $120 million at December 31, 2019.

In conclusion, our financial condition is strong, and we are in excellent position to continue this solid growth trend, while focusing on improvements in our operating margin and our return on invested capital.

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

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions)

And I'm not showing any questions at this time. I would now like to turn the call back over to Don Charron for any further remarks.

Don Charron^ Thank you, Josh. 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.