

Kimball Electronics Inc. (Q3 2021 Results)
May 6, 2021

Corporate Speakers

- Andrew Regrut; Kimball Electronics, Inc.; Head of IR
- Donald Charron; Kimball Electronics, Inc.; Chairman & CEO
- Michael Sergesketter; Kimball Electronics, Inc.; VP & CFO
- Jana Croom; Kimball Electronics, Inc.; VP, Finance

Participants

- Anja Soderstrom; Sidoti & Company, LLC; Analyst
- Michael Morales; Walthausen & Co., LLC; Analyst
- Hendi Susanto; Gabelli Funds, LLC; Analyst
- John Dasher; Pinnacle; Analyst
- Jason Crawshaw; Polaris Capital Management, LLC; Analyst

PRESENTATION

Operator: Good morning, ladies and gentlemen. Welcome to the Kimball Electronics Third Quarter Fiscal 2021 Earnings conference call. My name is Cindy and I will be your facilitator for today's call.

All lines have been placed in a listen only mode to prevent any background noise. After the completion of the prepared remarks from the Kimball Electronics leadership team, there will be a question and answer period. (Operator Instructions) Today's call, May the 6th, 2021, is being recorded. A replay of the call will be available on the investor relations page of the Kimball Electronics website.

At this time, I would like to turn the call over to Andy Regrut, Head of Investor Relations. Mr. Regrut, you may begin.

Andrew Regrut: Thank you, Cindy, and good morning everyone. My name is Andy Regrut and I recently joined Kimball Electronics as the Head of Investor Relations. I'd like to welcome you to our third quarter conference call. With me here today is Don Charron, our Chairman and CEO; Mike Sergesketter, Vice President and Chief Financial Officer; and Jana Croom, Vice President, Finance.

We issued a press release yesterday afternoon, with the results of our third quarter ended March 31st, 2021. To accompany today's call, a presentation summarizing the financial results has been posted to the investor relations page on our company website within the events and presentations tab. Or, if you're listening via the webcast, you can follow along by advancing the slides or download them from the downloads tab on the webcast portal.

Before we get started, I would like to remind you that on today's call, we will be making forward looking statements that involve risks and uncertainty and are subject to our safe harbor provisions as stated in our press release and SEC filings, and that actual results can differ materially from forward-looking statements.

All commentary today is focused on non-GAAP results. For the third quarter of fiscal 2021, this excludes onetime after-tax benefits amounting to \$0.5 million or \$0.02 per diluted share associated with non-operating items. Reconciliations of GAAP to non-GAAP amounts are available in our press release.

This morning, Don will start the call with a few opening comments. Mike will review the financial results for the quarter, and Don will complete our prepared remarks before taking your questions. Now I'll turn the call over to Don.

Donald Charron: Thanks Andy, and good morning, everyone. I am very pleased with our results for the third quarter. Our team remains resilient in the face of many ongoing challenges around the world, including the COVID-19 pandemic and the global shortage of semiconductors. Despite these headwinds, we delivered solid top line growth with very good results across multiple end market verticals. And our adjusted EPS in the quarter was up 56% compared to Q3 last year.

In addition, the operating margin rate once again exceeded our goal of 4.5%, and we generated strong cash flow from operations for the fourth consecutive quarter. On a year-to-date basis, our cash flow from operations has more than doubled from the prior year. Due to the global shortage of semiconductors, a significant amount of our shippable backlog shifted out of Q3 and Q4 of fiscal year 2021 and into the first half of fiscal year 2022. Many industry experts are forecasting that this semiconductor shortage will remain with us for most of this calendar year. Our materials teams around the world have been working day and night to find solutions to overcome this shortage. Based on the semiconductor delivery commitments that we currently have from our suppliers, we are still expecting a very strong fourth quarter of fiscal year 2021, both sequentially and year-over-year.

Beyond these excellent results, we have never lost sight of the fact that the health and safety of our employees remains our number one priority, and we continue to make every effort to keep our facilities safe. The number of employees testing positive for COVID-19 has remained at a low level, minimizing disruptions and allowing us to continue to deliver on our promises to our customers, which was evident in our top line results for the third quarter and year-to-date fiscal year 2021.

Net sales increased 6% compared to the same period last year. And while foreign currency did have a favorable impact, the growth was solid even after adjusting for FX. Strong sales increases were posted in our automotive, industrial and Public Safety verticals. Automotive sales were up 12% in Q3 from a year ago, with the strength resulting from ramp up of certain programs, including fully electric vehicles, lower

volumes in the third quarter last year which began to see the impact of COVID-19 and favorable foreign exchange rates.

An example of the programs with electric vehicles includes electronic power steering systems. It's an application and architecture that is largely the same for both electric vehicles and vehicles driven by internal combustion engines, or hybrids. This is an area where we continue to invest to keep pace with expected future growth as the popularity of electric vehicles rises. There are other applications that are similar in terms of approach and focus and we have been successful in winning additional programs. We have strong relationships with several customers that support many of the most popular brands in the world and we expect these relationships to fuel growth in this vertical market in the years to come.

On a sequential basis, sales and automotive were down 8% from last quarter, an outcome from the global semiconductor shortage. And while dependent on our ability to overcome the component shortages, we expect sales to continue to be strong into fiscal year 2022. The medical end market vertical was down 2% in Q3 as a result of strong prior year sales, related to the COVID-19 global pandemic and reduced elective procedures, also due to the ongoing global pandemic. We expect this decline to be short-lived as more of the population is vaccinated and physicians, offices, and hospitals resume elective procedures and activities.

Shifting now to the industrial vertical, sales increased 5% in the third quarter compared to the same period last year, with the strength resulting from automation, test and inspection sales; higher end market demand for climate control products, for instance, HVAC applications in the US; and favorable FX, partially offset by decreased demand for smart metering products. We expect a strong fourth quarter in industrial vertical driven by orders for machines scheduled to be shipped by GES. And finally, sales in Public Safety were \$13.5 million, an increase of 9% driven by the ramp up of new programs.

As I alluded to in our second quarter call, we have received board approval for another critical expansion of our global footprint. We plan to invest approximately \$25 to \$30 million on the expansion, which will double the size of our footprint in Mexico. We expect to break ground over the summer with completion within approximately 12 months. This, combined with our Thailand expansion is a continued demonstration of our strong market positioning and growth opportunity for the future.

And finally, I'm so proud of our team in the effort to deal with the challenges caused by the pandemic and the global semiconductor shortage. In April, we were honored by achieving the highest overall customer rating in Circuits Assembly's 2021 Service Excellence Awards. Consistency in anonymous surveys such as this speaks volumes about our customer service culture. So I'd like to point out that this is the third time, in four years, that we have been recognized for this award. Circuits Assembly is a leading industry publication covering the mixed technology electronics assembly marketplace and recognizes companies that receive the highest customer service ratings as judged by their own customers.

The awards were presented to outstanding electronics manufacturing services providers in the categories of quality, dependability, timely delivery, responsiveness, value for price and technology. And we were recognized for achieving the highest overall customer rating in all five service categories for EMS companies with annual sales over \$500 million. This is a great example of how our strong company culture and core values are helping us get through this together.

Now let's turn it over to Mike to discuss our third quarter results in more detail. Mike?

Michael Sergesketter: Thanks, Don, and good morning, everyone. During my comments, I will be referring to the slide deck Andy mentioned during his opening comments. As Don mentioned and depicted on Slide 3, third quarter net sales were \$310.3 million, a 6% increase compared to net sales of \$293.9 million in Q3 last year. Foreign exchange rates favorably impacted sales by 3% in the third quarter. A breakdown of sales by vertical market as described by Don is summarized on Slide 4.

Our gross margin rate in the third quarter reflected on Slide 5 was 8.4%, a 150 basis point increase from the third quarter of last year. The gross margin improvement was driven by improved operating execution; favorable product mix within our automotive vertical market, a result of a shift to more mature and larger programs; and favorable foreign currency rates, partially offset by higher profit sharing bonus expense.

Adjusted selling and administrative expenses were \$11.6 million in the third quarter, up \$1 million or 10 basis points when measured as a percent of sales compared to the third quarter of last year. This increase was primarily driven by higher profit sharing bonuses, higher salary and payroll related costs. As a reminder, adjusted selling and administrative expenses excludes changes in the fair value of our SERP liability, which is directly offset in other income and expense from changes in the fair value of the SERP investments.

Adjusted operating income for the third quarter was \$14.4 million or 4.6% of net sales as shown on Slide 7 in the deck. This represents an improvement from \$9.7 million or 3.3% of net sales in the same period a year ago, primarily driven by the increase in gross profits that I just mentioned. Other income and expense was an expense of \$600,000 in the third quarter, which compares to expense of \$1.9 million in the third quarter of fiscal year 2020. The expense in Q3 of this year includes \$600,000 in net foreign currency losses and \$300,000 of net interest expense, partially offset by \$200,000 in gains on the SERP investments.

The expense in the third quarter last year includes \$1.1 million of net interest expense, \$900,000 in losses on the SERP investments, and \$200,000 in net foreign currency gains. The effective tax rate for the current year third quarter was approximately 25%. In the prior year third quarter, the effective tax rate was approximately 28%.

Slide 8 reflects our adjusted net income trend. In the third quarter of fiscal year 2021, adjusted net income was \$9.9 million compared to net income of \$6.3 million in the third quarter of fiscal year 2020. Adjusted diluted earnings per share were \$0.39 in the third quarter. This compares to diluted earnings per share of \$0.25 reported for the same quarter last year.

Now turning to the balance sheet, cash and cash equivalents at March 31, 2021 were \$89.7 million. Operating cash flow trends are shown on Slide 11. Our cash flow provided by operating activities during the fiscal third quarter was \$31.5 million, driven by net income plus non-cash depreciation and amortization and changes in working capital. In the prior year third quarter, operating activities provided \$12 million of cash. Our cash conversion days for the quarter ended March 31st, 2021 were 66 days, down from 81 days in the quarter ended March 31, 2020, and down from 75 days in the second quarter of fiscal year 2021. Compared to the second quarter of fiscal year 2021, we saw improvement in each of our day sales outstanding, contract asset days, production day supply on hand, and accounts payable days.

Slide 12 reflects our capital and depreciation trends. The capital investments in the third quarter of \$8.7 million were largely to support launch and ramp up of new programs and to replace older machinery and equipment. We continue to study our capacity needs to support growth plans. The board-approved plan to expand our Thailand operations was officially kicked off last quarter. And the plan to expand our Mexico operation was approved this quarter. Both expansions add much needed capacity to support the forecast in growth from both existing and future customers and demonstrate our strong, organic growth opportunities.

Borrowings on our credit facilities at March 31, 2021, were \$60.5 million, which is down \$25.6 million from December 31, 2020, and \$57.6 million from June 30, 2020. Our short term liquidity available, representative cash and cash equivalents plus the unused amount of our credit facilities totaled \$226 million at March 31, 2021. There were no shares repurchased in the third quarter of fiscal year 2021. Since October 2015, under our Board authorized share repurchase program, a total of \$79.7 million was returned to our shareowners by purchasing 5.3 million shares of our stock.

In conclusion, our financial condition continues to be strong and we're in excellent position to take advantage of growth opportunities and improve operating margins and return on invested capital while being able to confront the continued uncertainties caused by the COVID-19 pandemic and the global semiconductor shortage. I'll now turn the call back over to Don.

Donald Charron: Thanks Mike. Before we open the lines for questions, I'd like to make a few closing comments. First, I need to reiterate how proud I am of our people around the world. We have made the health and safety of our employees the number one priority, all while continuing to deliver on our promises to our customers. The company is in a solid position and we are committed to build success in the future.

Finally, as previously announced, it is with mixed emotions we say farewell to Mike, our friend and colleague. Mike has been a trusted partner for decades and his leadership and in-depth knowledge of our business will be sorely missed. On behalf of our Board of directors and the entire company, I want to extend our sincere gratitude and appreciation to Mike for his dedication and service. Mike, we wish you the very best. You will always be a valued member of the Kimball Electronics family.

I also want to congratulate Jana on her new role as CFO. We are fortunate to have a leader of Jana's caliber ready to assume the reigns for this key position. Her experience in financial management, strategy and operations make her an ideal fit to move our organization forward. Jana, would you like to say a few words?

Jana Croom: Thanks, Don. I'm very excited about the opportunity to take over for Mike. Kimball Electronics has a distinguished history, a talented team, and a promising future with a strong company culture and a purpose of creating quality for life. I look forward to working alongside you and the other members of the leadership team to drive growth and enhance shareholder value.

Donald Charron: Thanks, Jana. I'm looking forward to it, too. With that, I would like to open the lines for questions.

QUESTIONS AND ANSWERS

Donald Charron: Cindy, do we have any analysts with questions in the queue?

Operator: (Operator Instructions) Your first question comes from Anja Soderstrom with Sidoti.

Anja Soderstrom: Hi everyone, and congratulations on a good quarter, amidst the challenging backdrop. My first question will be on the industrial segment and the GES business there. Can you just elaborate a little bit on how that's been trending? And also, maybe talk a little bit about the competitive landscape for GES?

Donald Charron: Sure. Anja, first of all, I want to just remind you that we do have a degree of seasonality in our GES business, and so -- and that seasonality, typically the strongest quarter has been Q4. Now we've just owned the company just short of three years. So we're learning more and more each and every quarter as we go. But we do have a degree of seasonality there. And our fourth quarter of our fiscal year is GES' strongest quarter.

Overall, if you -- and also, if look at what customers we serve with GES' services, they're primarily in the manufacturing of smart mobile devices and semiconductor industry. So those are the types of industries that our machines that we develop, design, and manufacture, they serve those needs, if you will, in the market.

And when you look at the spending, the capital spending trending in those areas, it's quite strong. Now it's focused in the smart mobile device area, and we're really happy with

where we have content and relationships there because those customers are doing well in the end market, in that, in their perspective end market, the semiconductor industry, as you know, is adding capacity at a pretty rapid pace right now, given the shortages.

And just the fact that demand has far outpaced supply here during this period, and so capacity is being added and we hope to be able to gain traction and grow there as those capital decisions, capital deployment decisions, are made within the semiconductor space. We are actively pursuing a diversification strategy because the technology that we have and own there at GES, especially in areas like optical inspection of really critical dimensions. That technology is used in, in many different manufacturing environments, supporting many different end market verticals. So we have a diversification strategy. It's active there, and we hope to continue to grow that business. But right now it's strong and it's trending upward in those two areas I mentioned, smart mobile device manufacturers and semi-conductor.

Anja Soderstrom: Okay. And then in the auto segment, it seems like you said the backlog is going to spill into the fiscal 2020, but you still have visibility for the fourth quarter and say, you have to apply to support as quarterdeck and just talk about the dynamics there and what a strong fourth quarter looked like there. You had a pretty easy compare year over year, but a little bit tougher sequentially.

Donald Charron: Yeah. I'll just preface what I'll say there, Anja, in the fact that we have commitments from suppliers for deliveries and we've -- we're factoring that into our production plans every day. As we speak, the biggest risk we face is if a supplier did come in, meaning that they gave us a delivery schedule and they couldn't meet it themselves for their own reasons. And so that's the biggest risk we face.

But that being said, when you look at the commitments we have, those commitments would support a strong fourth quarter for us. And plus, as we mentioned in the script today, the GES machines and the order for machines from GES will also be a strong contributor to the quarter, but coming specifically back to automotive, yeah, we are looking at the commitments we have from suppliers, and we are factoring those into what we think our production and sales will be in the quarter, and that's why we believe we're going to have a strong fourth quarter.

I also would just say that demand that it shifted out, it did not cancel. I just want to emphasize that. It shifted out. And so we can see a strong start to the fiscal year '22, especially in automotive because that demand is shifting out ahead of us. And there are several areas we can look to that will support that demand staying strong, such as inventory of vehicles in the U.S. being at or below all the time lows, and demand being quite high or buyers in the market. So that should prove to be very favorable for our automotive end market vertical. And especially as this component shortage starts to subside, I am confident in our ability to execute on the manufacturing side once the semiconductor shortage subsides.

Anja Soderstrom: And then in medic, what are you seeing there in terms of the electives returning?

Donald Charron: Yeah. Still a slow pace on that. As you know, we had the favorable impact of building in the COVID-19 year, when the demand was there for COVID-19 patient care. That's been built out and it's run its course, but we still see areas of our medical and market vertical that are not yet back at pre COVID-19 run rates. That's going to require people going to see their doctors again, people feel uncomfortable to go see their doctors. People feel uncomfortable to go to the hospital for elective procedures. That business has not recovered. And I think it's more difficult to predict, but look, I think we should all be encouraged by the vaccinations and the vaccination rates that we're seeing across the U.S. Obviously we have the rest of the world, we'd like to see keep pace as well. That should, that should help, and that would be a nice increase of opportunity to increase our sales there in a medical vertical when, when that does happen.

Anja Soderstrom: Okay. Thank you. And in terms of your facilitation, capacity expansion, you're talking about -- expanding Mexico now. Why Mexico, and what are you primarily producing in Mexico?

Donald Charron: Yeah, Mexico is a large facility for us today. In fact one of the largest facilities we operate and we've been there for decades, and it's a very popular preference of our customers, so. And I guess to answer your question, what do we make there? We support all four verticals there in Mexico. It's a very complex, large-scale manufacturing facility. And again, it supports all four of our end market verticals and we're at capacity. We literally had no room left in that plant. So we waited as long as we could, and we have opportunities in our new business opportunities pipeline that are very close to being awarded. So that's how close. I wanted you to know that's how close we take it before we make a decision to expand.

And the expansion decision is based on the popularity of that footprint to our customers. In other words, that's their preference. For various reasons, it's their preference. And that's where they'd like to see their product manufactured. So we're following, really following our customers with these expansions, if you will. It's really following their preferences, where they want us to build their products and what programs they have in the pipeline that they want produced in Mexico. And of course, as we announced last quarter, Thailand, that we're following their preferences. That's why those expansions are where they are.

Anja Soderstrom: And lastly, about your cash cycle days improvement, you said you target about 65 days since like you're off there and sustainable is add in, and what's the puts and takes there. And I guess that will support a completely improved cash flow, if you can keep it at that level.

Donald Charron: Yeah. Structurally, when we do our analysis structurally, we believe 65 days is where we should be operating on a pretty consistent basis. In this environment with component shortages, anytime you hear us say shippable backlog is pushing out

because of a shortage issue, as we talked about today, that usually means some inventory's coming in, but the one part you need to build the unit is not. And so we would expect to see our PTOH, which is our inventory metric, grow in this period. It could be short term and we work it back down, but we do think it's sustainable.

And I wanted to explain the global semiconductor shortage so that you'd understand that with this type of a shortage situation, where customers want the product, it's shippable backlog, but it's moving out because of the shortage, that some of that inventory's going to come in and we'll see a swelling, a temporary swelling.

But we are, as a management team, working hard to keep our cash conversion cycle at 65 days. And we haven't been there, and for various different reasons, we've kind of had to battle to get there over the last few quarters. We actually had excess inventory, for example, that we've been working down during this period in other areas of our business. So I would want us to think about 65 days as a normal landing pattern for us on the whole cash conversion cycle.

Anja Soderstrom: And what's your ability to take deposits for inventory that you need to hold?

Donald Charron: That's not as prevalent in our customer relationships and commercial agreements, but we have, and we'll continue in the future, have mechanisms to relieve inventory directly back to them. If it, for some reason, is excess due to their forecast or due to their demand going away. So we do have some relief mechanisms in our commercial agreements, but deposits isn't one of them.

Anja Soderstrom: Okay. I just want to wish Mike well on his new chapter and congratulate Jana on her new position. I'm looking forward to be working with you.

Michael Sergesketter: Thank you very much, Anya.

Jana Croom: Thank you.

Donald Charron: Thank you, Anya.

Operator: Your next question comes from Mike Morales of Walthausen & Co.

Michael Morales: Thank you, operator. And good morning, Don, Mike, and Jana. Good to talk. So let me get the important things out of the way first. I'll echo congratulations on your retirement, Mike, it's been a real pleasure working with you over the years and best of luck on your future endeavors, wherever that may take you. And likewise, congratulations to Jana on the new role, really excited to see what you can bring to the company.

All right, let's get down to brass tacks now. A lot of good color in the answers there. As I think about the commentary on the fourth quarter and the raw material shortages that

everybody seems to be facing right now, I think back to when we saw some production disruptions in the auto OEM space last year, and kind of the headwinds that, that caused. Certainly in the news, we're seeing a lot more of that across OEMs pretty much globally. Is that kind of baked into your expectation for the fourth quarter based on where you're sitting today, or just in that qualitative commentary that those production or disruptions, even with how severe they may be, there's still a pathway to sequential growth?

Donald Charron: We think so. Again, Mike, I just preface that with we're in this shortage, we've got commitments, we baked that into the Q4 outlook commentary and so the risks we face, that we have to manage is de-commitments. And we're doing that as I mentioned, our teams around the world are working this thing day and night, but we're not in total charge of that.

As you can imagine, with a supply base of the big names that I know you're familiar with, and the fact that we're in there competing for those parts in many cases with a lot of different, let's say buyers that need that material. But in terms of the demand, it's very strong. I mean, in terms of customers taking everything we can build, for example, very strong. So, if there is an opportunity to improve a shortage, for example, and instead of the de-commit risk I gave you, actually a supplier did better than they committed and delivered us more material, that certainly could just as easily deliver upside, more upside for us because the demand is very strong.

For us I think the big challenge is really to make sure that we don't get more de-commits. We have strong demand with existing customers, with existing programs. We got new programs, they're still ramping up, and we've got all three of our geographies really pushing hard. And I say, all three, China, North America, and Europe. And so yes, it's -- the demand is there. We've got to manage the de-commits and it should result in a very strong fourth quarter for us.

Michael Morales: Understood. And I think the auto industry has kind of found itself in the unique position right now of having stepped out of line as it relates to picking up these semiconductor components. And now they're at the back of the line and they can't cut to the front and get what they need. And as I think historically that's a very new thing for the auto industry.

So the question is, have discussions with any of your major customers, whether existing or prospective, changed or evolved as they think about consistency of supply? You had mentioned that the customer deposits are a huge part of the relationships now, but do you see anything changing or are there ways that this shortage impacts the way that you guys do business from a customer relationship standpoint as it relates to supply?

Donald Charron: Well, first of all, Mike, you said that very well. In terms of, let's say automotive, getting out of line and go into the back of the line and realizing they can't fight their way back to the front of the line. They're learning a lesson. I mean, we have the opportunity to talk to our customers, which again are some of the largest tier one companies in the world. And so they deal with all these vehicle OEMs. There is a lesson

being learned here by all, that should not have got out of line in the first place, should've had a more comprehensive supply chain strategy to get through the pandemic.

And yeah, I think the lessons are being learned, and I do think we'll see changes in how production schedules are fixed and -- set and fixed out further into the future versus sort of this idea that we somehow have this flexibility that, oh, if we're wrong and we dropped our forecast and we dropped our demand and we're wrong, and we want to quickly change it upward. Laws of physics start to come into play in terms of how fast you can turn back on the supplies, especially in the area of semi-conductors. So there's lessons being learned.

I do think what we'll see and what we've already required from our customers proactively. And this goes back several months ago, Mike, we were already asking our customers to place firm orders on us or forecasts that were very firm out for a full year. So that as we got back in line for this component supply, we stayed in line and we stayed in line with the right kind of forecast going out far enough. And so it's going to take a little while to get through this, but I definitely believe there's a lesson being learned here.

Michael Morales: Right, right. That's helpful. Maybe switching to the GES business and the positive commentary there. We can't talk about the shortages and the challenges to auto without talking about maybe the benefits that could bring to the GES business. Can you help me understand what the sales cycle looks like for that business? And is there some metric that you guys use to gauge the health of the sales funnel there, whether it's like evaluation tools in the field or some other metric that you'd be willing to share and just help me understand how prospective new business there is developing?

Donald Charron: Yeah. We're learning and we where there's things we want to do in that business. It's exciting. There's opportunities to apply this technology as I stated earlier, in many different areas of our existing business and we're users of the technology ourselves in our own manufacturing plants, so it's exciting. It's a capital equipment model, primarily.

Today, we have services, we have revenue from services. We have revenue from software, but primarily the largest part of the revenue is capital equipment. You'd think that, that orders for that capital equipment would be placed far in advance, just given the nature of it. But it really is not that way. At least our experience so far, it's not that way. These are machines that are worth hundreds of thousands of dollars, but the lead time is pretty short in terms of when we get that order and when that machine is expected to be built and shipped.

However, the development starts a lot sooner, in months, if not years sooner, in terms of the technology and the problem that technologies aim to solve -- aimed at to solve. And so we are working on trying to develop some better funnel metrics to communicate, to more effectively communicate around this business.

As I said, it's a technology-driven company and it's technology we, in many cases, own, in terms of intellectual property. So we're excited about the opportunities and the growth in the applications, but we're still learning. And I hope soon we'll be able to talk more about the funnel metrics, so that you can get an idea of what the outlook looks like.

And of course our diversification strategy, where we're hoping will help really kind of soften that degree of seasonality that I spoke about, because we have very strong Q4s that we have reported. And of course we've got a backlog number we're looking at for Q4 this year that's very strong, but we also have quarters that are pretty light. And so we were working on that as well.

Michael Morales: Got it, got it. That's really helpful color. It's good to see the consistency in the financial results too, as it relates to the margin target that you guys have laid out, especially in a challenging environment. So good works folks. As far as those targets that you've put out there, are you guys reevaluating where you're comfortable with the growth margin and the operating margin targets with now that we've got three consecutive quarters under the belt and structural improvements in place that seem like they're going to stay in a post-COVID world?

Donald Charron: Yeah. Great question, Mike, and thank you for recognizing the three consecutive quarters, cause we as management have been working on that for a long time to put some more consistency around that operating income margin target, and we have now hit it or exceeded it three quarters in a row. And we're happy about that, but we're not satisfied. We want to perform more consistent -- we want to get a few more quarters under our belt in terms of consistency.

Do we think there is a margin expansion opportunity? We do. We think there's margin expansion opportunity beyond our current target. We're not ready to put numbers to it, but we are working hard. First step of this part of our journey is to put some consistency. Put more than three quarters together, hitting our target. But I would want you to know that we as a management team believe there's margin expansion opportunities.

Michael Morales: Fantastic. Lastly from me, I'll ask the question this way, as you look at your facility portfolio right now, are there any other popular facilities with your customers that are near or at capacity?

Donald Charron: Yes. I don't know if you want more color, Mike, on the topic, I would want you to think about it this way: We have -- our new business opportunity pipeline is very healthy. And so our challenge is to look at our footprint and see where customers are wanting us to be. And as we approach floor space capacity in these operations make good, smart capital deployment decisions around expansion.

The other thing I would want you to know is we -- in this period, let's say over the next three years, our primary focus is going to be on expanding where we are. So in addition to where customers want us to be expanding where we are, and why is that message

important? If you think back to the Romania greenfield, those expenses are hitting you way beyond revenue, and you're building a new team.

You're getting certified, you're getting qualified. And you probably can remember all the quarters. We talked about how much of a drag Romania was on our results, because it was a greenfield. And now it's up and running and profitable, et cetera. So when we look at it gaining or adding capacity, to continue our growth in the future, we're going to look at expanding where we are, where we already have leadership teams in place. We already have the infrastructure in place. And so we can manage or sync up, the ramp up of expenses, closer to revenue. And we don't see those ramp ups as being as diluted, as long as say the Romania greenfield was.

There's certainly -- it can't be perfect. You're always going to have some expenses just ahead of revenue, but it's minimized in a model where we're expanding where we are.

And so when I look at our footprint, with Thailand and Mexico, with those expansions, we're set for several years. I look at our growth in China. I look at our growth in Europe. I know we just did Romania, but our growth in Europe, and we looked out into the future. Those are some expansions that we could be talking about in the not too distant future, but right now, I think Thailand and Mexico, at least for the next couple of years, I think that's going to be our primary focus. And we've got new business development plans that are aimed right at those expansions.

Michael Morales: And it'd be fair to assume that all of these discussions would be done in a similar way to the way that you're approaching the Mexico expansion, as it relates to prospective new business being on the cost to fill that expansion, right?

Donald Charron: That's right, that's right. Yeah. It's a kind of a field of dreams sort of analysis. I don't know if you ever saw that movie, but if you build it, they will come. And so -- but we try to say, well, we'd like you to sign a little bit of a commitment to us before we built it, before we put this baseball field in a cornfield in Iowa. But it is a bit of that, a challenge for us just to try line that up the best we can, but for customers really to commit a business to a site that's full, if you put yourself in their shoes, that's pretty tough, especially a larger program. So we've got to find the right balance in there. I think we did that in both the Thailand and Mexico business cases. And so now we're racing to get occupancy of those expansions and get awarded those programs from customers that basically pushed us to do it.

Operator: Your next question comes from Hendi Susanto with Gabelli Funds.

Hendi Susanto: And then first of all, thank you, Mike, for all our interaction and you will be missed. All the best for the retirement.

Michael Sergesketter: Thank you.

Hendi Susanto: Don, you've shared that you are expecting strength in Q4, both sequentially and year over year. You said like very strong. Is it reasonable to expect double digit on both? Can you quantify that?

Donald Charron: First of all, hello, Hendi. Thank you for your question. I can't quantify it with that type of precision, Hendi, but first of all, we know that the year over year comparison is somewhat of a soft comparison given the Q4 number we had last year. And so I think maybe that we set that one aside and just kind of look at the quarter we finished just now at \$310 million and say, how much was that impacted by these material shortages? How much material commitment do you have?

Yeah, when we look at the quarter we just finished and commenting that, a significant amount of ship, well, backlog moved out ahead of us. Some of that is going to get recovered in Q4. As I mentioned, there's a pretty good chunk of it that moved out to the first half of fiscal year '22.

But if I look at that \$310 million quarter and said, very strong, yeah, you're -- it's a stronger growth rate than what we had in Q3 that we think we'll be able to achieve. And as far as I can go with that Hendi, and again, I'd just reiterate that the big risk we've got to manage there is de-commitments. So I -- we could walk out of this call today and go to a meeting and find out one of our major semiconductor suppliers couldn't deliver what they committed to deliver for some reason.

So I would caution you with that, but in terms of the demand and the material commitments we have right now, strong quarter. And focused. I would ask you to focus on the sequential part of that more than the year-over-year comparison.

Hendi Susanto: Yes. And then, Don, if we focus on sequential, I think overall we are seeing a strong demand in automotive, and then people are expecting strong demand and then supply short dates for the next several quarters. And then, if you look at your automotive sales in the last quarter, like \$140 million, can we think that can be a baseline, while we are still dealing with strong demand in automotive and in short dates in components?

Donald Charron: Yeah. I think that's a good approach, Hendi. I think that's a good approach. That's how we look at it. I mean, that's how we look at it. Yeah.

Hendi Susanto: Yeah. And then, Don and Mike, gross margin has stayed above historical rates. There are positive and negative variables that other companies are talking now, such as like high raw material costs, higher logistics costs. And then, on the positive side negotiation for higher price, and then strong demand for electronic components. How should we think about gross margin in terms of those variables? I don't know which variables are applicable in the Kimball Electronics' case, I mean which ones may not be the case. Can you give some color on that?

Donald Charron: Well, I mean, absolutely. You said it well, Hendi, in terms of what those variables are, that are going to impact margin. I do think we're in a period of time where there's a recognition up and down the value chain, that we have increased costs and that those have to be dealt with. I think sometimes there's a disconnect in the value chain, and you might have those rising costs, but there's not a willingness to sit down and work on a commercial agreement that works for everyone in the value chain.

I think right now we have this sort of synchronization that's happening, part of it due to the pandemic, part of it due to the global semiconductor shortage. But there's at least an acknowledgment that these costs are real and they're increasing and they're likely not to decrease soon.

And so we factor all that in to our operating margin target. And because you also have the SG&A side of that equation, if you will, gross margin and SG&A, and as our business grows, we want to continue to look at operating leverage opportunities in our SG&A. And so I would say that if we do come off our 4.5% operating income target, it could be both, it could be gross margin and it could be more leveraged in our SG&A. But that's why we want it to stay on the 4.5% operating income target, because we, if we can consistently be around that number, I think it will mean that we're getting the gross margin we can, and we're leveraging our SG&A like we should.

And yeah, more to come on that as we evaluate whether or not margin expansion is available to us in the future quarters to come, but I -- we -- all of those kind of go into our blender of hitting our 4.5% operating income target.

Hendi Susanto: Okay. That's helpful. And then Don, can you give some color on one industrial segment outside of semiconductor equipment? And then secondly, Public Safety revenue seems to indicate a revenue bounce back and insight on those two?

Donald Charron: Yeah. So Industrial, first of all, Hendi, the biggest part of our Industrial vertical business is climate control products. And we have customers here in the US and we have customers in Europe. And so that I would just want you to know, first of all, that's far bigger than, for example, semiconductor. Semiconductor is more of a space for developing within GES, less of a really large revenue source today in our industrial vertical, climate control would be the biggest. And coming behind it, and what would have gained a lot of momentum before the pandemic was smart metering products, primarily in Europe, as that has really taken a hit due to the pandemic.

And once the pandemic subsides, another area where we would hope -- we would hope to see growth rates like they were back before the pandemic. And so climate control products right now are very strong. We mentioned that here in the US the HVAC customers we support are back at it and business is very strong. So that's a really positive sign for us. We think that will likely continue and we're waiting to get another boost from smart metering products when we get back to where we were, prepandemic there.

On the Public Safety side, we lost a legacy customer that we had for many years, and we've been talking about losing that legacy customer as the reason for the decline in Public Safety, we never liked to have that happen, but it happened. And we managed to - managed that to the exit phase of that business.

And our funnel has now caught back up with new programs. Some really exciting programs, as you know, Public Safety is not a big vertical for us, but we think it's very strategic and we have some really strategic names in there that we support. So it's nice to see that we finally have kind of gotten on the other side of losing that legacy business or are winding that legacy business down and having our new business funnels fill it back in.

Hendi Susanto: So, Don, how sustainable is the new funnel in the Public Safety segment?

Donald Charron: Well, we reported a nice number this quarter, that's a good sign and we're down to where we feel like we've got a solid base of business with a new funnel, typically Hendi, the challenge there, the business opportunities in Public Safety are smaller and a little less consistent, if you will, when compared to our other verticals. And there's more up and down undulations in that business. And, as I -- I can't give you an answer really to your question to how sustainable it is, but I -- when we talk about an 8% organic growth goal, we expect it in Public Safety, just like we do in the other verticals and on a consolidated basis. So I would want you to know we're not happy if we're not at least at 8% organic growth on a consistent basis.

Hendi Susanto: And then, let me ask this question for Mike. From -- Mike, can you give us some insight on the timing and then the amount of CapEx for additional capacity in Thailand and Mexico? I believe that you indicated about \$8 million to expand production capacity in Thailand. I don't know how much more you would need to complete that.

Michael Sergesketter: Well, that number is what we reported last time for facilities. And I believe that might've included the first line going in, it does not include working capital and other needs there, that as that business ramps up, we'll see a little bit of pickup there, but timing-wise, that money for Thailand is -- we started spending there in actually Q3, broke ground in Q3. And so a large part of that will fall into Q4 and Q1. And we expect to take occupancy of that location, I believe around December or January of next year should be ready.

On the Mexico expansion, we just got that approved this quarter. We're sort of into design phases there on the building. We've secured the land we would expect to break ground there probably in late June, early July. It'll take about 12 months. And, the number that Don reported is really facilities and the initial infrastructure to get the building up and running. And we tend to add capital as we needed to support the revenue growth within the building. So we'd be putting lines in kind of on a trigger basis as needed going forward.

But we would, again, we would expect to take occupancy of that capacity sometime next -- a year from now. Probably around next June and July, and we would have some business we think going into it immediately, so.

Donald Charron: And so Hendi, maybe if I could build on Mike's comments a little as well, in past calls, we've talked about sort of a more normalized rate of CapEx would be something at, or slightly above depreciation. But when you look at bricks and mortar, you just almost have to stack that right on top of what would be a normal CapEx run rate that would be at or slightly above depreciation.

So as you look at your model and how you build your model, I think you'd want to consider the fact that the \$8 million number for Thailand, roughly, and the \$25 million to \$30 million number for Mexico, they sort of sit on top of a CapEx number that would be somewhere close to depreciation and a little above. Does that make sense?

Hendi Susanto: So Don, if I interpret correctly, so the Mexico CapEx will be \$25 million to \$30 million?

Donald Charron: Yes. It'll be somewhere -- for the land and the building and the infrastructure, for the building, will be somewhere between \$25 million and \$30 million.

Hendi Susanto: Okay. And then will you spend that whole amount within a year?

Donald Charron: We'll take occupancy. It'll be like -- laid out in installments, as we break ground and move towards taking occupancy at the end. But yeah, we think Mexico we'll be taking occupancy somewhere around a year from now. So yeah that, that most of the capital would be deployed in FY '22.

Hendi Susanto: And then last question for me. Don, you indicated that capacity at Mexico is running at full capacity. Can you give insight into other manufacturing location, whether or not they have run at full capacity or close to full capacity?

Donald Charron: Thailand, we did the, that's why we released the expansion there. As I mentioned earlier Hendi, I think as we look at the preferences of our customers, new business pipelines and projected or forecasted needs. Yeah, I would say China and Poland, or maybe we could say Europe, but Poland would be areas that we're keeping a close eye on because they are running at high utilization rates today.

Hendi Susanto: I see. How about Romania, Don?

Donald Charron: Romania is ramping up, too. Also running at a high utilization rate. So, that's one of the things we want to study. It's unlikely we would expand them both at the same time, both being Poland and Romania, we would look at our, again, our customer preferences, where they are expecting us to add capacity in Europe, and then we would decide. We believe that's a little further out, Hendi, it's not next year, it's further out than Thailand and Mexico, but we can see where those operations are running from a

utilization standpoint. And we can see it coming, let's say in a three-year horizon for sure, possible.

Hendi Susanto: I see.

Donald Charron: Possible. Yeah.

Operator: Your next question comes from [John Dasher] of [Pinnacle].

John Dasher: Good morning, everyone. And thanks for taking my call. Most of my questions have been answered, but I just wanted to circle back to the capital spending for both Mexico and Thailand. Can you give us your ballpark estimate of what CapEx is going to be for both the year end, June '21 and next year, June '22? That would be very helpful.

Donald Charron: Yeah. '21 might be tougher than '22 John, just because depending on how some of that spending falls between now and the end of the fiscal year and the start of fiscal year '22. But if you look at our depreciation and as I said, we would expect a kind of a normal operating condition that we would run at depreciation or slightly above when we're growing, like we're growing.

So let's take that number at between \$30 million and \$35 million today, depreciation. And then you add on top of that, the Thailand and Mexico expansions, you're probably getting close to twice depreciation for fiscal year '22 or pretty close to it. And again, it depends how much falls into Q4 '21 and then how much sort of slips over to FY '22. But that's how we want you to think about it at least. That's about as accurate as I can get it to you at this stage.

John Dasher: So just thinking through those numbers, you're thinking \$60 million to \$70 million in FY '22?

Donald Charron: Ballpark. Yep, ballpark.

John Dasher: Okay. And '21, we haven't seen the Q yet, so I guess we don't know what the year-to-date -- or can you tell us what your year-to-date CapEx is for fiscal '21?

Donald Charron: Well, we were running around eight per quarter up until now. I think we could see a bigger Q4. That's the thing I'd want you -- so once you get a chance to look at the number, it's probably somewhere around \$22 million to \$24 million, in that range, but depending on how much that capital, as I mentioned, that could slip from Q4 into Q1 and next year actually lands in Q4, that's a number we're looking at, but it's likely going to be the highest CapEx quarter of the year, Q4 that is, likely to be the highest CapEx quarter of the fiscal year.

John Dasher: Okay. All right, good. And how are you anticipating financing Thailand and Mexico?

Donald Charron: From available liquidity.

John Dasher: Okay. All right. Cash flow, that's good. And you mentioned you're following your customer's request. I was just curious, the pipeline for the customers who are pushing you to expand Mexico. What verticals does that fall into for those new customers who are moving the expansion forward?

Donald Charron: That's really interesting. Good question. We have some large programs already awarded in automotive, industrial and medical. We have others that we're working on to get awarded. All three of those verticals will be well-represented in the expansion.

John Dasher: Represented equally, do you think, or skewed one towards the other?

Donald Charron: That's a really good question. They all are competing for capital. They all have to hit our targets for return on invested capital. But I would -- and you're looking at how it looks right now, yes, it could be a third, a third, a third.

Operator: (Operator Instructions) And your next question is from Jason Crawshaw with Polaris Capital Management. Please go ahead, Mr. Crawshaw.

Jason Crawshaw: Yes. Good morning. A couple of quick questions, I guess, in the case that you get a de-commit from a supplier, are there sort of penalties that you have to pay to the customer for the de-commit, i.e. that you can't fulfill the order? Or is that just sort of normal course of business, that is the reality of the current state of the situation? I guess that's the first question.

Donald Charron: Well, it ends up being in the conversation, Jason, that's for sure. But I think when it's this widespread, what we experienced, it's almost like a force majeure-kind of operating condition. And the value changes realizes that we're all going to have to get through this together and we can't just be firing lawsuits at each other. So I would say it ends up in the conversation and it ends up in some of the frustrating comments, but I think in general, we stick together and get through it as a value chain.

Jason Crawshaw: Got it. Okay, that's fine. And then I guess, just in terms -- second question. I mean, if you think about kind of the shortage in semi and auto, is it across the, I guess the entire chipset or sort of product line, or are there certain parts that are substantially exacerbated and then there's some parts of what, you're still going to get a fair amount of chips in autumn?

Donald Charron: Yeah. It's more like across everything, in terms of all component types. If you ran down the list of the big seven semiconductor suppliers in the world, they all have their challenges. I wouldn't necessarily hold one of them out as being better or worse than the other, so. And I would say this though, Jason, some of those

component categories will recover faster because the capacity increment and the lead time to actually make the part is different.

So they won't all get well at the same time, they didn't all get bad at the same time, get short at the same time. But the recovery will be different by component category.

Jason Crawshaw: Got it, great. And then I guess just the last question. Sort of when you do your forecasting, right, let's say you've got commitments from suppliers that, for a hundred, right? But you kind of look around, you see what the economic reality is. If they're telling you a hundred, do you kind of handicap and say, you know what, we're only going to bake in 90, or is your forecasting based on exactly what your suppliers are telling you?

Donald Charron: Both. It's both. If there is a track record of performance, we'll build our production schedule around that commitment from that supplier. If there's not a track record of performance, maybe if there's a track record of de-commits, yeah, then we'll hedge in what we put in our (inaudible).

Operator: I'm showing no further questions at this time. I would like to turn the conference back to Mr. Don Charron.

Donald Charron: Thank you, Cindy. Thank you, everyone. 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.