

Kimball Electronics, Inc.

Q4 and Fiscal Year 2021 Results Call

August 5, 2021

10:00 AM

Operator: Good morning, ladies and gentlemen, and welcome to the Kimball Electronics fourth-quarter fiscal 2021 earnings conference call. My name is Adrian and I will be your facilitator for today's call. All lines have been placed on 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.

To ask a question, simply press * and then the number 1 on your telephone keypad. Questions will be taken in the order they are received. Today's call, August 5, 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 now like to turn the call over to Andy Regrut, Head of Investor Relations. Mr. Regrut, you may begin.

Andrew Regrut: Thank you, operator, and good morning, everyone. Welcome to our fourth-quarter conference call. With me here today is Don Charron, our Chairman and CEO, and Jana Croom, Vice President, Chief Financial Officer. We issued a press

release yesterday afternoon with the results of our fourth quarter and full fiscal year ended June 30, 2021. To accompany today's call, a presentation has been posted to the Investor Relations page on our company website within the Events and Presentations tab.

Before we get started, I would like to remind you that on today's call, we will be making forward looking statements that involve risk 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 adjusted non-GAAP results.

For the fourth quarter of fiscal 2021, this excludes a one-time after-tax expense totaling \$0.3 million or \$0.01 per diluted share associated with nonoperating 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. Jana will review the financial results for the quarter and the full year fiscal 2021, and guidance for fiscal 2022. And Don will complete our prepared remarks before taking your questions.

I'll now turn the call over to Don.

Donald Charron: Thanks, Andy, and good morning, everyone. I'm very pleased with our operating results for the fourth quarter and the strong finish to our record-setting fiscal year 2021. Our team remains laser focused on fulfilling the commitments made to our customers, as we work through the ongoing challenges caused by the pandemic and the global parts shortage.

Despite the headwinds, we delivered strong topline growth, excellent margin expansion, and impressive earnings growth, with operating income exceeding our goal of 4.5% for the fourth consecutive quarter, and adjusted Q4 EPS increasing 71% over the same period last year.

For the full fiscal year, 2021 was a record year for our company with many financial metrics, including net sales, margin rates, earnings, cash flow from operating activities, and return on invested capital reaching all-time highs. Our team has demonstrated remarkable resilience throughout these unprecedented times, so we are well-positioned to carry the momentum from 2021 into fiscal year 2022.

As a result of the ongoing semiconductor shortage, a portion of our shippable backlog continues to shift out ahead of us, which will likely result in two very different halves in fiscal year 2022. Our full-year guidance which Jana will discuss in a few moments contemplates this bifurcation, as we expect the

material supply to steadily catch up with customer demand throughout the first half of fiscal year 2022, thus enabling us to ship the majority of the surplus backlog in the second half of the fiscal year and into fiscal year 2023. We expect a catching up on the backlog, combined with strong organic growth from new and existing programs, will provide significant year-over-year growth.

Beyond the record-setting results for fiscal year 2021, and the bullish outlook for fiscal year 2022, we have never lost sight of the fact that the health and safety of our employees remains our number one priority. Our protocols have minimized disruption to the business and allowed us to maintain excellent customer support, as reflected in our topline growth during this period of uncertainty.

Net sales in Q4 increased 15% compared to the same period last year. This was a stronger finish to fiscal year 2021, than what we discussed 90 days ago on our last earnings call. The growth was concentrated in our automotive and industrial vertical markets.

Automotive was up 92% in Q4 as compared to a year ago, as the industry returns to more normalized levels of volume after the shutdown a year ago due to the pandemic. The business continues to benefit from two industrywide megatrends. First, the demand for vehicles is red hot, as communities reopen from

the pandemic and consumers, many who have cash in their pockets, leave their homes and take to the road to reengage with society. OEMs have been responding to this surge in demand by ramping up production to keep pace, and most agree there's not a foreseeable end in sight.

The second megatrend is the continued growth in electronic content per vehicle. Cars and trucks are being designed with advanced technologies and expanded operating systems, with advancements including electronics steering, automated driver assistance, passenger safety systems, vehicle mobility management, electronic braking, and redundant systems for self-driving cars. These are all good examples of this megatrend, and represent continued growth opportunities for our business.

Moreover, the applications and architecture for these systems are largely the same for both electric vehicles and vehicles driven by internal combustion engines. And the stringent production standards in the automotive industry for these systems align well with our core manufacturing competency, often making Kimball Electronics the supplier of choice.

There's an inherent stickiness in these long-term relationships when we win a program, and it produces an ongoing stream of orders that allows for operating efficiency. You can see this dynamic in our customer base, which gives us confidence

in the growth potential of this critical market in the years to come.

Sales in the industrial vertical increased 17% in the fourth quarter compared to the same period last year, with the strength resulting from automation test and inspection sales, and higher-end climate control products. We expect this strength to continue in fiscal year 2022.

The medical vertical market was down 31% in Q4, as a result of strong prior-year sales related to the COVID-19 pandemic, and lower levels of elective procedures this year. We are starting to see this trend reverse, as more of the population is vaccinated and physicians' offices and hospitals are able to resume elective procedures and activities.

Longer-term, we believe the megatrends in the healthcare industry such as the world's aging population, increasing access and affordability to care, decreasing device sizes and connected drug delivery systems, are an excellent set-up for future growth in this vertical market.

And finally, sales in public safety were \$10.8 million, down 10% from the prior year. This is yet another temporary impact of the COVID-19 pandemic, as the reduction in sales was primarily related to commercial and hotel smart locking systems. We anticipate this market will return to normal over time as people resume travel.

I am so proud of our team and their efforts to deal with the challenges throughout the year. We have been working diligently to find solutions to minimize or even negate the global parts shortage. This is a great example of how our strong company culture is creating quality for life.

I'll now turn the call over to Jana to discuss our results in more detail, and lay out our guidance for fiscal year 2022. Jana?

Jana Croom: Thanks, Don, and good morning, everyone. Net sales in the fourth quarter were \$329.1 million, a 15% increase compared to \$286.2 million in Q4 last year. Foreign exchange rates favorably impacted sales by 3% in the fourth quarter of 2021.

Our gross margin rate in Q4 was 9.7%, a 240 basis-point increase from the fourth quarter of last year, driven by improved operating execution, higher sales volumes in the automotive vertical as Don highlighted, and favorable foreign exchange.

Adjusted selling and administrative expenses were \$13.8 million in the fourth quarter, up \$3.7 million or 0.7% of net sales compared to the fourth quarter last year. This increase was primarily driven by salary and payroll related costs and higher profit sharing bonuses. As a reminder, adjusted selling and administrative expenses exclude 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 fourth quarter was \$18 million or 5.5% of net sales. This represents an improvement of \$7.2 million or 1.7% of net sales when compared to the same period last year. The increase was driven by the higher gross profit that I just mentioned, partially offset by the gain in selling and administrative expenses.

Other income and expense was income of \$0.4 million in the fourth quarter, which compares to expense of \$2.7 million in Q4 fiscal 2020. The income this year resulting from gains on SERP investments and favorable FX, partially offset by net interest expense and all other expenses.

The effective tax rate in Q4 was 17.6%. The low effective tax rate in Q4 was primarily driven by a favorable mix of earnings and our various tax jurisdictions.

Adjusted net income in the fourth quarter of fiscal year 2021 was \$14.7 million or \$0.58 per diluted share, compared to adjusted net income in Q4 last year of \$8.5 million or \$0.34 per diluted share. As Don noted, this represents a 71% improvement in EPS year-over-year.

Now, turning to the balance sheet. Cash and cash equivalents at June 30, 2021, were \$106.4 million. Cash flow

provided by operating activities during Q4 was \$26.3 million, our fifth consecutive quarter of \$20 million plus.

Cash conversion days were the quarter ended June 30, 2021, were 64 days, representing a 17-day improvement from Q4 2020, and a two-day improvement from last quarter. Compared to Q4 2020, we experienced improvement in contract asset days and production days' supply on hand.

Capital investments in the fourth quarter were \$15.9 million, largely to support the launch and ramp-up of new programs and to support our facility expansions in Thailand and Mexico. We continue to study our capacity needs to support growth plans.

As highlighted on our Q3 call, we anticipate higher levels of Capex to support the expansions of our operations in Thailand and Mexico over the course of fiscal year 2022. Both expansions add much needed capacity to support the forecasted growth from both existing and future customers, and demonstrate our strong organic growth opportunities.

Borrowings on our credit facilities at June 30, 2021, were \$66 million, which is down from \$118 million a year ago. Our short term liquidity available, represented as cash and cash equivalents, plus the unused amount of our credit facilities, totaled \$207 million at June 30, 2021.

There were no shares repurchased in the fourth quarter of fiscal year 2021. Since October of 2015, under our board authorized share repurchase program, a total of \$79.7 million was returned to shareholders by purchasing 5.3 million shares of common stock.

As Don highlighted, the full-year fiscal 2021 was record-setting for our company, with a number of financial metrics achieving all-time highs. Net sales were \$1.292 billion, an 8% increase over the prior year. Adjusted operating income was 5.2% of net sales, a 180 basis-point improvement from fiscal 2020. Adjusted net income totaled \$56.4 million, compared to \$28 million last year. And adjusted EPS was \$2.23, more than double fiscal 2020.

Included in the results this year was a favorable impact from foreign currency rate movement, which resides in other income and expense. Excluding this impact of \$0.17, the adjusted that results for fiscal 2021 of \$2.06 was still well above the \$1.10 we reported a year ago.

We generated \$130 million of cash from operating activities, and our return on invested capital reached 13.1%, best in our history.

Now, turning to fiscal 2022. For the first time in our company history, we are providing guidance for the full fiscal year. We estimate net sales will be in the range of \$1.4 to \$1.5

billion, an 8% to 16% increase over fiscal 2021. Operating income margin is expected to be 4.5% to 5% of net sales. And finally, we expect to invest \$60 to \$70 million in capital expenditures in the fiscal year.

I'll now turn the call back over to Don.

Donald Charron: Thanks, Jana. Before we open the lines for questions, I'd like to take a moment to reiterate how proud I am of our team. We posted excellent operating results for the fourth quarter, despite meaningful headwinds, and finished a record year of strength (PH). We are also well-positioned to carry the momentum into fiscal year 2022, by guiding for growth. The company is in a solid position, and we are committed to build success in the future.

With that, I would like to open the lines for questions. Operator, do we have any analysts with questions in the queue?

Operator: As a reminder, if you would like to ask a question, press *1. The first question comes from the line of Anja Soderstrom with Sidoti.

Anja Soderstrom: Hi, everyone. Can you hear me?

Donald Charron: Yes, we can, Anja.

Anja Soderstrom: Thank you for taking my question, and congratulations on a strong quarter and year, despite the challenging environment.

Donald Charron: Thank you.

Anja Soderstrom: I just fell off the call. You talked about the auto industry and then, I assume, you talked about the industrial. You saw strength in the GS and the climate controls there; is that correct?

Donald Charron: Yes, that's correct.

Anja Soderstrom: And then what do you see in terms of the smart metering over in Europe? I would assume that the climate control is driven by the COVID, the people going back to the offices, and hotels and everything opening up over there. The controls stood up nicely during that elevation maybe normalizes and the smart metering in Europe is coming onboard again, or how should we think about the growth in industrial?

Donald Charron: Yeah, you know, the smart metering business in Europe is still being held back by the pandemic. And so it will require quite a bit of change yet, in terms of the environment there in Europe, and being able to have access for installation purposes of those smart meters. So we're anxiously watching that business and hoping for its return, but it's absolutely related to getting this pandemic behind us before we would see, let's say, pre-pandemic run rates.

You know, the rest of our business in the industrial vertical remains healthy. Climate control in a number of areas remains healthy. And as you said, you know, automation test and measurement, Q4 is their strongest quarter, and they had a

strong quarter in Q4 this year. So we expect the industrial vertical to continue to be strong for us as we go forward.

Anja Soderstrom: Okay. And what do you see in terms of the medical electives their that's sort of muting the growth there? How was that trending throughout the quarter?

Donald Charron: We're seeing signs of improvement, in that the trend there is improving in terms of those products we build to support those elective procedures and surgeries. So we're optimistic that that trend will continue. Of course, you know, with the new Delta variant and the sort of concerns around that, we're hoping that what we've seen in the past quarter in terms of a positive trend doesn't get reversed here this quarter. But so far, so good.

We're seeing a nice positive trend in terms of the return of that business. It's going to take some time, we believe, but it's definitely trending upward.

Anja Soderstrom: Okay, thank you. And also I might've missed it on the call, but the SG&A for the quarter was a bit elevated. I think it was due to salaries and performance bonuses. How should we think about that going forward?

Donald Charron: Yeah, I think--you're right, that's exactly what caused that number to move up. You know, I think--you know, obviously, with the guidance, the full-year guidance that we've provided, the 4.5% to 5% operating income margin,

that's really where I'd like you to focus. Obviously, that requires gross margin to be higher than SG&A by that range. So rather than trying to give you an SG&A number and a gross margin number, I'd want you to just focus on that range of operating income margin between 4.5% and 5%.

Anja Soderstrom: Okay, thank you. That's helpful. And you've been able to manage your working capital very well and building up parts like cash, and seems like you're going to continue to generate good cash. What are you thinking about the use of cash going forward?

Donald Charron: Well, first and foremost, supporting our organic growth. As we announced in previous calls and reiterated today, you know, the expansions--much needed capacity expansions in Thailand and Mexico, you know, funding those types of expansions to support what we see as a very strong organic growth funnel of new opportunities. And just to comment on the working capital, I'm just so pleased with the results this past year. You know, improving our cash conversion cycle.

I think structurally now with these improvements this year, we are about where we expect the business to run. For various reasons that we talked about in previous quarters, we had higher inventory levels, for example, and we explained why. But with the work we did this past year, I think structurally with the

cash conversion cycle--cash conversion days being at 64, structurally that's where we expect the business to run.

So going forward, you know, the working capital in dollars will increase commensurately with the topline growth. So that's a funding need as well when we think about growth going forward. It's not just Capex. It's having that working capital grow with that top line. And that absolutely is our number one priority for capital allocation.

Anja Soderstrom: Okay, thank you. That was all for me.

Donald Charron: Thank you, Anja.

Operator: Again, if you would like to ask a question, press *1 one. The next question comes from the line of Mike Morales with Walthausen & Co.

Michael Morales: Hey, good morning, Don. Good morning, Jana. Thanks for taking the questions.

Donald Charron: Morning, Mike.

Jana Croom: Morning, Mike.

Michael Morales: So I'll echo the congratulations, phenomenal work on the strong quarter and the great year, especially with everything that you and the rest of the industry has had to deal with. Yeah, really great numbers that you folks have put up.

I kind of want to start on understanding, you know, just how you guys did that. Certainly, dealing with tight supply

chains is in your guys' DNA, and that's what you do. Thinking about the last quarter, there were concerns about decommits on the supply chain. It seems like you navigated through that without too many of that--or those happening.

With where you are sitting today, has the outlook materially changed at all from what you were seeing last quarter, either positively or negatively?

Donald Charron: you know, in the whole, let's say, semiconductor shortage area, we've seen areas of improvement. We've actually seen some areas that have gotten worse, so it's a bit of a mixed bag. You know, I think as I mentioned in the last call, we are fortunate in that many of-- especially in our automotive business--many of the vehicles that we have content on through our customers are priority vehicles, vehicles that are getting priority with the chip shortages. That helps, but it's been impactful.

And as we mentioned, you know, we have a fair amount of shippable backlog that continues to move out ahead of us, and we're trying to manage that the best we can. In other words, organizing ourselves and planting ourselves around the gate, the gating item. We spent a lot of time--our operations team spent a lot of time trying to get that right. That's a lot of extra work, but it helps minimize the disruption of the shortages.

You know, it's hard to put an exact number on the shippable backlog that's rolling out ahead of us, but when you think about our guidance for the full year in that \$1.4 billion to \$1.5 billion range, as you know, Mike, we've had a target of growing the business around 8% organically. So that's sort of the low-end of our range. The high-end, you know, really contemplates catching up some of that surplus backlog.

So it gives you kind of an idea of how much that shippable backlog, how much in dollars that's moving out ahead of us. So that's something we really want to watch carefully, have a good plan to catch up on, so that we can continue to support our customers the way we have been, and yeah, get them back to the inventory levels they need to execute their plans as well.

So we're not out of it. The first half of fiscal year 2022, we believe, is going to continue to be challenging with these parts shortages, and we're going to have to do what we did last quarter for a couple more quarters before we could expect that, yeah, the supply would catch up with demand. That's why we're talking about '22 being two different halves for us. And, you know, we're optimistic it will improve.

Most analysts are predicting that the situation will continue to improve over the next couple of quarters, and we're hopeful for that, because that would really allow us to again focus our energies on other aspects of running the business.

Michael Morales: That's really helpful. And in your response there, you kind of touched on guidance, which I'd like to turn to. You know, as a shareholder, really appreciate the business being at a point where you guys are comfortable going out and putting these numbers out here. You know, I think that really speaks as a testament to the improvements that you guys have made and where the business is at today.

Thinking about the targets that you folks have laid out, historically when you've talked about that topline growth at 8% and operating margin target at around 4.5%, you mentioned it in your response just before that those are now kind of the low end of the guidance that you've put out.

So my question is, you know, as we think about longer-term targets and the outlook for the business, you know, has that 4.5% operating margin target that you guys talked about in the past, should we now think about a long-term target? Is that 4.5 to 5%? Or is there an opportunity for you guys to revisit and talk about longer-term targets beyond that? Just how are you thinking about it as a whole now?

Donald Charron: We're definitely staying on the operating income target. As you know, we put that target out there for ourselves; it must at least be a few years ago, quite a while ago at least. And we pushed ourselves hard to get there and to get there on a more consistent basis, with real improvements in

our operations; better operating leverage, better use of our footprint, you know, really focusing on the things we have to do to truly make those improvements that we could then predict going forward.

You know, our teams have done a great job, and despite all the headwinds we talked about and the pandemic and the shortages, we believe that we've made sustainable improvements in our factories and in our supply chain activities. Now, we're still battling some of those things that other manufacturing companies are battling, whether it's worker shortages, increases in wages and salaries, and other inflationary costs around raw material.

But we believe we've made improvements that are sustainable. We're going to work our way through those issues, and we think it's time to raise our expectations from that 4.5% target that we put out there, you know, those years ago, and be in that landing area, if you will, between 4.5% and 5% on a consistent basis.

We were just really tickled this year to be able to finish the full year with all four quarters above 4.5%. And we had to prove that to ourselves, that we think that those improvements are then sustainable going forward, but we believe they are.

Michael Morales: Great, and I think all of that makes perfect sense. Don, Jana, thank you so much for the color. Appreciate it.

Donald Charron: Thanks, Mike.

Jana Croom: Thanks, Mike. You, too.

Operator: Again, if you would like to ask a question, press *1. That is *1 for questions. I will now turn it back over to Don Charron for closing remarks.

Donald Charron: Thank you. 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: This concludes today's presentation. You may now disconnect.