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2019 Southwest IDEAS Investor Conference
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<<Conference Host>>

Our presenting next is SMTC Corporation. They're traded on the Nasdaq under ticker symbol SMTX. They're headquartered out of Ontario, Canada. They specializing global electronics manufacturing service provider, including product design, circuit board assembly, configure to order and build to order services. Presenting today is Ed Smith, the President and CEO; as well as Steve Waszak, the CFO.

<<Edward Smith, President and Chief Executive Officer, and Director>>

I showed him a video, the young fellow who just introduced me about somebody who quit their job, but when they quit their job, they brought in a little barbershop quartet and they sang to the boss. So they had that whole rhythm thing going. They were dancing. They said, I quit and he goes on, he goes on and on. So that's what he meant by, I didn't have the singing.

Thanks for having me. Thanks for taking the time and your interest in SMTC.

We are a contract manufacturer, so we build those little green boards that may be in your phone, maybe in a recorder, all your electronic stuff. And we do that for some marketplaces, which I'll talk about in the near future. We build sometimes the whole product. If you've been to a Chili's restaurant and you ever see the little thing that's on top of your table, the kids play games, they pay the little – put your credit card in. We actually build that whole product from start to finish for that, and that's for one of our customers.

We do not design the products. What we do is we take a design, make it better, make it more manufacturable, lower the costs, build it, and then ship it.

It's been a pretty busy year for us. So I'll just give you a little bit of overview on the year. We made an acquisition one year ago in November of a company called MC [Assembly].

At the time we started talking to MC, we're about the same size, $150 million. Looked like we were going to put together two companies would be $300 million. But by the time we were finished, we put the two companies together and we were $375 million. So in the midst of acquisition, we saw a double digit growth. Doesn't happen all that often, an acquisitions where you can do that.

Somebody asked me a little bit about synergies today and that came up in almost every conversation. So I'll tell you. We got not only the synergies we said, we would get, we got more synergies than we thought out of the acquisition. So, the other question I get is, would you do the acquisition again today? And my answer is I absolutely would do that. The same reasons exist today to do the acquisitions when we did it.

The year before we had grown 50% organically, this year with the acquisition we've grown double digits again. Next year, as I always say, it gets tougher and tougher as you get bigger and bigger growing double digits. We will be close to high single digits, closer to the double digits next year again. But as anything goes on in life, a lot of it matters what happens in Washington and the sentiment that they create in the marketplace that we live in.

[Slide 2] So I'll tell you a little bit more now about the company. These are forward-looking statements. I won't read all that to you. I'm sure you've seen many of these in your career.

[Slide 3] So as you can see, we not only do the little green boards, which are PCBAs, we do system integration. So one of our factories used to be the old Zenith TV factory in Chihuahua, Mexico. So if you think about a TV, it was a self contained thing. They did metals, they did plastics, they did cables, they do from top to bottom and build products.

We do testing, lots of different testing. If you were to go to one of our plants, like Melbourne, Florida, we do 5G, 4G, 3G, Wi-Fi, RF and all the testing of all the different communication protocols down there.

So when you walk into our plants, if you had one of these phones, it may not work right, because we may be scrambling the signal or do something. We do that because we do military work and we scramble signals for the military and build a lot of different military products, which I'll talk about in a second.

We also do vertical integration. So we can build all the way from a little board to a thing about the size of this room. And we do that for semiconductor capital equipment companies. We can do enclosure fabrication; we can do laser cutting bending and coding of enclosures and fabrication.

And then probably one of the most important things that people don't look at for EMS providers is supply chain. I came out of Avnet, so I used to be in distribution. You'd say, how did a distribution guy wind up going from a bad business to a worse business? If you think about Avnet's gross margin being in a 15%, 16% range and getting into this EMS business in 10% to 12%, some people would say, so you went from bad to worse.

My answer is 70% of our business is material and material costs. So supply chain matters in the EMS space. And I think we have the best supply chain management team in the industry. I used to sell and I was responsible for the sale of 40% of all electronics in the U.S. The gentleman who works for me running supply chain at SMTC was the guy who did the purchasing and selling for me at Avnet.

And then last but not least, support and maintenance. We do a lot of support and maintenance. One of our biggest support and maintenance customers is TV on airplanes. So interesting enough, we'd never built TVs for airplanes or any of the equipment that go on airplanes. But the company did build them, no longer supports them, so we actually support now upgrading, fixing, repairing. So if you get on an airplane and the TV works, you can say thank you. If it doesn't work, you can say they should replace it and send it back to us and we'll fix it for them.

If you look at our Q3, so we just announced our Q3. And it's an interesting quarter to announce because just before this quarter we announced we were getting out of China, we were closing our China facility in Dongguan, China. Sent or stop plummeting, I think people didn't understand it. Of our $375 million, it was only $16 million annualized. So it really wasn't a very big number. Of that $16 million we were able to move $8 million of that to Mexico. So on a top line revenue affect it was $8 million. On our stock price it actually cut it in half. And so, I never understood math. I'm not one of the financial advisors, but I could never understand how $8 million out of $375 million can affect something by half, but it did. And we need to fix it.

I will take the blame that we probably didn't make the announcement as clean, clear cut as we should. We will probably clean it up for future announcements. And so that's probably something we need to do.

We look at our Q3 we were up 14% year-on-year in EBITDA and as an adjusted EBITDA we were up 161%. So the numbers weren't that bad. When you look at the top line, revenue was up 65% and on a pro forma basis, we were down 5%. Down 5% looks like a big downward trend, unfortunately most of our industry was down double digits. So we probably performed as well as we possibly could and what they call an inventory correction.

In terms of quality, I think we're one of the better-quality houses and one of the better flexibility houses when you're our size in the EMS space. So we compete against companies like Key Tronic, SigmaTron, those are our size, but we also compete against companies like Benchmark, Plexus - the big guys.

What we have to do differently than they do is we have to be higher quality, more flexible with our customers, let them push and pull out, do the things they need to do, and then what we call it, a higher mix of products. So we have lower volumes, higher mix.

We need to be higher flexibility and higher quality. For that we get margins that are about double what those Tier 1 guys get. Our gross margin you'll see in a few minutes was over 12%, a lot of people will say, wow, that's a pretty good gross margin, the industry that gets into 6% or 7% range. We get that because we are high quality and we're high mix. And then the solutions, which I've talked a little bit about and I'll talk a little more later on.

So why should you as an investor invest in us? One is, we will become, and this year we moved into the number two spot from one of the worst spots, we'll become the highest EBITDA percentage of any EMS company that is public.

And so for me, I don't run a company unless I'm trying to be the best at what I do. And the best way to say you're the best is your financials. I always love the company says, hey, we're the highest quality, we're highest list, but here's our shitty financials. Don't worry about them. The reality is nothing else matters in the end than our financials because our customers will be willing to pay us more if we do higher quality and we're more flexible. So when customers are willing to pay you more, guess what happens? You make more money. And this was really a pretty simplistic mathematical equation that many people don't get right.

[Slide 4] This year we had a rights offering. So there's a lot of question of why we did the rights offering. We took out some term B debt, we had some junior debt on our books. When we did the acquisition, we were going to be over 4.2 times levered in terms of debt leverage ratio. And that 0.2 times they made us go to some junior debt that, that debt was very expensive, it had some very onerous covenants on it. And so mid year we did a rights offering and we were able to take that debt out. So we changed our whole debt structure at that time. We were a $60 million term loan, $12 million junior debt and then we had a $35 million ABL. Today we have a $65 million ABL and a $40 million term. So we lowered our term from $72 million down to $40 million by $32.5 million and we put it into an ABL. You might say, why would we do that? Because the term loans, average line 9% plus LIBOR and our ABL is 2% to 3% on a sliding scale plus LIBOR. So we lowered our debt costs.

We optimized our global footprint by ceasing manufacturing in China. You can only imagine being a $16 million plant in Dongguan, China. How many of you have ever been in Dongguan, China? You should go there. It's a very exciting place. This factory after factory, after factory, after factory, right across from us was the Mattel factory. And so being $16 million and being there was not very exciting. And then our government put tariffs in place and then the Chinese retaliated with tariffs back and that really made it to not very good situation. We got out. We'll be finished there on December 31st and then we'll move our equipment to our other plants.

[Slide 5] And then delivering best in class financial metrics, you'll see that in a second. So here's the financials. If you think about two years ago, I came in two years and a couple of weeks ago. If you think we were $130 million breakeven and losing money on a net income basis. Today we're on a $375 million. We've pre-announced our Q4, we're on $375 million, making $25 million of EBITDA and we're over 7% on EBITDA. So think about it, our gross margin would be in 12%, EBIDTA be in 7%. We're pretty efficient.

And our gross profit without intangible amortization is 12%. If you were to take out on net income a one-time charge for China, the non-cash portion of it, we'd actually be making 1.4% net income. So if you compare it to the rest of the EMS space, we're doing okay.

[Slide 6] The leadership team, I think we're very differentiated for a company our size. So I used to run Avent's business, grew it from $1.2 billion to $4 billion. I then started embedded business and grew from zero to $2.2 billion in seven years. And so I moved out of components business into a – so we went from really $1.2 billion $6.2 billion, but probably most importantly is, I've worked for Avnet for 10 years and in 2001 in the middle of dot-com crash wasn't very bright then part of my career. I left Avnet and went into this EMS business before. And that company was also public, a company called SMTEK. That stock went from $0.35 to $15-plus and in 18 months we were able to sell it. It had moved $0.35 to $15. I didn't want to sell it. I thought the stock could continue to go up. But the larger shareholders thought $15 and that type of growth in that short period of time was the time to sell the company.

Rich [SMTC's COO] had worked with me at SMTEK. Steve [SMTC's CFO] had been a customer of ours and sat on a board. And then Terry [SMTC's SVP Sales & Marketing] and Phil [SMTC's SVP Global Planning and Supply Chain] worked with me at Avnet. So this is a pretty seasoned team. You wouldn't normally see these people working at a $400 million contract manufacturer, except we like working with each other. So it's kind of like putting the band back together and working together.

[Slide 7] This is one of the keys to our secret sauce. I may not look very impressive to you, but we are really good at engaging customers and onboarding customers. You don't grow 50% organically year-on-year and you don't grow the way we've grown unless you know how to take customers onboard them and keep them happy. And so if you take a look at the top, that's how we engage with new customer. If you take the bottom down on a below, it's how we engage with new product. We are very strict on how we do engaging new customers and new products. And that's one of the secrets of why we can grow 4 to 5 times our industry.

And so for the past two years, we've outgrown our industry, quite a bit. And people say to me, don't you get nervous about growth? And my answer is, absolutely not. I love growth, I've lived my whole career in growth. One of the greatest things about growth, it covers up some of the things you screw up as you go along the way. If you don't have growth, every mistake you make becomes magnified 10 times. And so if you do have growth, sometimes you can cover this up and not see all those mistakes. So I know I'm human and not perfect, but if we have the growth, we can cover that bullshit up and move on from where we are.

[Slide 8] Here's our footprint. As you can see when we leave Dongguan, China, we will be out of China. We will keep an office in Hong Kong. We continue and we buy tens of million dollars worth of product in China and move them to our Mexico plant, we buy plastics, we buy other things over in China will continue to do that. So we'll leave some people there. We have a warehouse to avoid tariffs and taxes. It's a pretty complicated way to avoid them because as we move them into Hong Kong, then we move directly to Mexico. We're not under the auspices of the U.S. government. We move them into Mexico, we change the harmonic code and by the time they come into the U.S. they're under a different harmonic code and we don't pay tariffs.

Our original tariff bill, if I can remember the numbers correctly, when they announced the tariffs, it was $13 million. We were able to – by using this methodology to take that $13 million down to less than $500,000. And so we've been able to work around the tariffs pretty successfully over time.

We have two facilities in Mexico and as you know, Mexico is a growing entity for the U.S. manufacturing market. We have Zacatecas, which is in the center, a geographic center of Mexico, small town. I would not expect us to continue to grow there, only because the labor force, you're in a town of 4,000 and we employ 700 of those 4,000. I don't see a lot of growth there for us. Right now, we bused people in. We'll continue to do that.

But we would rather grow in Chihuahua. Chihuahua is much bigger city, much bigger labor pool. We've been in Chihuahua for 30 some years. We just celebrated an anniversary, had the Governor and Mayor come in, not to joke too much about it, but I try to sit as far away from them as possible, because they're always a target down in Mexico. And so the politics of the Mexican world is pretty crazy. If you think about Chihuahua and why I even say that is, if you look at the – what happened with the people, the Mormon People that were coming up we're not very far from there. So I actually have a security company that continues to monitor, who our employees are, who our management team is, how they're connected into the local market, used one of the things that you need to continue to do if you're going to do business in Mexico.

Our Melbourne, Florida plant is really one of the more exciting things when we bought MC, you can stand in a plant. We were there the other day at a meeting. We stopped the meeting at 09:48 and watched the SpaceX launched Falcon 9 rocket. So we can actually see it from there and that was pretty cool. But that whole town shuts down, when rockets are firing from Cape Canaveral. We can actually see them. We're right in the middle of Boeing, TRS, L3, we are in the middle of the military world. That plant builds military products. I expect that point to double over the next year to 18 months. So pretty exciting time for Melbourne, Florida there.

We're in Boston, Massachusetts. We made some announcements on that last year and we turned that into a new product introduction center. So this way engineers can come in, they can play with their designs, they can make it better, we can help them, our test engineers. So one of the things somebody asked me earlier this morning is how many engineers we have? Through the company, we have over 90 engineers. So we do everything from metal engineering, plastics engineering, test engineering, electromechanical engineering and we help our customers. We don't design a product, we just help them make it better, more manufacturable, higher quality.

So we question today, Toronto, Canada. I even got this question on the elevator today. It shows that we are headquartered in Toronto, Canada and there are 20 people in Toronto, Canada. That is where the company started.

SMTC stands for Surface Mount Training Center. It used to be an IBM division, where they tried out and engineered all the new products. And then it was spun out of IBM. We don't move the headquarters out of Toronto, Canada yet because our auditor would be considered a change of auditors if we moved to the U.S., because it's between two companies and there's no reason to go through that expense because there's just no reason. But we don't go there very often. Steve goes there pretty often. He goes, because our finances are done up there.

San Jose, we're on the same street if you ever go to visit Tesla, just keep driving down the street, you will see our plant. We are in Fremont, right outside San Jose. And so it's pretty cool. We have Tesla on one side and we have Didi [Chuxing] on the other side, Chinese Uber is on the other side. There's good news and bad news. There's a lot of good talent up there. The bad news is when Tesla is putting a crash on for cars, guess what they do? We started offering our people all kinds of incentives to leave us and then the quarter ends then all our people want to come back and work for us again. So a little bit chaotic up there in San Jose for sure.

Phoenix. Phoenix is our Center of Excellence for our supply chain.

And in Texas, El Paso, a pretty important place for us, this is where we move goods in and out of the U.S. So we have to bring in raw goods out of the U.S., it goes through El Paso. We are CTPAT certified. So we do not go through the customs. We do our own customs work and then we put finished goods back out through El Paso. The reason, El Paso, because there's all the border crossings, the reason we go through El Paso is we can hit any one of the 50 States in two days in normal transportation. And so our customers can expect two days having their products without paying any expedited fees.

The common copy and exact solutions, so anybody that knows Intel. Rich started his career Intel Quality in electronics. So we follow copy exact. That's an Intel thing. That means you can build any product on any line on any factory because you have the process down and just copying it.

[Slide 9] This is the markets we play in with pictures. And I won't bore you too long with these pictures other than, if you look at the little retail payment systems, that little black box, that's what I was telling you about, that you see a Chili's, how many of you have young kids? So you guys get it, you go there to Chili's, they played a little games, you try to keep them focused and then when you want to pay the bill and get out as quick as possible, you put your credit card in there. You don't have to wait for the waitress or waiter to get you in and out.

So the thing to the right of it is pretty interesting. You ever go to a candy bar machine and pay for a candy bar now with a credit card or soda or any of those, those little square boxes on there? We do those. And it started out, who invented that whole payment system? I'll surprise you, M&M, Mars Candy. And they did it because people didn't have changed and they were losing sales in their little candy. So they said, we've got to come up with a way that people can buy our candy when they don't have cash. And so we build those.

The gas pump looking thing, we build 80% of the payment systems in gas pumps in the country. So if you go buy gas, when you put your credit card in. We probably built that. We do 80% of those. So we're really good in the payment systems, in the payment system business. We're now branching out into the aerospace and defense systems. I announced that in our third quarter conference call that we booked $22 million of new customers and new programs and $15 million of that was in the aerospace defense, aerospace sensors, aerospace communications and aerospace missiles. So we're branching out an aerospace and defense. Test and measurement, we are growing.

[Slide 10] There you'll see in the numbers, and I'll go to that page. If you see our test and measurement growing, it grew from $26 million to $45 million and the first nine months of 2019 it's already doubled 2018, and you may say what's driving that? And it's 5G, we're the provider of 5G over in Korea. We were to provide our 5G in Southeast Asia. So 5G is really driving test and measurement for us. And one of our customers had lost that project and we were able to help them get product out within two weeks, where their competitor couldn't get products out in two months and we wanted up helping them win the Southeast Asia business.

Industrial, power and clean technology, some people call it IoT, because they think IoT is really cool. I think IoT is not that cool, but that's my own personal opinion. Because I think we've been doing IoT for a long time. There we make meters and different things, where it communicates using modules either through Wi-Fi, 3G or LTE.

Sorry about that. I have a little cold today. And then most important, if you look at the last line there, aerospace and defense. Two years ago, we did not – zero aerospace. Last year, we did $5.1 million and this year we will finish about $22 million. Next year, I expect that to be almost $50 million to $100 million, all depending about what contracts we land. And you might say, why do I point out aerospace and defense is because it's our highest margin business. And so somebody said, do you think you can sustain 12% gross profit? My answer is not only, we will sustain it. We will grow it from where it is today going forward.

[Slide 11] It's a little bit on the financials. We have about 28.1 million shares out, fully diluted 28.9 [million]. Our net debt, and so this is always interesting number is about

$70.2 million of bank debt and $14 million of leases. Our Florida building actually falls into a lease even though it's rent, because of the term of the lease. So if you think about $25 million of EBITDA for the year, which we put out, and $70 million of bank debt, our bank debt now less than three turns.

And so somebody said, one of the big questions I get is how comfortable am I and what leverage? I'm very comfortable at three or under. I'd like it to be two and under. But what CEO would like to have no debt. It'd be nice to have no debt. But I'm very comfortable that in one year we went from 4.2 times bank debt down to less than three. And so I expect that to continue.

Our stock price on 11/8 was $2.45. The good news is in the short couple of days since 11/8, our stock price now is today was at $3.15 to $3.20. So it's made quite the move over the last couple of days.

Long term, we continue to believe that our revenues will grow double-digit. Our gross margins will continue to be in a 12% or 14%. And our EBITDA margin will be between 5% and 10% depending upon quarters and all of those different things and seasonality. But the reality is we will be the number one company financially when we finished the year. As you may see in baseball, going from worst to first, in the last two years.

[Slide 12] Balance sheet, so this is where we have some work to do. Our cash to cash cycle is now 78 days. We're going to get that back down into the low-60s. We had it actually at 58 and we've let it sneak up a little bit on us during the acquisition and we'll go get that fixed.

[Slide 13] And then, I won't bore you with this other than this kind of lays it out. We're going to be a high growth company with good financial metrics, which was always a good for returns.

So with that, I'll take any questions you may have.

Q&A A *[Please note the conference provider did not have microphones for the audience asking questions which caused the questions to be inaudible and not transcribed.]*

<Q>: [Question Inaudible]

<A – Edward Smith>: So we think we'll have free cash flow of $14 million plus. Well, we're going to do is pay – first thing, we're to do is pay the debt down enough to get out of a term loan. And convert all our debt to an ABL. And the only thing that would change that is, if we did another acquisition. And obviously pay that through debt. But that would be the goal, if everything remained significant.

One of the nice things about closing our plants in China, we were going to spend about $7 million in CapEx next year. That cost that in half. We're going to move that equipment from China into our other plants. So we'll save ourselves about $3.5 million moving that.

So we think we'll take the debt out. We'll have to invest less into capital equipment and we'll get a better return. Did I answer what you…

<Q>: [Question Inaudible]

<A – Edward Smith>: We did it. Closed it on June 30, before this – just as a second quarter ended, we raised $14.6 million, after expense, I think it was $13.9 million after all expenses. And we did, I think it was $3.15 or $3.19. And we were oversubscribed multiple times, $3.75 or something. So we had a couple of backstops that we actually didn't wind up using. One last question then I had got to go, because my little red light is flashing. Any more questions?

<<Edward Smith>>:

Well, thank you for your time. I appreciate it. Thanks for your support.