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SMTX - Q4 2017 SMTC Corp Earnings Call

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CORPORATE PARTICIPANTS

Blair McInnis *SMTc Corporation - VP of Finance & Corporate Controller*

Edward J. Smith *SMTc Corporation - President, CEO & Director*

Roger Dunfield *SMTc Corporation - CFO*

CONFERENCE CALL PARTICIPANTS

Charles Neuhauser

Steven Kohl

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the SMTc Fourth Quarter and Full Year 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference may be recorded. I would now like to turn the conference over to our host for today's call, Mr. Brian (sic) [Blair] McInnis. You may begin.

Blair McInnis - *SMTc Corporation - VP of Finance & Corporate Controller*

Thank you, Atoya. Before we begin the call, I'd like to remind everybody that the presentation includes statements about expected future events and financial results that are forward looking in nature and subject to risks and uncertainties. The company cautions that actual performance will be affected by a number of factors, many of which are beyond the company's control. And that future events and results may vary substantially from the company -- what the company currently foresees. Discussion of the various factors that may affect future results is contained in the company's annual report on Form 10-K, on Form 10-Q and subsequent reports on Form 8-K and other filings with the Securities and Exchange Commission. All forward-looking statements are made as of the date of this call. And except as required by law, we do not intend to update this information. This conference call will also be available for audio replay in the Investor Relations section of SMTc's website at www.smtc.com.

I will now pass the call over to Eddie Smith, the company's President and Chief Executive Officer.

Edward J. Smith - *SMTc Corporation - President, CEO & Director*

Thank you, Blair. Welcome, and good morning, ladies and gentlemen. I'm Eddie Smith, SMTc's President and Chief Executive Officer. On this call today with me is Roger Dunfield, SMTc's CFO; and Rich Fitzgerald, our COO. It's hard to believe that it's been nearly 12 months since as I was appointed President and CEO of SMTc. Shortly after joining the company, we put in place a series of initiatives to restructure and reposition the business to become a more successful, end-to-end electronic manufacturing services or EMS provider to address our customers' needs. While we still have more to do, our team has accomplished much in a short period of time. Some of our accomplishments include: we made significant progress to stabilize our operations with our global restructuring plan that was designed to align our cost structure with our revenue levels; we consolidated our Chinese operations to utilize our facilities more effectively; we received our FDA registration and certification for our Chihuahua operations; we expanded our sales channels, adding new customers, at the same time reduced the fixed costs associated with selling channels by adjusting the mix of fixed versus variable expenses with an increased use of third parties. We worked closely with our customers to regain their confidence and have stabilized our customer base, and more importantly, are beginning to expand that base and added new product lines that we support.

And finally, we strengthened the organization with key hires including Rich Fitzgerald, our COO; Bob Miller as Vice President of Customer Acquisition; And Steve [Wozac], Vice President of Mergers and Acquisitions. In the fourth quarter, we exceeded our plan and achieved sequential growth of 12.2% in our revenue and 11.3% in our adjusted EBITDA over the third quarter of 2017. While I'm pleased with our progress thus far, I'm even more



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excited and looking forward to SMTX's next phase of operational improvements. We will turn our attention from cost reductions to growing the company's top line, both organically and through accretive acquisitions to increase our scale, improve our margins, adjusted EBITDA and ultimately return to profitability. We believe crisp execution of our strategic plan will enable us to deliver enhanced shareholder value.

I'll now hand the call over to Roger to review the financial details, then come back with some additional comments. Roger?

Roger Dunfield - SMTX Corporation - CFO

Thank you, Eddie, and good morning, everyone. Revenue for the fourth quarter of fiscal 2017 was \$38.6 million compared to \$39.7 million in the same quarter in the prior year, an increase compared to \$34.4 million in the third quarter of fiscal 2017. The increase from the prior quarter was primarily the result of revenue opportunities from both existing customers and new customers, increasing production during the quarter. For the fiscal year 2017, revenue was \$139.2 million compared to \$167.9 million in 2016. Gross profit for the fourth quarter of 2017 was \$2.9 million or 7.5% of revenue compared with \$3.4 million or 8.6% of revenue for the same period in 2016; and \$3 million or 8.5% in the third quarter of fiscal 2017.

Adjusted gross profit, which excludes the impact of unrealized foreign exchange gains or losses on unsettled forward foreign exchange contracts, was \$3.4 million or 8.9% as a percentage of revenue in the fourth quarter of 2017 compared to 3.6% or 9 -- \$3.6 million or 9% in the same period in the prior year. Gross profit in the third quarter of 2017 was \$3 million or 8.6%, and adjusted gross profit was \$3.1 million or 9%. Net loss was \$0.9 million for the fourth quarter of 2017 compared to a net loss of \$0.6 million in both the fourth quarters of 2016 and 2017.

Adjusted EBITDA was \$1.2 million in the fourth quarter of 2017 compared to \$1.1 million for both the fourth quarter of 2016 and the third quarter of 2017. The increase in the fourth quarter of 2017 compared to the prior quarter is due to improvement in adjusted gross profit from higher revenue, partially offset by additional selling and general administration expenses to support the revenue increases.

While our net losses fluctuated due to swings in unrealized gains, foreign exchange gains and losses on unsettled foreign exchange contracts, we have stabilized our adjusted EBITDA and improved over prior quarter.

Before I turn the call back to Eddie, let me also add, we remain focused on making additional working capital management improvements to accelerate efforts to strengthen our balance sheet and reduce our net debt. At the end of December 31, 2017, we had working capital challenges regarding collection of a small number of customers which held payments. The outstanding balances for these customers were substantially collected subsequent to year-end.

Now I'll hand the call back to Eddie to provide some additional remarks before opening the call for questions.

Edward J. Smith - SMTX Corporation - President, CEO & Director

Thanks, Roger. I'm pleased that we continued to implement our strategic plan and produced another quarter of quarter-over-quarter growth in revenue and adjusted EBITDA. Our accomplishments in 2017, expansion of our sales funnel, provides support that 2018 can position us to achieve double-digit top line growth and adjusted EBITDA incremental growth during 2018.

With that, let's take questions from those on today's call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have a question from Steven Kohl of Mangrove.



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Steven Kohl

I had a couple of things I wanted to speak to. Eddie, when you look at the strategic plan, kind of looking out to '18 and double-digit top line growth -- and I may have missed this, I think you said just incremental growth in adjusted EBITDA. Can you maybe spend a few minutes kind of speaking to what -- how the model's likely to work as we scale? So as we start to ramp up revenues, when we start to see margins improve and at what level do we start to move into a GAAP profitability point of view here? And do you see that happening this year at some point?

Edward J. Smith - SMTC Corporation - President, CEO & Director

Yes. So first of all thanks, Steve, for attending; and I know it's late for you, so I appreciate you attending. Yes, for us there's been 2 things that affect -- so let's talk about scale. Obviously, our scale matters. And as we scale up, if you had X growth in top line sales, you normally have X plus something in profitability because of scale. And so we didn't see that last quarter only because, in doing what we did last year to get ourselves more aligned, we needed to add some resources back. We no longer need to do that. So if we grow X -- say X is 10 -- our EBITDA would grow X plus or 10 plus something. And so our profitability as we grow next year, and I said it would be double digits, our profitability will grow that double digits plus something else because we will scale and make our factories more efficient as we fill them up, right? You only have to pay for lighting once. You only have to pay the rent once. So once we've covered those fixed costs, we get the leverage that we need that have additional margin. So we believe that we will become, like I said, X plus that more profitable. As far as the GAAP -- the second question, which is a great question, one that's a little bit frustrating to me is, when I got here, there were a lot of hedges that were done because a significant amount of our revenue is done in Mexico. So we have a lot of hedges. As you could tell, some quarters that's better, some quarters that's worse in our net. So half of the movement in the net income is from those hedges -- UFX, as we call, unrealized foreign exchange. And Roger talked about them. I have changed our hedging program, and we changed it last quarter, so that we don't have those type of the swings and that type of variability. So with all that being said, we have a better line on to GAAP profitability. And I believe as we get into the second part of next year, we will be GAAP profitable in the company based on our forecast.

Steven Kohl

Okay, thanks. And last question, and I'll hop back in the queue, is when you look at -- you talk about organic growth and acquisitions, when you look at the -- when you -- given the current capital structure that you have, what types of things would you look at from an acquisitive standpoint? Are you trying to sell particular facilities? Are you targeting certain markets? I know you've addressed some of these -- I know you mentioned them in the past; are you seeing sufficient opportunities out there to give you confidence that you'll be able to close some of this stuff this year?

Edward J. Smith - SMTC Corporation - President, CEO & Director

Yes. So I have spent a significant amount of my time -- and that's why I brought Steve on to do M&A -- significant amount of my time analyzing the market for what's available, what would be -- we'd be interested in. So clearly we don't play today because of our corporate structure in the ITAR, mil, aero, defense and medical space. Now the first part of it, mil, aero, we don't do that because of the way we're structured. And so one of the things with an acquisition, we'd like to change that, so we can play in the ITAR business, the mil, aero defense. But what as -- I call highly regulated markets. And the second part of that, the medical, we're going to do that organically. So last quarter we added a couple of medical customers on. We got our FDA certification and registration, both. Normally that takes about a year. Rich and his team were able to do that in -- a speed that I never thought was possible, in about 6 weeks or so. So we're looking for accretive acquisitions that have some reasonable scale that play the in medical and military market because those customers are normally more profitable and they're a little more sticky going forward, little more long term. And there is possibilities out there.

Operator

(Operator Instructions) The next question is from Craig Booth, a private investor.



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Unidentified Participant

Yes, so I was just wondering if you could elaborate a little more on the return to profitability. I guess I was expecting it to have already happened this quarter or maybe at the latest, the current quarter. I'm just wondering what, kind of, slowed it down, the delay? You maybe did kind of hit on it on the last call, but if you could just elaborate on it a little more I'd appreciate that.

Edward J. Smith - SMTX Corporation - President, CEO & Director

Yes. And so when you measure profitability for EMS companies, they measure it two different ways. One is EBITDA, and that's really what most people get a multiple off of in EMS companies, is a multiple off of EBITDA, and that's how companies are valued in our space. And obviously 2 quarters ago we weren't profitable on the EBITDA in Q3. We gained a little profitability in Q4, and we expect that trend over the next year to continue to get better, and our scale will help that. The second thing that I think you're referring to and I think Steve referred to is the actual GAAP net income profitability. And that's a little bit -- in our space, a little bit more tricky because you have depreciation, you have tax, you have amortization, and we are a very capital-intensive business. So you have to utilize those assets to 100% to be able to get the net income positive. So as I said, I think as the year goes on, you'll see us first get closer and then become net income positive. We do have one little -- I would call it different than our competitors and that is getting our hedge -- hedging right and getting that fixed. And so we have put a new hedging strategy in, in Q4 and that will show some effect as we get into Q2, Q3. We do -- in our forecasts, we do -- like I said, our net income spots. So I did not expect to be net income positive. So I know you expected, but we had put together a restructuring plan and we did not expect Q4 to be net income positive. So we're -- we did better than we thought. But I didn't expect that we would be able to overcome the utilization issue for a couple of quarters.

Unidentified Participant

Okay. I guess, maybe I misunderstood the previous call from a quarter ago. I was thinking that this was the quarter we were going to turn profitable or at least break-even. So maybe I had a misunderstanding on that; I'm not really sure. And I guess to go little further, I think on the last call you had talked about -- there was 4 different potential customers that we were hoping to get signed, and I'm wondering if you could elaborate somewhat on that.

Edward J. Smith - SMTX Corporation - President, CEO & Director

So Craig, we've signed all 4 of those customers. And we probably have added a couple more. The supply chain in the semiconductor space and the electronic space is extremely tight. But the first 2 significant customers actually had revenue last quarter. And obviously, they gear up as the year goes on. It takes about a year for a customer to get to what I would call 100% efficiency. So in Q4, 2 of them were actually in, building stuff in our factories. 1 is actually moved out to Q2. So we got 0 revenue from 2 of them, but we expect to be building for all 4 in Q2, partly because the supply chain is very constrained out there. Now we have not affected our revenue to date because of those supply chain. But as you look at other EMS companies and they do their earnings announcements, they actually have spoken about the constrained supply chain. Lead times have gone out. From 2 to 3 years ago, where there were 8 to 12 weeks lead times in our marketplace, are between 26 to 52 weeks with some parts even being allocated, which means that you have to get special allocation when you're moving customers around and that delays it. We've been very blessed that we've been able to bring 2 customers on with none of those supply chain issues. So I give Rich and his team a lot of credit that we haven't run into those supply chain issues. But the reality is, no customer immediately comes on, but all 4 of those we've talked about are now building with us. They're signed and supply chains in place and starting to move forward. Plus, we've added a few new customers, as we've gone here. But with all that being said, Q1 is normally our seasonal quarter where -- it's our least strong quarters. So we have some work to do in Q1. But for the year, I would tell you right now, as long as supply chain doesn't get in our way, it is going to be an excellent year.



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Unidentified Participant

Yes, it definitely sounds good to me going forward. I guess it was just the timing of it that had me somewhat concerned. What do you see looking further down the road for potential contracts or new customers? It seems like you had hinted on that the previous call that there was some stuff in the possibility stage. And I'm just wondering if you got any more updates on that?

Edward J. Smith - SMTX Corporation - President, CEO & Director

Sure. We've added a head of sales. So that we had a little more focus in what I would call the organic growth area. Our pipeline is up significantly from where it was in terms of quotes and activity. We continue each quarter to add customers -- 1 or 2 per quarter, maybe sometimes more. I think the reason that I announced the 4 customers a couple of quarters ago is because while we were restructuring, it's normally very difficult to attract customers when you're in a middle of a restructure, because your financials -- you're announcing lagging information. So customers normally don't want to sign with somebody who's struggling. The fact that now we're starting to make an EBITDA profit and we're starting to be more efficient in how we operate in terms of other financial metrics, I think it's going to even lead to more customer contracts. So right now we're pretty satisfied, but I will tell you, interestingly enough, we're going to see growth this year from a lot of our existing customers giving us additional programs, additional business. And that had not been in past -- in the previous past. So I would tell you, Craig, I am satisfied with where we are on the sales side. Obviously, I'd like the top line to grow 25%. I'm not so sure the supply chain today would allow that to happen. It's not easy to move supply chains today, for sure.

Unidentified Participant

I guess, one last question. Assuming that we reach all of our goals and maybe even exceed somewhat, is there a potential to ever bring back our closed plant in China? Or is that something that is totally done and over with? I'm just wondering maybe we need to have more capacity like that in the future. I'm just wondering what's out there, whether it be the one we closed or what other possibilities are there.

Edward J. Smith - SMTX Corporation - President, CEO & Director

I would say if we're going to expand in China, it'll be through M&A, where we buy somebody and they have a facility in either China or Southeast Asia, in the low-cost regions. I don't see we green-fielding anything in China right now. Many of our customers are actually bringing things back from China to our Mexico plant. So I would say I don't foresee us opening another plant in China, greenfield. The only way that will happen is through M&A.

Operator

The next question is from Charles Neuhauser of Mainwall Investment Management.

Charles Neuhauser

Actually, I was going to focus on new customers and sales growth and pretty much everything you just discussed. But specifically, could you let us know how -- if you're looking at double-digit revenue growth this year, how much of that would come from new customers compared to existing customers giving you more business?

Edward J. Smith - SMTX Corporation - President, CEO & Director

Definite -- it's a phenomenal question -- first of all, hello, Charles and phenomenal question. I would say it's about split, 50-50 in growth of our new projects within our existing customers. We've put an effort. When I first came in a year ago, I said the quickest way we can grow is to get more business from our existing customers. Because adding a new customer takes about a year for us to be fully baked, get up to full speed, get operational



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efficiencies. And I didn't think we had that amount of time to do that, and I wanted to move quicker. So we've been pretty successful with our existing customers and growing them. So for the year, overall, new versus existing customer growth, I would say it's about 50-50. But I say that now, and like I said, our quote log hasn't been more robust. And so if we land a couple of those quotes, it could tilt to new customer being more growth than new projects within our existing customers.

Charles Neuhauser

Okay, well, that sounds pretty good. So I understood what you said about new customers being leery about signing on if you're in the midst of a restructuring. But it sounds like you have got over that hump with new customers and that your existing customers have given you somewhat of a vote of confidence by giving you new business. Is that pretty much the way you feel?

Edward J. Smith - SMTX Corporation - President, CEO & Director

I'm going to have you run these calls. It's perfectly what I was trying to say. So -- exactly, our -- we were able to talk to our existing customers when we did the restructure plan and told them what we expected. And we beat all those milestones. So obviously they have confidence: "Okay, they're doing what they said they were going to do, plus." So we gained their confidence. The new customers -- many of the new customers had a relationship with one of the executives at SMTX, and they were able to walk them through the restructuring plan and make them comfortable that our restructuring wouldn't affect their manufacturing. So I think we're over the day-to-day concerns. I think it's now into the growth. I kind of put the restructuring plan together as first stabilize the company, then make it EBITDA-positive and then grow. We're in the grow. And when I say grow, there's 2 ways to grow, obviously: organically and then acquisitively. And so I think the organic is well on its way. And I think the next phase of that is -- and that's why I've hired Steve to be the Vice President of M&A, because the next phase is to go out and look at the right acquisitions and get us in new markets.

Charles Neuhauser

Good. Well, as you said, when you first started speaking this morning, it's been less than a year since you've been onboard. And frankly it sounds like quite a lot of progress in fairly -- and realistically, a fairly short amount of time.

Edward J. Smith - SMTX Corporation - President, CEO & Director

Thank you. Thank you very much. And the team's done a great job. I couldn't be prouder of the people here at SMTX, for sure.

Operator

I'm showing no further questions in the queue at this time. I'd like to turn the call back over to Eddie Smith for closing remarks.

Edward J. Smith - SMTX Corporation - President, CEO & Director

Sure. Thank you very much. I'd like to once again thank our valuable customers, our supportive suppliers, dedicated employees and our patient investors for their -- and customers for their commitment and drive every day. We have exciting opportunities ahead of us as we move past our restructuring phase into our growth phase during 2018 and beyond. While the first quarter of 2018 has seasonality, I look forward to updating you on our progress in 2018 on our next earnings call. Have a good day. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for participation, and have a wonderful day.



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