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MC Assembly Acquisition Conference Call

Tuesday, November 13, 2018 at 8:30 a.m. Eastern

CORPORATE PARTICIPANTS

Blair McInnis – *Vice President of Finance*

Eddie Smith – *President and Chief Executive Officer*

Steve Waszak – *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the SMTC's acquisition of MC Assembly Conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your touchtone phone. To withdraw your question, please press star, then two. Please note this event is being recorded.

I would now like to turn the conference over to Blair McInnis, SMTC's Vice President of Finance. Please go ahead.

Blair McInnis
Thank you. Before I begin the call, I'd like to remind everyone that the presentation will include statements about expected future events and financial results that are forward-looking in nature and subject to risks and uncertainties. The forward-looking statements on today's call include, without limitations, statements regarding the company's plans, including prospective financial information for SMTC as a standalone entity for the fourth quarter of fiscal 2018.

This prospective financial information has been prepared by and is the responsibility of the company's management. The company's ability to execute its growth plans, including the outlook of the combined business, projections regarding the combined business, and strategic and financial benefits of the combined business, are forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995.

The company's management believe that the quarterly forecasted revenue and Adjusted EBITDA have been prepared on a reasonable basis, reflecting the best estimates of judgments and represent, to the best of management's knowledge and opinion, the company's expected course of action. Actual results could differ materially from those projected in those statements as a result of a number of factors, including but not limited to adverse changes to the key markets we target, reliance on a small number of customers for a portion of our sales, risks arising from our international operations, competition that could cause us to lose sales, and the other factors set forth in the company's annual and quarterly reports filed with the SEC.

The company is under no obligation to and expressly disclaims any such obligation to update or alter any of the forward-looking statements made in this release. The company's website, including material available in the Investor Relations section of our website, whether as a result of new information, future events, or otherwise, unless otherwise required by law. Because this information is highly subjective, it should not be relied on as necessarily indicative of future events. 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 what the company currently foresees.

Discussion of the various factors that may affect future results are contained in the company's annual reports on Form 10-K, Form 10-Q, our press release announcing the acquisition of MC Assembly dated November 9, 2018, 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.

In addition, during the call we will reference the consolidated results of SMTC and MC Assembly for 12-

month period ended September 30, 2018, as well as Adjusted EBITDA. Please note that this information has been extracted without material adjustment from the underlying schedules used in preparing SMTC's and MC Assembly's financial statements excluding the impact, if any, of any purchase price accounting adjustments for the 12 months ended September 30, 2018.

EBITDA is not an earnings measure recognized by GAAP and does not have a standardized meaning prescribed by GAAP. Accordingly, EBITDA may not be comparable to similar measures presented by other companies. EBITDA should be considered in addition to and not as a substitute or superior to operating income, cash flows, revenue, or other measures of financial performance prepared in accordance with GAAP. EBITDA is not a completely representative measure of either the historical performance or necessarily the future potential of the combined entities.

These non-GAAP financial measures should not be considered in isolation and should be viewed in addition to, and not as an alternative for, the company's reported results prepared in accordance with GAAP. Additionally, the company's non-GAAP financial information may not be comparable to similarly titled measures reported by other companies.

This conference call will also be available for audio replay in the Investor Relation section of SMTC's website at www.smtc.com. Now I will pass the call over to Eddie Smith, the company's President and Chief Executive Officer.

Eddie Smith
Thank you, Blair. Welcome and good morning, ladies and gentlemen.

I'm Eddie Smith, SMTC's President and Chief Executive Officer. On this call with me today is Steve Waszak, SMTC's CFO.

Last week we reported our Q3 results and I'm pleased today to discuss our recent announcement released Friday, November 9 to acquire MC Assembly.

To aid you in understanding how the acquisition changes the profile and opportunities for SMTC, we update our investor slide deck, which is on our website. The acquisition is both accretive and, more importantly, we believe transformative, and puts SMTC on a path that significantly accelerates our growth, and further believe we will create significant value for our shareholders and offer strong benefits for customers of both companies.

Steve will discuss the details of financing package associated with the transaction to acquire MC Assembly. But before we jump into our announced acquisition, I wanted to reflect on my vision and talk briefly about what's occurred at SMTC under the existing leadership team.

It was important, when I came on, to stabilize the company and solidify things before we went out and made an acquisition like the one we announced last week. When I came in, SMTC was experiencing some fairly meaningful challenges. Revenue was contracting, the company was experiencing losses. My first order of business was to stabilize the business, rebuild trust with our customers on our ability to deliver quality products on time, and with a company possessing sound financials, to make sure their needs were going to be met going forward, ensuring we had a strong business.

It was also critical for me to build the right executive management team, which I believe I have done. Over the last 18 months, as a team, we've accomplished a lot. In 2017 when I first entered the picture, revenue was contracting, while 2018 revenues were up more than 34.5% for the nine months ended September 30 as compared to the same period of 2017. Fortunately the market has taken notice of what's been accomplished and our stock has performed well on an absolute and relative to the overall market.

We feel like we've positioned the business well and established a strong platform and team for even more growth. One of the ways this can be accomplished is through acquisitions. This is an executive team with tremendous experience in executing and integrating acquisitions. We feel like we've found an incredible fit with the acquisition of MC Assembly.

I'd now like to talk about the strategic merits of the MC acquisition and tell you why I'm so excited about the merger of equals. Importantly, we achieve scale with respect to revenue, customer, cash flow, and facilities. MC gets us further into highly complex regulated end markets, where the combined company will benefit from expanded presence in what we believe to be highly attractive, growing, and underpenetrated end markets of aerospace and defense, industrial, and medical, all end markets where we can achieve the right margin profile for our shareholders.

The acquisition will also strengthen the combined company's presence in the growing industrial IoT market. Both companies share customer focus and dedication to operational excellence, no customer overlap, further diversification across customers. The combined customer list will be populated with a diversified breath of industry-leading top tier OEMs and service providers across attractive end markets.

Complementary geographic footprint, six facilities in total, three in strategically positioned areas of the US close to critical customers: Silicon Valley, Northeast for medical customers; two sites now in Mexico, which is of growing importance; and one in China. We believe this combined footprint is particularly important, considering the trade tariff environment, which is driving meaningful growth to North American-oriented EMS providers.

On the financial side, we believe this is a very compelling and accretive acquisition. We've acquired the business for our mid-six multiple on trailing Adjusted EBITDA, which, given MC's financial profile and strategic merits of the deal, is attractive pricing. We also believe we've executed a successful financing package to support the acquisition and fund strong lending partners in PNC, who was SMTC's existing lender, and TCW Direct Lending.

While we are comfortable with the current leverage profile, we are and will continue to be laser-focused on de-leveraging the balance sheet as we integrate MC Assembly and grow the combined business. Fortunately, the platform facilities and associated equipment are all in place to handle significantly higher levels of business and revenue. So the cash flow that we're generating will be available for debt repayment. We are comfortable with our free cash flow metrics and how that could translate to our ability to pay down our debt in the coming quarters.

And finally together, both management teams are working collaboratively to implement over $6 million of identified annual cost reduction opportunities from purchasing, operational advances, corporate and shared services, redundancies that our combined companies expect to implement during 2019, and our new non-reoccurring costs from approximately $3 million.

I could go on about these compelling reasons why this acquisition will change the trajectory of SMTC, but given time constraints of today's call and our desire to answer our stakeholders' questions, I'll now hand the call over to Steve to briefly review the transaction's details, and then come back with some additional comments before opening the call for questions. Steve?

Steve Waszak

Thank you, Eddie, and good morning, everyone. I appreciate you taking the time and having the interest to join us this morning. I'll keep my comments as brief as possible. We financed the acquisition of MC Assembly and associated transactions costs from proceeds of a new debt financing package along with cash from STMC's balance sheet raised in our rights offering. PNC Bank provided SMTC with a new secured $45 million asset-based revolving credit facility from which $22 million was drawn at closing.

Additionally, TCW Direct Lending, LLC provided SMTC with a senior secured loan facility in the amount of $67 million, of which $62 million was drawn at closing with $5 million available on a delayed draw basis to fund possible earn-out under the purchase agreement. After transaction closing, SMTC repaid all $27 million outstanding debt on our existing bank indebtedness. Finally, we are assuming a $10 million facility lease in connection with the transaction in the Melbourne, Florida facility.

Now I'd like to hand the call back to Eddie to provide some additional comments, some guidance and outlook for the fourth quarter, and open for questions.

Eddie Smith
Thanks, Steve. As I reported last week, we remain on track with our strategic goals and are in fact exceeding our annual business plan. Following our announced 56% same quarter Q3 year-over-year revenue growth and 34.5% year-to-date increase in 2018 versus 2017, the company is updating its current expectations, as previously updated on our July 23 press release, for the fourth quarter and full year in 2018 on a standalone basis before integrating MC Assembly.

SMTC as a standalone entity, the revenue range in Q4 will now be between $53 million to $56 million, or up more than 37% to 43% over Q4 2017 with an adjusted EBITDA of between $2.4 million to $2.6 million for the year ending December 31, 2018. We are on track to generate between $188.3 million to $191.3 million in revenues, or 35% to37% more than 2017 with adjusted EBITDA between $7.3 million and $7.5 million in 2018, as compared to a negative $1.5 million loss in 2017.

Steve?

Steve Waszak
As GAAP reconciliation, we arrive at adjusted EBITDA for Q4 2018 by adding back to our expected $700,000 of earnings our expenses of $895,000 for depreciation, $505,000 for interest, $179,000 for income taxes, $105,000 stock-based compensation, and $85,000 of restructuring charges. For the year ending December 31, 2018, we arrive at our adjusted EBITDA by adding back to our expected $1.5 million of earnings, our expenses of $3.3 million for depreciation, $1.7 million of interest, $564,000 for income taxes, $383,000 in stock-based compensation, $293,000 in restructuring charges, and a total of $338,000 from unrealized foreign currency gains and losses.

These GAAP reconciliations are posted to our investor website, at SMTC's website, www.smtc.com. Eddie?

Eddie Smith
In closing, our acquisition of MC Assembly we believe will significantly enhance our capabilities, enable SMTC to even better serve our existing customers, while positioning SMTC for an even faster and more profitable growth trajectory. And as I said at the outset of today's call, the acquisition is transformative and most importantly, combined company creates a more powerful diversified EMS provider with enhanced scale with a strong North American manufacturing footprint to address new growth opportunities.

For our stakeholders, the acquisition makes SMTC an even stronger company that delights our customers with superior service and rewards our stockholders with enhanced shareholder value. With that, let's take questions from those on the call today.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then two. At this time, we will pause momentarily to assemble our roster.

And our first question comes from Aman Gulani of B. Riley FBR. Please go ahead.

Aman Gulani
Hi, guys. Thanks for taking my question and congratulations on the acquisition. So my first question, going to get more color on what the top-line growth rate is for MCA, and then also the gross margin profile.

Eddie Smith
Yes, so we have not put out any information other than what we put out the other day on the MCA for the trailing 12 up to September. And so I would say their growth rate is lower than ours by a significant amount. That's something we can help them quite a bit on, Aman. So first of all, good morning.

And then, as far as the margin profile, when I talk about a MBA, their MBA is significantly higher than ours. When it gets down to the gross margin, it's much more in line with each other. So I think as we take SMTC's capability of squeezing out more margin out of that MBA, I think we can help make the situation more profitable. And that's one of the things we'll try to do is clearly make them more efficient in their manufacturing processes. Today we start off with a lower MBA and create about the same margin. So I think it will be accretive. And so we'll get in there and start working on that right away.

Aman Gulani
Okay, that's helpful. And then how quickly do you think you can extract the $6 million in cost synergies from the acquisition? And then you said you're going to take a $3 million non-recurring charge. So will that occur in the fourth quarter?

Eddie Smith
Yes, so we will start the synergies in the fourth quarter, but the ones that cost us the significant amount of that $3 million will start in Q1. So Q4 will be more of the purchasing synergies from our distributors and others. There'll be more of those type of synergies in Q4. Q1 will be more of the, what I would call, people synergies, but cost synergies will start in Q1 and finish out through the year in 2019.

Aman Gulani
Got it. Okay. And then, just moving on to the end markets. They're definitely bringing a diverse base of end market opportunities for you guys. What's the split of end market revenue for MCA, and then specifically what's the portion of aerospace and defense revenue for MCA?

Eddie Smith
Yes, so that's the exciting part, Aman. Of this whole deal, to me, the regulated markets of aerospace, defense, medical. We had gotten our AS9100 recently and put out a press release on that, but this will get us a jump right in it that we're already doing work. We're already doing ITAR work. It's about 20%

in the aerospace and defense. It'll be about 20% also in the medical. The rest is across industrial IoT. One of the things MC will bring us that we don't do a lot in today, which is the industrial IoT, a lot of Wi-Fi, a lot of communication, wireless communications in the Wi-Fi space, the LTE space, and some capability there.

As you know, with industrial IoT it's all about communication of data and moving data around. So if you think about it, we added on defense and aero, much higher margin, medical--a higher margin, and then industrial IoT. So it brought us some capabilities and probably some of our existing customers will be able to use some of those capabilities also besides new customers.

Aman Gulani
Got it, okay. And then just one more from me. In terms of capacity, specifically in your Mexican facilities, now that you have two. What does that look like? I know you gave me some color on the last call with the SMTC, the Mexican facility capacity looked like, but what about the new facility that you're bringing in?

Eddie Smith
Yes, so that's actually another really good question. So we had started down a path, before we went down this path of acquisition, of building another building on our 17.5 acres that we own down in Chihuahua. This actually gives us an opportunity to now be in two different cities in Mexico and expand in a lower-cost region. And so, they already have some capacity that we can utilize. So we're not under the pressure of we have to expand today or tomorrow, but I can see in the future expanding. And then we would expand in a lower-cost region in Zacatecas.

Aman Gulani
Got it. Okay, thank you. I'll pass it on.

Eddie Smith
Thanks, Aman, you have a great day.

Operator
Our next question comes from Lucas Davenport of Retail. Please go ahead.

Lucas Davenport
Hi. Good morning. Just two questions. The first question regards the percentage of capacity that MC is at in their facilities. And the second question is kind of a split. Part A, I guess, if you want to call it that, is the debt levels concern me a little bit regarding this deal. How long do you anticipate it would take to pay off at least a good chunk of the debt, if not all of it, before it comes down to more manageable levels? And second, how much of the debt would you, do you think would factor in as it pertains to interest payments on a quarterly basis? Thank you.

Eddie Smith
So, Steve, you want to take that?

Steve Waszak
Yes, so on the debt levels, we are focused on using our free cash flow to pay down debt, and we have some other alternatives for taking it on as well. So we do anticipate this coming down probably at least by a third on a leverage ratio within the year 2019 and we have some goals to even be more aggressive than that. So we're keenly focused on this. It's interesting. If you take the two companies before acquisition, obviously MC was private, we have actually the same or less debt on the balance sheet than the two companies combined had.

Also, our average cost at capital or blended cost of capital is probably in the 9% range. So we have, again, interest expense that we believe is certainly, we've modeled it and it's at or less than it was on the combined companies going into the transaction. So we feel very, very comfortable, although we understand it's something we need to focus on keenly, that we can service the debt and bring down the leverage within '19 in a very meaningful way. It's one of our top priorities.

Eddie Smith
And then, as far as capacity, and having additional capacity, all of the MC facilities had capacity that we could utilize, because we started bumping up against our capacity. In particular, down in Mexico, which was keen for us. They are below the 80% level. And I would probably not want to get into more detail of that, but we will have quite a bit of time now to go figure out, as we grow in Mexico at the rates we're growing, what we need to do next in Mexico.

We had got to pretty dangerous levels in our facility in terms of we were at 85% or above. And when the end of the quarter came around, because we built more towards the end of the quarter than earlier in the quarter, that became problematic. So we had been figuring different ways. The problem of building a building is it was going to take us 18 months, which would have been too long, and so we were out looking at other alternatives. And so, this is a good alternative for us right now. But clearly, based on the tariff and some of the other issues going on in the geopolitical world, I could see Mexico continuing to grow at a much faster pace than the rest of North American market.

Anything else, Lucas?

Lucas Davenport
That's it. Thank you.

Steve Waszak
Thank you, Lucas.

Eddie Smith
Thank you, Lucas.

Operator
Our next question comes from David Kohl of SMTC. Please go ahead.

Steve Kohl
Hi, guys. I've got both Kohls. I'll be chiming in on, it's Steve Kohl. Good morning. First of all, congratulations, and I am awake. So that's a good sign as well from the long trip, but I wanted to address a couple of things. Could you speak for a minute on MC's facilities in terms of conditions? I know SMTX in the past, we have been working on replacing equipment, what have you, what is the condition of their facilities? Is it relatively new? Is the equipment new? How are you feeling about that?

Eddie Smith
Yes, they had some really nice facilities. Myself, Rich, Steve all got the opportunity to tour the facilities. I couldn't be happier with where we are in equipment. We believe we won't be spending significant amounts of capital equipment to replace capital equipment. It would really be, if we have to spend capital, it'll be expansion capital in the future. But most of it will be repair and that type of work. But their equipment is newer than ours was and in better condition.

Steve Kohl
And when you look at their customer relationships, Eddie, are they long term? I know you did a great job kind of outlining kind of what their mix is. I'm just curious, what's the longevity? Have they had a lot of turnover in their key customers? Are they long-term customers? What's been the status of those relationships on some of the big ones?

Eddie Smith
Yes, they're very similar with the SMTC when I got here. They have a core set of customers that they have had long-term relationships with. And then they have, what I would call, the next outer band of customers where they stay for a while and then they move on as they grow or shrink. But their core customers—and when I say core, that would probably be 75%-80% of the business—have been there in a double-digit period of time.

Steve Kohl
Okay, and in terms of I guess looking at opportunities to leverage, I know you had talked about some of the cost savings in terms of getting EBITDA margins and leveraging them. Where do we see—and I think if you look, this year you guys have done a great job for example as revenues have gone up, retaining more on EBITDA—where do we have to be to get, as we look for the year, forgetting the synergy issue, should we see that just as you move more stuff from facilities and we get a bigger pop on margin as the year goes on as you move some of the stuff around and get better facility optimization? Or what are you thinking there?

Eddie Smith
That's actually a great question. I believe there's two ways we're going to get more margin in this particular deal. One is clearly synergies and that will get us more margin, but the second one is, I actually think the way we run factories as efficient as we are on less MBA, if we can help MC with that we will get more margin on the efficiencies. And then the third is factories and scale. As we fill each of the factories more, just like we did at SMTC, and we grow, that scale will drop a significant amount of margin to the bottom line.

So I would say it's a multiple-prong approach. One is to get the synergies out as quickly as possible and get the business running at a very high level. The second is making all the factories as efficient as possible. And then, the last is growing so that the factories have more scale and can drop more to the bottom line.

Steve Kohl
Right. Thank you very much, guys, I'll get back in the queue.

Eddie Smith
Well thanks, Steve, have a great day.

CONCLUSION

Operator
This concludes our question-and-answer session. I would now like to turn the conference back over to Edward Smith for any closing remarks.

Eddie Smith
Thank you, operator. I'd like to remind you that we'll be participating in two conferences this quarter: the ninth annual Craig-Hallum Alpha Select Conference in New York later this week; and in December at the eleventh annual LD Micro Main Event Investment Conference in Los Angeles. Information about

these events will be posted on our Investor Relations section of our website.

In closing, I want to thank our employees, leadership team, business partners, distributors, and our investors for their support. And very importantly, I want to welcome the MC Assembly team to SMTC, and, of course, reporting our progress to our various stakeholders over the next several quarters. So thank you and have a great day.

Operator
The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.