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# EDITED TRANSCRIPT

Q2 2020 SMTC Corp Earnings Call

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## CORPORATE PARTICIPANTS

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**Edward J. Smith** *SMTC Corporation - President, CEO & Director*  
**Steven M. Waszak** *SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions*

## CONFERENCE CALL PARTICIPANTS

**Michael Roy Crawford** *B. Riley FBR, Inc., Research Division - Senior MD, Head of The Discovery Group & Senior Analyst*  
**Steven Andrew Kohl** *Mangrove Capital Partners - Partner*  
**Tyler Leroy Burmeister** *Craig-Hallum Capital Group LLC, Research Division - Research Analyst*  
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## PRESENTATION

### Operator

Good morning, and welcome to the SMTC Second Quarter 2020 Financial Results Conference Call. (Operator Instructions) Please note that this event is being recorded.

I would now like to turn the conference over to Blair McInnis. Thank you, and over to you.

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### **Blair McInnis** *SMTC Corporation - VP of Finance & Corporate Controller*

Thank you. Before we begin the call, I would like to remind everybody 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 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 is contained in the Company's annual report on Form 10-K, quarterly reports 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.

During the call, we will also reference certain non-GAAP measures, including adjusted gross profit, adjusted net income, EBITDA and adjusted EBITDA. Please refer to the press release we issued yesterday for reconciliations between GAAP and adjusted results.

Management believes that these non-GAAP financial measures, which when used in conjunction with GAAP financial measures, provide useful information to investors about operating results, enhance the overall understanding of past financial performance and future prospects and allow for greater transparency with respect to key metrics SMTC uses in its financial and operational decision-making. The Company's management believes that adjusting for the additional temporary costs attributable to the COVID-19 pandemic allows for a better comparison of the Company's performance to prior periods, which is consistent with the Company's recent amendments to the financial covenants and its financing agreements. These non-GAAP financial measures are used by management to manage and monitor SMTC's performance and also frequently used by analysts, investors and other interested parties to evaluate companies in SMTC's industry. The presentation of this financial information is not intended to be considered in isolation or as a substitute for or superior to the financial information prepared and presented in accordance with GAAP and should not be construed as an inference that SMTC's future results will be unaffected by any items adjusted for in these non-GAAP financial measures.

Finally, this conference call will be available on the Investor Relations section of SMTC's website that includes a link to today's webcast at [www.smtc.com](http://www.smtc.com). The Company has also posted a slide deck which interested parties can find next to the link of today's webcast. We will be referring to these slides from time to time during our call this morning.

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

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### **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 with me today is Rich Fitzgerald, our Chief Operating Officer; and Steve Waszak, our Financial -- Chief Financial Officer.



First, before discussing the quarter, I want to thank the entire SMTC team and our supply chain partners for their hard work and dedication as we continue to navigate through these unprecedented times to meet our customers' changing demand requirements. I'd also like to thank our stockholders for their continued patience and support during these trying times.

As you can see on Slide 3, revenue for the second quarter was \$90.4 million from \$90.9 million in the same quarter a year ago and down 5% from the prior quarter and below our second quarter guidance of \$96 million to \$99 million. While our customer demand during the first half of the second quarter of 2020 tracked to our internal plans, we experienced changes in demand requirements, primarily from some of our retail payment systems and commercial avionics customers, and order rescheduling from other customers in the latter part of the quarter. We believe this resulted from our customers modifying their requirements in response to the shifting demand of their respective end customers.

By maintaining a strong and diverse customer base and carefully managing our expenses and business operations, we were able to generate improved bottom line results, including adjusted EBITDA of \$6.4 million or 7.1% of revenues, which was at the higher end of guidance range, which enabled us to report an adjusted earnings per share of \$0.08 per share.

Our supply chain did an outstanding job working around availability and the logistics issues resulting from the COVID-19 pandemic to ensure we could meet our customers' changing requirements. Drawing upon key supplier relationships that Phil Wehrli and his team have developed over the years, our supply chain team continues to proactively work around many obstacles, instituting new processes, expediting material, setting up new sources of supplies and anticipating potential component shortages and changing lead times.

As I noted on Slide 4, our business development teams continue to expand SMTC's market share and expand our sales funnel. Over the last 3 quarters, we saw strong traction in securing in excess of \$130 million of new business, including \$26 million in the second quarter, primarily from new and existing customers in the aerospace defense and industrial IoT markets, leveraging our RF and sensor manufacturing test expertise. As we continue to navigate through the challenges presented by COVID-19 pandemic, we have implemented innovative onboarding processes to overcome plant access and travel restrictions to win new business and launch new customer programs. We are encouraged by the positive responses we have seen from our customers and look forward to resuming our top line growth momentum beginning in the second half of 2020 and continuing in 2021.

Barring any significant new impacts of the continuing COVID-19 pandemic on our business, we believe we are positioned for an improving financial performance in the second half of the year. As we look ahead, we expect again to stay on track as we did in Q2 for achieving our long-term model with gross margins ranging between 12% to 14% and our adjusted EBITDA in the range of 7% to 9% of revenues.

As pleased as I am with our ability to adapt quickly to the current environment, I am especially proud that SMTC and our employees continue to demonstrate a commitment to our local communities through donations and support, including much-needed PPE equipment.

Let me wrap up my introductory remarks by reiterating that the health and safety of our employees remains a top priority for SMTC as we continue to meet our customers' requirements and ensure continuity of our supply chain with all our facilities currently remaining open and operating in accordance with all applicable health and safety regulations.

Steve Waszak, our CFO, will now discuss our second quarter results in more detail and some of the steps we're taking to improve our results in the back half of the year. After Steve's remarks, I will return with some additional commentary on our progress in the second quarter and our goals going forward before we open the call to questions. Steve?

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**Steven M. Waszak SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions**

Thank you, Eddie, and I want to additionally express my thanks to all of the SMTC employees for their commitment and dedication as we work together through the challenges of the continuing COVID-19 pandemic. I'm also grateful for the support of our customers and partners and the patience of our shareholders.



Now let me discuss our financial results, which you can see on Slide 5. As Eddie commented, revenues in the second quarter of 2020 was \$90.4 million compared to \$95.1 million in the prior quarter and \$90.9 million for the second quarter a year ago. During the second quarter of 2020, we had one 10-percent plus customer.

Our gross profit for the second quarter of 2020 was \$10.7 million or 11.8% of revenues, up from \$9.6 million or 10.1% of revenues in the prior quarter. The improvement in gross profit was primarily due to tight cost controls and product mix.

Our Q2 2020 adjusted gross profit was \$11.8 million or 13% of revenue excluding \$846,000 for noncash amortization of intangibles related -- in connection with the acquisition of MC Assembly, \$1.2 million of COVID-19-related costs and \$971,000 of noncash unrealized foreign exchange gains on unsettled forward exchange contracts. In comparison, our Q1 2020 adjusted gross profit was \$11.7 million or 12.3% of revenues.

Selling, general and administrative expense for the second quarter of 2020 was \$7.1 million, essentially flat as compared to \$7.2 million for the first quarter of 2020. As a percent of revenues, SG&A expense increased slightly to 7.9% in the second quarter of 2020 compared to 7.6% of revenues in the prior quarter. In comparison, SG&A was 7.2% of revenues in Q2 2019.

We reported net income of \$955,000 in the second quarter of 2020 compared to \$775,000 in the prior quarter and a net loss of \$2.5 million in the same quarter a year ago. Adjusted net income in the second quarter of 2020 was \$2.4 million. In comparison, we reported adjusted net income of \$2.2 million in the prior quarter and adjusted income of \$1.1 million in the same quarter a year ago.

Adjusted EBITDA in the second quarter of 2020 was \$6.4 million or 7.1% of revenues, which includes the add-back of \$1.2 million of COVID-19-related costs as compared to adjusted EBITDA of \$6.2 million or 6.9% (sic) [6.5%] of revenues in the prior quarter and \$6.1 million or 6.7% of revenues in the same quarter a year ago.

Now I'd like to take a few minutes to comment on the balance sheet and other key financial metrics that we reported for the second quarter. Our cash-to-cash cycle averaged 82 days compared to 73 days during Q1 2020. The increase in our cash-to-cash cycle was attributable to the shift in customer forecasts within the quarter that resulted in higher-than-anticipated inventory levels exiting Q2.

Second quarter 2020 DSO was 64 days with DPO at 73 days. Inventory turns for Q2 2020 were 4.0 turns compared to 4.5 turns in Q1 2020. Capital expenditures were approximately \$700,000 in Q2 2020.

Net debt at the end of the second quarter of 2020 was \$84.6 million compared to \$83.6 million in the prior quarter. Both periods included \$3.6 million for the extension of the Company's Fremont, California facility lease in February 2020. In comparison, net debt was \$95.9 million for the same quarter a year ago.

Net debt, excluding our finance and operating lease obligations at the end of the second quarter, was \$68.4 million compared to \$68.3 million at the end of the prior quarter. Our debt-to-trailing 12-month adjusted EBITDA ratio, excluding leases, was 2.66, which we have reduced from 4.67 since the MC Assembly acquisition. Including capital leases, our debt-to-trailing 12-month EBITDA -- adjusted EBITDA ratio was 3.15, which is in line with our public company peers. We remain focused on continuing to reduce our debt-to-EBITDA ratio by the end of the year.

As noted on Slide 6, our financial priorities during the COVID-19 pandemic are squarely centered on tight control over expenses, carefully managing our working capital and maintaining strong relationships with our partners to ensure financial flexibility, so we can adapt and support our operations through this uncertainty.

At the end of the quarter and subject to our debt covenants, we had \$30.9 million available under our asset-based lending facility. To provide increased covenant flexibility as we navigate through the continuing COVID-19 pandemic, we have also amended our credit facilities.



Following up on the Q2 expense control initiatives that we've announced in our last earnings call, in Q3, we implemented additional cost-cutting measures, including head count reductions primarily in our Zacatecas, Mexico facility; and reduced capital expenditures benefiting from installation of machinery and equipment shipped from the China manufacturing operations at our -- within our North American plants.

Concluding my comments, based on our current demand and known supply chain visibility and assuming our facilities continue to remain open and operate at currently planned levels, we expect revenues to range from between \$190 million and \$205 million and adjusted EBITDA to range between \$13.7 million and \$15 million in the second half of 2020.

With that said, here's Eddie for some additional comments on the business. And thank you.

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

Thank you, Steve. Before we open up the call for questions, I'd like to share with you a few of our accomplishments in the second quarter and then discuss our goals as we look ahead, which we have noted starting on Slide 7.

The COVID-19 pandemic has not only impacted our second quarter results but has also clearly changed the way we work, live and play. On the last quarter's earnings call, Rich outlined the numerous safety measures and health safeguards we implemented to protect our employees and their families. Those efforts remain in effect, and we're continuing to invest in these and other health and safety initiatives. In fact, we've invested approximately \$1.2 million in Q2 and plan to incur a similar level of costs in the second half of 2020 to support those initiatives.

Now let me recap a few of our second quarter accomplishments:

To enhance our North American plant capacity, we completed the installation of equipment we shipped back from our factory in China that we closed in December when the lease expired. This will enable us to support additional production at our North American facilities without the significant capital expenditures we would have otherwise needed.

To overcome travel restrictions imposed by COVID-19 pandemic, protect our employees and maintain operations at our facilities, we instituted virtual onboarding for new customer programs using GoPro cameras, Zoom and Microsoft Teams software.

To keep the flow of new products entering volume production in the second half of this year, our engineering production staff in Boston and Fremont successfully launched 8 new product introductions or NPI programs in the second quarter. Both of these factories have been instrumental in our ability to secure new programs from our existing customers.

To grow our top line going forward, we've added more than \$26 million in new [multi-year orders] (corrected by company after the call) in Q2 from 4 new customers and 8 existing customers, bringing the total of new orders awarded to us to over \$130 million over the past 3 quarters. I am gratified by the confidence and loyalty our customers have placed in us and pleased that our backlog remains strong as we enter the second half of 2020.

Let me switch gears and discuss our key initiatives and goals for the second half of this year. As I look ahead, our top 4 goals remain:

First, my priority is to launch the new programs awarded SMTC and continue to grow our market share in key markets that play to our strengths, including industrial IoT, the highly complex and regulated markets of customers supporting the defense and aerospace industry, which you can see on Slide 8. These markets provide a stable and solid base to profitably grow our business in the second half of 2020 and beyond.

Second, to achieve and maintain our leadership position in terms of operational performance among our Tier 3 EMS peers, including revenue growth, gross margin, EBITDA margin and net margin percentage. We've included how we stack up favorably against our peers on Slides 9 and 10.

Third, to keep our employees and their families healthy and safe and prudently manage the business through the ongoing COVID-19 pandemic. We will do this by maintaining the health and safety measures we have implemented. As Steve said, we are focused on tight control over expenses, carefully managing our working capital and maintaining strong relationships with our partners to ensure financial flexibility, so we can adapt and support our operations through uncertainty.

And finally, to remain very customer-focused by providing superior service that will, together with operational excellence, ultimately reward our stockholders with enhanced shareholder value.

With that, Steve, Rich and I will take questions from those on the call today.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) The first question is from the line of Mike Crawford from B. Riley.

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### **Michael Roy Crawford B. Riley FBR, Inc., Research Division - Senior MD, Head of The Discovery Group & Senior Analyst**

Eddie, could you walk through the capacity utilization at each of your primary facilities and where -- and currently and where you'd like to see that by year-end?

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

Yes. So we don't put out, Mike, exact utilization, so I'll just give you some ranges. And then -- so if you were to take Zacatecas, it's below 50%. If you were to take our Chihuahua facility, it's above 80%. We don't like to get it above 90%. So right now, we're doing some expansion there. We're building some extension to our building and doing some things. So we have the equipment to expand there, and we just need some space, so we're in the process of doing that in Chihuahua. Our Fremont plant is about 60% thereabouts. Our Boston plant is about 50%. And then our plant in Florida is probably a little bit above 50%, closer to probably in the 70s.

So we have plenty of room to expand. I think the only plant that really has what I would call a need to expand in terms of footprint would be Chihuahua. The rest of them could probably add a significant amount of business and not have to expand the footprint. May have to buy some equipment, but we have plenty of expansion room.

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### **Michael Roy Crawford B. Riley FBR, Inc., Research Division - Senior MD, Head of The Discovery Group & Senior Analyst**

Okay. And then right now, defense is only 10% of the business mix but seems to have captured a disproportionate amount of recent wins in the last 3 quarters. So if we're to fast-forward at this time next year and after you have these defense programs pick up in 2H '20 and then early next year as well, where do you see that mix? Do you see that getting to 20% of revenues that quickly or maybe, I guess, 1 year from now and maybe 3 years from now? Your best crystal ball on where defense might be as part of your business mix.

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

Yes. So if you think about it, 2 years ago, we were at 0. A year ago, we were at 5% same quarter, Mike. This year, we're at 10% of our revenue being defense/aero. I would expect it would have been, if the avionics business didn't crater last quarter, it probably would have been 15%. I would not be surprised, next year, 2021, if we don't finish the year up 25% to 30% of our business being defense/aero.

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### **Michael Roy Crawford B. Riley FBR, Inc., Research Division - Senior MD, Head of The Discovery Group & Senior Analyst**

Okay. Great. And then last question for me. I think this might be for Steve. But where would you like to see inventory days by year-end as you kind of unravel the excess in the payment systems in com or avionics and then same with the cash conversion cycle?

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### **Steven M. Waszak SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions**

Yes. I think from an inventory perspective, we'd like to see that in the 4.5 turns range, which would will get us more into the 80 days. So we do that then clearly, we want to try to -- on the cash-to-cash days, get this closer into the low 60s in total. So both those initiatives are certainly a high priority for us.

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**Operator**

The next question is from the line of Tyler Burmeister from Craig-Hallum.

**Tyler Leroy Burmeister *Craig-Hallum Capital Group LLC, Research Division - Research Analyst***

Thanks for letting me ask a few questions on Christian's behalf. First question, just any additional color you could give on the second half split. Based on your orders, your customer conversations, should we expect a more even split between Q3 and Q4 or a ramping in Q3 and a heavier Q4? Any color there would be great.

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

Yes. So I think we'll see close to a double-digit ramp from Q2 to Q3, and then I think that will slow down a little bit to a smaller ramp in Q4. But we are clearly growing this quarter from Q2. Some of it being the fact that when avionics and retail payment systems kind of went sideways last quarter, there just wasn't enough time in the supply chain to get revved up in other portions of our new customers.

So we've won a lot of new customers. I think last call, we talked about some of the wins and what markets they were in and a significant amount of were in the defense/aerospace market and other parts of the highly regulated market. So Tyler, we'll see a big jump Q2 to Q3, and then we'll see a smaller jump Q3 to Q4.

**Tyler Leroy Burmeister *Craig-Hallum Capital Group LLC, Research Division - Research Analyst***

That's great, very helpful. And then a few thoughts on your strong margins here. Gross margins in the quarter, I think, were 13%, already at the midpoint of your long-term 12% to 14% model, way ahead of where we were thinking they'd be. So I guess anything onetime in nature maybe to call out in the quarter? And where should we expect them going forward? Is 13% kind of a fair run rate? Or should we expect maybe a drop down to more towards 12% or the lower percent of that range?

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

No. I think 13% -- we will hold 13%, if not go up a little -- tens of points here and there based -- as the mix gets stronger in the aerospace/defense, we're very comfortable with the 13%. I don't see any reason that'll move down. So we got what we wanted by starting to go after the type of customers about 1 year, 1.5 years ago that get us those type of margins.

So -- and I think on the EBITDA, when you think about the same thought process on EBITDA, we -- when we get through this COVID, for us, it's a scale game, right? So as we grow, our margins will continue to get better on the EBITDA side. So I would think they're going to also get a little bit better. I don't think dramatically better, but they'll get a little bit better. And then next year, as our defense/aero business and some of the other new customers we add on, I think they'll get even better.

So I'd see that both -- we've gone on a journey. We went from 3% 2 years ago to 6% last year, high 6s this year. Now we're at 7%, and I expect that to continue to get better on the EBITDA. And I would expect the gross margin at 13% or a little bit above as we go forward.

**Tyler Leroy Burmeister *Craig-Hallum Capital Group LLC, Research Division - Research Analyst***

That's great. A little bit of a follow-up there, I guess. How should we be thinking about mix as it impacts margin? Obviously, you just commented aerospace and defense is a positive, but anything else to call out as either positive or negative as regarding mix impact on margins?

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

The -- I would tell you that the sensor and IoT business, I call them highly regulated markets. They're not always medical markets, but there are markets that are regulated. And the highly regulated markets, the things that are very complicated to build, we normally get a better margin for than things that are just -- you go down a line, there are green board, you drop pieces on them. And so we have quoted and received orders for what I would call much higher-complexity box-built products. And so I would continue to tell you that's why I feel so strongly that the margin will stay where it is and maybe even slightly increase.

So we have stopped searching out this low -- high-volume, low-margin business because it just doesn't fit our model very well.



**Steven M. Waszak SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions**

Tyler, I would say -- this is Steve, real quick. Having been here looking at the last 4 to 5 to 6 quarters with the acquisition of MC, it's given us the opportunity to really move more into the complex areas within the manufacturing, so the industrial IoT, the RF, the testing, the sensors and then with the -- with some of the aerospace and defense. And that's bled over into Boston, Billerica facility. And it's also starting to see some wins that are going to be allocated into the Fremont facility.

So that journey in the last 4, 5 quarters has allowed Rich under his leadership to really bring more complex manufacturing, expertise and culture into the Company. So with that, you don't typically step backwards and go into more mass production. You stay with more complex. So I'm really pleased with how we've grown that expertise across and that which contributes to this improving gross margin, in addition to Rich just being a marine and being very, very crisp on cost controls.

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

The other -- the last thing I would tell you, Tyler, is we are getting from very vertically integrated with our customers. As you know, we have a metal shop, and we do cables down in Mexico. But one of the things that Rich did last year that's really paying dividends this year is we got into the highly technical space of wire bonding, hybrid circuitry, systems on a chip-type stuff. And it is very complex. But in the system sensor business, you need to do wire bonding and put parts straight to board. So that's really been a big plus in terms of margins.

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**Operator**

Next question is from the line of Steve Kohl from Mangrove.

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**Steven Andrew Kohl Mangrove Capital Partners - Partner**

Wanted to talk about a few things. One, could you speak a little bit about the employee base? I know Rich and team have been doing a really good job protecting them. Can you maybe give us some color on kind of what the turnover looks like? Have you had to switch some folks out? I know you talked about a few cuts in Zacatecas. But what's happened kind of across the other plants? Has it been stable? Are you finding better -- is the pandemic creating opportunities to get new people in some cases? Or what's happening there?

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

Yes. It's -- so I can almost spend an hour just on this subject. And so first of all, Steve, the -- and the -- so every plant has a different story. Every state has different rules. Every country has different rules. So in Mexico, we had one plant that was in a red state and one plant that was in a yellow state. But when they go red, people that have underlying conditions, women that are lactating or pregnant, people that are over a certain age are sent home with pay. And those are those COVID costs, so part of those COVID-19 costs that you see that are onetime. And then we have to go out and hire people to replace those people because obviously, we have to work. So there is some new people, and they get more efficient over time, not super efficient the first day. We have to train them, show them our way. So we do have some of that going on in Mexico.

And then we do live in a society now that people do get COVID, and we have had different cases at different times. We've only had one person actually come to work with COVID. Most call in sick. And we take temperatures before people come in, and we go through all those safety things. When somebody comes down with COVID, they stay home until they get negative tests, and there's a certain amount of time, and there's other things. So yes, there's been cases of COVID. And yes, people have stayed home. But in Mexico in particular, they have rules that people stay home even without COVID. And so we've had to hire new people and move things around. And I give Rich and his team, all the plant managers a lot of credit. We haven't had plants shut down. We've kept them operating even though sometimes we have to take a certain amount of people out of the business if they've had contact with somebody who's gotten it.

So it's a juggling act. We, unfortunately, have plants in Florida and California, which are some of the highest states in the United States, the 2 highest states. And so people get them and get this disease. And so then we got to go replace that person plus anybody they've been in contact with and until we get through it. We have had different instances at different places where we do logistics at the border and different things.



So we'll work through it. I can tell you that it hasn't dramatically affected our business, but it has affected our business here and there. And then we work through it, just like we should. We have rules and regulations and processes to overcome it. Rich has done a great job creating those processes, and then we have to work with our employees and partners as that happens.

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**Steven Andrew Kohl Mangrove Capital Partners - Partner**

Great. And let me ask a question just talking. I know Rich is a miracle worker on operating stuff. But when I look at your capacity utilization rates and where the margins are, it seems that if we move up from, let's say, 40%, 50%, 60% and up to 70%, 80%, and I know you're talking in tens, Eddie, but why wouldn't we get a more dramatic move in margins particularly as the mix is shifting given the fixed cost nature of the business. So what am I missing there since I must be missing something?

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

Because as you grow, you also -- as you grow, right, you also have other costs in terms of buying equipment, training people, buying inventory, doing things. You become -- well, as you add customers at first, you're least efficient, right? Over time, you may get some efficiency. But then customers, obviously, as they see you getting more efficient, they want better pricing. They want this. They want that. And so in the end, one of the things about being a public company that don't help the situation is customers seeing margins. And so that doesn't help.

So I think moving to the top, it's really a dogfight between one and one other competitor of ours in terms of being top margin players in this segment, and we'll continue to progress. I just don't think it will be as quick as it may seem.

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**Steven M. Waszak SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions**

Steve, this is Steve Waszak. Steve, remember, too, the mix that Eddie talked about, our highest capacity is down in Chihuahua. So that's going to be where you're getting your -- probably your least margin increase because that capacity is always fairly high. The additional capacity is more in Fremont, Billerica and Melbourne. And that's where we're onboarding new customers at this time, particularly in Melbourne.

So you may see increased margins for those capacity increases over time. But in the next, let's call it, 2 to 3 quarters as you onboard new customers, you won't see that. So it's part of it's a mix issue, too, in terms of where the capacity is across the different sites within SMTC.

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**Steven Andrew Kohl Mangrove Capital Partners - Partner**

Great, Steve. And as you look to your new -- you have a good, obviously, strong bookings over the first 9 months. What are you seeing in terms of your pipeline? You mentioned some of the programs you have in Billerica and Fremont. Are you comfortable that you've got a fair bit of business that would kick in new orders as we look into Q4, looking to 2021 or Q3 and Q4? How does that -- how do you feel about your pipeline these days?

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

I couldn't be more excited, and I say that with no hesitation. We have landed contracts. And even though we're going to see a significant increase in the second half, many of those contracts are going to be small as they ramp up. And I would tell you, I couldn't be more excited about the contracts we've landed during this COVID-19. A lot of people say, how do your salespeople get contracts? I would tell you a lot of it's based on our relationships, and so customers are behaving differently. But I think going forward, I couldn't be excited about the pipeline -- more excited about the pipeline.

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**Steven Andrew Kohl Mangrove Capital Partners - Partner**

And when you look to '21, I hate to jump -- I know you've just given guidance obviously for the second half of this year. But how should we be looking at 2021? Should we be looking for top line growth from 2020 levels with the margin expansions that you kind of spoke of earlier? And do we get to -- putting Steve on the hook, do we start to see some free cash coming in as we look to the back half and into next year? How do you balance growth versus free cash generation?

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

Yes. So clearly, I'm not the expert on the COVID-19 vaccine. I'm not an expert on where the world is going. Like I just said, I'm very positive about the pipeline and the numbers we've announced in terms of new contracts and all of that. So I would say the same thing I just said: I'm very, very excited about next year. We're not prepared to put out guidance for next year. We'll probably do that sometime in the December time frame, I would think, or later this year. But until we have a vaccine, I would be remiss to put out any numbers for next year and what's going to -- I don't expect -- I would tell you this: I don't expect the retail and the commercial airplanes, those 2 customer segments for us, I have no expectation that they'll come back in 2021 at all.

**Steven Andrew Kohl Mangrove Capital Partners - Partner**

And Steve, just on the last question, just on free cash. How do you -- I know you're trying to move those numbers around a bit here. But how do you see free cash as we look out through the balance of this year into next year, realizing that it's a little bit clouded?

**Steven M. Waszak SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions**

Yes. We're not being specific about it, Steve, yet anyway. We are generating free cash flow now. I mean we're getting -- you get saddled with the additional COVID expenses. We did about \$1.2 million in the first half of the year. So that drains some of your cash. But we are generating free cash flow now. We've done a great job on the CapEx side by bringing over the equipment from China and all that. So we are, single-digit percentage-wise on the operations, bringing free cash flow to the Company now. So -- which is very different than where we were 6 months ago. And we will continue to do that.

Our AR has been strong, our collections on AR. Our customers have been respectful with us in terms of how they're acting. We're having great relations with our suppliers, and the business is being efficient as you see those gross margins. So we are generating, I would call, moderate levels of free cash flow. And we're very encouraged by the outlook to hear what -- the efficiencies we're gaining.

**Operator**

The next question is from the line of [Craig Boots], a private investor.

**Craig Boots - Private Investor**

Yes. I'm wondering about any delays that you may have in business. I think you mentioned one with the avionics, and I'm just wondering if you could elaborate some on that.

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

Yes. So the most difficult thing for us has been so far, Craig, has been the delay of getting new programs started up for reasons like people can't travel, engineers can't come to our factory, qualification issues, those issues. We've started coming up with processes to work around that, which I think will drive some good things in the second half of the year and into 2021, using GoPros and iPads and all kinds of flips and turns to get customers qualified. I think people are more relaxed about qualifications right now so that's why I'm very upbeat about it. But clearly, it's pushed out a couple of big contracts a quarter or 2, where we'll see major revenue in those contracts in 2021 and minor revenue in Q3, Q4.

So yes, there's definitely a pushout. But on the other hand, customers are not moving around as much as they normally do because they can't qualify my competitors either. So you're getting a lot more renewals and that stuff. So yes, it happens, but we're learning how to work around it.

**Steven M. Waszak SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions**

Craig, this is Steve Waszak, too. I would tell you that in the numbers that we looked at in the outlook for the second half, we have played in avionics, going substantially to 0 in our outlook based on what we're seeing today with Boeing and where the airlines are. And the second is retail payment systems. We don't see those coming back in the second half of the year either. So we've vetted our forecast with our customers. Eddie and Rich are directly involved with our key customers with their forecast updates. So we've vetted all those -- the turndowns into our second half forecast as we look today.

**Craig Boots - Private Investor**

Okay. I guess in relation to this, though, what about the big one that was announced in January with those 3 avionics, aerospace and defense contract business that we talked about on that press release? How has that been affected by the COVID?

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

That has pushed out the qualification into ramping. We thought it would ramp second half of 2020. It will now ramp the first half of 2021, so it's pushed out things for a quarter or 2 across all of that, but we haven't even seen a ramp on those programs yet. That's why I'm excited about we're seeing growth in our existing customers back to a level we thought we'd see, and then we're seeing new customers on top of that. So when they kick in, it should be a very strong first half of next year.

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**Craig Boots - Private Investor**

Well, that sounds great. So it's just a matter of being patient, I guess. Hopefully, I can do that. I've been so far.

So I guess I got one other quick question. I hope this isn't anything to worry about. When Rich was named to that AME Board, it made me wonder, is there any danger that we could lose any of you guys to anybody else that might want you guys for themselves instead of you staying with us? I'm just curious if you could mention on that.

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

This is -- I got to give you the award for the most original question I've ever had on one of these. We've worked together often -- Rich, myself and Steve, and this is something I'm very proud of. And we've been able to remain together, both as customers, as peers and working together as much as you can figure in 20 years. So my answer to you, Craig, is we came in here to do something. And our goal ultimately is to make this the best Tier 3 contract manufacturer both financially and operationally. We are getting close to that goal. We're not there yet. We have one strong competitor that has kept us from being #1. If you look back a year ago and we would have these same results, we would be #1. But they've gotten better over the year, and we've gotten better but at a little faster rate. So our job is not done here, and so I don't sit around every day wondering about Rich and Steve and myself. We're here to finish this job, and we will do that. No doubt about that.

The Board that's Rich -- and I couldn't be prouder that AME picked him to be on the Board. There's no doubt that all 3 of us get approached to be on Boards and different things, and it's a matter of time. Rich, that was really driven by people seeing what Richard was doing in respect to his work. But that particularly won't drive him to go do something else. Being #1 here and once we get to the #1 spot, that'll be a year or 2 away, and then we'll see what we go do. We'll see how that goes. But no, there's -- I don't think -- that's not high on my risk list right now.

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**Steven M. Waszak SMTC Corporation - CFO and Senior VP of Mergers & Acquisitions**

Craig, I'd also tell you, this is Steve, that Rich's nomination to that Board, what really excites us, it came through customers. So they saw the work that we had done, the quality we deliver, things of that nature. So being nominated and being endorsed by your customers is just tremendous.

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**Craig Boots - Private Investor**

Well, that's great to hear, and I'm glad none of you are thinking about leaving. You're the main reason that I've stuck with you guys because I know the leadership here is great.

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

Well, thank you. Thank you. And as you know, there's always people that love us and always people that don't love us. So we appreciate the ones that do, no doubt about it.

With that, I think that was the last question, so okay.

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**Operator**

Ladies and gentlemen, that was the last question for today. I now hand the conference over to Mr. Ed Smith for closing comments. Over to you, sir.

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

Sure. Thank you, operator. In closing, I want to once again thank our employees, leadership team, business partners, distributors and our stockholders for their continued support and look forward to reporting our progress to our various stakeholders as we go forward. Thank you. Have a great day, and be safe.

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**Operator**

Thank you very much. Ladies and gentlemen, this concludes your conference call for today. Thank you for attending today's presentation. You may now disconnect your lines.

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