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Q3 2018 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

Aman Raj Gulani *B. Riley FBR, Inc., Research Division - Associate Analyst*
Steven Kohl

PRESENTATION

Operator

Welcome to the SMTC Third Quarter 2018 Financial Results Conference Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Blair McInnis, Vice President of Finance. Please go ahead.

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

Thank you. Before I begin the call, I'd 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, 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. The 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 with me, today is Steve Waszak, SMTC's CFO; and Rich Fitzgerald, our COO.

I'm pleased to report another strong quarter, again exceeding our business plan, and we're on track for our first profitable year in many years. I will now review our third quarter results.

After the close of the market yesterday, we reported results for our third quarter of 2018 that exceeded the high end of our pre-announcement on July 23. We finished the quarter with \$53.7 million in revenue, up 56% from our comparable quarter last year and 20.7% from the prior quarter. Adjusted gross margin improved from 9.0% a year ago to 9.6% in Q3 2018. Our third quarter adjusted EBITDA of \$2.4 million was \$1.1 million higher than a year ago.

I'm pleased to report that our net income in Q3 was \$864,000, representing a \$1.4 million improvement over the same period a year ago and a \$961,000 improvement over the prior quarter. In Q3, we saw strong demand and, in fact, increased our revenue over the same quarter in prior year in all of our major customer industry segments.

We also recently completed investment of nearly \$5 million for our facility and equipment expansion program in North America to support our growing global customer base. The SMTC recently earned AS9100D certification, and we can now for the first time address the needs of our customers in the avionics, aerospace and defense industries. A multibillion-dollar opportunity. We also received our 13485 certification that should open up many new opportunities to us.

Our backlog remains strong and barring any further tightening of the supply chain by electronic component suppliers, should support our revenue growth in excess of 35% for the full year in 2018, over what SMTC reported in 2017 and positive year-over-year trends for adjusted gross profit margins and EBITDA metrics.



We remain intensely focused on execution of our business plan with detailed attention to operational excellence with respect to quality of product and service. The accuracy of our orders delivered and deliveries that are always on time.

To strengthen the management team, we recently brought Terry Wegman on board as Senior Vice President of Sales and Marketing. I couldn't be more excited. Rich and I have all worked with Terry before and have met, so we have firsthand knowledge of his extensive track record of success in sales and marketing. We issued a press release on Terry October 22, which we encourage you to review. But at the highest level, Terry brings over 30 years of sales, marketing and strategic account experience to SMTC. Terry rejoins me, Rich and others here to build a long-lasting, profitable and valuable contract manufacturing business.

While we are pleased with our progress to date, with 2 of last 3 quarters having been profitable and on track for our first profitable year in many years with better than 30% organic or internal top line growth for the year. There are additional growth opportunities that we continue to pursue.

I will now hand the call over to Steve to review SMTC Q3 financial details, and then come back with some additional comments and take questions. Welcome, Steve.

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

Thank you, Eddie, and good morning, everyone. I appreciate everyone taking the time and having the interest to join us this morning.

As Eddie commented, third quarter was -- third quarter revenues was \$53.7 million compared to \$34.4 million for the same quarter in 2017. Now \$1.7 million of this revenue reported in Q3 '18 was due to the impact of new revenue accounting standard, ASC 606. That said, the remainder of our 56% year-over-year growth is revenue as a result of increased orders from existing and new customers added over the past 12 months. In Q3 '18, we had 3 10% customers accounting for a total of 35.7% of our revenue. I am pleased to report that we saw year-over-year increase to customers across our industrial, network and communications, power and energy, and medical industry sectors.

Gross profit for the third quarter was \$5.2 million or 9.8% of revenue compared to \$3.0 million or 8.6% of revenues in the same quarter of 2017. Adjusted gross profit in the third quarter, which excludes the impact of unrealized foreign currency gains or losses on forward contracts, was \$5.1 million or 9.6% as a percent of revenues compared to \$3.1 million or 9% in the same period of 2017.

Operating expenses, which is comprised largely of selling, marketing, and administrative expenses were \$3.7 million in Q3 2018, \$730,000 higher than the \$2.9 million we recorded in the same quarter 2017. That said, as a percent of revenues, operating expenses were 6.9% in Q3 2018 as compared to 8.6% of revenues for Q3 2017. This year-over-year increase in spend was related primarily to hire senior management in sales and importantly in supply chain, travel and variable compensation during the third quarter of 2018 related to the increased revenues.

As Eddie mentioned, the company reported net income of \$864,000 for the third quarter of 2018. In comparison, the company reported a loss of \$551,000 for the same period a year ago.

Adjusted EBITDA was \$2.4 million in the third quarter of 2018 compared to \$1.1 million for the same quarter of 2017. The increase in the quarter on adjusted EBITDA compared to the same period in the prior year was due to higher revenue, in addition to improved gross margins and lower administrative expenses as it relates to percentage of revenues.

Now before I turn it back to Eddie, I want to comment a little bit on the balance sheet. At the end of the third quarter, we have \$14.7 million in cash, which certainly included a contribution from the Rights Offering that we completed in August. We had \$11.8 million of net debt, and we have \$13.4 million of funds available to borrow under our revolving credit line with the PNC. \$3.2 million was utilized in cash flow from operations in the quarter, primarily support working capital for accounts receivable inventory and expanded in accelerating revenues in the quarter.

Our cash-to-cash cycle was strong at 63 days as compared to 60 days in the prior quarter, with DSOs of 62 days and DPO of 37 days. And inventory turnover on an annualized basis was 4.9 times for the third quarter of 2018, requiring some additional investments for recognition of the constrained supply chain in the market today to have components available for Q4 shipments. Now that I -- I'd like to turn the call back to Eddie to provide some additional comments before we open for questions. Thank you.

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

Thanks, Steve. To summarize, we remain on track with our strategic goals are, in fact, exceeding our annual business plan. With a strong Q3 with year-over-year growth in revenue, adjusted gross margins and adjusted EBITDA.

Global demand trends remain strong, and we believe we're taking market share at existing customers and are poised to win additional new customers. Our focus on operational excellence continues to pay off and thus far has allowed us to migrate -- mitigate the impacts from component shortages that others may have reported this year.

The outlook for the balance of the year continues to look strong, and we expect, as Steve just mentioned, to achieve revenue growth in excess of 35% for the full year 2018 over 2017 barring any unforeseen disruptions to the supply chain or impact from tariffs and positions. I look forward to updating you on the progress on future earning calls as we make SMTC an even stronger company that's delighted to customers with superior service, rewards its stockholders with enhanced value. With that, let's take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Aman Gulani of B. Riley FBR.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

The first question for me, now that you have a certification for aerospace and defense and avionics, how quickly do you think you can ramp and make that segment a meaningful part of revenue?

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

Yes. So, I think it will take us -- we have engaged with conversations with customers previously before we got the certification. And so, I would expect us somewhere in late Q4, early Q1 to get our first orders that will have to go through the qualification process. I would expect remaining revenue to come late 2019, early 2020. I think the medical is a little bit quicker for us because we already had some of the certifications in place. We already have some medical customers building with us. The avionics and aerospace, defense markets really are a cult stock for us. So, I would expect this 2019 to have limited upside for us there. But we have a strong pipeline of customers, and we're targeting very specific customers. So, I would expect us to receive orders late Q4, early Q1, start the qualification process, but not really get significant revenue till late in the year.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

And that's helpful. And then what would you say like the biggest end market that's driving growth right now? And then also, are you seeing growth coming mostly from existing customers that are ramping up production or is it new customer wins?

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

Yes. So, the market is growing the quickest for us if you think a single market, even though many of them are growing, is the smart data center products we make. So, we make some products for the data center that are smart products and in that particular case and those customers, we build the whole product. We bend the metal, create the metal, do the PCBs and build their whole product. That's the fastest growing. But I would also tell you we're seeing growth in the semiconductor equipment market. We're seeing growth in the communications market and in the payment systems market also. So we're seeing some pretty good growth across the board, but the one that stands out as a star clearly is the data center business.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

Okay. And then in terms of key drivers for the gross margin improvement, I mean, particularly this year and then also like sequentially from the last quarter, what do you attribute the improvement in the gross margin to?

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

Yes. So, I think it's a combination of 2 things. One is as we continue to get bigger and utilize our factories better, and Rich and his team continue to get more efficient in the factories, obviously, that helps our gross margin. And then the second part of it is continuing to use and leverage our expanded scale to get better pricing from our distributors. So better PCB on the parts, clearly that helps and then a better utilization in our factories.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

Got it. Okay. And then what's the overall capacity looking like right now? And then specifically in Mexico that seems to be your biggest production facility. How much capacity do you have there?

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

Yes. So that's another great question. We put about \$4.5 million of capital equipment in there, both in our metal shop and in our electronics manufacturing facility. So, we're in the mid-80s in terms of capacity. But in terms of floor space, we have plenty of capacity there. We're probably in 50%. It would just require some capital to expand significantly. We continue to see some expansion. Our other plants are less than 50% utilized. So, we have plenty of capacity in other plants, and we have some capacity in Mexico to expand. We clearly could make Mexico even more efficient and probably grow 20%, 30% without putting a lot of capital equipment in. But if we grew more than that like we grew this year, 40-plus percent, we would have to put some more capital equipment in there for sure.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

Got it. Okay. That makes sense. And then in terms of CapEx, I'm guessing there should be some more the next quarter and early Q1 as you ramp and add more capacity, what sort of number are we looking at for CapEx?

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

It's not going to be as much as this year. And clearly, we had a quite a bit of capacity on this year. I would say it's probably half of what we added on this year. And I would -- based on our plan, and we just finished our 2019 planning session, I would assume that's probably going to come in Q2, Q3, again for the year. I think we're good through Q1. I think Q2, we'll add some capacity. And then I think we'll go from there and then add some capacity Q2, Q3.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

Okay. All right. Yes. That's helpful. And then with the Rights Offering, you provided fourth quarter guidance. I mean I know you usually give guidance, but I just wanted to know if that sort of guidance still stands.

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

Yes. We feel very strong about our guidance in Q4. Obviously, Q3 was very strong and I'm very pleased where we are going into Q4, especially since we're so late in the quarter. But I don't see a lot of risk to Q4 at all.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

Okay. And then last question for me. Are you still seeing shortages for MLCC capacitors and how is that impacting the business? And how are you sort of mitigating that risk?

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

Yes. So MLCC is really tight and it continue to be tight. But through our supply chain run I saw early and others, we have not -- I'm sure that any of our customers down or lost revenue because of that. I think we'll continue to do that. We're buying ahead. So, if there's one negative to the tightness. So, a lot of positives for us because our supply chains been so strong. That's why we're getting the growth. But the one negative is it hurt our churns. Clearly, we're taking in any inventory on MLCCs and tough to get parts that the -- from our suppliers, and we're holding that inventory, which is lowering our return. So, I've had the balance or give up saying, okay, take the

additional inventory in for the fact that then we can make our revenue numbers. So, I expect that tightness to continue all through next year. I thought it was going to alleviate in Q4 this year. But from what I'm hearing in the marketplace, nobody is talking about the lead times getting shorter. I will tell you, on some components, things are easing up. But MLCCs, when you talk about them specifically, that's not the case. But other components are clearly getting easier to get.

Aman Raj Gulani B. Riley FBR, Inc., Research Division - Associate Analyst

Got it. Okay. And one more for me. Any new notable wins in the third quarter that you're able to talk about that is, who the customers are?

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

Yes. So in the medical space, we are in qualification with a pretty nice -- I don't know if you'd call it genome, but that type of disease detection business. And I think that will give us pretty significant revenue going into next year. But we got to get through the qualification phase clearly. And so I think we put that out in our press release about getting our ISO 13485. And so those are numbered out in our press release, you guys can take a look at. But it's a good question. Thank you for that.

Operator

The next question comes from Steve Kohl of Mangrove.

Steven Kohl

First up, again congratulations on another very good quarter. It's always I think as shareholders we fail to appreciate fully what goes into getting the numbers. We only kind of look at what they are at the end of the quarter, but we kind of suspect that you might have the few ups and downs during the quarter, and we do appreciate you reducing our stress with that. Let me talk about a couple of things. One thing that I jump out of me here today was the incremental leverage, right. If you look at your sequential revenues, I think they're up a little over 20%. But to me, more importantly, your incrementally EBITDA is up over 50% annual incremental EBITDA margin on an adjusted basis I think is 86 or something on that revenue. Can you speak a little bit to what drove that? Is that a mix issue? Is it greater efficiencies? Is it the supply chain? Is it everything? Number one. And then number two, how do you look at that as we get the mix shifting more towards some of these newer opportunities that are kind of the stickier certification-based stuff. Does that also ultimately drive that higher over time and will we start to see that in '19?

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

So first of all, thanks for coming on Steve. But clearly is scale matters. So as we fill factories and make them more efficient, our -- not only does the revenue go up, but our EBITDA and net income grow up at a faster pace. And so I think on a couple of calls back, I talked about our model of MVA and dropping a significant amount of additional MVA, once the plant becomes profitable. One of the nice things about where we are today is all of our plants are profitable. When I first got here about a year ago, one of our plants was profitable, the other 2 were not. So now that the other 2 are profitable, we expect a significant amount of their MVA to drop to the bottom line. So as they grow and they do that, you're going to get a higher percentage of profit -- EBITDA and other profit to drop to the bottom line. And you're right. It was 86%, I think, this quarter. You probably won't see 86% every quarter, but if we grew 20%, I would expect EBITDA to grow 20% plus some derivative of that. And so it's not a straight line. And as we utilize our plants better. The reason we're starting to getting into AS9100, 13485 and those customers are those customers start at a higher profitability level at the beginning of the process. So that will help the profitability also. So it's not a \$1 for \$1. When you sell \$1 to the highly regulated markets, you can make \$1.5 on the bottom line. And so for us, that's why we're going to those markets. They are very attractive. They are big, but they're also more profitable. If you look at our long-term goals, we're starting to creep up to the bottom side of the long-term goals. So we put out a long-term goal on EBITDA of 6% -- 6% to 10%. And as you can see, we're starting to gain on that 6%. And you've also seen on our long-term goal on the gross profit side, we put out 10% to 12%, and we're starting to gain on that 10%. By the time we finish Q4 going into next year, I think we'll be close to getting those goals that we talked about. So every incremental dollar leads to X-plus some incremental number in terms of profitability. And -- so as we grow, I expect our profitability to get better and better.

Steven Kohl

Sounds good. Let me turn to one more area. I think over the last several quarters that you talked about kind of strategic goals that you had for the company. And I guess, I talk about them in terms of the stores. I think about of them 4, maybe it's a 4-legged store. But one is



kind of -- number one is kind of growing existing customers, which you guys have done a wonderful job. Two is kind of getting existing new corporate logos, which I think you've also done quite well. Three, is moving in the specialty areas, military, aerospace, aviation, avionics and medical. And four is in organic growth. And I guess as I look at that, you've kind of knocked off the first 3. Have you changed your view on the fourth at all, or is that still an important part of directionally where we're heading with the business on -- in organic growth?

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

No. So -- no -- I brought Terry on to take some of the -- so I was leading the sales organization, so take and open up some time for me to do other things and do things I need to get done. So what's going to happen is Bob Miller, who we brought on before Terry, is going to go run our initiative in the defense aerospace. So we'll get some good focus in the defense aerospace market, and Bob has a lot of experience there. Terry will run getting us new logos, organic growth in the new markets we're looking for. And then Josh Chien, he now runs getting us more business at our existing customers. So that means new divisions of our customers, new products, new things. And he's been very successful with that this year. So hope we're still going after those 4 different segments. And some have done really, really well this year. Other ones, we have some work to do to get to where we need to get to. But as a general rule, I think each person knows what their team has to go and get. So I don't expect the growth to slow down for a bit here. I think we still have a lot of opportunities we're closing and we're in call and all of that. So hope we still have that as our goal.

Steven Kohl

So the \$5 million that you spent, how much of that is actually been spent? And was that the \$4.8 million that you spoke about and was that largely in Mexico, or Fremont or where did the -- how much of its fund on the \$5 million, or where is it going? And what type of returns should we get off of that?

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

Sure. We spent all of it now because as anybody willing to give us money, we'll almost spend it. So they gave it to us, we started spending it. But the Q2, actually about \$3.5 million got installed in Q2, another \$1.5 million got installed in Q3. The predominance of it went into Mexico, some went into Fremont. And as the \$4.5 million went into Mexico so that \$500,000 went into Fremont. So it's all installed now. I would expect us to start getting some efficiencies out of that this quarter. But I would say, it will be 100% getting its return in probably Q1.

Operator

The next question comes from [Craig Boots], a private investor.

Unidentified Participant

I'm wondering a few different things. About the tariff issue in China. I know there's a possibility they could greatly increase tariffs and if they did that, how would that affect us?

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

Yes. So it's already had an effect because some of the electronic components are already being tariffed. Now we mitigated a lot of that tariff issue with our customers because we moved the manufacturing to Mexico. That continues to happen. If they go across the board, I mean, just through all the products like they're threatening, I think it will have some impact on some of our customers. But there's ways for us to mitigate it by building elsewhere and doing different things. But there's no doubt that if they go across the board that will make it a little more difficult. So far, Craig, we've seen very little effect in our business on the tariff issue. We've had them at the move, like you said, customers, but other than that it hasn't had a very good effect yet. I think the next round could be significant to us.

Unidentified Participant

Let's hope that does not occur. I think you did mention something that I'm going to have you elaborate on. You said we could move more stuff to Mexico. It seems to me there was a recent press release that had talked about that. I don't know if this is \$5 million you've already mentioned or maybe it had to do with the new plant altogether. And I'm just wondering if you could talk about that and how it's going to affect getting new contracts.



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

Yes. So I don't think it will affect getting new contracts. I think customers are getting digital bills and demand still remains strong. So I don't think you have that effect. But some of the customers that are in our U.S. plants have started taking looks at, should I move from the U.S.? The other thing they're looking at, Craig, which is really upside opportunity for us is some of our customers who build in China today and ship a completed good back to the U.S. are saying, hey, do you have enough capacity in your Mexico plant for us to move that product out of China, built it in Mexico and then ship it to the U.S. And so actually, there is more upside opportunity than probably downside risk.

Unidentified Participant

Okay. That hopefully sounds like a winner to me. How about the new certifications that have been discussed lately. I'm just wondering how that's going to translate going forward on new contracts that sort of thing, or if we got anything that's about to happen.

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

Yes. So the reason we did all of those certifications is to get new contracts. On the ISO 13485, I think we announced the new contract with it. So we did announce that, and I'll let you read that. I believe that will open up other opportunities still for us. On the AS9100, it takes a little longer for people to switch business. We have to wait for new contracts, new government things to happen. So that will take a little longer. And like I said earlier, I think it will be Q4 2019 to Q1 2020 before that has a significant effect.

Unidentified Participant

Okay. And the new contract that you did mention. Yes, I'm familiar with that I believe it's like, I think, it was \$15 million if I recall. I'm just wondering how quickly are we going to see that turning into revenue.

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

You're already seeing some of it in revenue. So you're already seeing some of it, and it will continue to increase as we go here.

Unidentified Participant

How about the Rights Offering? Did that bring in everything that we need or is there the potential that we may need more as far as going forward to fulfill everything we want to do for growing?

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

Yes. It's another really good question. We don't foresee the need today, the Rights Offering, the way the company is structured. We continue to grow with our ABL. And as Steve said, we have some cash from the Rights Offering, and quite a bit availability, probably more than we've had in a while. So we have about \$30 million of working capital. We could deploy if we had the customers. So I don't see for a working capital need to deploy equity in the near future. But those things change and there might be some other reason we would need it. But today, I don't see an immediate need for working capital.

Unidentified Participant

I guess that's both good and bad. I mean, Rights Offering turned out real good for me. I fully part took in it and I'm glad I did. So in that regard, I wouldn't mind seeing another opportunity but I'm glad, we don't need more money. That's also good so I guess, with all that I'll let you go.

Operator

I see no further questions in the queue. So I would like to turn the conference back over to Eddie Smith, President and Chief Executive Officer for any closing remarks.

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

Thank you. I'd like to remind you that we're participating in 2 conferences this quarter. The 9th Annual Craig-Hallum Alpha Select conference at New York and the 11th 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, the leadership team, our business partners, distributors, customers and our investors for their support and, of course, reporting our progress to various stakeholders over the next several quarters. Thank you, and have a great day.

Operator

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

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