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Q1 2019 SMTC Corp Earnings Call

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PRESENTATION

Operator

Good morning, and welcome to the SMTC First Quarter 2019 Results Conference Call. (Operator Instructions) Please note that this event is being recorded.

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

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

Thank you. Before we 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.

Discussions of the various factors that may affect future results is contained in the company's annual report on Form 10-K, Form 10-Q and subsequent reports on Form 8-K and other filings with the Securities and Exchange Commission. All forward-looking statements are made as of the date of this call. And except as required by law, we do not intend to update this information.

This conference call will also be available for audio replay in the Investor Relations section of SMTC's website at www.smtc.com.

SMTC will be participating in the B. Riley FBR Annual Investor Conference on May 22 in Los Angeles, and the 16th Annual Craig-Hallum Institutional Investor Conference on May 29 in Minneapolis.

Information about these events has been posted on the Investor Relations section of our website.

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

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

Thank you, Blair, and good morning, ladies and gentleman. I'm Eddie Smith, SMTC's President and Chief Executive Officer. On this call today is Rich Fitzgerald, our Chief Operating Officer; and Steve Waszak, SMTC's Chief Financial Officer.

As the press release we issued yesterday indicates we got off to a strong start to 2019. Steve will discuss our financial results for the first quarter and provide our guidance for 2019. After Steve's review of the numbers, I'll come back and offer my thoughts on the progress made and priorities on our continuing journey to make SMTC into a company that delights our customers and delivers increasing shareholder value.

With that, Steve Waszak.



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

Thank you, Eddie, and good morning to everyone, and thank you for taking time to join us.

As Eddie mentioned, we will start the call with my review of the quarter's financial results, and then I'll turn the call back over to Eddie for his comments.

To frame my discussions on financial results, as with the year-end results call, I'll be referencing numbers for 2019, which includes SMTC plus MC Assembly combined, also 2018 year-over-year, which includes as previously reported by SMTC, which as a reminder includes MC Assembly from acquisition date of November 9, 2018. And then finally, when you hear the word pro forma, this will include SMTC and MC Assembly numbers assuming MC Assembly was part of SMTC in the first quarter 2018. So with that, hopefully we frame a dialogue that we can understand each other on this call this morning.

That said, our revenue for the first quarter was \$102.6 million, up \$65.5 million or 177% compared with \$37.1 million in the first quarter of 2018. On a pro forma basis, again, assuming MC Assembly had been part of SMTC in the first quarter of 2018, revenue increased 45% from \$70.7 million in the first quarter 2018. Approximately \$3.8 million of revenues reported in the first quarter of 2019 was due to the impact of the revenue accounting standard ASC 606 compared to \$1.7 million in revenues in the same period in the prior year.

During Q1 of '19, we had one 10% plus customer.

Moving on, our gross profit for the first quarter was \$8.6 million or 8.4% of revenues compared to \$3.9 million or 10.4% of revenues in the same quarter of 2018. The year-over-year decline in the GAAP gross margin percentages was primarily due to the higher labor charges in Q1 2019 and a \$1.8 million noncash expense for the amortization of intangibles with the MC assembly acquisition. In April, we implemented steps, which Eddie will discuss further in a few minutes, to address the higher labor costs, and we expect to see a rebound in our gross margin percentage as we progress through the year 2019.

Above said, our adjusted gross profit was \$10.5 million or 10.2% of revenue compared to \$3.5 million or [9.5%] (corrected by the company after the call) of revenue for the same period last year.

Going below the gross margin lines, selling, general and administrative expenses were \$6.7 million in Q1 of 2019 or approximately 6.5% of revenue compared to \$3.5 million or about 9.5% of revenues recorded in the same period of 2018. The year-over-year dollar increase was primarily a result of the acquisition of MC Assembly.

Net income in the first quarter of 2019 was \$1.2 million and included \$624,000 of restructuring charges and a \$3.1 million noncash gain from the reversal of a prior quarter's accrual for a contingent consideration related to MC Assembly acquisition. In comparison, the company reported a small \$8,000 net income in the same period a year ago.

Adjusted EBITDA increased 494% to \$5.5 million in the first quarter of 2019 compared to \$922,000 in the same period a year ago. The large increase in the first quarter adjusted EBITDA compared to the same period in the prior year was due to a 177% increased revenue from both SMTC and MC customers.

Now before I turn the call back to Eddie, I'd like to comment on the balance sheet and a few other key financial metrics. At the end of the first quarter, we had \$1.6 million in cash. Our important cash to cash cycle remained strong at about 66 days, and we generated \$2.8 million of -- in cash from operations during the first quarter of 2019.

Net debt at the end of the first quarter was \$95.9 million and includes debt incurred in November 2018 associated with the financing of MC Assembly acquisition of \$50 million of Term A and \$12 million of Term B debt, and \$16.5 million of finance and operating lease obligations, of which \$5.4 million of that \$16.5 million represents increases in operating leases or right-to-use liabilities associated with the adoption in January 1, 2019 of the new lease accounting standard ASC 842 for leases. In comparison, net debt at the end of end of 2018 was \$92.3 million. Net debt at the end of the first quarter -- net debt excluding these financial and operating lease obligations was



\$79.4 million as of March 31, 2019, as compared to \$80.8 million at the end of 2018.

During the first quarter, we filed an 8-K noting we sought a waiver from lenders associated with covenants on our senior debt. That said, higher than anticipated levels of revenue together with strong collection activities in the first quarter of 2019 eliminated the need for the senior debt leverage covenant waiver that we secured during the quarter.

We generated \$2.8 million from cash from operations in the first quarter of 2019. Most importantly, our cash-to-cash cycle was 66 days compared to 67 days in the prior quarter with DSOs at 58 days and DPOs at 73 days. Inventory turnover on an annualized basis was 4.5x for the first quarter 2019. Finally, cash associated with identified cost to implement our acquisition synergies should be cleared by the end of Q2 reducing the need in the second half of the year to devote any cash to these acquisitions or integrated-related activities.

As Eddie will highlight, we are very focused on improving our efficiencies, particularly within our newly acquired MC Assembly facilities as well as reshaping our balance sheet to provide the flexibility and added growth capacity.

We are currently evaluating a number of alternatives which Eddie will again outline in his comments and we will provide an update at the appropriate time.

While we did not plan to provide quarterly guidance, we believe showing our expectations for the full year provides increased insights to possible results and the combined SMTC-MC company as integrations activities complete and further efficiencies are realized during 2019. We are off to a strong start and see a great funnel of business opportunities ahead of us.

That said, for the full year, we are currently forecasting revenues in the range of \$393 million to \$408 million. That is up 85% from the midpoint of our guidance from -- \$216 million SMTC reported in 2018. If we compare the midpoint of \$345 million, which assumes MC Assembly had been part of SMTC for the full year during the 2018, our guidance on the top line revenue of \$393 million to \$408 million represents a 16% increase year-over-year improvement.

As we implement operating efficiencies that I briefly mentioned, and Eddie will again discuss in more detail, we expect an improvement in our adjusted EBITDA from \$10.2 million in 2018 to between \$27 million to \$29 million in 2019, continuing our expansion of adjusted EBITDA to approximately 7% of revenues at the midpoint of our guidance that I just provided to you in 2019. And it's a level which we believe positions SMTC in the top quartile of our operating performance metrics relative to our peers in the EMS market.

Now with those comments, I'd like to hand the call back to Eddie and provide some additional comments before we plan to open for questions. Thank you again.

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

Thanks, Steve. As the numbers that Steve presented indicate, we continue to make solid progress in building a stronger SMTC. I'll now add some color on the progress made in the first quarter and my priorities for 2019 in our journey of transforming SMTC into a stronger company.

First, we are experiencing continued robust top line growth, which has been accelerated by our acquisition in November last year of MC Assembly. Within the end market of our customers, our industrial, power and clean tech, retail and payment systems, test and measurement customer sectors all contributed to the strong growth in revenue in the first quarter, while semiconductor capital equipment showed a decline consistent with global trends for first half of 2019, and defense and aerospace experienced strong bid and quote activities, although, longer sales cycles to realize awards and associated revenues.

The slow start to the semiconductor sector was not surprising as many in the industry likely doubled booked semi orders last year when there was a supply constrained environment. We expect our defense and aero business to pick up later this year as we rewarded new business in that sector from both existing and new customers. We have posted a slide deck on the Investor Relations section of our website that provides specific revenue contribution from our various market sectors.

With the strong start to 2019, we're anticipating another year of double-digit revenue growth. I am pleased to report that our growth has been driven by increased business and several new programs at existing customers plus the addition of new customers. In the first quarter, we awarded 7 new programs from existing customers, and we also saw growth from these customers in their existing programs. As important, we added 3 new customers in Q1 to our growing customer roster.

Second, we continue to make progress with our integration of MC Assembly and through April have recognized a significant portion of the synergies we expected from the November 2018 acquisition. As Steve alluded, our Q1 results were negatively impacted by labor inefficiencies primarily at our Zacatecas Mexico facility. We have taken steps in Q2 to address this situation, including a realignment of our workforce and strengthening our leadership on site. A key element of our integration plans involves empowering local site managers to make decisions and focus on programs to improve plant efficiencies.

We expect to complete our integration activities by the end of Q2 and have identified additional operational efficiency opportunities that we believe will lead us to exceed our original synergy goals as announced from the acquisition.

To date, our actions should result in over \$5 million of annualized cost savings synergies from purchasing and operational advantages and corporate and shared services redundancies. We remain focused on identifying, implementing additional efficiencies across all 6 SMTC manufacturing sites in its pursuit of achieving best-in-class operating or financial metrics among its EMS peers.

Third, we saw a loosening up of the supply chain during the first quarter, which our supply chain team is positioned to leverage. Based on our current forecast, we expect our inventory turns to increase allowing us to support pursuit of increased business development in the second half of 2019 as new programs enter their startup phases.

Which brings me to the fourth and final point, I would like to emphasize on today's call, namely our focus on strengthening our balance sheet and further reduce our cash-to-cash days. In addition to being focused on second half of the year increasing our inventory turns and other operational efficiency opportunities, we're also evaluating alternatives to reshaping and deleverage our balance sheet. To finance our acquisition of MC Assembly, we entered into 2 senior term loans totaling \$62 million and a \$45 million asset based line of credit.

During Q1, we reduced our senior debt leverage on a trailing 12-month EBITDA basis assuming projected annualized synergy savings to 3.3x from approximately 4x in Q4 2018 at the time of acquisition of MC Assembly. While we have not made any definitive decisions, we are currently examining alternatives that could reduce the cost of debt and provide more flexibility and added growth capacity. Our increasing market value in 2018 and start of 2019 provided an opportunity to step into additional equity shelf-filing structures. My strategy and focus is to address the high cost of the \$12 million of outstanding Term B debt put in place with the acquisition of MC Assembly.

To summarize, after operational efficiencies implemented in April that I mentioned relating to our integration of MC Assembly, we believe we have significantly enhanced our capabilities with the acquisition, in particular within the aerospace and defense capabilities, to even better serve our growing base of customers as the steps we've implemented year-to-date kick in. We believe to see accelerating profitability in the second half of the year of 2019.

As I look ahead, we are committed to deleveraging our balance sheet, achieving industry-leading performance metrics, growing our business to become the top Tier 3 EMS segment leader, making our company an even stronger company that delights our customers with superior service, taking care of our employees and rewarding our stockholders with enhanced shareholder value.

With that, Steve, Rich Fitzgerald, our Chief Operating Officer, I will take questions from those on the call today.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Mike Crawford from the B. Riley FBR.



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

What can you tell us about these 3 new customers in Q1? And then second part of that is, how will the ramp of new programs with these customers affect margins sounds like in the second half?

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

Yes. So obviously, what -- as you ramp up customers, you get the factories get more efficient, right, because you don't have to pay for the lights, you don't have to pay for your overhead cost a second time. But what we have found over the last year is ramping them up is not an overnight process, even though I'd like it to be. So I think you'll see Q3, Q4 revenue starting to be positively affected by these programs. But the other part of that is, of the 3, 1 of them is a defense aero customer and those take even longer. So I'd expect significant revenue probably Q1 of next year. We'll do the qualifications Q2, Q3. We'll go through that process and then, Mike, I think Q1 will have significant aerospace and defense revenue there.

So we're also expanding our aerospace and defense customers in our Melbourne plant and that's going pretty well. And so I would also think the second half of the year, primarily late Q3, early Q4, we should see existing customers growing kind of like what we did at SMTC.

First, get the company to operationally be efficient, rich has done a great job with the MC facilities, and then start winning new programs within your existing customers and then adding some others. So we kind of slowed down the amount of new customers we picked up, Mike, just because as we work through the efficiencies and work through reshaping the debt and the balance sheet. But no doubt, those 3 customers are customers we want and we're excited about.

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

Okay. And then I also think that you get better at manufacturing a product after you get your hands on it for a little while. And is that process any different you think with the 7 customers where they've now given your new SKUs to manufacture? Or is it about the same with the new customers and new products with existing customers?

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

Well, that's a good point. The -- if it's a reiteration of an existing customer, it happens pretty quickly. But if it's a totally new product within an existing customer, it's like adding a new customer. You're not very efficient at first, then you're start getting a little more efficient, and normally after 9 months to 12 months then you're very efficient and you're making pretty good money on that product.

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

And so of those 7 expansions are any of those falling in that latter category?

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

Yes. Most of them fall into new products within an existing customer. We've really been targeting getting new products, not just reiterations of our old products. So I'm very excited about the second half of the year and those type of things, but no doubt about it, also the supply chain loosening up as much as it has over the last 3 months. I think that will speed up some of that, Mike, and maybe we'll see in Q3, some pretty exciting things. But no doubt about by Q4 it will be very exciting.

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

Okay. Thanks. Just 2 more if you don't mind, quickly. Is there any particular aspect in supply chain that's loosening like capacitors? Or is it just more broad-based?

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

Yes. It's funny you say that. So I was just at EDS, which is Electronic Distribution Show, on Monday and Tuesday, and I met with many executives over those 2 days. Capacitors are now being -- the orders are being taken and they're not on allocation anymore. Even though lead time seem to be out still, but certain capacitors are down to a normalized 10 or 12 weeks depending upon case size. So capacitors I think you're starting to see some loosening up there. I think the automotive capacitors are still very tight in some specific markets. And overall, unless you have sensors, most of the semiconductor guys are loosening up quite a bit. I think that has to do with Asia, significantly, the book to bill in Asia is negative obviously, and Asia softening, which has helped the supply constraint.



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

Okay. Eddie. And then last question maybe more for Steve. As you've talked about your capital structure and -- is it fair to say that it's just this \$12 million Term B that's the primary thing you're looking to address given the probably unnecessarily high coupon of just that small \$12 million piece?

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

I think, Mike, it's clearly our first priority. As we go through this and see other opportunities, we may go further because there's really 2 things we're trying to hear is trying to restructure it so that we can eliminate the Term B. And on the same path, how do we provide more capacity in the working capital to grow the business as we look toward second half of the year in 2020. One of the reasons we have a number of -- \$393 million to [\$408 million] (corrected by the company after the call) in our forecast is that, we really have some constraints around how much we can grow with the current debt structure, the debt leverage ratio and things like that. So as we go forward, I can't say that the Term B will be the only thing, but that's our first priority and our highest priority in the near term. But we also want to prepare for next year as we've talked to look to grow the company organically with additional working capital capacity.

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

And Mike, I'll add one little bit. The Term B is dictating the terms for the other part of the loan. So it's clear to us we need to clean up the Term B specifically so that we can change the terms and conditions on the ABL and the other part of the term. So I think that the way it'll look at some point was, we'll still have an ABL, we'll still have a smaller term and we won't have a Term B. So I think you're right in the question, we're very focused on the Term B so we can change the structure of the ABL and the rest of the term.

Operator

And next question comes from Lucas Davenport who is with [Retail].

Unidentified Analyst

So I have a couple of questions. The first one kind of follows up on the last caller. On the November 7 call, there was a question asked about the rights offering and if that brought in everything, and the response was that you didn't foresee the need today back in November, the way the company was structured and also that there was no need for working capital to be deployed in the near future in terms of equity. But then obviously, in March, the shelf filing was kind of unexpectedly filed at the last -- I'm not sure where that came from, but it was filed kind of unexpectedly at least to me. So can you elaborate on that a little bit? Why there seems to be a disconnect? Am I just misunderstanding that?

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

Sure. Nope. I think you're very accurate in what we said on November 9. But November 9, we hadn't bought MC Assembly. We hadn't grown 55% year-on-year. So obviously, that requires more working capital. We live in a world that, obviously, AR and inventory is important. So with the acquisition of MC, we clearly had to take on different type of debt, which on November 7, we hadn't closed the deal and it may never have closed, as you know, in any deal until it's closed, it's not closed. So at that point, we had already worked out with our lenders to increase our ABL. But when we changed to an acquisition, that changed things. The reason we filed an S-3, many companies filed shelf S-3s, and the reason we did it at that particular point is our stock was over \$4.76, which got us out of the baby shelf rules. So we decided that, that was a good time for us to file a shelf and it went through the SEC. So at the time, November 7, we were very accurate. We didn't need that to continue to grow our existing business, the way our business was structured at the moment. Clearly, doubling the size of our business in one acquisition is transformative and when that happens things happen. At the same time we did that, [Lucas], we also grew the business year-on-year as you heard by the numbers, quarter-on-quarter Q1 combined entity to Q1 combined entity by 40-some percent. If I was to predict on November something of last year that we were going to grow 40-some percent in the middle of a merger, I probably would've been -- people would've said, you're absolutely out of your mind. And so the reality is business changes, things change. We made an acquisition, we grew it at a rate that was 4 to 5x the industry average growth. So growing 4 to 5x and doing an acquisition at double the size of the company changed what we needed to do. We didn't -- we did the shelf for a big number. We don't need that big number. But we did that because we were advised by many people that if you're going to do a shelf, do it for a certain number. But the reality is, as Mike asked in the call -- question before, really our focus is a much smaller number so that we can restructure our debt, and you can read into that we're very focused on our very high cost Term B loan.



Unidentified Analyst

So just a follow-up on that. When do you expect -- or when can it be expected that the debt will come down to maybe say around \$50 million that's completely outstanding. Can you like estimate that?

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

I wouldn't even estimate that because if I grew at the rate I'm growing right now, obviously, it takes more working capital to grow at that rate. So \$50 million number is not the strategic number. What's more important to me is that we continue to take our debt leverage ratio down below 3 and I'm attempting to do that before the end of the year. That's my goal is to be under 3x leverage before the end of the year, right? If I'm a billion-dollar company by the end of the year, \$50 million -- if I'm \$500 million, \$50 million would not make any sense.

So it's really not a number for me, it's a ratio of the debt leverage for the company. And right now, as you could see, from Q4 to Q1, we went from 4x leverage to 3.3x our senior leverage. It's going down. I know that people think, hey, it's -- use your leverage, but if we continue to have free cash flow the way we're doing now, continue to pay our debt down, by the end of the year, I feel very good, we'll be below 3, it'll be in a very reasonable space.

If you look at our space and when they do acquisitions in the EMS Tier 3 space, normally that leverage stays pretty high for a while. We actually in 1 year will get it down to a very reasonable level. So I am very comfortable with where we are and what we have -- the plans we have going forward. I also know we filed a very big shelf and that got people's attention. We do not plan to use the whole self. We did that as a mechanism if there was something that was really exciting out there that we would take a look at it.

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

This is Steve. Lucas, it's the other stat that you -- is one that we measure quite frequently for working capital efficiency that complements the debt levels is the cash-to-cash cycle. So we're at about 66 days today as we go, which is far better than the industry average in -- many companies around the 80s. So we have about 66 days of cash to cash, this means when we buy inventory versus ship and collect our receivables and pay our payables, we're at 66 days cash-to-cash cycle. Our goal is to certainly bring that down further. But we're -- we monitor that daily, weekly from that perspective. So that's in terms of -- complement hand to hand with debt, the cash-to-cash cycle is an important stat as well to keep an eye on.

Unidentified Analyst

Okay. And just one last question is, it seems like you're being very -- I'm just reading into this so tell me if I'm wrong, you're very conservative with the future projections for revenue. Is that accurate? It's hopefully going to be higher than what you're projecting it'll be because it seems to me just over -- if you just -- I think it's like \$400 million for entire, if I remember reading it, but it's approximately the same numbers for this course. So am I being right that? It's a very conservative estimate?

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

I think there's a couple of things. I don't use the word conserve, I use the word thoughtful. We're using that projection for different reasons. One is, I've -- we're squeezing our working capital right now, trying to take the debt leverage ratio down. So we're taking our inventory down. We're being efficient with our working capital. I want us to get more efficient. Right now it's not the time to continue to grow our top line just to grow it. We want to become more profitable, more efficient and -- so some people may say conservative, I would say prudent or very thoughtful.

Operator

The next question comes from Christian Schwab from Craig-Hallum Capital Group.

Christian David Schwab *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Great start to the year. Can you -- Steve, can you walk through the drivers that are going to cause gross margins to improve throughout 2019?

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

Yes. There's couple of things, Christian, thanks for your questions and thanks for joining the call. As Eddie commented, we really had some labor inefficiencies in one of the plants, the new plant Zacatecas. That's really a large plant for us. So in terms of percentage of production, it's clearly double digits. It's probably in that 30%, 35% of our total production. So we had a labor -- some labor inefficiencies in the first quarter getting our hands around the new sites, and Rich has implemented actions in the first 2 weeks of April to correct some of that going forward. So the biggest increase we'll have is around regaining some labor efficiencies in Zacatecas, which mirror what we do in other facilities. So Rich is very disciplined about his percentage of labor on revenue, on production, and we'll get back there with Zacatecas plant from that perspective. And then I'll ask Rich to maybe join as well to give us a comment or 2 in terms of -- because he is very detailed, Christian, as you probably know by now in terms of where we're moving that gross margin and what are the key drivers to move that beyond just direct labor. Rich?

Rich Fitzgerald SMTC Corporation - COO

Thanks, Steve, appreciate it. So very specifically to Zacatecas. Some of the challenges that we were faced with when we did the acquisition and we took it over were some new growth customers, as Eddie talked about, and onboarding those customers. There were 6 customers that were put into the business between Q4 and Q1. They caused some inefficiencies. There were also some accelerated cost challenges that the factory was faced with around equipment maintenance and things like that we've actually corrected.

In addition, I think you heard Eddie and Steve both talk about some accelerated operational efficiencies that we implemented in April of this year that'll actually help prop up the gross margins in the business very specifically around Zacatecas and that factory because it is a large scale effective for us. But in addition to that, some of the other efficiencies that we actually built in is part of the synergies were actually implemented between March and April as well, which will prop up the gross margins as Steve talked about.

Christian David Schwab Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst

Okay. That's fantastic. As we go on the more of a longer-term outlook, your 10% to 15% continuation of top line revenue growth over medium to long term that you've highlighted, Eddie, can you talk about which sectors you feel you have the greatest opportunity for top line revenue growth either expansion with existing customers or new customers on the industry sectors that you broke out, and thank you for that level of detail as well.

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

Sure. Clearly for us, we're already deep in the test and measurement space and that is going to continue the grow. That's growing much quicker than any other market we have right now. Also the payment system marketplace, we're pretty big in the secured payment systems, and that marketplace is growing. Clearly, there's pieces of the market that concern me, the semiconductor equipment side of the market, capital equipment has clearly not been as robust as it had been previously. And I think that hangover is going to be a little longer term. I think it'll actually be 2020 before that market gets back to a reasonable.

But what excites me most long term is -- Christian, is the defense and aerospace market. When we got here that was single digit market share that we're in for us, that will clearly next year in 2020 and late 2019 get into the double digits and the start driving some really good gross profit margin business and some very outstanding business. We do that in our Melbourne, Florida plant predominantly. We have plenty of room to expand there with putting very little capital into that plant. So we have quite a bit of capacity. And so the reality is, we're really going to grow in I think the payment, test and measurement or even some people -- those are industrial markets clearly. And I think defense and aerospace long term is going to be extremely exciting for us. We're quoting business that's just incredible when you hear the numbers in the defense and aerospace part of the business, but it takes a long time to go from quote to win to fruition. But we are right now doing some call builds for different customers.

We also announced last year that we were a direct supplier to the government, and we haven't even built our first board for the government, and we're going through that qualification process. And so we'll start seeing revenue for that either late Q4, early Q1. So that'll be another growth for our 2020 year. So I would say short term it's going to be test and measurement, payment systems longer term and much bigger will be defense and aerospace.

Christian David Schwab *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

And then lastly on that, Steve, I would assume your margins in those businesses are similar to other contract manufacturers, which would be some of your most profitable customers that you deal with other than potentially some in the medical space. Is that fair to say as well?

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

Yes, it is. And I think the other thing to emphasize that Christian, so clearly, that's one of the drivers of the acquisition of the MC Assembly. As we looked at our -- as we've told you before, we looked at 20 plus very crisply -- of who'd we target to acquire. So that was one of our key points. The other is with the backgrounds of Eddie and Rich in that space, we've got the historical competencies in terms of quality and how to do the -- how to support government facilities. Invite you to come down in Melbourne facility. It's outfitted, and we've made a lot of progress even since the acquisition outfitted for all of the things that Eddie is talking about doing some of the qualifications, builds and things of that nature.

So clearly, it is from that perspective. And also think back, Christian, when Eddie and Rich came into SMTC, the second half of '17, where the business on an EBITDA basis was running almost neutral. And Q1 of last year of '18 it was about 3% on revenue. Today, we're 5.5-ish percent of revenue. Majority of that comes from margin increases, efficiencies in the factories. And this is the benchmark of Rich in terms of how he runs plants with the efficiencies in the plant. So we will continue to do the track record along certainly the aerospace defense. But we will do some of the same in Boston, Zacatecas and certainly, keep redoubling back with Chihuahua in Fremont as well. This is a hallmark of our COO and we'll continue to emphasize this. So we've got supreme confidence that this is going to show in the numbers. And that's really where the plant gets to the EBITDA of \$27 million to \$29 million relative to where we're at today at \$5.5 million on a quarterly basis.

Operator

Our next question comes from Steve Kohl from Mangrove.

Steven Andrew Kohl *Mangrove Capital Partners - Partner*

Well, let's see, why don't I only take a second and just talk about the balance sheet for a second -- inventory turns. Thanks, Steve, you mentioned what 4.5x, I know obviously, that number I would think you'd want to have it up markedly from that. Can you talk a little bit about kind of the trend that we can expect to see on inventory turns? And what some of the issues are? Are we having to hold inventory more for somebody's -- military aerospace stuff or we're holding stuff and not shipping it out obviously due to lead times? But what would be a reasonable expectation on where that number goes and how much we plot it out?

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

Great question, Steve. Now remember, again, I'll keep reemphasizing our COO here, but as we came into the acquisition with SMTC, we were running between 5 and 5.5x in inventory, which slowed a little bit last year because of the constraints in supply chain. So Eddie allowed Rich to go above on some of his inventory buys. So we had kanbans for some of our key customers to make sure we had provided on-time delivery. As we see 2 things -- and as we came in the MC acquisition, they historically run about 4.5x inventory turns.

So as we look forward, we see 2 things happening. The efficiencies of our processes under Rich around how we plan, procure and ship our inventory will increase MC's from 4.5 as well as we see supply chain loosening up as Eddie talked about. So we won't back away from some of the kanbans we've put in place with some of our customers. So we have metrics that we run. You probably see some of the KPIs relative to by a customer, by a plant in terms of turns. We anticipate these terms will move to 5x and maybe be as much as 5.3x to 5.4x as we exit this year of 2019 in terms of our planning process.

So we've got that deep in the scope of how we plan our business. And there is real reasons behind it relative to loosening of the supply chain as well as inheriting MC's and applying SMTC processes to the MC inventory and procurement process. Now it all comes Phil Wehrli, who is an SMTC Supply Chain Director. So these are the steps that will come into play, and it happens naturally day in and day out.

Steven Andrew Kohl Mangrove Capital Partners - Partner

Sounds good. Let me ask another question just about -- I know we've got the 6 plants, and understand Zacatecas I think you mentioned. One of these days, I'll actually be able to pronounce that, it may take a couple of years. But when we look at your plants now, are they all profitable? And how are you doing about moving base floating and moving customers around? I presume that's one of the issues that gives you flexibility now with the acquisition you can shift stuff. Is that actually happening, not happening and what's kind of the plan as we look out for the balance and the next year?

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

Steve, I'm going to ask Rich to address that for you, but as soon as you can spell -- I mean (inaudible) Zacatecas, we're going to ask you to spell it.

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

Yes. That's awfully true.

Rich Fitzgerald SMTC Corporation - COO

Especially, if we have to name the actual city that it's in, which is called Fresnillo. But -- so the neat story is all the factories are profitable. If you remember when we first came in and as a part of the transformation of SMTC, we had some challenges with 2 of our sites, both those sites are actually profitable now. We've actually done the same on the MC side. Part of the synergies and the operational efficiencies that we put into place have actually created a springboard specifically for the North American sites. So I feel comfortable that they will continue to stay that way. And if I can add, both Eddie and Steve continue to emphasize the military aerospace business for Florida being a key focus for us. As we did the acquisition, it is going to continue to be a key focus of mine as well to make sure that we're putting the right operational efficiencies in place but also putting the right tools, processes, procedures, systems and controls in place to get to the direct government business, which should prop up margins as well.

Steven Andrew Kohl Mangrove Capital Partners - Partner

That's accurate. I guess let me talk about Melbourne for a second. I do look forward to seeing it and I -- but can you address the sales -- Eddie, you mentioned earlier that the sole idea of bidding qualification testing, getting a shipment. But that's what 9 months, right? I mean if we're looking from start to finish, those are 9 months more or less, and what is the cost that you actually incurred that's being expensed during the 9 months? So are we essentially incurring expenses in '19 that will then come through in much -- we'll see a big lift in '20, not only in revenues as that ramps, but those costs are going to disappear? Am I getting that right as you're adding more customers on the qualification testing stuff?

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

Yes. So you have a cost upfront where you do call then you hold some inventory, so it clearly bloats your inventory for a period of time, and your inefficient, your first couple of bills and then you start getting more efficient as time goes on. And so my answer, Steve, is, we've added quite a few customers over the last couple of quarters. And as we add these customers, we're a little bit less efficient than I would like us to be. But it's just a fact of the way the whole qualification process in the onboarding of customers go. So yes, long term, we'll be a lot less -- a lot more efficient and have a lot less of these costs. But sometimes in some of the military, they know that it takes a long time and they'll let you bill them for the excess inventory, they'll let you bill them for some of these cost. But as a general rule you can't and you become more efficient over time. So I'm excited that we'll get way more efficient over time. I think Christian Schwab asked the question the right way. As we add these customers in there -- in our factories for some period of time, we'll get more and more efficient, and our gross profit margins will move up and EBITDA will move up with it.

Steven Andrew Kohl Mangrove Capital Partners - Partner

And what is Florida running nowadays? So when you look at Florida is not -- obviously, we're not running 100% in there. How much of a window opportunity do we have? And when you look at the contracts that you're going through call testing now what is the revenue potential for those in '20?

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

Yes, I think, Steve, you'll have to look it up in the 10-K, I don't have it in front of me. And to be honest, we don't traditionally go through factory by factory. So I think you'd have to look in the 10-K for that or I'll get it for you, we'll send it to you.

Operator

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

Unidentified Shareholder

I was wondering if you could give a little more insight on that shelf that we had talked about here a couple of calls ago. What was said already was helpful. But I guess, what I'm wondering is, obviously, the share price today is at where we'd like it to be, and I'm hoping that this is not something we have to use anytime soon. We'd obviously be better off if we wait somewhere down the road when the share price is better. And I'm just wondering, if you're able to give a little more insight on how we intend to use this shelf or maybe a little bit on the timing of it?

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

Yes. Clearly, as you can read in my compensation, Craig, that any dilution makes it more difficult for me to collect my compensation, that's with the whole leadership team, Steve and Rich. So we realize the stock price, we realize the S-3 filing, the stock was significantly higher. We also realized that restructuring of our working capital is important. And so my answer is, it's not where I want it to be. So that will take into consideration. We'll take a look at what we're going to do. But as I also said earlier, we filed a bigger shelf than we probably needed because we were given guidance to do that. We also filed it particularly at that point in time because it got us out of the baby shelf rules. And so right now there is nothing for me to report on the thing, but as soon as there is, we will.

Unidentified Shareholder

So I guess, if I'm understanding it right, you're probably not intending to use this anytime real soon hopefully then when you do use the share price will be considerably better than it is right now. And I guess you had kind of mentioned on that previous call that you'd possibly use it on any future acquisitions like the one we just did with MC for instance. I'm just wondering if you could shed more insight on your philosophy on not so much on the timing maybe, but how you might intend to use it if it's for such a thing as an acquisition?

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

I -- Craig, I don't plan to talk about timing of anything we plan to do. So I'll leave that with the -- as you keep saying, I said we were -- I'm not saying anything. Timing is what it'll be, will be the appropriate time. As far as using it for an acquisition, it gives me the flexibility or opportunity when I'm discussing an acquisition with a counterparty that we have a weapon to pay for an acquisition, that we have collateral and it's available to us if we're going to need to do that. And -- so the fact that people like to remind me of our November 9, where I said we weren't going to do anything right at that point and we wound up buying something and changing what we're going to do. Things change every day in business. Today, I'm not looking at acquisition, I'm looking to integrate the MC Assembly acquisition, finish that up, get -- gather the profitability we should get from that acquisition and the growth, but you just never know. So I'll leave it with that. It's sits there, but at this point, we don't have any reason to use that big a S-3. So...

Unidentified Shareholder

Okay, that sounds. Definitely I like the results that we've had so far. It's definitely been good as far as I am concerned.

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

Well, thank you, thank you.

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

Thanks, Craig, and thanks for your long-term support, too. You've been with us since the first call that I've been around. So thank you.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Ed Smith, CEO, for any closing remarks.



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

So thank you, operator. In closing, I want to thank our employees, leadership team, business partners, distributors and our investors for their support. I look forward to reporting our progress for our various stakeholders over the next several quarters. Thank you for your time and effort today. Have a great day.

Operator

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

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