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Update Conference Call

Friday, September 20, 2019, 8:30 AM Eastern

SMTC Participants

Ed Smith – President & Chief Executive Officer

Steve Waszak – *Chief Financial Officer*

Rich Fitzgerald – *Chief Operating Officer*

PRESENTATION

Operator

Good day, and welcome to the SMTC Corporation September 2019 Business Update Conference Call. All participants will be in listen only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero on your telephone keypad. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your telephone keypad. To withdraw you question, please press star then two. Please note, this event is being recorded.

I would now like to turn the conference over to Steve Waszak, Chief Financial Officer. Please go ahead.

Steve Waszak

Thank you, Andrew. Before we begin the call, I'd like to remind everybody that the conference call today will include statements about expected future events and financial results that are forward-looking in nature and subject to risks and uncertainty. The company is 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 affect or may affect future results are 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 on 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, SMTC's President and Chief Executive Officer.

Edward J. Smith

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

The purpose of this call today is to provide our stakeholders with a business update. I will keep my prepared remarks relatively brief. As the press release we issued after the market closed yesterday indicates, we've decided to wind-down our Chinese manufacturing operations when our current Dongguan, China facility lease expires in December 2019 and have updated our financial guidance for the balance of 2019 and provided an initial outlook for 2020.

Let me provide color on our decision process and our expectations. Customer concerns about uncertainties relating to the prolonged impact of tariffs and macro-economic factors have caused a number of our customers to begin to re-evaluate demand for some of their products and reconsider where they outsource their manufacturing. Several customers have requested us to move their production out of China. Revenues attributable to production from our manufacturers in China accounted for 5.3% of SMTC's revenue in the first half of 2019. Based on our current forecasts, we expect revenue attributable to our manufacturing operations in China to decline more than 30% in 2019 as compared to full year of 2018, with continued contraction in 2020, resulting in negative operating margins from our China site. As a result, after more than a decade in the Chinese market, we will use the end of our lease term later this year as an opportunity to exit China as we continue to augment our strong North American manufacturing footprint.

SMTC expects to record related to closure of its China manufacturing operations, restructuring and other charges of \$5.4 million to \$5.8 million, which includes up to \$3.3 million of non-cash accelerated asset write-downs, and other cash-based expenses, including employee-related costs. The majority of these charges are expected to be incurred in the remainder of the third and fourth quarter of 2019, and the net cash required to wind down the Chinese manufacturing operation is not expected to exceed \$1.5 million.

As you know, we completed of the integration of our acquisition of MC Assembly in Q2, and, in Q3, we have added new capabilities and certifications in our Billerica, United States location that provides our customers with quick-turn manufacturing. This expansion follows our investment in Q2 when we upgraded and expanded our capacity at our Fresnillo facility in Zacatecas, Mexico, enabling a 25% increase in capacity, contributing to continued efficiency and profitability gains at this site.

We believe our expanding North American operations, combined with our debt restructuring as announced in August, provides a good foundation for continued growth. Also, as we noted in our last earnings call, long supply-chain lead times that impacted the market over the 18 months are now contracting, and that has impacted selected customer inventory requirements and thus their near-term demand.

Finally, in addition to the China closure, we're seeing softness in certain end-markets across semiconductor equipment and data center expansions. Accordingly, we are updating our full year 2019 revenue from a range of \$354 [million] to \$362 million, which includes \$16 million of revenues in 2019 attributable to SMTC's operations in China. This compares to our GAAP reported revenue of \$216 million in 2018, with \$23.5 million attributable to MC in the acquisition November 2018, as compared to \$345.2 million assuming MC Assembly had been part of SMTC for 12 months in 2018. The 2018 revenue figures I just mentioned included [*the webcast*](#)

statement should have been “excluded”] \$21.5 million in revenue attributable to our manufacturing operations in China We expect Adjusted EBITDA for the full year in 2019 to range between \$25 [million] and \$26.5 million, as compared to \$10.2 million in 2018 on a GAAP basis, and \$18.1 million on a proforma basis, assuming MC Assembly was part of SMTC for 12 months in 2018.

With our integration of MC Assembly and bank refinancing completed last quarter, our collective focus is on growing our funnel of business, including recent awards of \$15 million of new business and new programs during the current quarter, within the end-markets we are targeting. We anticipate will begin shipping Q1 of next year. We expect our 2020 revenue and adjusted EBITDA will exclude any operations in China to range between \$390 million and \$410 million and \$29 [million] to \$31 [million] million in EBITDA, respectively. Finally, we expect to generate up to \$14 million of free cash flow from operating activities for the full year of 2020, which we anticipate will result in a debt-leverage ratio of approximately 2.5 times, using outstanding revolving credit facility, term loans outstanding and financial capital lease obligations against adjusted EBITDA on a trailing twelve months basis, exiting 2020. We have provided a reconciliation of the adjusted EBITDA for both 2019 and 2020 in our press release.

Let me wrap up by saying that despite the constantly changing geo-political winds that make managing any business a challenge, we remain committed to further deleveraging our balance sheet that I discussed and, very importantly, growing our top-line and achieving industry-leading performance metrics to become the premier Tier 3 EMS segment leader. I look forward to finishing 2019 strong, and I’m very excited about 2020. With that, Steve, Rich, and I will take questions from those on the call today. Thank you.

Operator

We will now begin the question-and-answer session. To ask a question, you may press star then one on your telephone keypad. If you’re using a speaker phone, please pick up you handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press star then two. At this time, we will pause momentarily to assemble our roster.

The first question comes from Mike Crawford of B. Riley FBR. Please go ahead.

Mike Crawford

Thanks. Eddie, as you get out of China, what’s the desirability of having some kind of Asian footprint being at somewhere else in Southeast Asia to complement your North American operations?

Eddie Smith

Yeah, over a long period of time, we would love to do that, Mike. The reason we didn’t do it right out of the gate was it just would have been too difficult to be closing one and opening another at the same time. So, in 2020 we will look at options in Southeast Asia in places like Malaysia, Thailand, Philippines. Vietnam a lot of people throw around. I think the problem with Vietnam at this point is it’s grown so quickly and the infrastructure isn’t as robust, but, clearly, we would like to be in Southeast Asia. And the other part of that is we’d like to have an anchor tenant or two before we go and sign up for expense down in Southeast Asia. And today, none of our Chinese customers were supportive enough to say, “Hey, I’ll give you a three year deal at this minimum value for us to go open something up.”

So, we got to go look for an anchor tenant. We got to go look for the right place to be. Is that the Philippines? Is that Thailand? Is it Malaysia? Where that would be. And probably 2020 will have some better view of that.

Mike Crawford

Okay, thanks. And then, I don't know if this is more for Steve, but you mentioned that there's a little bit of a demand low as people start to work down inventories due to easing of the supply chain where's there's been these long lead kind of items. So, for SMTC, what does that mean for you relative to working capital and inventory turns that you'd be targeting for next year?

Eddie Smith

Yeah, so, that's a great question because, as our customers try to wind down their inventory, we'll do the same things and try to lower inventory. So, we will lower our inventory through the rest of this year, probably not as quickly as I would like, but clearly it'll be lower both in Q3, Q4, and we'll continue to lower it in 2020. And our target inventory turns, Mike, would be six inventory turns in 2020.

Mike Crawford

Okay, great. Thank you very much.

Eddie Smith

No, thank you.

Operator

Once again, if you have a question, please press star then one on a touchtone phone.

The next question comes from Tony Billgolf, a private investor. Please go ahead.

Tony Billgolf

Hey. Good morning, guys. I know you guys have include leases in your leverage ratio, but, just to clarify, interest-bearing debt right now somewhere around 65 and then target low 50s, exit 2020?

Steve Waszak

I would say, Tony, our interest-bearing debt today is, term A is 40, and then our ABL, our working capital is in that 35 to 40 range, as well. So, the number's really closer to 80 before you start including [unintelligible].

Tony Billgolf

Okay. I thought was—that's after the rights offering cash?

Steve Waszak

Yes, because we use our rights offering cash to pay off the term B, which was 12. So, we paid that off.

Tony Billgolf

Okay. As far as customers in China--.

Eddie Smith

Can I add one thing to that, Tony? As our inventory goes down, and we talk about free cash flow, as our inventory goes down, so will our debt. And so, when we talk about the \$14 million,

that's free cash flow from profitability. If we can get back to six turns, we'll take quite a bit of that working capital. The \$35 million, \$40 million will come down, also.

Steve Waszak

So, Tony, my projection on that is if we go from where we're at today, about 4.7 turns of inventory and bring that to 6, that will generate in the range of \$8 [million] to \$10 million in terms of free cash flow as we look forward. Additionally, just on cost to capital while you're on the topic, and then we'll move on to your China question, by using the rights offering to pay off the term B and by restructuring the debt as we did in August with doing more ABL and less term, we paid the term A down by \$10 million. Our blended cost to capital has moved to 7.5% interest from just under 10% entering the quarter. So, from that perspective, our cash interest has gone down on that balance, as well.

Tony Billgolf

Okay, great. And then, how much of the business from China are you going to be able to move to Mexico? Or is it maybe some of the consumer stuff just not even worth moving?

Eddie Smith

No, it's a great question. The stuff that's not worth moving, we won't move. So, the consumer stuff we definitely won't move. But there's a couple customers and a couple key pieces of business, which, as you can see by our strong 2020 numbers, about half of that business, customers have committed to moving. So, it will help us in 2020, but through Q3, Q4, we'll be in a wind out, and it will wind up in a different bucket, the China bucket.

And then Q1, it'll wind up in Chihuahua. So, we expect to have that completed by December 31st, because that's when our lease runs out. So, we need to have it completed by then. So, it's about half of what I would call the continuing business. And if you think about our business being on a \$23 million run rate, probably half is business we wouldn't want to move, and then half of that we'll move.

Tony Billgolf

Okay, awesome. And then that leads into my next question. If I look at what you're expecting for Q3 and Q4 as far as EBITDA percentage, it just doesn't look like there's going to be much EBITDA percentage expansion for 2020.

Eddie Smith

Yeah, so, here's where you start running into the law of bigger numbers, right. When we start getting over 7% EBITDA, our customers start seeing that and saying, "Hey, you're making a lot of money on me. I don't want you to make an unbelievable amount of money." So, some of it we have to get through efficiencies. So, we'll continue to become more profitable, but it won't be as dramatic as it has been in the past. And our long-term goal's been eight to ten, and there's a good chance we'll be creeping up to eight mid-year next year and then going over eight later in the year.

So, here's what I'd say. Probably first quarter won't get to our long-term goal, but we'll be heading that direction. And, as the year gets on, we'll probably surpass the eight on the bottom side. So, by getting more efficient doing the things we did the last year, we jumped way up in terms of EBITDA percent, from three to six to over seven, but I don't see us continuing at that rapid pace.

Tony Billgolf

And I think you had said in August—I don't know if everything just got taken down just a little bit, but following the same direction as far as Q3, Q4 sequentially?

Eddie Smith

Yeah, so, some of our customers, because of this inventory overhang, are pushing out quickly, and what you don't want to be is in conflict with your customers. So, we've allowed some of them to do that even though contractually they weren't able to. But having a fight with a customer's probably not a great spot to be in. So, it's moved quicker than we expected, but if you think the underlying numbers—and it's probably a good question that I'll probably get 50 times later today, so I might as well walk through it now. If you take the \$345 [million] on the day of integration and you take China out, we had base business of \$322 [million]. You take midpoint of our guidance for the year at say \$360 [million], just because it's easier for me to calculate. It means we're going to grow this year in the middle of an acquisition, and we're focused on trying to fix our Mexico thing during the acquisition. We're going to grow almost double digits, if not over double digits in terms of 10% growth in the midst of that, the integration, the banking thing, and all of that.

If you take us finishing us at \$360 [million] to next year, we'll grow once again another 10% or significantly higher than the industry growth going right now. So, we're still seeing growth from our core business, but it's clear to me that our customers, because of the lead time and because of what we said in the semiconductor space and the data center space, our customers have taken a dramatic turn quickly to right size their inventory and right size the business.

Now, the good news for 2020, which we announced in this call, is we've already won \$15 million of new contracts that start Q1 of next year. We're in the qualification phase as we speak. And, of that \$15 million, \$12 million of it is in spaces we want to be, medical or military. And so, we're pretty excited about the pipeline now that we're refocused on growing the topline, but it can never happen fast enough, and obviously I never walk away going, "Wow, that was great, and that was fast." It just seems to take longer than it should.

Tony Billgolf

Okay, last question. So, there are some headwinds, obviously, with the semis and data centers. I think Gilbarco has maybe some tailwinds the last couple years as far as replacement for the chip and PIN in the gas stations. Are you seeing any potential headwinds for larger customers like that for 2020, or at least flat?

Eddie Smith

So, first of all, I don't normally talk about specific customers, so I'll talk about that market segment, because we have multiple customers in the payment segment. We have seen growth this year, and I'd expect to see that continuing, because the technology continues to evolve in terms of putting chips in your cars, putting touch things, putting your phone where you can touch and pay over your phone. So, I don't expect it be explosive growth, but I don't expect it to go backwards. So, the payment systems business is a pretty steady business of us. Not huge growth but not backwards either.

Operator

The next question come from Greg Weaver of Invicta Capital. Please go ahead.

Greg Weaver

Yeah, hi. Good morning. Thank for doing the call here.

Eddie Smith

Thanks for being on it.

Greg Weaver

You just answered my question a little bit there, but, just in terms of the \$20 million that disappeared out of the back half of the year if I ex out China, how much of that would you say is the inventory pull down versus semi and data center?

Eddie Smith

Yes, so, that's the question of the day. I would say that semi and data center is probably \$12 million of that \$20 [million], and the inventory is about \$8 million of the \$20 [million] And you never know exactly if it's inventory or their lack of demand, because some of the customers will say "Well, I don't have the demand." And part of the reason they don't have the demand is they don't have the inventory. So, you're going in this cycle, but it's clear that lead times, our customers don't view the inventory risk like they viewed it a year ago. "I have to have the inventory, because I won't be able to service my customer for 26 weeks."

It's clear when the industry came down from an average of 26 weeks to 12 or even 8, at this point, it continues to collapse. That customer said, "I'm going to take my inventory down, because I don't need this just in case inventory any longer." So, I'd say it's about 12 and 8, but it could be closer to 50/50.

Greg, it's just because it's hard for us to figure out their underlying demand quickly. And it's happened so quickly that it's hard to get those numbers. We'll get them over time, because as GDP comes out and other information comes out, but so far I think that's what we're evaluating, about a 12 to 8 split

Greg Weaver

Alright, that's helpful. And just the only other follow-up there is just on the semi and data center, any other color there? Is it one specific customer, or are you seeing multiple guys in both those spaces causing issues or?

Eddie Smith

Yeah, I wouldn't have pointed them out if it wasn't multiple customers. And I would tell you, just to give you an interesting fact is, when it comes to semi equipment, one of the issues that you have—and I'll give you the two big issues that they're experiencing. One is that just recently, China started putting a tariff on the equipment going into China. So, it's not only coming out of China. It's going into China. And so that had a pretty quick impact. Obviously this equipment is not cheap, and when you have to pay 10% tariff, it clearly slows down the marketplace.

And so, when all that gyration happened where it was not only what was coming out gets tariffed, but what was going in gets tariffed, it became a double whammy. The second part of that on a semiconductor space, when you look at the semiconductor book to bill, it went negative earlier in the year, but it's now about .89 to 1, and that's pretty significantly negative. And in my career, when you go below .9 to 1, people slow down their inventory, they slow down different things. But the positive news, if I want to speak a positive, is our underlying core business is still growing double digits. I think what we need to do here is win more new customers quicker, and that's my number one focus now for the rest of the year.

Greg Weaver

And you've got a bit of a gap there from when you pulled back in the early part of the year due to working capital?

Eddie Smith

That's very astute. You're absolutely right. We didn't go after certain customers because we wouldn't have the working capital, and so it left us a little bit of a gap that I wish, to be honest with you, now I look back and probably would have filled some of these gaps with some of those new customers. But the good news is the pipeline's grown pretty quickly, and we've won some business pretty quickly. And it continues. So, we have some customers in today that could be some good upside. So, it's a pretty exciting time when it comes to the customer thing from where we were a quarter ago when we were pushing them away and holding them off. And so, I'm pretty excited about 2020, to be honest with you.

Greg Weaver

And then in terms of your offerings, the fact that you have so much Mexican capacity, is that one of the allures? Because the two things you cited were medical and aerospace. So, there's \$15 million. I'm thinking that's probably not being made down there?

Eddie Smith

So, medical we make down in Mexico, and customers like it down there, because it's lower cost and they don't get their IP stolen. So, medical is going to be down in Mexico, and the military is going to be either in our plant in Fremont or our plant in Melbourne with the predominance in our Melbourne, Florida plant. And it's pretty exciting in Melbourne. I would invite any one of you to come down and take a tour of it. We're in a facility that used to be a defense contractor's facility, so it's pretty cool and pretty nice facility. So, I think we're now landing what we want to land, which is higher margin business and longer-term contracts.

Greg Weaver

Okay. Thank you very much.

Eddie Smith

No, thank you.

Operator

The next question comes from Charles Neuhauser of Mainwall Investment Management. Please go ahead.

Charles Neuhauser

Yeah, hi. When you were talking about the revenue progression, I want to ask the 51st question. The \$360 [million] round number that you threw out for this year, does that include revenue from China?

Eddie Smith

So, no, that does not include the revenue from China.

Charles Neuhauser

Right, okay, good. And then a couple of more mundane questions. The \$80 million round number debt situation that you have right at the minute, would you expect that to be somewhat lower by the end of the year, because you've worked down some working capital or inventory?

Eddie Smith

In 2019, probably not, because we're going to use some cash to put—we'll work some inventory down, but we'll use some cash to close the China operation.

Charles Neuhauser

Getting out of China [unintelligible].

Eddie Smith

[Unintelligible] but once we've finished that at the end of the year, we expect to start having free cash flow from our operations.

Charles Neuhauser

And then one more mundane, picky question. How many fully diluted shares of stock are out there right this minute?

Eddie Smith

Just under 29 million.

Charles Neuhauser

Right. Now, on a bigger picture question, can you talk a little bit about how this MC Assembly merger has developed, how that's going, how, in hindsight, it has progressed or not? That's the general question, please.

Eddie Smith

Sure. We bought the company, and we had an influx of business almost immediately. It led to some operational inefficiencies down in our Mexico plant that we had bought from MC. We put a lot of focus Q1, Q2, but it also created some banking or working capital financing issues. It made us tight on our covenants, because the inefficiency didn't make us as profitable as the growth would—should have allowed us to be. And we fixed some of that. I would say it's probably 90% fixed. We still have a little bit of ways to go in Zacatecas, but, as overall, it continues to get better and better by the day and by the month. Rich and his team have put a lot of focus there and have done a great job getting us to where we are.

But it clearly, it was an undertaking that, if I was to look back, it was an undertaking probably a little bigger than I thought. We viewed it as a business that was running pretty well, and when we got into it, we had to make a lot of changes that we didn't expect. So, it slowed us down a little bit in the first half of the year. And, as Greg said, it created a gap in new customers and revenue in the back half of the year that we're now fixing for 2020. So, would I do it again? Probably if I was in the same situation, because it gave us some scale, and, obviously, making \$25 [million], \$26 million in EBITDA is much better than making \$5 [million] or \$6 million in EBITDA. Obviously, scale wise, this has really transformed the company. But I would say it wasn't as easy, and I learned a lot of lessons.

When I at Avnet in my previous history, we made a lot of acquisitions, and they were very big. But we also already had scale, so it was easier for us to absorb. In a smaller company, absorbing somebody almost equivalent in size to you is an undertaking that is a pretty monumental task. So, I feel good about it now, but I can tell you there were some pretty difficult days early in the year in terms of operations and integration.

Charles Neuhauser

Okay, that's fair enough. And the main point is that right at the moment, you feel you're 90% of the way there, and it [unintelligible] by the end of 2019, you should feel that that acquisition is running as well as you would have hoped initially. Is that fair to say?

Eddie Smith

Yeah, so, think about it this way maybe on the financial side instead of the operational side. When we bought them, there was about \$18 million EBITDA adjusted. We said we were going to have about \$6 million of synergies for the year, which was \$24 million, and we'll finish above that when it's all said and done. We'll finish--\$25 [million] to \$26.5 [million] is what we're guiding. So, it's clearly given us the scale we wanted.

It's clearly helped us with our EBITDA and being a company. One of the issues we ran into with some of our customers before the acquisition was, "Hey, I don't want to give you more business, because if I give you more, I'm too big a percentage". We have not, since the day we closed the acquisition, had that conversation with any customer. And so, clearly the scale matters, and I think our customers who know us everyday and deal with us everyday realize we're pretty much done with the integration. We're officially done. We're not making any more cuts because of that. But the reality is we just need to get a little more efficient down in Mexico still.

So, with that, I want to thank everybody for attending the call. I know the China thing probably was something that we had talked about before or hinted about. Clearly the tariffs have had an impact there. We'll continue to grow, and we'll continue to grow in 2020. So, thank you, everybody, for your time.

Operator

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