SMTC Corporation (SMTX)
Q2 2017 Results Earnings Conference Call
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Executives

Blair McInnis - Investor Relations
Eddie Smith - CEO
Roger Dunfield - CFO
Rich Fitzgerald - COO

Analysts

Stephen Cole - Mangrove
Charles Neuhauser - Mainwall Investment
Stephen Cole - Mangrove

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the SMTC Q2 2017 Earnings Call. At this time all participants are in a listen only mode. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Blair McInnis.

Blair McInnis

Thank you, Jimmy. Before we begin the call, I'd like to remind everybody that the presentation includes 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. A 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.

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

Eddie Smith

Thank you, Blair. Welcome, and good morning, ladies and gentlemen. I am Eddie Smith, SMTC's President and Chief Executive Officer. On this call with me today is Roger Dunfield, SMTC's Chief Financial Officer, and Rich Fitzgerald, our COO.

During the quarter, we executed our Global Restructuring Plan, which was communicated on May 15, 2017, when we filed our 2017 first quarter results. This was a challenging decision, but one which was -- required the company to right-size our cost structure to align with our revenue levels. We operate today in addition to reorganizing our corporate structure. Our Global Restructuring Plan was substantially completed during this quarter, resulting in a global headcount reduction of approximately 180.

The closure of our Suzhou facility is expected to be substantially completed during the third quarter. The process of closing Suzhou facility included the transfer of customers to our other manufacturing facilities. The final production extended into July; however, this transition has been executed by our team effectively, and I do not anticipate any subsequent delays.

The company has engaged with several manufacturing representative firms in different regions, which represents an additional sales channel to accelerate our growth with limited up-front fixed costs. These relationships have already resulted in new quotes and new customers, which we anticipate will generate revenue by the end of 2017.

As I announced in the first quarter's earnings call, we hired Rich Fitzgerald as our new Chief Operating Officer. Rich is responsible for the three manufacturing facilities, in addition to the engineering and supply chain groups. During the quarter, Rich has met with a number of our customer suppliers, as well as visiting each of our facilities, to better assess and understand our capabilities. In addition to our capital requirements, we are very excited to have Rich join us, and I would like to take the opportunity to welcome Rich to SMTC.

Let me turn it over to Rich.

Rich Fitzgerald

Thanks, Eddie. Good morning. It's a privilege to be a part of this team, and I look forward to the opportunity to serve our shareholders, customers, employees and supplier-partners alike. I'm eager to lead us through this transformation, and in my first six weeks, I'm pleased that we've made meaningful progress.

With that, I will hand it over to Roger to review the financial details.

Roger Dunfield

Thanks, Rich. Revenue for the second quarter of fiscal 2017 was $33 million, compared to $43.6 million in the same quarter in the prior year, and essentially flat compared to $33.2 million in the first quarter of fiscal 2017. The reduction from a year ago is primarily the result of volume reductions from a customer; however, quarter-over-quarter revenue has stabilized.

Gross profit for the second quarter of 2017 decreased by $1.7 million to $1.4 million, or 4.3% of revenue, compared with $3.1 million, or 7.1% of revenue, for the same period in 2016. Adjusted gross profit as a percent of revenue in the second quarter of 2017 was 3.4%, compared to 7.2% in the same period of the prior year.

Gross profit for the second quarter decreased by $2.1 million, compared with $3.6 million, or 10.7% of revenue, in the first quarter of 2017. Adjusted gross profit as a percentage of revenue in the second quarter of 2017 was 3.4%, compared to 6.9% in the prior quarter.

The reduction in gross margin in the second quarter of 2016 is due to additional inventory provisions for excess and obsolete materials of $0.5 million and customer accommodations of $0.7 million recorded in the quarter. In addition, further reduction of gross margin from the second quarter of 2016 is due to reduced revenue to cover fixed costs and some product mix.

Net loss was $6 million for the second quarter of 2017, compared to a net loss of $0.6 million for the second quarter of the prior year and a net loss of $0.3 million in the first quarter of 2017. Adjusted EBITDA reduced to negative $3.6 million in the second quarter of 2017, from $0.9 million for the same period in the prior year, and negative $0.3 million in the first quarter of 2017.

The reduction in the second quarter of 2017 is partially due to the aforementioned additional charges in the second quarter of 2017 and lower revenue compared to the same quarter in the prior year. Included in the selling and general administration expenses for the quarter ended July 2, 2017, was an additional provision for bad debt expense of $0.8 million, related to one customer that management does not believe is collectable. This increase in selling and general administration expenses is partially offset by reductions in labor as a result of the previously announced restructuring plan.

In addition, there were noncash charges incurred in the quarter ended July 2, 2017, from impairment of property, plant and equipment predominantly related to the U.S. and China segments of $1.6 million. With the on boarding of the company's new chief operating officer, each facility's capabilities and capital requirements was assessed.

As part of this assessment, it was determined that $0.6 million in assets specifically identified as having no further use were impaired. The remaining impairment charges of $1 million related to the U.S. segment asset group, specifically due to continued site operating losses.

Restructuring charges of $1.4 million were recorded during the second quarter of 2017 as a result of the restructuring plan communicated on May 15, 2017. The closure of the Suzhou facility is underway, with final production and transfer of customers completed at the end of July 2017. The closure and transfer of business is substantially completed, with minor wind-down activities remaining.

Debt net of cash of $10.7 million is down from $11.2 million in the first quarter, and we believe we will continue to reduce debt as we manage working capital and generate cash from operations. As you can see, along with our restructuring, we incurred some significant charges for impairment and other provisions during the quarter. These charges impacted our net loss and adjusted EBITDA for the quarter by $5 million and $3.6 million respectively.

I will now hand the call back to Eddie to provide some closing remarks.

Eddie Smith

Thanks, Roger. We're in the early stages of the company's transformation, and I'm encouraged by the progress we've made thus far. I believe we have initiated an effective strategic plan, and one which we believe will increase shareholder value. While I do not expect substantial change in revenue next quarter, I do expect to be EBITDA-positive. I'm excited about the prospects in expanding our sales funnel with both new and existing customers. We've seen some early progress from our representative firms we started establishing during the quarter, in addition to the relationships we continue to build with our existing customer base to service their needs. I intend to purchase additional SMTC stock in the near future when the insider-trading window is open.

Finally, I ask that our employees, customers and other shareholders continue to put their trust in SMTC. I'd also like to thank them. We appreciate their dedication and continued support during this period of change.

At this I'd like to open up the floor for questions.

Question-and-Answer Session

Operator

[Operator Instructions]

A - Eddie Smith

Can you repeat the question?

Operator

My apologies, sir?

A - Eddie Smith

Was there a question?

Operator

No, sir, I was giving information for the questions. I was giving a minute to collect questions. I see a couple people have queued up. Would you like me to begin?

A - Eddie Smith

Yes.

Operator

All right, our first question comes from Stephen Cole from Mangrove. Please go ahead.

Q - Stephen Cole

Good morning, guys. Thanks for having the call, as always. I guess, Eddie, what I'd like to do for a few minutes is talk -- or maybe go back to Rich's -- why don't we do that first. Let's talk -- I know he's only been here six weeks, but I'm curious on -- we'd obviously done a fair amount in terms of facility consolidation and taking out some costs, but maybe he could spend a few minutes, based on what his experiences have been so far and what he's seen and where we are. Have we taken all the measures that we need to do? And where are we on the -- and how does this dovetail into the strategic plan? And then I've got a few questions for you as well, Eddie.

A - Eddie Smith

Sure. Thank you, Steve. I appreciate it, and thanks for being on it. Let me turn it over to Rich to answer.

A - Rich Fitzgerald

So, as I continue to go through the information, one of the things that I clearly am looking at is this improvement processes and what I call business management processes in the transformation. These are things that will bring standardization as we do the facility consolidations and better efficiencies, whether it be in labor, whether it be in material. Obviously, with my background and these relationships that we have, we'll -- being able to create synergies that perhaps we hadn't had before.

Q - Stephen Cole

Okay. And Rich, so, are we done with -- when you look at the capabilities, and you've made some of the decisions to shut things and what have you, have you seen some areas that you can -- that we can expand on, or do we have capabilities that the company hasn't been properly exploiting, that potentially get to a smart business, or what do you see along those lines?

A - Eddie Smith

So, Steve, if you don't mind -- this is Eddie.

Q - Stephen Cole

No, not at all.

A - Eddie Smith

[Multiple speakers] put out that we're not only expanding our capabilities in the plants like there in Chihuahua, we expanded our metal-bending capability and actually our -- some of our customers we moved from Suzhou over to Chihauhau are going to start using our box-build capability, where we actually bend the metal. We also, through the relationships of Rich and myself, we also have entered into an agreement with [indiscernible] to do some value-added reselling of boxes where we can do some value-added. So we clearly are going to expand our capability outside of where it is today, and taking our Suzhou plant and moving it in with our Dongguan plant clearly will give Dongguan some capability they didn't have before, because we used some specialized machinery up in Suzhou that we've now moved down to Dongguan and can do some different things for our customers down there. We're excited about that.

Q - Stephen Cole

And let me just address that, and I'll get out of the -- get back in the queue. Eddie, one for you here: So, the key -- yeah, we realize that we've got a transformation. Obviously, the thing that's frustrating for shareholders with SMTC is we've gone through multiple transformations, right? Over a number of years, and we thought we were moving on the right track, and now we're back in another transformation. And I think that the key that we can all agree on, once we get the thing right-sized, is growing revenue. And I know you talk about the pipeline, and we're not -- I guess your guidance more or less is for a flattish type of quarter in Q3, but maybe you can address kind of where the pipeline is, the types of opportunities that you're seeing, and the sales cycle times with the things that you're pursuing. What are those lead times looking like? And when do we start to see that turn in revenues that we need to see, obviously, to get above this breakeven level?

A - Eddie Smith

Yeah, so first of all, you have to stabilize the company and stop contracting. And as I look at SMTC over the years, it's contracted significantly year in [indiscernible] out over the last couple of years. So, I think the fact that we've kind of stabilized at a $33 million, $33-plus million number actually is a good first start, right? Not losing any more customers, not having to fight that battle. Right-sizing the company could add size so that it can become EBITDA-positive was also another important step in this process. Now the question is, and I think you asked the appropriate question, is how do we bring in additional business? And we really are going to do it two ways. The quicker way will be to get additional business from our existing customers. And first of all, we had to win their confidence over, which we've been doing over the last couple of months, [indiscernible] here, we're in this for the long term, and we can do a good job, high-quality products. And the fact that we can be more efficient for them if we do more business with our existing customer. That was step number one in terms of growth.

Step number two in terms of growth was getting more feet on the street, which was signing the reps. Step three was actually getting them to get us in front of their customers, getting quotes and winning some orders. I'm actually pleasantly surprised that we've actually got quotes pretty quickly, and we've actually got a couple new customers in the pipeline, but those don't start up overnight. I don't want somebody to say, hey, you got a new customer today, and the significant revenue will be next quarter. These things take three, six, maybe even nine months, dependent upon how mature the product is that's moving. But clearly, I am pleasantly surprised at how quickly both our existing customers, and we're starting to look, quote and add new customers. As far as the -- and I do hear this a lot, about hey, there's been many CEOs that have told this story about restructuring the company and doing that. I can't answer for why those didn't work. What I can answer for today, I know where we are. We had a plan, we have key performance indicators, KPIs, in terms of quotes, are up significantly. In terms of wins, those are also up significantly. I am [indiscernible] at how quickly both [indiscernible] customers and new customers are [indiscernible].

Q - Stephen Cole

Okay. Very good. Thank you very much, Eddie. That's helpful. And I'll pop back in the queue.

A - Eddie Smith

Steve, I appreciate it.

Operator

And our next question comes from Charles Neuhauser from Mainwall Investment. Mr. Neuhauser our line is open.

Q - Charles Neuhauser

Morning. The previous caller beat me to the punch with most of the important questions, which I appreciate your answering. That's helped clarify things. So really, all I have left to ask is a very picky financial question. The revenue is flat, as we've talked about, but the inventory number seems to have gone up noticeably in both the first and second quarters, and it looks like you've dipped into your revolver to finance that. And since I assume you took all the write-offs you could think of in this recent quarter, I would think that the inventory is fresh, or not subject to write-down. So why is the inventory up to that extent?

A - Eddie Smith

Sure. So, let me give you a couple of reasons, and then Roger can either clarify or add on to whatever I have to say. So, first of all, thanks, Charles, for joining us. But the inventory is up for a couple different reasons. First of all, when we added the [indiscernible] on as a value-added reseller, we had to take inventory up to get that project started. And so, whenever you start new customers' new things, you have to take on inventory before you actually ship it. So you have to bring it in to do the value-added work, and that normally doesn't happen within the same quarter, so there's always that timing issue when you add new things on. Second, we've had some customers where, as we went from just doing PCBAs to doing box-build, obviously you need to bring more inventory for that. We've had some customers have us push out at the end of the quarter and hold some finished-goods inventory, and clearly, last but not least, we need to do a better job to be more efficient on the inventory, and I think you'll see us, as an aggregate for our existing customers, take our inventory back down. Obviously, when Roger talked about reducing the debt in the future in his comments, I think that's where we're going to get the money to reduce that debt. I don't know if you want to add anything, Roger.

A - Roger Dunfield

Clearly, inventory is a focus. I believe we came in at five turns; our target is seven or above. That's where we've been in the past, and that's clearly where we're going to focus and target to be at in going forward.

Q - Charles Neuhauser

Great. Thank you very much.

A - Eddie Smith

But you hit the great -- the perfect question, because that clearly is something that we've got to -- as we add new customers, we need to stay focused on inventory and cash flow, because it takes a while to turn from raw inventory into finished goods and then shipments.

Q - Charles Neuhauser

Right. Well, I think we'd all agree, if you're successful in bringing in new customers, which will actually grow the top line, putting up with a little extra working capital for the first quarter or two as you bring the new business on is the price you have to pay. So, I'll look forward to the payoff from that, so to speak. Thank you very much.

A - Eddie Smith

No, thank you.

Operator

And we have a follow-up question from Stephen Cole from Mangrove. Mr. Cole your line open.

Q - Stephen Cole

Yeah, one more question, guys. So, one of the things when we talk about new customers, obviously there's different approaches, and Eddie, you talked about some of the things that you're doing. We know that the predecessor management went after this whole idea of smaller, kind of this innovation center type of thing, and going after smaller folks and kind of grow with them, and that obviously brings risk, and I don't know if that's where we've been able to just write off as one of those customers. But can you give me a little bit of a sense on what the ideal profile of a new customer looks like in terms of size? Are we moving up the food chain? Are we starting to decide that we're going to be a true Tier 2 supplier and not try to be a Tier 1 supplier? What are we trying to do, and what is our strategic vision as we go forward here over the next few years?

A - Eddie Smith

It's a great question, and so, Steve, I spent, at first, trying to figure out who are we and where do we go? I think your observation in this innovation center was pretty accurate. I actually personally believe that we're going to do some amount of innovation, but that's not going to be our primary focus. As you said, they're very risky, taking some of these startups and trying to create innovation. I'm not sure that we have the capability to take as much risk as was taken in the past, and some of that risk now is having a negative effect on the company. I actually think we are a great Tier 2 or Tier 3 -- you can call it either one -- I think our capabilities are in a Tier 2 range, our size is in the Tier 3 range. Tier 2 or Tier 3 industrial high-speed circuits and RF [Indiscernible] EMS provider. My answer would -- I don't think we can continue to be everything to everybody, including a lot of startups. I think we can pick up a startup if it's strategic and fits what we do, but we are really good, if you think -- look at our customers, at what I would consider leading-edge high-speed circuitry. Many of our customers are test-and-measurement companies that are on the edge of new technologies. Many of them are in a semiconductor test-and-measurement space and a [Indiscernible] space. Those type of companies are leading-edge. So we build leading-edge projects; there's no doubt that we have capabilities many don't have. The fact of the matter is, I think the company was focused on startups, which may not bring you revenue for 2 or 3 years. I have changed the focus to getting into more what I would call mature customers so that when we land a customer, its immediate revenue impact is much more significant than waiting 3 years for us to ramp up with the customer, if their product ever does ramp up. I mean, on the other -- it reduces, obviously, the financial risk, too.

Q - Stephen Cole

One -- and I kind of said that I've got one follow-up to that, but how do you see the mix of the sales funnel working between your internal sales force and really third party, this rep organizational plan that you're rolling out? So maybe you can kind of give us a sense on how many sales folks do we have now, have you made changes there, are you looking to make changes, and really, what are the ideal mix? And I guess it's hard to know that for sure now, but what is -- what would that mix look like, or what does the target look like as we go forward?

A - Eddie Smith

Yeah, so we continue to have salespeople, and I'd be reluctant to tell you the exact number, but we have a few salespeople. And I would say it this way: I think, in the end, even when the reps are involved, we'll have some of our salespeople closing the deals, doing the quoting. And so, obviously, it takes resources to get to the end.

I think when you break that down, and I'm taking a very big leap here to say it's probably 50/50, with the reps bringing in kind of our increased revenue and existing sales force bringing in the other 50.

I think almost at the very beginning, as I said, our existing customers over the next couple of quarters are going to drive our growth, giving us new programs, new divisions, new projects. That growth, I can see we've already quoted our existing customers a significant amount of business, and so it's just a matter of getting those things closed and moved. And then, I think the quarters that follow that will be new customers ramping up. And since we're going after less startup companies, the revenue is much more stable, already known, and they have an existing customer base, so you don't get these big spikes up when they introduce a new product and then it spikes down, which really has been an issue as I go back and look at [indiscernible].

Operator

And I am showing no further questions at this time. At this time I'd like to…

End of Q&A

Eddie Smith

Okay. Well, I want to thank everybody. First of all, I want to thank our employees and our existing customers for hanging in through the very difficult restructuring. They've done a great job in closing Suzhou and combining with Dongguan. We've done that both efficiently and with meeting our customers' expectations. So I want to thank our employees and our customers.

I want to thank our shareholders for being patient through this restructuring, and hopefully we will reward our shareholders in the near future. So with that, I want to thank everybody for attending, and we look forward to having our next call in November 2017. Thank you. Have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes the program.