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SMTX - Q3 2017 SMTC Corp Earnings Call

EVENT DATE/TIME: NOVEMBER 02, 2017 / 8:30PM GMT



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CORPORATE PARTICIPANTS

Blair McInnis *SMTC Corporation - Corporate Controller*

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

Roger Dunfield *SMTC Corporation - CFO*

PRESENTATION

Operator

And good day, ladies and gentlemen, and welcome to the SMTC Third Quarter 2017 Earnings Conference Call (Operator Instructions) As a reminder, this conference may be recorded.

I would now like to turn the conference over to our host of today's call, Mr. Blair McInnis. You may begin.

Blair McInnis - *SMTC Corporation - Corporate Controller*

Thank you, Tanya. 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. 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.

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

Thank you, Blair. Welcome, and good evening, 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 CFO; and Rich Fitzgerald, SMTC's COO.

I'm excited with the progress we've made on our strategic plan this quarter. I'm pleased with the quarter-over-quarter revenue growth. This demonstrates our efforts to stabilize our sales funnel with existing customers, while expanding our opportunities with new and existing customers. We've executed new agreements with a number of representative firms during the quarter, some of which have already translated into new customer prospects. What is more substantial is the growth in positive-adjusted EBITDA compared to the negative-adjusted EBITDA incurred in the first 2 quarters of 2017. This substantiates our plan to reduce cost globally to rightsize our operations with the ultimate goal of earning net income. We will continue to execute on our strategic plan, and are optimistic the end of the year -- we'll end the year with a stronger fourth quarter.

The company generated positive-adjusted EBITDA \$1.1 million on \$34 million in revenue in the third quarter of 2017 compared to \$1.3 million of adjusted EBITDA earned on revenues of \$43 million in the third quarter of 2016, which shows the restructuring plan had rightsized the company and the go-forward leverage we will have as we increase sales. We have stabilized operations and show some sequential growth quarter-over-quarter. We will recommence merger-and-acquisition activities in 2018. We will continue to work closely with our customers and new customers to grow organically. But M&A is key to achieving the growth potential that we are pursuing in the near term.

I'll now hand the call over to Roger to review the financial details. Roger?



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Roger Dunfield - SMTX Corporation - CFO

Thanks, Eddie. Revenue for the third quarter of fiscal 2017 was \$34.4 million compared to \$42.7 million in the same quarter in the prior year, an increase compared to \$33 million in the second quarter of fiscal 2017. The decrease from the prior year was primarily the result of reduced volumes of \$6.3 million due to 2 customers. One of these customers product reached end-of-life, and the other customer transferred a portion of its business to other contract manufacturers. However, quarter-over-quarter, our revenue increased due to opportunities with new and existing customers.

Gross profit for the third quarter of 2017 was \$3 million or 8.6% of revenue compared with \$3.6 million or 8.5% of revenue for the same period in 2016. Adjusted gross profit, as a percentage of revenue in the third quarter of 2017, was 9% compared to 8.5% in the same period of the prior year. The decrease in gross profit dollars was due to the decrease in revenue compared to the same period in the prior year. However, the increase in gross profit percentage was due to higher margins on improved product mix and a lower-cost structure as a result of the restructuring plan. Gross profit of \$3 million for the third quarter of 2017 increased by \$1.6 million when compared to \$1.4 million of gross profit or 4.2% of revenue in the prior quarter. Adjusted gross profit in the third quarter of 2017 was \$3.1 million or 9% as a percent of revenue compared to 3.4% in the prior quarter. The increase in adjusted gross margin in the third quarter of 2017 compared to the prior quarter is due to higher revenues, a lower-cost structure as result of the restructuring plan, and additional charges reported in the second quarter of 2017 that were not incurred in the third quarter of 2017.

Net loss was \$0.6 million for the third quarter of 2017 compared to essentially breakeven for the same quarter in the prior year and a net loss of \$6 million in the second quarter of 2017. Adjusted EBITDA was \$1.1 million in the third quarter of 2017 compared to \$1.3 million for the same period in the prior year. Adjusted EBITDA increased over the negative-adjusted EBITDA of \$3.6 million reported in the second quarter of the 2017 due to improved gross profit discussed above and additional charges included in the second quarter of 2017.

We incurred additional restructuring charges, primarily related to the continued administrative activities involved to wind down and close the Suzhou facility. The closure was substantially completed by the end of the third of 2017, with no substantial ongoing operation. We do anticipate some additional minor-restructuring charges through the end of 2017. Our inventory reduced in the third quarter of 2017 compared to the first 2 quarters of 2017 as management continued to drive down inventory based on supply-chain management and resolving excess and obsolete inventory. Debt net of cash of \$11.8 million is up from the \$10.7 million in the second quarter of 2017. Net debt increased to fund the working capital related to higher revenues and due to the timing of CapEx spend.

Now I'll hand the call back to Eddie to provide some closing remarks.

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

Thanks, Roger. We're on track with our strategic plan and we've achieved some important milestones during the quarter. We have shown our quarter-over-quarter revenue growth and earned a positive-adjusted EBITDA, reflecting a substantial improvement over the first 2 quarters of 2017. Our sales funnel is strong, with revenue expected to be earned from new customers going forward. We have recently added 4 new customers and received orders for qualification bills from all of these new customers in Q4, with production to start in 2018. In conjunction with these new customers, we have received our FDA registration for our Chihuahua operations. I believe we have stabilized the existing customer base, with opportunities for new business with some of our existing customers. We are optimistic that we'll finish the year with a strong fourth quarter and expect to continue our positive revenue and financial momentum into 2018.

At this time, I will open up the floor for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)



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And our first question is from [Lucas Davenport], investor.

Unidentified Participant

So my question is that I've been a long-time investor in this company for numerous years. I have heard numerous CEOs come and go, saying that the horizon is bright. By around the quarter, we're going to see an uptick, but it just seems like it doesn't happen. So I'm just trying to figure out like what are you guys doing to develop shareholder value? Because this company has been treading water. The debt, it always kind of just stays at the same level. I understand the debt is, I think, around \$10 million, \$11 million net cash, but that always happens a couple quarters down. You see the debt increase and spikes substantially, then come back down. I mean, I understand before there was a problem because of the economy, but now the economy is doing very well. So I don't understand why we're really barely chugging along here.

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

Yes. So I'll try to take your questions and break it down into different parts. So I would say this that the frustration that you sound like you have over the last couple of years, obviously, I've only been here for 2 quarters, and so I don't have a lot of the history other than being a supplier to SMTC and understanding how they've gone up and down and debt's gone up and they've had those type of issues, but I've dealt with it as a supplier of SMTC. We -- I came in here a couple of quarters ago as an interim and decided to stay on. We put a plan together to restructure so that we can add new customers. Obviously, the revenue had been declining before I got here on a continual basis, almost 3 or 4 quarters in a row. So our first goal was to stabilize the company and get the revenues get flat, which we did the very first quarter. This is the second quarter and now we have the revenue going in a positive projection, and I hope it continues. I am optimistic it will continue to go that way. But we're in a EMS business and there are peaks and valleys. I mean there's always a possibility, but I feel very confident that we're in the right going -- headed in the right direction. I can understand your frustration has taken a long time. I have looked back at the stock and, obviously, any company that had a \$1 billion market cap back in 2001 and has a \$26 million market cap this year could be frustrating, depending upon when you bought it. But I can't recreate the history or change the history. All I can do is to tell you that this quarter, we got the company to grow after it had been declining from Q4 to Q1. Then Q2, we got it to flatten out. And now Q3, we got it to grow a bit. And as I said in my statements, I am pretty optimistic that, that should continue for a period of time. We've added 4 pretty significant customers. They're going through the qual. There's always a chance that we don't qual, otherwise, we wouldn't do a qual. But one of them what is it? Well enough that we actually got our FDA registration. So definitely not an easy task turning around the company, but this clearly is a turnaround. And it will take a couple of quarters for some of that to go on.

Unidentified Participant

Can you estimate where the revenue's going to be next quarter?

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

We don't give forward guidance. But you can read into the statement when I use words like optimistic and other things like that. So we just won't give guidance, it's just not what we do. But I appreciate the question, but there's no doubt about it. I am not the other management teams. I have worked with many of them in different places, so I can't answer for them. All I can answer is, how we're going do going forward.

Unidentified Participant

Can I ask you this question then, do you anticipate debt being paid off in the next year?



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

Once again, it -- the EMS space is an interesting space. If we grow too quick and we start growing, debt will actually increase. But our profitability will increase equally. And so that actually is depending upon how quickly we grow and for how long where the debt will be. And so I would never commit to paying something off not knowing where that's going. The second part of the debt issue is if we do M&A and when we do M&A and how we do M&A, is how do we structure the M&A deal. We deal with that -- we do it with the equity or we do it with a combination. And so once again, I wouldn't commit -- here's what I'll commit, that we will continue to be very diligent on the working capital and watching how we use our working capital. We'll continue to try to feed the inventory as well as possible, and be fringing on the receivables in the table. So I would never commit to taking the debt off depending upon what goes on that far out.

Unidentified Participant

Okay. My last question is the revenue from the new customers you said in 2018. What quarter specifically in 2018 do you anticipate seeing some of that revenue start to come in?

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

Yes. So we're in the qual phase with all 4 of those customers, and typical to this industry, some come in quicker than others. We've already qual-ed for one of the customers, so I would expect that in Q1, one of those customers will start seeing some pretty significant revenue. And then I think as late Q1, Q2, I think you will see some of the other customers. So I don't think it's very far away, so...

Operator

And our next question comes from [Tony Dobauf], private investor.

Unidentified Participant

Nice job stabilizing everything. So the 4 new customers, can you comment at all about like size potential? I know previous management was focusing on smaller startups. I'm just curious if you've been able to tap any, sort of, older business that's more seasoned and less volatile?

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

Yes. So 3 of the 4 customers are seasoned customers. One is a public company, 2 are private. My focus and the team's focus has not been those startups and those small companies. As you know, when you saw the restructuring last quarter, we wrote off bad debt from some of those startups that didn't make it. And with our profit margins going after startups, you better make sure you pick the right startup or you're going to be writing off. And you write off like we did the last quarter restructuring \$800,000-plus. And what happens is, it cost -- you need to do \$10 million of sales just to breakeven when you're writing that type of thing off. So I have switched the focus of the team, which I did quite a bit ago. That's why we brought the reps on to look for -- clearly, that if it was the right startup I would do it. But I would tell you as a general rule, we will only deal with companies that are both financially capable and already have a pipeline of business. So we're not through this, and they have a lot of business this quarter and then they don't. And we're a victim of the market by that so. These are all, other than 1, pretty significant customers.

Unidentified Participant

Okay, great. I get the sense that quality has improved, and I am curious if that's affected the share of wallet any with some of your older customers.

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

For some of our older customers, and I would thank our customers for this, have made us a better company by requiring higher quality. If you think about the space we play in with some of our customers in what I would call the high end of industrials, which is the test-and-measurement space, the semiconductor-manufacturing space and some of that, data centers, you can't have a blip in quality, because these machines -- our part of the machine may be hundreds of thousands of dollars, but the overall machines and things they sell are significantly higher in terms of -- like some of them could sell up to the tens of millions of dollars. So when we brought Rich Fitzgerald on, our COO, job one was to get our quality to a level and I think -- and most of the factories were there. We still have some work to do, and quality never sleeps as I say. So we'll always continually have quality. But clearly, getting the FDA registration, and not just certification, but actually registered with the specific product in our Chihuahua plant, I think reinforces the fact that we would have very high quality or we wouldn't be able to get registered.

Unidentified Participant

And then the -- so it sounds like the late-stage pipeline is looking good with those 4. How's the top of the pipeline as far as new stuff that maybe you expect to win later this quarter and into early 2018, that maybe won't start production until mid-2018 or later?

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

Yes. So we added the reps on, besides, we reorganized the sales team. Actually, cut some of those costs to the sales team, and went for a more variable cost by adding reps on. That function is now complete. We've added reps across the U.S., and we cover 75% of the U.S. with the rep [slab]. We do have some direct sales people up in what I call Silicon Valley and other areas. So I think the pipeline right now, I would call it strong. And I think it will continue to get stronger. These things have a tendency -- I think there's 2 types of pipelines. There's one with our existing customers getting more projects, and I think I would call that as doing good, but not as good as I would like it to be. But with new customers, I would call it strong. And I think as our financials improve and our situation improves, I think our existing customers will have more confidence and give us an increase in business.

Unidentified Participant

And it -- I might be misinterpreting the press release and what you said previously, but it sounds like there might be like a new line of business that you've also introduced that you and Rich were able to bring on the embedded.

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

Yes. So we're doing some data center -- we call it embedded business, and it's -- a lot of it drives and servers and high-performance servers, drives, things like that, storage memory in the data center. And so we actually had sales last quarter. So first quarter out, we took in some inventory and we actually sold it already. Took in some more inventory at the end of this quarter, which we expect to sell out over the next quarter or 2. So we've actually started a new line of what I would call embedded business, which is very concentrated in the server market.

Unidentified Participant

Okay. Fantastic. Last question, I know prior management team was exploring M&A activity, and it seem like there just wasn't a lot on the market. I am curious if there is more available now? And what kind of size you're looking to acquire?

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

Yes. So I don't want to go too deep to try to give my competitors the opportunity to know where I'm looking and what I'm looking at. But I'm not looking just to acquire somebody to -- for scale. Right now, I'm looking to acquire somebody in the Western part of the United States to enhance



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our 3-month plan. Then I'll -- probably the first M&A activity will be small, and you may shake your head and say, why small? Because the first one I do, I want to make sure we get it right. Understand the process, our team's capable and we are able to perform at a level that makes it acceptable. So it won't be super big. As far as availability of companies to buy, I've said this much in my career, there's always somebody out looking to sell, and there's always out somebody looking to buy. The key to all of this is getting somebody to agree to a price that the seller wants to pay and the buyer wants to sell for. And right now, we're in the very early stages. So I've put all of that on hold when I first came in, because there was a lot of focus that needed to be done in the restructuring and not focusing on M&A. And so my answer is, we're pretty early in the game.

Operator

And I am showing no further questions at this time. I would now like to turn the conference back to Eddie Smith for closing remarks.

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

I'd like to thank our dedicated employees and our customers for their commitment and drive every day. I think we're effectively executing on our strategic plan. And I'd like to thank for their contribution, our supply partners, as they continue to support us through not only this quarter, but as we grow. I want to thank all of you for joining our call and for your continued support of our company. We expect our next earnings call to take place in March 2018. We look forward to speaking to you then. Thanks, and have a nice holiday.

Operator

And ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day.

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