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SMTX - Q2 2018 SMTC Corp Earnings Call

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## CORPORATE PARTICIPANTS

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

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

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

## CONFERENCE CALL PARTICIPANTS

**Harry Venezia**

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the SMTC Second Quarter 2018 Earnings call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to introduce your host for today's conference, Blair McInnis, Vice President of Finance. Sir, you may begin.

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

Thank you. Before I begin the call, I'd like to remind everybody that the presentation will include statements about expected future events and financial results that are forward-looking in nature and subject to risks and uncertainties. The company cautions that actual performance will be affected by a number of factors, many of which are beyond the company's control, and that future events and results may vary substantially from what the company currently foresees. Discussion of the various factors that may affect future results is contained in the company's annual report on Form 10-K, Form 10-Q and on 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.

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

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

Thank you, Blair. Welcome, and good morning. Ladies and gentlemen, I'm Eddie Smith, SMTC's President and Chief Executive Officer. On this call with me today is Steve Waszak, SMTC's CFO; and Rich Fitzgerald, our COO.

I'm pleased to report that we're exceeding our business plan. Our focus is now on accelerating our growth. After the close of the market yesterday, we reported results for our second quarter of 2018 at the high end of our pre-announcement on July 23. We finished the quarter with $44.5 million in revenue, up 34.8% from a comparable quarter last year and 19.8% from prior quarter. Adjusted gross margin improved from 9.5% to 9.8%, while adjusted EBITDA was $1.6 million, which is $5.2 million higher compared to second quarter 2017.

The past year has been important for us as the team has clearly made significant progress in achieving a higher level of operational and financial performance from top to the bottom line. In addition to announcing terms of our Rights Offering in a press release 2 weeks ago, we provided financial guidance for remaining quarters of 2018. While we do not intend to provide forward guidance on an ongoing basis, we wanted to ensure that stockholders considering participating in the Rights Offering had that information. Steve will provide specifics of the guidance later in the call, but let me just say, we believe we have sufficient visibility and confidence in our ability to achieve that guidance with our current plant capacity.

During the second quarter, we added 2 new customers and further expanded programs with existing customers. We continue to see strong demand from both existing and new customers with growth in our semiconductor, test and measurement, and medical business lines. Our backlog barring any future -- further tightening of the supply chain by electronic component suppliers should support revenue growth in excess of 25% for the full year in 2018 over 2017 and positive year-over-year trends for our adjusted margins and EBITDA metrics.

We remain intensely focused on crisp execution of our business plan with detailed attention to our operational excellence, industry-leading quality metrics and superior customer on-time delivery. Our Fremont and China sites earned a profit for the first time in 7 quarters collectively. Both sites have won new customers, while improving our efficiencies. Our Chihuahua Mexico site continues to be a showcase, especially in light to the 301 tariff concerns, which we are carefully monitoring, and the leveling of the playing field against China specifically, with labor rates continuing to increase in China rapidly.

Our supply chain and operations team are continuing to drive further improvement to meet our customers' commitments despite reports of industry challenges, resulting from increasing demands for certain components, including MLCCs, or multilayer ceramic capacitors. We now support the needs of 17 customers using some version of a kanban, which is a highly efficient lean, just-in-time manufacturing program.

While we are pleased with progress to date, we have much to do to capitalize on the opportunities I see for SMTC. To achieve our vision, we are continuing to seek additional programs on our existing customers as well as continuing to secure new customers. And we are on track to achieve AS9100 accreditation in our Fremont facility this quarter, which will provide an opportunity for us to do and expand into avionics, aerospace and defense markets.

We will also explore M&A opportunities that provide synergistic benefits or high-value end markets to accelerate growth and enhance shareholder value.

I'll now hand the call over to Steve to review the financial details, and then come back with some additional comments. Welcome, Steve.

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

Thank you, Eddie, and good morning to everyone. Thank you for joining us this morning. As Eddie commented, revenues for the second quarter were $44.5 million compared to $33 million for the same quarter in 2017. $1.3 million of this revenue reported in the second quarter 2018 was due to the impact of the new revenue accounting recognition standards, ASC 606. The remainder of our 35% same quarter year-over-year growth was a result of increased orders from existing and new customers and -- added over the last 3 quarters. With our expanding revenues, the company has 3, 10% customers accounting for 34.8% of total revenues. We saw year-over-year increases in customers in industrial, power, energy, electronic payment processing and medical industry sectors. Revenues from customers in networking and communication sectors saw slight decreases over the same period a year ago.

Gross profit for the second quarter was $4.3 million or 9.6% of revenues compared to $1.4 million or 4.3% of revenues in the same quarter of 2017. That said, adjusted gross profits in the second quarter, which excludes the impacts of unrealized foreign currency gains or losses, was $4.4 million or 9.8% as a percent of revenues compared to $1.1 million or 3.4% for the same quarter in 2017.

Operating expenses, which are comprised of selling, general and administrative costs, were $3.6 million in the second quarter of 2018, $463,000 or 11.3% lower than the $4.1 million we recorded in the same quarter of 2017.

Further, the company reported net loss of $97,000 also in the second quarter compared to a net loss of $6 million in the same period a year ago. Adjusted EBITDA was positive in the second quarter 2018 compared to $3.6 million in the quarter a year ago. The increase in the second quarter compared to the same period in the prior year was due to improvements in adjusted gross profit from higher revenues and improved margins and cost-reduction efforts. In addition, the second quarter of 2017 included were certain impairments and increased bad debt and inventory associated with the company's restructuring that are not reoccurred in the second quarter of 2018.

Now before I return the call to Eddie, I'd like to comment on the balance sheet, talk about third quarter opportunities for us and comment on the Rights Offering, which we recently announced.

As of the end of the quarter -- end of the second quarter, we had $2.1 million -- or $2.0 million in cash. We had $19.7 million in net debt, with $10.5 million of available to borrow under our credit line with PNC. $2.7 million was utilizing in cash -- from cash flow from operations in the quarter. This is primarily to do -- to support working capital for accounts receivable and inventory for the expanding -- both the expanding revenues in the current quarter and preparing for the future quarters as well. Our cash-to-cash cycle was 61 days compared to 63 days in the prior quarter, with DSOs of 61 days and DPOs of 74 days. Inventory turnover on annualized basis was 5.0x in the second quarter of 2018.

On July 23, we issued a press release and announced the terms of our $13 million Rights Offering to holders of our common stock of record at the close of business on such date. Stockholders should carefully read the prospectus supplement, which can be found on our or the SEC's website, www.sec.gov, because it contains both important information, including timing on how to exercise and pay for those rights. Unless the company extends the offering period, all rights will expire now at the close of business, 4:00 p.m. on August 22.

As indicated in the July 23 press release, we have received commitments from Red Oak, Wynnefield and -- 2 of our largest stockholders, as well as members of the board and members of the executive management team and other outside investors with an aggregate to have funded more than $13 million as we project in the current Rights Offering.

As Eddie mentioned earlier, we do not intend to provide further guidance on an ongoing basis. We did provide guidance in our July 23 press release to ensure that stockholders considering participating in the Rights Offering had (inaudible) needed to make that decision. For those who did not see the press release, let me quickly summarize Q3 and Q4 guidance as we provided.

Q3 revenues of -- in 2018 ranging from $48 million to $51 million, up from $34.4 million in the same quarter a year ago, with adjusted EBITDA projected to range between $1.9 million to $2.2 million, up from $1.1 million in Q3 2017.

Q4 revenues will range between $48 million to $51 million, up from $38.6 million in the same quarter year ago, with adjusted EBITDA projected to range between $2.0 million and $2.5 million, up from $1.2 million in 2000 -- Q4 2017.

For the full year 2018, we expect to see revenues ranging between $178 million to $184 million, up 28% to 32% over 2017 levels. And as Eddie commented, the company has made progress for (inaudible) to achieve at the higher end -- the higher levels of these outlooks provided today.

We currently -- as Eddie also commented, we currently have capacity to support customer demand in excess of $200 million in our plants as we look forward over the next year.

Let me wrap up my comments by reiterating that we are, as a company, driving each quarter to achieve operational excellence in all phases. This includes our financial metrics as we made -- remain focused on making additional working capital management improvements to accelerate efforts to strengthen our balance sheet and remain focused on improving both the top and bottom lines.

Now I'd like to hand the call back to Eddie to provide some additional comments and certainly take questions that you may have from today's call.

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

Thanks, Steve. Let me conclude by saying the global demand trends remain strong, and we believe we are taking market share with existing customers and are poised to win over new customers. Our focus on operational excellence is paying off and is allowing us to mitigate the impacts thus far from component shortages that others have reported.

In short, we remain on track with our strategic goals, and are, in fact, exceeding our annual business plan. We had a strong Q2 with year-over-year growth in revenue, adjusted gross margin and adjusted EBITDA. The outlook for the balance of the year looks strong, and we expect to achieve revenue growth in excess of 25% for the full year 2018 over 2017, barring any unforeseen disruptions in the supply chain or impacts from tariffs.

I look forward to reporting on future earning calls our continued progress on towards making SMTC a stronger company that delights its customers with superior service and reward its stockholders with enhanced shareholder value.

With that, let's take questions from those on the call.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from [Lucas Davenport], a private investor.

**Unidentified Participant**

Couple of questions. Can you -- I'm sorry, I might have missed this because I've been listening to the calls -- sorry, listening to the ones that already started. Could you say who the 2 new customers were that were mentioned in the release?

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

Yes, we don't disclose our customers' names unless they like us to. And so far, we have not put out a press release on any new customers, but we -- all we could say is we have 2 new customers. And at some point, we may start disclosing and putting up press release for our new customers, but that has not been what we do.

**Unidentified Participant**

Okay, understood. And I just want to make sure I understood this correctly. Roughly, 8% of the revenue -- the growth from this -- for the year-over-year quarter was due to accounting, correct?

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

No, no, no. Only $1.3 million of the increase was due to the accounting. All the remainder was due to increased shipments revenue from customers.

**Unidentified Participant**

Okay. Sorry, I thought it's 8%, maybe I was wrong. Maybe my calculations are wrong. What -- are they -- is there going to be future share offerings just like the ones that were done on July 23?

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

At this point, there's no plan for future share offerings, but, obviously, it's like anything. We -- as we grow and we need capital or there is any other strategic opportunities to do that, we'll take a look at what's the best way to finance our business. But at this point, we haven't gone past the Rights Offering. We still need to close that and then see where things go.

**Unidentified Participant**

Okay. And my last question is kind of built on that. So I believe on the call, it was mentioned that there's roughly $10 million or so in borrowing capacity from the bank. So this offering is going to raise approximately $13 million, right?

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

Yes.

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**Unidentified Participant**

Why -- I'm just curious as to why the bank borrowing was not utilized versus this offering? And second -- the second part to that question is, I believe it also mentioned regarding approximately over $200 million in sales that the factories can accommodate. How much more of this $13 million that was raised if that's used to purchase additional equipment? How much more will they increase that $200 million by?

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

Sure. The -- so the reason we went and raised the money is for many different reasons that you can see in the press release we put them out for a different corporate purposes, capital equipment, and obviously, other potential corporate needs. So I'll -- the answer to your question was the board thought there was an opportunity now as the business recovered, that this would be a good time to raise some capital potentially by lowering the debt, and so we decided to pull the trigger now. So we didn't put -- and there's no thought about putting it all into equipment. Because, obviously, as you grow with customer, you have inventory and other things that you need to also pay for. But at this point, I would just say, you need to refer to the press release on what we're going to use the funds for. As far as the growth over $200 million in our factories. And the way our ABL works, Lucas, is as we grow and we have more assets, which is inventory receivables, our actually availability from the bank also grows. So we have $10.5 million today at the end of the quarter. And as we continue to grow that, that number may grow up or we may use that for inventory or other things. So I would tell you our capacity today as we look at capacity. And if we grow in a much more normalized state than big comps, we're probably okay to grow and -- I'll say it this way, if we could keep our cash-to-cash conversion in below 60 and at the rate that we use money, we could actually grow pretty significantly, obviously, without raising any more money. So I don't see raising money just around the business as a viable option at this point for a very long time.

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

And, Lucas, this is Steve Waszak. Just to go back to your question on the rev rec and the revenue on the accounting standards. If you look at Q1 of 2018 versus Q2, we grew revenues by about $7,359,000. Of that, $1.3 million was related to the accounting revenue recognition standard. So $6 million of that number is all based on customer demand increases. Thing to see here was substantial around the customer demand increase, so just for clarity.

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**Operator**

(Operator Instructions) Our next question comes from Harry Venezia with HealthCare Capital.

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**Harry Venezia**

I really appreciate the guidance you gave for the next few quarters. But my question has to do with just 1 thing as the company is poised to grow, and I'm sure that's primary purpose of the Rights Offering. Can you give us some idea of how much working capital you expect the company to need over the next 12 months? I do see that $2.7 million was used in this just finished quarter.

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

Yes, I would say -- thank you for your questions. It's Steve Waszak, the CFO. As we look towards our modeling, and we've shown quarters that far exceed what we're showing for Q3 and Q4 outlooks, we see in the range of $4 million to $5 million of working capital requirements as go forward. We did this quarter increase inventory beyond what we would normally do, based on the supply chain, as we look at our customers that give us forecast or somewhat of a 6 to 12 months out. So with that, in the tightening supply chain, we did do a little more investment in inventory to make sure we did -- we have a supply, we needed to fill that demand and never have a customer lying down or not be able to ship to them. So as we look forward, we're going to have less growth in working capital as we grow the business. But as I look at my model here going out, it's probably in the range of maximum of $5 million or maybe $3 million to $5 million, somewhere in that range of this increasing working capital.

**Operator**

Thank you. This concludes today's Q&A session. I would now like to turn the call back over to Eddie Smith for closing remarks.

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

Thank you. I'd like to remind you that we will be participating at the Canaccord Genuity 38th Annual Growth Conference in Boston tomorrow. Information about this event is posted on our Investor Relations section of our website.

In closing, I want to thank our employees, the leadership, business partners, our distributors and our investors for their support, and look forward to reporting our progress over the next several quarters. Thank you.

**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a great day.