THOMSON REUTERS

EDITED TRANSCRIPT

Q2 2019 SMTC Corp Earnings Call

EVENT DATE/TIME: AUGUST 08, 2019 / 9:00PM GMT

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

Christian Schwab *Craig-Hallum - Senior Research Analyst*
Tyler Burmeister *Craig-Hallum - Research Analyst*
Aman Raj Gulani *B. Riley FBR, Inc., Research Division - Associate Analyst*
Lucas Davenport *- Retail investor*
Robert Porier *- Retail investor*

PRESENTATION

Operator

Good afternoon and welcome to the SMTC Second Quarter 2019 Results Conference Call. (Operator Instructions) Please note this event is being recorded.

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

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

Thank you. Before we begin the call, I'd like to remind everybody that the presentation will include statements about expected future events and financial results that are forward-looking in nature and subject to risks and uncertainties. The company cautions that actual performance will be affected by a number of factors, many of which are beyond the company's control, and that future events and results may vary substantially from what the company currently foresees. 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 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. Information about upcoming investor conferences in which SMTC will be participating will be posted on the investor calendar on our website, and include Doherty's 2019 Institutional Investor Conference in Minneapolis, Craig-Hallum's Alpha Select in New York, and the 12th annual LD Micro Main Event in Los Angeles.

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

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

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

As the press release we issued after the market closed today indicates, we have completed our integration activities of MC Assembly. We have continued to improve our operational efficiencies, and we reported strong year-over-year growth in revenue and adjusted EBITDA, which remains on track to show substantial growth over last year and within the range of our previously communicated guidance.

Steve will discuss our financial results for the second quarter and guidance for the balance of 2019. Following Steve's review of our second quarter results and outlook for 2019, I'll share my thoughts on our progress made and priorities as we focus on providing our customers with best in class service and delivering increasing shareholder value.

Steve Waszak?

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

Thank you, Eddie. Good afternoon everyone and thank you for joining and taking the time to join us. As Eddie mentioned, we will start the call with my review the second quarter financial results, and then I'll turn the call back to Eddie for his comments on the business.

As we did in the last quarter's conference call, I will be referencing 3 sets of numbers; first, our 2019 quarter, which includes combined SMTC and MC Assembly results; second, 2018 year-over-year, which, as we mentioned, includes as "previously reported" GAAP numbers by SMTC, which, as a reminder, includes MC Assembly from the acquisition date of November 9, 2018; and finally, you will hear the word "pro-forma", and this will include SMTC and MC Assembly, assuming MC was part of SMTC for the entire second quarter of 2018.

Now for the results. Our revenue in the second quarter was $90.9 million, up 104% compared to $44.5 million as previously reported in the second quarter of 2018. On a pro forma basis, again assuming MC Assembly had been part of SMTC in the second quarter of 2018, revenue increased 10.9% in Q2 2019 compared to the second quarter of 2018.

Approximately $3.4 million of this revenue reported in the second quarter of 2019 was due to the impact of the revenue accounting standard for ASC 606 compared to $1.3 million of the revenues in the same period in the prior year. During 2019, we can report we had one 10% customer in that period.

On a GAAP basis, gross profit for the second quarter of 2019 was $9 million or 9.9% of revenues, compared to $4.3 million or 9.6% of revenues as previously reported in the second quarter of 2018. This year-over-year increase in the GAAP gross margin percentage was primarily due to the $46.4 million increase in revenues quarter-over-quarter for the acquisition of MC Assembly.

Our 2019 adjusted gross profit, which is a non-GAAP measure, was $10.8 million or 11.9% of revenue and excludes non-cash $1.8 million of amortization of intangibles recorded in connection with our transformative acquisition of MC Assembly last year. In comparison, Q2 2018 adjusted gross profit was $4.4 million or 9.8% of revenues.

Selling, general, and administrative expenses for Q2 2019 was $6.6 million, up $3.7 million as reported in the same period of 2018. As a percent of revenues, SG&A decreased to 7.3% of revenues in Q2 2019, compared to 8.2% of revenues in the same period as reported in 2018. This is as a function primarily of higher revenues in Q2 2019.

We reported a $2.5 million net loss in the second quarter of 2019, which included $1.5 million of restructuring charges, which is primarily associated with the integration of MC Assembly. In comparison, the company reported a net loss of $97,000 in the same period a year ago.

Now, adjusted EBITDA increased 280% to $6.1 million in Q2 2019, as compared to $1.6 million as previously reported in the same period of 2018. Q2 2019 adjusted gross EBITDA jumped 78% over the prior year on a pro forma basis, again assuming MC and SMTC were combined for the period of Q2 2018. The increase in 2019 second quarter adjusted EBITDA compared to the same period in the prior year was driven by the increase in revenue as well as some operating efficiencies upon the combination of the companies.

I'd like to comment on the balance sheet and other key financial metrics that were reported for the quarter. As of the end of Q2 2019, we had $634,000 of cash. Our cash-to-cash cycle was at 74 days, and our DSOs was approximately 64 days with our DPOs at 71 days. Inventory turnover was at 4.5 turns for the second quarter of 2019.

Net debt at the end of the second quarter was $86 million and included the debt incurred in November, 2018 associated with the financing of the MC Assembly acquisition of $50 million of Term A and $12 million of Term B, and $15.6 million of financed and operating leases, of which $5.6 million included in the $15.6 million represents operating leases on the right-to-use liabilities associated with the adoption on January 1, 2019 of the new accounting standards, ASC 842, leases.

In comparison, net debt at the end of 2018 was $92.3 million. Net debt excluding our operating leases was $70.4 million as of June 30, 2019 as compared to $80.8 million at the end of 2018.

As part of our ongoing activities to improve our capital structure, we completed a rights offering and a registered direct offering that generated gross proceeds of $14.6 million at the end of June. On July 3, we used $12 million of those proceeds to accelerate pay-off of our standing Term B debt.

This week we refinanced our credit agreements. The amended credit agreements recorded and reduced the Term A outstanding balance to approximately $40 million from $50 million. We also expanded our borrowing capacity with improved covenants under these asset-based revolver facilities to $65 million from $45 million to better support our future growth.

We remain very focused to improve our efficiencies as well as reshaping our balance sheet to provide further flexibility and added growth capacity. We are currently evaluating a number of alternatives which Eddie will comment on as well as we provide additional updates is appropriate.

Before turning the call back to Eddie, let me quickly comment on our year's outlook. Customer concerns about the continuing impact of tariffs and macroeconomic factors has caused, as we experienced in the second quarter, many customers to review and begin to revise as to where and with whom they outsource their manufacturing. While we believe SMTC is well-positioned with our North American facilities, and we expect our customer demand may be impacted over the second half of the year as customers continue to react and adjust to the ongoing geopolitical impacts of the global trade.

As a result, our current expectation is for the revenue and for the adjusted EBITDA for 2019 will more likely approach the lower end of the prior guidance of $393 million to $408 million in revenues and $27 million to $29 million for adjusted EBITDA for the full year of 2019.

With that, allow me to return the call back to Eddie for additional comments on the business.

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

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

First, we continue to experience robust year-over-year top line growth across all of our industry sectors, except for semiconductor, capital equipment, and data center sectors. Our sales growth was led by our custom measurement sector, which increased $22.3 million or 269% from Q2 of 2018. Our growth in this sector was supported in part by the 5G telecom adoption in Korea.

Our industrial, power, and clean tech customers, who grew 13.6% -- $13.6 million, over 283%, and our aerospace and defense business based in Florida added $4.8 million in sales Q2 2019 compared to zero sales Q2 2018.

As I mentioned on our last quarter's conference call, the slow start to the semiconductor sector this year was not surprising, as many in the industry likely double-booked semi orders last year when there was a supply constrained environment. As we look ahead, we do not anticipate a rebound for that industry until 2020 at the earliest.

On a more positive note, we expect our aerospace and defense business to gain traction over time, as past awards for new business do start placing purchase orders and shipments.

We have posted a slide deck on the Investor Relations section of our website that provides the specific revenue contribution from our various market segments.

Looking ahead, we expect another year of double-digit revenue growth for SMTC. Our growth is being driven by increased business of several new programs at existing customers, plus the addition of new customers. In the second quarter, we were awarded 4 new programs for our existing customers, and we expect to see growth from our customers in their existing programs. As important, we added another 2 new customers in Q2 to our growing customer roster.

Second, we completed our integration of MC Assembly in the quarter as expected and started to initiate steps to improve the efficiencies at several of our sites, including the realignment of our workforce and strengthening the on-site leadership at our Fresnillo in Zacatecas, Mexico. We have also reviewed and reassigned some customers to specific SMTC teams and plants that would better meet their specific needs.

Those initiatives, as well as synergistic cost savings we discussed in the past from the acquisition, are starting to pay off. During the quarter, we upgraded our Fresnillo facility by adding a copy exact, full SMTC standalone automated line designed for high-volume/low mix enterprise customers' needs, and other equipment that will increase our capacity by approximately 25%.

Increasing capacity and improving the efficiencies of our Mexican operations is particularly important in light of today's uncertain geopolitical environment. With tariff concerns high in the minds of our customers, we incurred additional costs in the second quarter as we shifted some customers' production from our China facility to Mexico. We remain focused on identifying and implementing additional efficiencies in this pursuit of achieving best in class operating and financial metrics among our peers.

To better support our customers, we expect to open our New Product, or NPI, and Manufacturing DFX Center of Excellence in Billerica, Massachusetts this quarter to provide customers with world-class quick turn manufacturing that can accelerate the launch of products with the flexibility to scale into a low-cost geography that is available from our other sites, which brings me to the third and final point I'd like to emphasize in today's call, namely our focus on strengthening our balance sheet to support growth.

At the end of June, we completed an equity raise for a total of $14.6 million, which we used to pay down our Term B loan. And this week, we have restructured our debt with less restrictive covenants and a higher level of available working capital. In addition, we actively are working to improve how we manage our working capital. For example, we've recently implemented an AR collections improvement plan and taken other steps to increase our inventory turns.

Let me wrap this up by saying we remain committed to further deleveraging our balance sheet, achieving industry-leading performance metrics, growing our business to become the premier Tier 3 EMS segment leader, making our company an even stronger company that delights our customers with superior service, taking care of our employees, and rewarding our stockholders with advanced shareholder value.

With that, Steve, Rich, and myself will take questions from those on the call today.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question today comes from Christian Schwab with Craig-Hallum.

Tyler Burmeister ***Craig-Hallum - Research Analyst***

This is Tyler on behalf of Christian. So first, I was hoping if you guys could give any other color on the customers or end markets that are being maybe particularly affected by this geopolitical and tariff issues, or if it's really pretty broad-based.

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

Yes. So now with the addition -- so it started out in the 25% tariffs on China. It hit specific customers and it was focused on specific types of products, so it didn't hit all our customers. Obviously, with the new announcement of the additional 10% tariff, it's going to go across all our customers and anything we shifted out of our Dongguan facility, or products that we buy on the electronics component side for all our facilities in the Americas, in Billerica, Melbourne, and Freemont. So clearly it now has a much broader impact going forward.

The other part of it on the tariff thing, Tyler, was mid-quarter the unsurety of the Mexico tariffs, were they going to happen, were they not going to happen, how long would they last, what that cost would be. And so we had customers hesitating with did they want to place orders for the future. I think that will come back. I think that was a short-term issue.

I think the Chinese tariff issue is a much longer-term issue. And clearly, our customers are looking to move from China to other locations. Many of them are looking to move to Mexico. So I think short term it creates a little unsurety, long term it creates an opportunity for our Mexico plants. And that's why we increased the capacity in Mexico, to prepare for some of our customers to move out of China and move down to Mexico.

Christian Schwab ***Craig-Hallum - Senior Research Analyst***

And then maybe on the same or a similar train of thought, to reach your full year guidance at $393 million at the low end would suggest some decent recovery in the second half. I was wondering if you could provide any thoughts on what the trajectory of that looks like. Are we going to see a ladder step up in Q3, more linear, Q4 weighted? Any thoughts there would be helpful.

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

Yes. So I think we're going to see a jump up in Q3 and then a further step up in Q4 on the top line, obviously with the bottom line following at a much quicker pace.

The Q2, you had two things going on besides the tariffs. We were very conservative with our working capital and taking additional sales because we were constrained by that Term B loan and the covenants, right? And if we would have spent too much working capital bringing new customers on quickly and used up our working capital, clearly that would have been a problem for us.

So now that we have a little bit less restrictive covenants, we have more headroom with a higher ABL, which expands as you add customers, I think we're poised to go back into the significant growth mode quarter after quarter.

Christian Schwab ***Craig-Hallum - Senior Research Analyst***

Just on the margins, the gross margins in Q2 here are 11.9%, pretty strong basically at the low end of your 12% to 14% range. Is there anything there you want to call out, anything maybe one-time in nature, or going forward should we be thinking that you can basically be operating in the range with the recovery in revenue?

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

Yes. So long term, we said we're going to operate in the 12% to 14% range. And if you look over the last two years, we started in the 7% range and have continued to increase. There's always sometimes short-term blips based on a particular customer, a particular shipment. But over multiple quarters, we'll continue to increase that to the 12%, 14% range.

There's really nothing in particular special about this quarter. And so as we get more efficient in our factories, I think we quickly will be over 12%, heading more closer to 14%.

Operator

Your next question comes from Aman Gulani with B. Riley.

Aman Raj Gulani ***B. Riley FBR, Inc., Research Division - Associate Analyst***

So my first question is about you said you've moved some customers to the Mexico facility. Just wondering, how quickly can those customers start ramping and start benefiting from production in a low-cost region?

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

Yes. So it's a great question, one that's not easily answered but I'll do the best I can. Some customers, it's pretty quick. So we're able to get some customers to move from one factory to another within the same quarter. There are other customers that we try to build some offer stock or revenue because they take longer and you've got to go through either PPAP or some other certification, and that could slow down the move.

But I would tell you as a general rule, it's probably between 3 months and 6 months even with getting approvals and certifications. Doing a really good job, we'll get it in 3 months; not such a great job, getting it in 6 months.

Aman Raj Gulani ***B. Riley FBR, Inc., Research Division - Associate Analyst***

And then just in regards to capacity utilization in your Mexico facilities, where it does that stand right now?

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

Yes, that's a great question. We put a lot of equipment in last year into our Chihuahua facility. We put a new SMT line in. We put in a lot of additional SMT capacity and increased our capacity in Chihuahua by almost 50% last year.

So this quarter, we added in our Zacatecas facility a new line, a high-speed SMT line, and increased that capacity by 25%. So we have enough -- I get this question a lot, how much capacity we have in both facilities. At this point, we could either add more equipment -- and for the existing equipment, we're probably in the 60% to 70% range. But if we added more equipment, we probably could double our sales and not have to have another footprint.

Aman Raj Gulani ***B. Riley FBR, Inc., Research Division - Associate Analyst***

And just last quarter you mentioned that all the facilities were profitable. Is that still the case?

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

Yes. Yes, currently all the facilities are profitable. Obviously, the tariff effect, right? I'm not naive to know the tariff effect is going to have some effect on not only our China facility, but it may have effect on some of our smaller U.S. facilities. We're evaluating that now and then we'll take whatever appropriate action to try to make it hurt as little as possible.

Aman Raj Gulani ***B. Riley FBR, Inc., Research Division - Associate Analyst***

And then can you talk about are you seeing any component shortages out there? I mean, I know last year there was tightness with MLCCs. But has that largely loosened up now?

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

I could sell you all kinds of components if you had money at this point. No doubt about it, the lead times are -- you may get a spot shortage, but we no longer worry about lead times. And I actually think some of the softness in our top line this particular quarter was caused by customers had overbooked or held safety stock and now are burning that safety stock off. And that's why I think we'll see the step function of sales in Q3, Q4. I think this is really the step time.

I also have some slides I can share with you, Aman, about from the peak to the trough on the components where it looks in terms of lead times. And I think lead times are down about, across the board in the U.S., about 38% from where they were the peak.

Aman Raj Gulani ***B. Riley FBR, Inc., Research Division - Associate Analyst***

Yes, that would be great. Can you talk about the amount of work you're doing on NPIs? Are you doing more NPIs than you were last year? And then are the NPIs that you are doing toward the end of last year, are you seeing them ramp up?

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

Yes. So we did 32 specific NPI orders in Q2. We just started breaking that out, so we are now starting to take NPI specific orders. So what used to happen is we'd get NPI. We'd build the NPI in our production factories and then we'd move to production.

But that was really slow for some of our customers and they were not happy, so this is clearly customer convenience. But I think it's happened so quickly we have more and more of our customers moving towards this, hey, we'll do NPI locally and then we'll do production in a low-cost region.

Operator

Your next question comes from Lucas Davenport with Retail.

Lucas Davenport ***- Retail investor***

How much money was saved with the refinancing and the Term B paid off, the interest payments quarterly? Can you give a ballpark figure on that?

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

So we think, yes, a ballpark would be yearly savings of about $3 million in interest expense.

Lucas Davenport ***- Retail investor***

In which quarter do you expect to -- I know you talked about ramped up sales in Q3 and Q4, but when do you expect to see significant growth from the aerospace and defense businesses? Is that in Q4?

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

Well, we're seeing growth, obviously, going from zero to a $16 million plus run rate in one year. We continue to win orders from our existing customers and new customers. And so that'll continue to ramp up over the next couple quarters.

We have some pretty significant quotes out. And if we were to win them, it normally takes from win to actual production about 6 months in the aerospace and defense. So I would tell you whatever you want to call it, a huge jump, will probably be 6 months out or so.

Lucas Davenport ***- Retail investor***

When do you expect to be able to obtain profitability, in what quarter?

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

When you say profitability, are you talking net income profitability or are you talking about EBITDA profitability?

Lucas Davenport ***- Retail investor***

Net income.

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

Yes, Lucas, this is Steve Waszak, the CFO. I think we'll continue this year to be very close to it. This quarter we had some restructuring charges with the acquisition with MC. But I think certainly by Q1 of next year, if not a quarter sooner than that, but certainly by Q1 of next year, consistently showing that. So, we've got all the restructuring charges behind us and things of that nature.

Operator

(Operator Instructions) Your next question comes from Robert Porier with [retail Investor] (corrected by company after the call).

Robert Porier ***- Retail investor***

I was just wondering, out of curiosity, I know tariffs and political issues have been an issue. But coming onboard from where -- the existing board that we have now, there must be a number of contacts and positions that we can avail ourselves to. I'm just wondering, is this working out in any way? I mean, are we bringing anything onboard with us?

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

Say that one more time? I don't think I understood the question, or I didn't hear it properly.

Robert Porier ***- Retail investor***

I'm sorry. I know with the tariffs and the political issues but coming onboard to SMTC and the people that you've brought with you, there's a lot of possible contacts out there and contracts or existing clients. You must have something in the offering that you can bring onboard to SMTC, that people know you and they trust you and they will move on. I don't know. It's just -- I'm just wondering. Is there anything out there?

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

Sure. We went from a $120 million run rate the day I walked in the door to almost a $400 million run rate. And we've added new customers, new market segments, and some of that is from our contacts and those type of things.

I'm not sure what you're asking me. If it's in terms of growth, we've had double digit growth. Last quarter it was 50% year-on-year. This quarter it was 10% plus. I'm not sure what the question is, other than we'll continue to grow. We'll continue to use our contacts to grow. And we'll continue to do what we do.

If you're asking are we going to grow faster, we did have to be careful on our growth in Q2 because of our banking covenants, and so we were much more careful. But we're also doing an integration. And during an integration, we grew way quicker from Q4 to Q1 than I had expected. And obviously, that ate up some of our working capital and we needed to be cautious with that.

Robert Porier ***- Retail investor***

That's good. The thing is, I've been here for many, many years, and you get frustrated. And sometimes you really don't know the questions to ask, and sometimes other people don't ask the questions that you think they would ask.

But I'm trying to liven up this conference call a little bit because it's been so long here. And I know everybody's getting frustrated. You go to the chat boards or whatever you talk to, and you just don't know where to turn anymore. And I just don't want to see a sell-off. I want people to feel confident, and that's all I'm trying to look for. This is the first time I've really talked on this board, and I've been here for probably 15 years.

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

Here's what I would tell you. So we've grown faster than any other EMS provider in the industry, or one of the top couple, over the last two years. Our EBITDA now is either number 1 or number 2 in Tier 3 percent EBITDA, which is really how companies like ours get rated.

We'll continue to grow. We'll continue to make our EBITDA. And as somebody asked a question earlier about gross margins, we're at number 2 in gross margin now. So we went from being one of those companies that didn't do a very good job to a company that I think will be a premier company.

And so hopefully that livens it up and cuts down the chat board stuff. But the reality is, my job and the rest of my team's job is to go run the best company we can run, which we feel going from worst to first is a pretty good job in 2 years. And we'll go from there. And hopefully that livens up the call.

Robert Porier ***- Retail investor***

I want to thank you for that. But you have to understand the frustration of many shareholders when you've seen the previous board members and presidents and situations that we've come through. And I think what you're doing is right, but sometimes it's hard to really relay that to the shareholders at the same time. You know what I'm trying to say?

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

We do a lot of conferences, and we show the progression to be best in class. There's a slide -- go look under our Investor Relations slide. We show the progression of going from a company that was negative EBITDA to a company that this quarter made more than 7% EBITDA, and margin that was in 7% to a margin that now is second to only one of the EMS companies that are public that report.

And so I feel pretty confident we're in the right direction. We'll continue to do that. I want to thank you for your question.

And I want to thank -- and let me just kind of read a closing statement. In closing, I want to thank our employees, leadership team, business partners, distributors, and our stockholders for their support, and look forward to reporting our progress to our various stakeholders over the next several quarters. Thank you and have a great night.

Operator

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