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SMTX - Q3 2019 SMTC Corp Earnings Call

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PRESENTATION

Operator

Good evening, and welcome to the SMTC Third Quarter 2019 Financial Results Conference Call. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Blair McInnis. 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 are contained in the company's annual report on Form 10-K and 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 be available for audio replay in the Investor Relations section of SMTC's website at www.smtc.com. Information about investor conferences later this quarter in which SMTC will be participating is posted on the investor calendar on our website. We'll be participating tomorrow in the Craig Hallum's Alpha Select in New York. And on November 20, we'll be attending the 2019 Southwest IDEAS Investor Conference in Dallas.

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

It was 1 year ago, on November 9, that we closed a transformational acquisition of MC Assembly. Over the past year, the team has successfully completed our integration, expanded SMTC's capabilities to new end markets, implemented a number of efficiency initiatives, increased our customer base and importantly, gained important scale in an industry where scale matters. We also successfully navigated through some challenging macroeconomic challenges facing the EMS industry.



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As a result, during the first 9 months of 2019, our revenues increased to \$282.3 million, up 14.5% over the 9 months in 2018 on a pro forma basis, which assumes MC Assembly have been part of SMTX in 2018. Even more impressive, was our improvement to our adjusted EBITDA, which grew 53.9% to \$17.8 million over the first 3 quarters of 2019 when compared to the first 3 quarters of 2018 on a pro forma basis.

I will now turn the call over to Steve, who will review the third quarter numbers and will provide our full year 2019 and initial 2020 guidance. After Steve's review and comments, I will come back and share some further thoughts before we open the call to questions.

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

Thank you, Eddie. Good afternoon, everyone, and thank you to those who have been in service to our country.

As we did in last quarter's conference call, I will be referencing numbers for 2019, which include combined SMTX and MC Assembly results, 2018 year-over-year included, as previously reported GAAP numbers for -- by SMTX, which, as a reminder, include MC Assembly from acquisition day on November 9. And finally, you will hear the word pro forma, which Eddie has used already. This includes SMTX and MC Assembly, assuming as SMTX was part of SMTX for the entire quarter of 2018.

Moving on to the results. Our revenues in the third quarter was \$88.7 million, up 65.2% compared to \$53.7 million as previously reported in the third quarter of 2018. On a pro forma basis, assuming MC Assembly has been part of SMTX in the third quarter of 2018, revenue decreased 5.4% in Q3 2019 compared to the third quarter of 2018. Our GAAP gross profit for the third quarter of 2019 was \$8.9 million or 10% of revenues compared to \$5.2 million or 9.8% of revenues as previously reported the third quarter a year ago.

Our Q3 2019 adjusted gross profit was \$10.8 million or 12.1% of revenues and excludes the noncash \$1.8 million amortization of intangibles recorded in connection with our acquisition of MC Assembly last year. In comparison, Q3 2018 adjusted gross profit was \$5.1 million or 9.6% of revenue. This year-over-year increase in the gross margin and adjusted gross margin percentages was primarily due to synergies implemented and efficiencies gained with the acquisition of MC Assembly and the \$35 million increase in revenues. During the third quarter of 2019, we had one 10% plus customer.

Selling, general and administrative expenses for the third quarter of 2019 was \$6.5 million, up from \$3.7 million in the quarter a year ago. As a percentage of revenues, SG&A expenses were 7.4% in Q3 of 2019 compared to 6.9% in the third quarter a year ago.

We reported a \$5.7 million net loss in the quarter of 2019. That said, it included \$6.5 million of restructuring charges, of which \$5.5 million of those charges related to our closure of the Dongguan, China manufacturing operations. This charge associated with the closure includes \$3.5 million of noncash accelerated asset write-downs and \$2 million of cash-based expenses and other exit costs that results in an adjusted net income in 2019 for Q3 was positive \$2.1 million, which excludes the amortization of intangibles associated with the MC acquisition, these restructuring charges, stock-based compensation and fair value adjustment of warrant liability, in comparison with company recorded net income of \$864,000 in the same period a year ago.

Adjusted EBITDA increased to \$6.3 million or 7.1% of revenues in Q3 2019 from \$5.5 million or 5.9% of revenues on a pro forma basis for the third quarter a year ago. The improvement in adjusted EBITDA was due to gains from operational efficiencies and the synergies achieved and increased scale from the complete integration of MC Assembly following the November 2018 acquisition.

Now I'd like to comment on the balance sheet and a couple of other key financial objectives and metrics that's reported for the third quarter. As of the end of Q3 2019, our cash-to-cash cycle was 78 days, with DSOs improving to approximately 60 days and DPO is steady at 69 days. Inventory turns were 4.2 turns for the third quarter of 2019.

In Q3, we amended our asset-based revolver facility and credit agreements to reduce the Term A outstanding balance to approximately \$40 million from \$50 million. We expanded our borrowing capacity from \$45 million to \$65 million under the ABL and with improved covenants that better supports our future growth. We also used \$12 million of the \$14 million in gross proceeds generated from the rights offering, which we successfully closed in the final weeks of the second quarter of 2019 to accelerate the paydown of our Term B debt.



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Net debt at the end of the third quarter was \$84.4 million and includes remaining debt Term A incurred in November 2018 associated with financing of the MC Assembly acquisition of approximately \$45 million and \$14.7 million of financing and operating lease obligations, of which \$4.3 million of the \$14.7 million represents operating lease rights and use liabilities, which we adopted in January of 2019 under the new lease accounting standard ASC 842. In comparison, net debt at the end of 2018 was \$92.3 million. Accordingly, our net debt, excluding finance and operating leases, was \$69.7 million as of September 30, 2019, compared to \$80.8 million at the end of 2018.

Before turning the call back to Eddie, let me quickly add some additional comments on our previously announced decision to close the manufacturing operations. And finally, I want to reiterate our full year 2019 and initial 2020 guidance, which we provided back on September 19, 2019.

Revenues attributable to the production from our manufacturing operations in China accounted for 5.3% of our revenues in the first 9 months of 2019. Given that a number of customers had indicated their desire to move their production out of China, if we did not close our China manufacturing operations, our forecast indicated that we would experience further revenue contraction that we would have seen thus far and would have been resulted in negative operating margins from the Dongguan, China facility in operations in 2020.

Our planned closure of our China manufacturing operations remains on track. We expect to transfer a selection of products and equipment in the China facility to other North American plants such that the company's manufacturing capacity should not be impacted in 2020 once the transfer of the equipment is complete.

With that said, let me return this back to Eddie for comments on our business.

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

Thanks, Steve.

As I mentioned at the outset of today's call, we have taken steps to improve our financial and operational performance as we have navigated through the changing 2019 macro environment. We remain focused on achieving leadership positions in each of our key metrics.

I'll now add some color on the progress made in the third quarter and articulate the reasons for enthusiasm behind our expectations as we continue to transform SMTX into an even stronger company.

First, we continue, to believe, to gain market share during the current EMS market slowdown. In Q3, we won a new business with 3 new customers, added 2 new programs with existing customers. None of these new wins resulted in Q3 revenue. One of these awards is expected to begin in Q4, with the remainder expected to begin in 2020. In Q4, we've already had a dozen additional programs awarded to us, as well as increases in existing programs that will, together with our wins in Q3, generate revenues in excess of \$22 million and have a positive impact in our 2020 business.

During the third quarter, we saw a 20% quarter-over-quarter revenue growth in our telecom networking and communications sector, led by customers with demand in our products associated with 5G implementations. We also experienced a 10% sequential revenue growth with our industrial, power and clean technology customers and an 8% increase from our aerospace and defense customers.

Looking at our business on a year-over-year basis, our test and measurement revenue was up \$17 million or 162%, followed by revenue growth in our industrial, power and clean technology business, which increased 13.2% or 186%. Our aerospace and defense business revenue of \$5.2 million versus 0 revenue a year ago, and we saw an increase of \$3 million or 40% from our medical customers. Our semiconductor business is beginning to stabilize, and we expect to resume growth during 2020. We've posted a slide deck on our Investor Relations website with a more comprehensive breakdown of our revenues by customer sections.

Second, to better serve our customers, we opened our new NPI facility in Manufacturing (DFx) Center of Excellence in Billerica, Massachusetts in Q3 on schedule. I'm pleased to report that we've already had over 30 new product introductions run through this process. This new capability provides customers 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.



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Third, to reduce costs and improve production efficiencies, we eliminated the weekend shift this quarter at our Fresno factory in Zacatecas, Mexico. We were able to do this because in Q2, we upgraded our Fresno facility by adding a "copy exact" full SMT standalone automated line designed for high volume, low mix enterprise needs and other equipment that will increase our capacity by approximately 25%. To meet future output capacity out of North American sites, we are also proceeding on schedule to transfer the production lines from our Dongguan facility to our plants in Fresno and Fremont, California, thus reducing the CapEx we would have otherwise incurred to increase capacity at those sites. In fact, we are already in process of moving \$7 million of anticipated customer sales for 2020 to our Mexican sites from Dongguan facility in China.

Fourth, our team continues to earn important new certifications. At our plant in Chihuahua, Mexico, we recently celebrated its 20th anniversary with dignitaries, including the Mexican state's Governor and city's Mayor in attendance, achieved ISO 13485 status, while our Fremont plant was recertified with AS9100 rep date and our Billerica, Massachusetts plant earned its 13485 certification.

As we look ahead, we expect another year of growth in 2020 as our funnel of new business continues to grow. With new orders already secured, the integration of MC Assembly acquisition completed and our plans to implement further operational efficiencies, the elements are now in place to make 2020 a more profitable year.

Let me conclude by reiterating what I reported last quarter, that it is that we remain committed to further deleveraging our balance sheet, achieving industry-leading performance metrics. Growing our business to become a 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, rewarding our stockholders with enhanced shareholder value.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Christian Schwab with Craig-Hallum Capital Group.

Christian David Schwab - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Great. Eddie, could you talk to us about whether you believe that customers lowering inventory levels, which I think kind of slightly impacted you guys in the back half due to a lot of general purpose commodity chips shrinking and lead times, do you believe that was just kind of a 1, 1.5 quarter phenomena? And as it relates to the top line growth that you're looking for in 2020, is that recognition of new customers and new program design wins? Or just a little bit greater clarity on that, please.

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

Yes, no problem. Clearly, with the lead times dropping as quickly as they did, Christian, everybody wound up having inventory, every part of the supply chain. So you had -- manufacturers had more inventory they needed, distributors had more inventory than they needed. Right? We wound up with more inventory than we wanted. Our customers wound up with more inventory because everybody had built up these buffers because the lead times have extended so far out. And in some cases, some ships, you couldn't get for a year, like MLCCs and stuff like that. That is getting more normalized. I wouldn't say it's completely normalized. But I would say probably by the end of Q1, it will be completely normalized. But we have -- our funnel right now is significantly robust. Of that \$22 million that we talked about a new win so far, about \$15 million of it is in the defense aerospace segment. And as you know, it looks pretty strong when you start in that business because if you do a good job, it's repeat business, right? We were always doing something overseas and need more equipment. So I think it's going to be a combination of our existing customers, moving back up a little bit. And then our new wins on top of that. So I think the combination will get us back into the -- if you think about the run



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rate we're on, and the growth we need to get to our midpoint of guidance, you're talking right around 10% more or less. If you think about 10% growth year-on-year, it will take some new projects and our existing customers to stabilize and move back up.

Christian David Schwab - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Great. And then my last question, I know you guys talked about stability coming next year and in some -- like in other capital equipment. In the data center area for you guys, are you guys seeing strength or stability or a return to growth next year in that area?

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

Yes. So those customers are talking about return to growth. We have not seen it yet, but they're talking about our preparation for capacity in terms of capacity planning. So I would say we're going to see low single-digit growth to mid-single-digit growth, which is much better than, obviously, a decline that we had this year. So we're pretty excited about that space. I think there's a lot we can do there.

Operator

Our next question comes from Mike Crawford with B. Riley FBR.

Michael Roy Crawford - *B. Riley FBR, Inc., Research Division - Senior MD, Co-Head of The Discovery Group & Senior Analyst*

Eddie, nice to see you guys reiterate that \$390 million to \$410 million revenue guidance for next year. With the reiterated guidance for this year, however, it would imply a dip in Q4 versus, I think, Q3. So is there something going on regarding the end of year like shuttering of a facility or anything like that to watch out for in Q4?

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

No. I think Q4 will be -- we're looking at a pretty good number in Q4. I think you'll see a little growth off of where we are today in Q3. So no, I'm pretty excited about Q4 also. And so I think the market has stabilized. I think that's a good word. So Q4 didn't see the drop we thought we might see. So I'm pretty excited about that. And then I think we'll start seeing growth next year again, Mike, in the high single digit, low double-digit growth.

Michael Roy Crawford - *B. Riley FBR, Inc., Research Division - Senior MD, Co-Head of The Discovery Group & Senior Analyst*

Okay. That's helpful. I think perhaps and just the reiterated guidance versus say a raising of the four maybe in your press release was a bit conservative and let have that answer. And then but you did talk about doing better in margins. I just want to confirm whether that was better next year versus this year or better versus the prior guidance where you were talking about margins that would enable \$29 million to \$31 million of EBITDA next year?

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

Yes. So we finished Q3 at 7.1% on the EBITDA, right? And next year, we're talking about a \$400 million at about 7.5% to hit that midpoint, right, the \$30 million. And so we're going to have to get a little bit better. And I think what's going to happen is we'll start the year off in the low 7s. And by the end of the year, we'll be in the high 7s, low 8s next year.

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Michael Roy Crawford - *B. Riley FBR, Inc., Research Division - Senior MD, Co-Head of The Discovery Group & Senior Analyst*

Okay. Great. And then with the defense wins, in particular, are there any subsectors of that market, like sensors or other -- like missile or radar components that are driving the bulk of those wins? Or is it mixed?

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

That's a good question. I would say sensors. And I would say communications, so far, but we have some pretty large quoting that we've been doing in the missile space. So it's pretty exciting. I think we're all over the defense market, and I think it's getting to be really exciting. But I -- definitely in the communication sensors, we've already landed some deals.

Operator

Our next question comes from [David Cannon].

Unidentified Analyst

So my first question is on the guidance for 2020. Essentially, you're saying like a high single-digit organic rate of growth. How much would you say you're relatively certain of in your pipeline? And then how much of that incremental revenue in 2020 you still need to execute and close upon from the sales funnel?

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

Yes. So I think we have line of sight to a good portion of it, David. I think when we talk about closing \$22 million, we're going to close this year at \$370 million something. And if you look at our -- this year guidance and next year guidance and talking about growth in the 8% to 10% range. So we just talked about \$22 million being landed. You always have a little bit of customer projects that go away. But I would say a good predominance of it, if the market doesn't do anything crazy or funky, we'd feel pretty good about the guidance, that we have it under control.

Unidentified Analyst

And then, Steve, what do you think for -- assuming you hit your guidance, where do you see free cash flow for 2020? And then what kind of a pro forma debt number?

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

Yes. So David, thanks for your question. As we reported in the last call, it is within the guidance we gave for 2020. We view the -- our ability to generate \$14 million of free cash flow, and that will substantially go to pay down the debt. So we have an opportunity to get that from where it is today, clearly, in that certainly under 3 and certainly closer to 2.5 range in terms of applying the free cash flow there.

Unidentified Analyst

Okay. And then my last question, I guess...

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

David, can I add one?



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Unidentified Analyst

Sure.

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

Add one thing for that, David. So when we closed the deal, the bank's debt, the bank debt leverage was 4.02, with leases of 4.84. We left Q3, bank debt leverage of 3.09 and with the lease of 3.74 million, so we took it down about 1 turn in a challenged year at the end, right? So when Steve talks about another \$14 million of free cash flow, there's no doubt we can get closer to 2 than 3 next year with that free cash flow and having 2 turns of debt or thereabouts, a little bit above that.

Unidentified Analyst

Okay. So the -- my follow-on to that is, at some point in the year, it sounds like you'll be positioned opportunistically for M&A, you'll have some dry powder. What does the pipeline look like? And how would you handicap doing another transaction? What kind of size do you think in 2020?

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

It's always one of the great questions. So we do talk to a lot of people, they talk to us, we talk to them. It's a continuing back and forth. I wouldn't even hesitate to guess what the -- if the right deal came along, we probably would do it sooner than later. But if the right deal doesn't come along, we'll wait. We have some patience doing \$400 million and making \$30 million of EBITDA puts us pretty close to the top of the Tier 3 space, and that's really our ultimate goal. The size is not the #1 most important thing. Even though scale will make us more profitable, but it has to be the right scale. So right now, we're not -- we're not close to anything, only because we're trying to run the company for the way the macroeconomics are. So I would say we'll continue to look, but there's nothing imminent.

Unidentified Analyst

Okay. If you found the perfect company continues to sketch out what it would look like, is there a certain sector? Would it be more military, like an MC Assembly or government business or commercial, medical? What areas do you think you need to fill in that would be most attractive?

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

Okay. So now you just did on what I would look at, which is the same thing we did last time. We would go evaluate where they are in what I would call the highly regulated markets, medical, military, even some of the telecoms are highly regulated. So we would look for things that are sticky, highly profitable. And so we would continue to look in aerospace, defense, medical and in any other highly regulated markets. And there's been some that have come our way that we've taken a look at that are really expensive. So we also have to pay the right price and do the right thing to watch out for our shareholders' money. So -- but you're right, the space matters this time. The last time it was for scale. This time, we don't need as much scale. We really would look for the right marketplaces.

Operator

Our next question comes from [Craig Boots], private investor.



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Unidentified Participant

Yes. So I guess I have 2 questions I'm wondering about. On this revised revenue that we did back end of September, I'm kind of wondering how much of that can be offset by the fact that we have closed the facility in China. Obviously, that's going to cut down on expenses. And so I'm just wondering how that will offset the reduction in revenue that you put out on that press release.

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

Yes. So we reduced the revenue for this year and we put out guidance for next year, so you'll see the growth from year-on-year. And China was about \$16 million at the point that we made that disclosure, it's about 5.3% of our sales. And so some of it, we're going to move, some of that money. We're going to move to some of our plants, but we'll probably lose about half of it, Craig. And then next year's guidance speaks for itself.

Unidentified Participant

Okay. And then I guess the other thing, it's also in relation to that facility. How much of the business that it did is going to actually move with us to our other facilities? Or how much are we going to lose as opposed to how much of it's going to get transferred to other facilities?

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

So about -- we have been saying about 50% is going to transfer. So that will happen Q1 of next year and continue through Q2. So as I just said, about 5.3% of the business. So if you take half of that, it's -- I don't know, 2.65%, but the reality is about half will move over.

Operator

Our next question comes from [Lucas Davenport], private investor.

Unidentified Participant

I'm actually quite surprised, based on the last statement that was put out, I commend you guys for your management. Just very brief questions. Do the revenue numbers that you put out today include sales from China, yes or no?

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

Yes, they do.

Unidentified Participant

They do. Okay. And what is the target net debt amount for Q4 2020?

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

I don't think we put out our target. We don't put out our target. But as Steve walked through, if you think about somewhere in the low 2s in terms of leverage, that Steve was talking about, you can figure out -- you take the \$30 million of EBITDA, and you can figure out the rest from there.



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Unidentified Participant

Okay. And finally, the -- are we still on track for a positive net income in Q4 of this year?

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

Yes, we would have had positive net income this quarter if we didn't close China. So all those -- even noncash charges jump into that, we would add over \$1 million of net income. So I don't expect a dramatic change next quarter on a negative way that way. So I would hope, for sure.

Unidentified Participant

Charges that are attributed to the closure of the plant in China, are they -- have they even...

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

So if you took out those charges and the restructuring charges, you'd actually have net income of \$1.2 million.

Unidentified Participant

No, no, I'm saying have there -- have -- are most of the charges that are going to be utilized, are they already done for this -- or how many more charges are going to be used in Q4?

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

We are -- for China, we are using no more charges for Q4. And for the rest of our business, I would tell you, I don't see anything that would have any type of effect, real effect on Q4.

Operator

Our next question comes from Harry Venezia, Health Care Capital Advisor.

Harry Venezia

Eddie, I appreciate the update and the progress that you've made. Can you help me interpret the -- I think your comment about the dozen or so additional programs that can bring revenues upwards of \$22 million online in the fourth quarter? The 2 questions are, one, should we consider that to be a run rate of about \$88 million to \$90 million for full year 2020? Secondly, is that \$22 million, could we stack that on top of the \$89 million in the third quarter? That seems to me to be a little bit too aggressive for the fourth quarter. So maybe you can just comment on why you wouldn't stack the \$22 million on top of the \$89 million for our fourth quarter revenue expectation?

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

Yes. So what we said, and so we were talking fast, is that one of the programs will hit in Q4. But the \$22 million is spread over next year, 2020. So basically take 2020, split it up, and you're talking \$4 million and \$5 million per quarter, but it doesn't lay out exactly that way. Defense will have a big build then they won't build. And so -- but it's \$22 million for the fiscal year 2020, and you have a small amount, about \$1 million something for Q4 of that \$22 million. So a very small amount in Q4, the rest 2020. And obviously, this is up until Q3 numbers. Q4 will win more programs to David's question earlier, and we'll continue to add on to that to get up to the \$400 million run rate.



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Operator

That concludes our question-and-answer session. I would like to turn the conference back over to Eddie Smith for closing remarks.

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

Sure. First of all, I'd like to wish all the veterans -- to thank them for their service and to everybody else, Happy Veterans Day.

In closing, once again, I want to thank our employees, leadership team, business partners, distributors and our stockholders for their continued support and look forward to reporting our progress to our various stakeholders over the next several quarters. Thank you, and have a great day.

Operator

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

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