Sevcon, Inc.
First-Quarter Fiscal 2017 Investor Conference Call
Wednesday February 15, 2017

Management's Prepared Remarks

David Calusdian:

Good morning everyone, and thank you for joining us. If you have not received a copy of the earnings press release issued yesterday, you can find it in the Investor Relations section of the Sevcon website, Sevcon.com.

Please be reminded that remarks that management may make during this call may contain forward-looking statements about future financial results. Important factors that may cause the company's actual results to differ materially from the anticipated events, performance, or results expressed or implied by the company's forward-looking statements are described in the risk factors detailed in its periodic reports filed with the SEC, which can also be accessed through the Sevcon website. The company advises you to read them and cautions you not to place undue reliance upon any forward-looking statements that may be made this morning, which speak only as of the date of this call. Sevcon undertakes no obligation to update any forward-looking statements.

During this call, Sevcon will use the financial metric, adjusted EBITDA, which is a non-GAAP financial measure. The Company reports on this metric because it is a key measure used by its management and Board of Directors to evaluate the ongoing performance of the business and to develop short- and long-term operational plans. Accordingly, the Company believes that adjusted EBITDA provides useful information to investors and others in understanding and evaluating Sevcon's operating results in the same manner as its management and Board of Directors.

For a reconciliation of adjusted EBITDA to net income or loss, the most directly comparable financial measure calculated and presented in accordance with GAAP, please refer to the table “Reconciliation of GAAP to Non-GAAP Measures” in the Company’s first-quarter news release.

With us today are Sevcon’s Chief Executive Officer Matt Boyle and Chief Financial Officer Paul Farquhar. At this point, I will turn the call over to Matt.

Matt Boyle:

Thank you, David. Welcome everyone. Thank you for joining us this morning.

Looking at the first quarter overall, revenues increased 38% to $12.5 million over the prior year, reflecting $5.2 million in revenues from Bassi. Our Bassi acquisition has performed above our expectations, having reported 33% revenue growth post-acquisition compared with the same quarter in the prior year. And, we are seeing that success continue into the second quarter.

Partially offsetting the contribution from Bassi were lower sales from the industrial side of the business, due to a continuation of the challenging macroeconomic headwinds our customers are facing. Conversely, sales to our on-road customers grew by 25% in the first quarter compared with last year. As we'll discuss later in the call, we have seen excellent traction with on-road OEMs and our pipeline of major projects is growing.

Let me provide you with some more context around revenues for the quarter.

In the controller and capacitor reporting segments combined, we recorded $7.4 million in revenue, which was down 19% from $9.1 million a year ago. Excluding FX, that business would have been down 9%.

Looking at the geographic breakdown…

Excluding Chargers, revenues were down high double digits in Asia, almost entirely due to the macroeconomic challenges in the industrial sector, specifically the lack of demand in the Aerial Work Platform sector in that region. A significant component of the demand issue with Ariel Work Platforms was customers carrying higher-than-average inventory going into a traditionally quiet quarter. We expect that inventory to come down and Ariel Work Platform demand to start to rebound in the coming quarters.

Including Bassi, revenues were still down as, at the moment, Asia is not a significant market for our Chargers.

Controller sales in the United States were down 5% from a year ago, excluding Bassi, largely due to a further drop off in sales to the Mining sector and lower sales in Airport Ground Support equipment. Sales were up 45% including Bassi.

Excluding Bassi, sales in Europe increased by 12% year-over-year, due to higher sales into the on-road sector. Including Bassi, sales were up 123%.

Our Chinese joint venture continues to perform very well. In our first fiscal quarter we shipped field trial units of our Gen5 controller to the Tier 1 customer we discussed last year. In addition we also shipped field trial units to a Chinese on road OEM in the first quarter. We are very happy with the progress being made in China. Looking at these results by end-use sector, our industrial off-road markets continued to be weak. Airport ground support, aerial work platform, fork-lift truck and mining were all down. Excluding Bassi, nearly all of the declines in the quarter were due to the traditional end-use markets.

Our capacitor business also was down double-digits in the quarter, due to a lack of railway project investment across Europe.

Other EV was up double-digits in the quarter, after reporting flat sales in Q4. Higher product sales to Seakeeper and Polaris drove the increase.

Turning now to on-road… Sales in the first quarter were up 25% from last year, due to product shipments in North America, Europe and China. As we've discussed previously, this business will be inherently lumpy from quarter to quarter due to the timing of orders as we ramp up this business.

Sales in the 2-wheel sector were up 14% due to demand from European customers, while four-wheel sales were up 32%, largely due to increased engineering services revenues from our on road projects and shipments of Gen5 in China..

Before I turn the call over to Paul to review the financials in more detail, I'd like to provide you with an update on our growing on-road project pipeline.

An increasingly important component of our on-road revenue comes from Engineering Services. Customers pay us to re-engineer existing Sevcon products to provide them with a reliable solution that meets their specific needs. As a result, our customers have lower development costs and are able to get to market in a much shorter time.

We are very focused on turning our pipeline of opportunities into projects. Getting more projects gives us the real potential of future production.

In addition to the five projects in our pipeline that we've previously communicated, we've contracted with another on road OEM for an electric drivetrain. The project becomes Sevcon's sixth major project in the development pipeline.

To give a little background, we had been working with the customer throughout 2016 to help optimize the drive-train for the project. As a result, we will now develop an inverter based on our existing Gen5 technology. The start of production is expected to be in the fall of 2018. Over the initial three-year production period, revenues are forecast to total in the range of $150 to $200 million. The agreement contains two near-term milestones, including the initial product sample and proof-of-concept in the current second quarter of fiscal 2017, and performance testing in the customer's vehicle in the fourth quarter of fiscal 2017.

With the addition of this project, we now expect total production revenue from the six projects in our pipeline to be approximately $356 to $406 million over the five-to-seven-year production lives. Two of these six projects are expected to go into production in fiscal 2017, one goes into production in 2018, one goes into production in 2019, and two in 2020. We'll then be adding on revenue for spares in the five to 10 years following the completion of production.

Our expected total production revenue has grown dramatically over the past several quarters, which is a testament to the success of our strategy to invest in engineering resources to capitalize on significant opportunities in the on-road market.

In general, to move from the development stage -- where we receive engineering revenues on a percentage of completion basis -- to production, we need to hit three key milestones for each customer project. These include the initial sample of the product and proof of concept, performance testing that proves the product works within the customer's vehicle, and the creation of production tooling for the product and completion of software for the customer.

During the first quarter, we hit 3 key milestones on our way to project completion. In the project with the performance car manufacturer we provided the first A sample, on the Marine application, we completed the design and commissioned tooling and have received the first orders for start of production. On our European manufacturer of trucks and buses we completed the milestone on time. In evaluation of the vehicle performance however it is clear that we and the OEM have more work to do. In recognition of this, under completion accounting we decided to be prudent and accrue for all of the anticipated costs to completion, although we expect further revenues for engineering services following our negotiations.

During fiscal 2017, we now expect to achieve six major milestones across our six major projects, including two milestones in the current second quarter.

In summary, we are bullish about our prospects in fiscal 2017. While we expect challenging off-road conditions this year, we expect to see an uptick in our on-road business as a result of our strong project pipeline. We are excited by the confidence that an increasing number of on-road OEMs are placing in our solutions, and we look forward to meeting the remaining six important milestones we have before us in 2017. As we look even further out, our project pipeline and the market demand for electrification solutions provides us with significant opportunity for growth.

With that, I'll turn it over to Paul?

Paul Farquhar:
Thank you Matt and good morning everyone.

Reviewing Sevcon's financial performance for the quarter and starting with the Income Statement, total revenues increased 38% to $12.5 million, from $9.1 million in the same period of fiscal 2016. This increase included $5.2 million in sales from Bassi. Foreign currency fluctuations decreased reported sales by $0.9 million, or 10.4%, for the quarter, mainly due to a stronger U.S. dollar compared with the Euro and the British pound than in the first quarter of fiscal 2016. Excluding the impact of currency fluctuations, revenues increased 48%.

In terms of geography, and including Bassi revenues, sales in Europe increased by approximately 114%, due to a strong performance in France. In the U.S., sales increased by 45%. Sales in China increased 98%, albeit off of a lower base, due to the strong performance by our JV. Sales in Asia were down approximately 75% due to lower industrial sales, primarily for aerial work platforms and fork-lift trucks.

Turning now to operating expenses, our traditional business benefits from our low-cost manufacturing model. We rely on third parties for the majority of our controller production as outsourcing to trusted manufacturing partners allows us to add capacity while minimizing the addition of fixed costs. Bassi conducts its own manufacturing.

Our operating expense includes engineering and R&D costs, which are reported net of grants received and refundable tax credits related to U.K. R&D incentives. Our engineering and R&D expense was 11.5% of sales in the first quarter of fiscal 2017, compared with 9% last year, when we did not have the charger division. This reflects our on-going commitment to product development and improvement.

On a reported dollar basis, total operating expense for quarter one increased by $1,236,000 from the same period of fiscal 2016, which is largely accounted for by the inclusion of the Bassi unit in 2016 as well as our increase in R&D investments. Operating expense as a percentage of sales decreased to 41% in Q1 2017 from 43% a year ago.

Sevcon reported an operating loss for the first quarter of fiscal 2017 of $2.4 million compared with operating income of $180,000 in the same period last year. Keep in mind that this included the additional engineering investments to capitalize on our strong project pipeline as well as $0.3 million for the amortization of intangible assets and fair value adjustments from the acquisition of Bassi. In addition, in quarter one, following a change of requirements by a customer, we recognized $500,000 of potential additional costs against one on-road project and we are currently renegotiating the scope of this project.

We reported an income tax benefit of $489,000 this quarter compared with an income tax charge of $11,000 in Q1 last year.

After dividends paid and accrued of $91,000 to holders of Series A convertible preference shares, Sevcon reported a Q1 net loss attributable to common stockholders of $2.5 million, or 48 cents per share. This compares with income of $11,000, or zero cents per diluted share, in Q1 of fiscal 2016.

Adjusted EBITDA, which excludes Bassi acquisition costs, was a loss of $2.4 million in the first quarter of fiscal 2017 compared with positive adjusted EBITDA of $0.6 million in the first quarter of fiscal 2016.

Let's turn now to cash flow in the quarter. Excluding the impact of foreign currency, operating activities used $3.5 million and $0.3 million was invested in tooling, test and R&D equipment in the quarter as we continue to invest in capitalizing on electrification opportunities.

The number of days' receivables was 2 days lower at 70 days at the end of Q1 2017 than at the end of the last fiscal year.

We continue to have a $1.1 million bank overdraft facility with RBS Nat West Bank available to our U.K. subsidiary companies which was unused at the end of Q1. This overdraft facility was renewed for a further period of 12 months in July 2016 although, in common with most overdraft facilities in Europe, it can be withdrawn on demand by the bank.

Sevcon ended the year with cash and cash equivalents of $10.4 million. This compares with $14.1 million in cash at year end 2016. The net $3.7 million decrease in cash year largely reflects the operating loss in quarter one and the investment in R&D equipment.

In summary, we are in solid financial condition with a strong balance sheet that enables us to capitalize on the opportunities before us. We continue to invest in engineering resources as our pipeline of major on-road projects grows and we expect that to result in substantial revenue and profitability growth in the years to come.

With that, Matt and I will be pleased to take your questions.

Matt Boyle:
Thank you all for joining us today. We look forward to speaking with you on our next call.