Sevcon, Inc.
Fourth-Quarter 2015 Investor Conference Call
Tuesday, December 9, 2015, 9:00 a.m. ET

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 afternoon, 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.

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. We appreciate your joining us this morning.

I'll begin our prepared remarks with some comments on quarter four and the fiscal year. Paul will follow with the financial review, and then we'll open the call for your questions.

We ended fiscal 2015 on a strong note. Sales were up 4.7% from quarter four of fiscal 2014, driven by a significant increase in on-road OEM applications. This increase was partially offset by the continued weakness in our industrial business and by currency fluctuations.

Before I get into the Q4 results in more detail, I'd like to take a moment to comment on the year and our strategy going forward.

Fiscal 2015 was a record year for Sevcon and a year in which we made excellent progress. Our total sales increased 8.5% from fiscal 2014. Sales for on-road applications were up 50%, while sales in our traditional off-road, industrial market segment were flat.

We logged a record number of product shipments during the year, and rolled out customizable technology solutions designed for on-road and off-road applications that are designed to help achieve a 30% value improvement over traditional technologies.

We introduced our breakthrough GEN5 technology platform in September, concluding the fiscal year with a key milestone. GEN5 is a breakthrough because it uses standardized core components that allow the cost-effective development of a wide variety of products and solutions for on-road and off-road electrification. These core components are setting new standards of reliability, flexibility and security, allowing customers to easily adapt and customize them to their specific applications.

Customer response to GEN5 has been extremely encouraging. We currently have a number of projects in the pipeline that will be utilizing our GEN5 Size 9 and Size 7 on-road motor controllers designed for high performance electric and hybrid electric vehicles. GEN5 products designed for off-road applications are on our roadmap for the near future.

Our vision is to become the leading supplier of electrification technology to our target industrial and automotive markets. We're pursuing high-value electrification niches in on-road and off-road applications that promise strong growth and where our products can achieve leadership positions.

However, penetrating these new markets will require significant investment in engineering, sales and marketing. Therefore, we expect earnings to be somewhat volatile in the interim as we lay the foundation for the next cycle of robust growth.

Now, I'd like to discuss our results for quarter four, starting with geography. As a reminder, it's our policy not to discuss specific customer relationships until we're in commercial production and shipping in volume.

Sales in the United States remained strong – up 15% year-over-year, driven mostly by the on-road OEM, Marine and Agri sectors and despite a continued weakness in Mining and other traditional markets. Sales in Asia increased 7% from the prior year on continued growth in shipment volumes. Although sales in Europe declined approximately 8% year-over-year, driven by lower demand from the Industrial sectors, we saw significant improvement out of the United Kingdom, mainly due to the engineering work we’re doing with partners in Germany.

Looking at our quarter four results by end-use sector, sales remained weak in our industrial off-road markets, continuing to reflect the underlying macroeconomic trends. Mining, aerial work platform, and fork lift truck sales were down double-digits from quarter four last year. We did see, however, a modest improvement in Chinese fork lift sales..

Our emerging marine business kept its positive momentum going during the quarter, and we expect that to continue. We finalized an engineering contract with Seakeeper, a manufacturer of gyro stabilizers for leisure yachts and commercial marine applications, to develop a smaller version of the controller that we are currently shipping to them for use in larger vessels.

This smaller controller includes some of our new Gen5 inverter technology. This was specifically designed for this application. This is just one of the new Sevcon Electrification products currently being trialed and employed by OEMs and Tier 1 suppliers in both the agricultural and construction equipment sectors in Europe, Asia and South America.

Similar to our marine business, our agriculture business also grew nicely during the quarter. We expect both agriculture and construction equipment to contribute more significantly to our top and bottom lines during the next few years.

Turning now to the on-road business in quarter four, we saw strong growth in both the 4-wheel and 2-wheel sectors, with 4-wheel up 144%

and two-wheel up 67% year-over-year. It's the second consecutive quarter the 2-wheel sector showed significant growth. Sales in the 2-wheel market were once again driven mainly by product shipments to electric motorcycle OEMs in Europe and the United States. As a reminder, the 2-wheel sector tends to be lumpy from quarter to quarter.

In the 4-wheel sector, growth was driven by the continued recognition of engineering services revenue and the overall progress we are making on the electrification project with a large German manufacturer of trucks, buses, engines and transportation solutions.

We're also making progress with our Chinese joint venture, which is initially targeting 4-wheel on-road electric and hybrid vehicle applications, selling principally to Chinese Tier 1 automotive suppliers. We expect the JV to begin production shipments sometime in calendar '16. Longer term, we believe the JV positions us to expand our opportunity set in what is becoming the world's largest market for two- and four-wheel electric vehicles.

In addition to the on-road and off-road sectors, we continue to see accelerated growth in our Other EV market, where quarter four sales were up 23% from the prior year. Along with the progress we're making with Seakeeper, this growth was driven by product shipments to a wide range of customers for numerous applications, including recreational vehicles, golf carts, and utility vehicles.

For fiscal 2015 as a whole, Other EV sales were up 42% year-over-year, comprising about 20% of our sales, which is another indication that electrification is appearing in a wide variety of applications and geographies.

Looking forward to fiscal 2016, we believe Sevcon is well-positioned for further design wins with an expanding number of GEN5 products and an increasing base of blue-chip customers. We expect that our traditional off-road industrial markets will continue to be weak and a proxy for global economic trends. We're taking the necessary steps to accelerate our industrial sector growth, and these initiatives are progressing well.

In both the off-road and on-road sectors, we're continuing to focus on opportunities related to the global demand for electrification. In total, our targeted electrification niches will represent an estimated $2.4 billion addressable market by 2020. We believe that our GEN5 technology will enable Sevcon and its customers to be faster to market, reduce risk, and gain share in high-growth electrification applications.

As I mentioned earlier, we expect to remain in an investment phase to allow us to capitalize on the growing number of electrification projects in our pipeline. We anticipate that our earnings will be lumpy from quarter to quarter for the next couple of years, as a result. That said, we'll continue to execute against our long-term growth strategy while remaining focused on the bottom line and on creating value for our shareholders.

With that, I'll turn the call over to Paul for a review of our financial results. 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 4.7% to $10.5 million, from $10.0 million in the same period in fiscal 2014. As Matt mentioned, this growth reflects increasing customer demand for the products we've been developing for an expanding range of applications in the on-road sector and our Other EV category, including higher product volumes shipped to Seakeeper.

Foreign currency fluctuations decreased reported sales by $554,000, or 5.5%, for the quarter, mainly due to a stronger U.S. dollar compared with the euro and the British pound than in the fourth quarter of fiscal 2014. Excluding the impact of currency fluctuations, revenues increased 10%.

In terms of geography, our overall Q4 sales growth was largely driven by the United States and the Far East, where revenues increased by approximately 13% and 7%, respectively, from the same period last year. This was primarily due to growth in the 2-wheel and 4-wheel on-road OEM and Other EV sectors, including marine. Sales were down approximately 10% in Europe mostly reflecting a decline in sales to aerial work platform fork-lift truck customers partially offset by higher sales to on-road OEM's.

These year-over-year increases more than offset a reduction in sales in our North American mining business. Mining continues to be challenging due to the global decline in this sector and in coal mining in particular.

As Matt mentioned, we are making good progress with our Chinese JV, which continues to ship product prototypes designed specifically for the unique requirements of the Chinese market.

Turning now to operating expenses, we are continuing to benefit from our low-cost manufacturing model. We've traditionally relied on third parties for the majority of our production. Outsourcing to trusted manufacturing partners allows us to add capacity while minimizing the addition of fixed costs. As a consequence, our operating expenses consist primarily of product development, engineering, sales-related expenses and general and administrative expenses, including compensation and direct R&D costs.

Our operating expense includes engineering and R&D costs, which are reported net of grants received. Engineering and R&D expense, net of grants, was 12% of sales in the fourth quarter of fiscal 2015, compared with 9.0% in Q4 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

On a reported dollar basis, total operating expense for Q4 decreased by $111,000 from the fourth quarter of fiscal 2014. However, in Q4 last year we recognized two non-recurring charges amounting to $699,000; a $481,000 charge for the establishment of our Chinese joint venture and a charge of $218,000 to recognize a write-off arising from a bankrupt customer in France. Excluding the impact of these two charges, operating expenses increased by $588,000 reflecting the additional cost in 2015 of the Chinese JV as well as increased investment in sales and engineering, including the hiring of additional staff. This investment in additional resources was in response to the higher order intake and to address substantial potential future opportunities. In addition, the increased operating expense year on year reflected lower grant income in Q4 2015 compared with the prior-year period. The Company recorded grant income of $49,000 in the fourth quarter of 2015 compared with

$105,000 in the fourth quarter of 2014; this grant income was recorded as a reduction of research and development expense in each period.

Foreign currency fluctuations decreased reported operating expense by $217,000, or 6%, due to the stronger U.S. dollar compared with the euro and the British pound than in the fourth quarter of fiscal 2014.

Sevcon generated operating income for the fourth quarter of fiscal 2015 of $677,000, compared with an operating loss of $94,000 in the same period last year.

We reported an income tax charge of $218,000 this quarter, or 38% of pre-tax income, compared with a charge of $21,000, or 17.5% of pre-tax income in Q4 last year. The increase in the effective tax rate year-on year was due to a $112,000 write-down of a deferred tax asset in Q4 2015 without which the Q4 2015 effective rate would have been 18.5% of pre-tax income.

After dividends paid and accrued of $105,000 to holders of Series A convertible preference shares, Sevcon reported net income attributable to common stockholders of $254,000, or 8 cents per share, for the fourth quarter of 2015. This compares with $37,000, or 1 cent per share, in Q4 of fiscal 2014.

Let’s turn now to cash flow and working capital items. Excluding the impact of foreign currency, receivables, inventory, and prepaid expenses and other current assets increased by a combined $2.2 million, which decreased cash during the period. Accounts payable, accrued expenses and accrued taxes increased by a combined $1.4 million in the fourth quarter, which increased cash during the period. The Company invested

$221,000 in tooling, test and R&D equipment during the quarter as we invest in capitalizing on the electrification opportunity Matt spoke about.

The number of days' receivables was 6 days lower at 60 days at September 30, 2015 than at the end of Q4 last year.

Sevcon ended the fourth quarter with cash and cash equivalents of $8.0 million including the rights issue funds. This compares with $11.2 million in cash at the September 30, 2014 year-end and $1,700,000 of bank loans. The $3.2 million reduction in cash year to date included the repayment of $1.7 million of loans provided by Citizens Bank less a new loan of $500,000 drawn down, $263,000 of preferred stock dividends paid, $98,000 of common stock purchased and retired, $1.3 million of capital expenditures and $145,000 related to the effect of exchange rates on cash.

With regard to the repayment of the $1.7 million loan with Citizens Bank, we have retained the $3.5 million secured revolving credit facility with that Bank. This revolving credit facility will expire in June 2017 when any principal drawn down at that time will be payable in full. We also have a $1.4 million bank overdraft facility with RBS Nat West Bank available to our U.K. subsidiary companies. This facility was renewed for a further period of twelve months in July 2015 and was unused at the end of the fourth fiscal quarter.

Let's now look at Sevcon's results for fiscal 2015 as a whole.

Total revenues for the fiscal year were $41.1 million, compared with $37.9 million in fiscal 2014. In our Controls segment, sales increased by $3.3 million, or 9%, and in our capacitor segment sales declined $102,000, or 5%, year-on-year.

Sales increased 1% in our traditional off-road, industrial market segment and sales in the on-road market increased 41% year-over-year. Sales for on-road two-wheel applications were up 30% and sales for four-wheel applications were up 46%, primarily reflecting growth in Europe and North America, including both EV and hybrid applications.

Gross profit for fiscal 2015 was 42% of sales, compared with 39% in fiscal 2014. This increase reflects a higher margin sales mix in the Controls segment in 2015 as well as the impact of fixed overhead costs representing a lower percentage of the sales total.

Sevcon reported operating income of $1,894,000 for fiscal 2015, versus $1,025,000 in the prior year.

We recorded an income tax charge of $406,000, or 21% of pre-tax income in fiscal 2015 compared with $85,000, or 10% of pre-tax income last year. The higher effective tax charge in 2015 largely reflects the $112,000 write-down of a deferred tax asset in the fourth quarter of 2015 as well as the impact of differing tax rates in the different jurisdictions in which Sevcon does business.

Reflecting the factors that I just outlined, Sevcon reported net income for fiscal 2015 of $1,135,000, or 32 cents per diluted share after preference share dividends of $440,000 or $0.13 per share. This compares with $909,000, or 28 cents per diluted share, in fiscal 2014 after preference share dividends of $23,000.

Wrapping up, and echoing Matt, we are committed to continuing Sevcon's profitable growth, and look forward to reporting our progress in the quarters ahead.

With that, we'll be happy to take your questions. Operator, you can proceed with the Q&A now.

[Q&A session]

Matt Boyle:

Thank you and thanks everyone for listening this morning. We look forward to speaking with you next quarter. This concludes our call.