Sevcon, Inc.
Fourth-Quarter 2014 Investor Conference Call
Wednesday, December 10, 2014, 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 releases issued yesterday afternoon, you can find them 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 concluded fiscal 2014 on a strong note. Sales were up 13% from the fourth quarter of fiscal 2013. This was our seventh consecutive quarter of top-line growth as sales increased 3% from the third quarter. Since the first quarter of fiscal 2013, we have seen consistent improvement in underlying market demand, order visibility, shipments and revenue in most of our markets, although Western Europe continues to lag at times. Customers are embracing Sevcon's modular, easily adaptable powertrain solutions that only our engineering expertise and application knowledge can provide. These highly flexible products allow us to address ever more applications. I will say more on this later.

For full year fiscal 2014, sales increased 18% from the prior year. In our traditional off-road, industrial market segment, fiscal 2014 sales were up 22%. Sales for on-road applications increased 5% driven by China and the US, but were offset by lower sales in Europe.

As I have already said we concluded fiscal 2014 with our seventh quarter of increased sales and it was a successful year from a bottom-line perspective. Leveraging our revenue growth we delivered a $1.6 million improvement in net income on a like-for-like basis resulting in earnings of $0.19 per diluted share. We also established our Chinese Joint Venture in 2014 which recorded a substantial order in its first quarter of trading.

In addition to all of that, we closed the year with a very successful and substantially over-subscribed rights issue. It was important for us to raise these funds in order to facilitate the continuing growth of the business, both organically and inorganically. I'll have more to say about our growth strategy in a moment.

Looking specifically at quarter four, all of our geographic territories grew lead by the US. Our sales growth in the Far East continues to be driven primarily by product demand in the industrial sectors in Japan and China. We also benefited from increased U.S. shipments for aerial work platforms. Quarter four sales in these sectors were up double-digits year-on-year, which more than offset a decline in sales to mining customers. Our on-road business in China was less of a factor than in recent quarters but is still improving.

Our increased sales in the U.S. this quarter reflected further growth in shipments for on-road vehicles and a new marine application in our "other EV" category, both of which I'll also discuss in a moment.

Europe was a mixed bag for us this quarter. Conditions remain challenging in France and Southern Europe including Spain and Italy. Our business in Germany and Eastern Europe is steadily improving.

These market conditions reflect the general weakness in parts of the European economy. Although our industrial markets were up in Europe year-over-year, this growth was offset by lower order volume from our on-road vehicle customers such as Renault and the now bankrupt customer in France.

Across all our geographies, our aerial work platform and fork-lift truck business was up both quarter on quarter and year on year. Although growth in industrial demand has been less than robust and volatile at times, we believe we've picked the right partners to work with in the right places in the market. In the areas where there was substantial growth in demand, we had presence; in areas where there was modest growth we still had the presence, but to a lesser extent.

Our on-road business in both the two-wheel and four-wheel sectors was down double digits from quarter four last year, reflecting the lumpiness that we've previously discussed and most significantly the bankruptcy in France. Although we expect our on-road business to continue to be lumpy from quarter to quarter going forward, we are solidly on track toward reaching our goals for long-term growth. As an example, despite the bankruptcy in France and for fiscal 2014 as a whole, our four-wheel on-road sales were up 21% from 2013, with the second half being up substantially from the first half.

In terms of quarter four specifically, there were two key on-road market challenges. First, sales were down year-on-year in the two-wheel sector due to lower shipments to electric motorcycle customers in Europe and to a lesser extent Asia, partially offset by higher shipments in the US. The other challenge related to shipments to four-wheel on-road customers, where a combination of factors including the bankruptcy in France depressed demand.

As we've discussed previously, our JV in China is initially targeting on-road electric and hybrid vehicle applications, marketing and selling principally to Chinese Tier 1 automotive suppliers.

The JV made its first shipments to customers and recorded its first sales in China during the fourth quarter, as anticipated. These shipments were product prototypes designed specifically for the unique requirements of the Chinese market. The challenge we faced in quarter four was slower-than-expected production, which led to lower shipment volumes than we had initially planned.

Looking ahead, we see these initial sales as the precursor to larger production orders and volume shipments related to a number of projects in China that we expect to come to fruition in fiscal 2015. Longer term, we expect that our joint-venture will enable us to forge relationships with additional new customers in what is becoming the world's largest market for two- and four-wheel electric vehicles.

Our major upside in the on-road sector in quarter four was the continued growth in our project activity in hybrid powertrain systems. These projects are globally prevalent and several are in Europe and Asia, including two in Germany that could become significant opportunities for us over time. I'll say a little more about Asia in a moment.

In the Other EV category, quarter four sales were up more than 50% year-on-year, primarily driven by growing controller shipments to Seakeeper, a U.S. manufacturer of gyro stabilizers for leisure yachts and commercial marine applications. Along with the Asian and German automotive OEM business I mentioned earlier, our relationship with Seakeeper is the leading edge of what we envision as Sevcon's next major growth opportunity, which is the electrification of ancillary powertrain systems in motor vehicles and various commercial and industrial traction and power applications.

Working closely with our customers, we are developing new integrated subsystems that leverage products such as our Gen 4 controllers and new high voltage/low power products in a growing range of electrically powered solutions. These solutions are designed to meet the increasingly stringent MPG and emissions standards being implemented by governments around the world.

For example, we're developing solutions for replacing inefficient hydraulic steering and hoisting systems with more efficient electric systems. We're also designing solutions to help replace outdated ancillary components such as belt-driven cooling pumps, superchargers, turbochargers and cargo refrigeration units with electrically driven technologies. We're also working with OEM partners on automotive start-stop, as well as solutions designed around products in new off-road industrial applications.

We believe the automotive industry's push for electrification will be a major growth opportunity for us going forward. Looking across all our end markets, we're encouraged by the strength of our new business pipeline. In general it's our policy not to discuss specific customer relationships until we're in commercial production and shipping in volume. Overall, however, our customers seem to be more positive about the outlook for their businesses.

In support of this and as we announced yesterday, we've entered into a major new electrification contract in the Far East. The agreement is with a Tier-1 automotive supplier based in South East Asia, to supply motor controls for a new line of hybrid electric passenger cars.

Under the contract, which could produce up to $50 million of revenue through 2020, Sevcon, will design, manufacture and supply an advanced motor controller for a new line of hybrid electric 4-door sedans. Sevcon expects initial prototypes for fleet test vehicles to be available in June 2015. Thereafter, Sevcon will supply controllers as ordered by the customer, with production shipments expected to begin in the first quarter of 2016.

Following last month's announcement of our Chinese joint venture's first success, signing this contract with a respected Tier-1 supplier in the Far East is another milestone for our growing on-road electric vehicle business in the Asia Pacific region. It is also an example of how our electrification focus is enabling us to capitalize on the global automotive industry's transition from internal combustion to hybrid electric drivetrain technology. One of the first variants of the new generation of products that we plan to roll out over the next several years, this controller is designed to provide the advanced motor control functionality required for hybrid electric passenger car applications, while also complying with the latest EV safety requirements.

So, looking forward, we believe that our core technology platforms can be applied and sold across multiple, higher growth markets as the world transitions to electrification. Tactically, we are using our technology excellence and strong presence in traditional off-road markets to enter new higher growth sectors and territories. Our key strategic challenge is scaling the business to achieve our potential. As system electrification becomes more widespread we anticipate growing both organically and through acquisitions. As a result, capital structure and capital allocation are key strategic priorities for Sevcon. We are actively executing against these priorities, as evidenced by the oversubscribed rights offering we successfully completed this past September, which will help fuel our growth. We would like to thank all of our stockholders who subscribed to the offering. We look forward to reporting continued growth and improved profitability in fiscal 2015

With that, I'll now turn the call over to Paul for a review of our financial results. Paul?

Paul Farquhar:

Thank you Matt and good morning everyone.

As a reminder, the Controls segment that Matt discussed is Sevcon's core business. We also operate a legacy capacitor business that continued to report a small amount of operating income in the fourth quarter of fiscal 2014.

Reviewing Sevcon's financial performance for the quarter and starting with the Income Statement, total revenues increased 13% to $10.0 million, from $8.9 million in the same period in fiscal 2013.

In terms of geography and excluding foreign currency effects, our Q4 sales growth was largely driven by North America where revenues increased 22% from the same period last year. This growth in North America coming from significantly improved sales to Aerial Work Platform and Fork Lift Truck manufacturers as well as sales to the four-wheel on-road sector, to manufacturers of off-road recreational vehicles, and to Seakeeper, the new customer Matt mentioned earlier. Together these areas more than offset a reduction in sales to the North American mining sector.

Our fourth-quarter sales in the Far East were up 4% year-over-year, driven by stronger product demand for aerial work platform and fork lift truck applications offset by a decline in sales to the on-road sector in China as Matt mentioned.

As with last quarter, sales in Europe were largely flat compared with the prior-year quarter; this is largely a consequence of the stagnant economy in certain parts of Europe.

Turning now to operating expenses, we continue 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.

Total reported operating expense for Q4 increased by $966,000 from the fourth quarter of fiscal 2013; this increase was largely due to two non-recurring charges amounting to $699,000: a $481,000 charge for the establishment of our joint venture and a charge of $218,000 to recognize a write-off arising from a bankrupt customer in France which we discussed on our Q3 call. I'll come back to both of those non-recurring charges in a moment.

Excluding the two charges just mentioned, operating expenses increased by $267,000, or 9%, quarter-on-quarter. This increase in part reflects continued investment in sales and marketing and engineering and research and development, including the hiring of additional staff, in response to the strong top-line growth. Of the $267,000 increase, $116,000 relates to adverse currency movements compared to the prior year. In addition, the Company recorded grant income of $105,000 in the fourth quarter of 2014 compared to $72,000 in the fourth quarter in the prior year; this grant income was recorded as a reduction of research and development expense in each period.

Our reported operating expense includes engineering and R&D expense, which are reported net of grants received. R&D expense, net of grants, was 9.0% of sales in the fourth quarter of fiscal 2014, compared with 9.7% in Q4 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

On our call last quarter we discussed a $550,000 receivable from SITL-Brandt Motors, one of our customers in France, which entered into legal administration in early January 2014. In April 2014, the Commercial Court in Lyon in France gave Sevcon the option to recover from the customer the entire inventory of material represented by the $550,000 receivable. This inventory represents current saleable product and, in the opinion of management, can be sold by the Company's French subsidiary to alternative customers in a reasonable timescale.

The SITL business was acquired from the administrator in July 2014 by Cenntro Motor Corporation, a Nevada based manufacturer of all-electric vehicles. As discussed on our Q3 call, we were seeking at that time to engage with Cenntro to discuss the recoverability of the outstanding receivable and the future supply of controls for electric vehicle manufacture. Whilst discussions regarding future supply to Cenntro are still on-going, we decided in late November 2014 to recover in full the inventory represented by the receivable as cash recovery of the receivable was deemed unlikely.

We have accordingly taken a charge as mentioned earlier, of $218,000 in the fourth quarter which reflects the gross profit on the original sale being the difference in value between the receivable of $550,000 and the carrying value of the inventory recovered. We are currently in discussion with a number of existing customers to re-sell this inventory in the current fiscal year.

As Matt mentioned earlier, the Chinese JV made its first shipments to customers and recorded its first sales in China during the fourth quarter, as anticipated. These shipments were largely product prototypes designed specifically for the unique requirements of the Chinese market.

We discussed on our call last time that the activities of the Chinese joint-venture company in the third quarter were limited to the investment of initial capital by each party and the sourcing of business premises and the hiring of engineering and sales and marketing staff. As shipments commenced in the fourth quarter we recognized in full the legal and start-up costs of the JV which amounted to $481,000. As this is a 50:50 joint venture, this charge reduced Sevcon's net income for the quarter by $180,000, after tax. The financial statements of the joint-venture company have been consolidated within Sevcon in Q4.

There was an operating loss for the fourth quarter of fiscal 2014 of $94,000 compared to operating income of $407,000 in the same period last year. Excluding the two non-recurring charges just discussed, operating income in the fourth quarter would have been $605,000, a 49% increase over the prior year.

We reported a small income tax charge of $21,000 this quarter, compared with a charge of $307,000 in Q4 last year, which largely reflected a write-down in the value of deferred tax assets in our UK controls subsidiary business due to a reduction in the UK Corporation Tax rate.

Our effective tax rate for the 2014 year was 10.4%. This low rate reflects the significant variance in income tax rates in the jurisdictions in which we do business and the relative profit or loss made in each business in each period. In addition, there is a continuing impact of the year-on-year reduction in the corporate income tax rate in the UK and the on-going availability in the UK of favorable R&D tax credits, which further reduces our effective UK and global Income Tax rate.

Sevcon reported net income of $37,000, or 1 cent per diluted share, for the fourth quarter of 2014, compared with $45,000, and 1 cent per diluted share, in Q4 of fiscal 2013.

Turning now to cash flow and working capital items and excluding the impact of foreign currency. In the fourth quarter of 2014, receivables, prepaid expenses and other current assets decreased by a combined $1 million which increased cash during the period. Inventories increased $84,000 and accounts payable and accrued expenses decreased by a combined $141,000 in the fourth quarter both of which reduced cash during the period. The Company invested $185,000 in test and R&D equipment during the quarter.

The number of days' receivables was 66 at September 30th, 2014 versus 65 a year earlier.

As discussed on the call last time, the Company filed with the SEC in late July a rights offering of Series A Convertible Preferred Stock intended to raise $10 million before expenses. The offering, which was heavily oversubscribed and raised $9.3 million after costs, gave all of Sevcon's existing stockholders the opportunity to participate. The net proceeds will be used for general corporate purposes and growth, including funding Sevcon's ongoing research and development, product commercialization initiatives and acquisitions of other businesses.

In terms of the balance sheet currently, Sevcon ended the fourth quarter with cash and cash equivalents of $11.2 million including the rights issue funds. This compares to $2.1 million a year earlier. Finally, we closed the fourth quarter of fiscal 2014 with $1.7 million of long-term debt compared with $1.8 million a year earlier.

Since the 2014 year-end we have paid down the $1.7 million loan represented by the long-term debt just discussed. This loan was provided by RBS Citizens Bank although we have retained the $3.5 million secured revolving credit facility with that Bank. This revolving credit facility was extended as of September 30th, 2013 and will expire in June 2017 when any principal drawn down at that time will be payable in full. We also have a $1.5 million bank overdraft facility with RBS Nat West Bank available to our UK subsidiary companies; this facility was renewed for a further period of 12 months in July 2014 and was unused at the end of the fourth fiscal quarter.

Let's now look at Sevcon's results for fiscal 2014 as a whole.

Total revenues for the fiscal year were $37.9 million, compared with $32.2 million in fiscal 2013. In our Controls segment, sales increased by $5.4 million, or 18%, and in our capacitor segment sales grew $300,000, also an 18% increase year-on-year.

Sales increased 22% in our traditional off-road, industrial market segment and sales in the on-road market increased 5% year-over-year. Sales for on-road two-wheel applications were down 20% which was more than offset by a 22% increase in sales for four-wheel applications, primarily reflecting growth in Asia and North America including both EV and hybrid applications.

Gross profit for fiscal 2014 was 39% of sales, compared with 36.6% in fiscal 2013. This increase reflects a higher margin sales mix in the Controls segment in 2014 as well as the impact of fixed overhead costs representing a lower percentage of the sales total.

Sevcon reported operating income of $1,025,000 for fiscal 2014, versus an operating loss of $948,000 in the prior year. As discussed earlier, we recorded in the fourth quarter of 2014 non-recurring charges of $699,000 in respect of the set-up costs of our Chinese JV and a write off arising from a bankrupt customer in France. The operating loss for fiscal 2013 included a one-time restructuring charge of $605,000 in the second quarter. Excluding these items from both periods, there was non-GAAP operating income for fiscal 2014 of $1.7 million, compared with an operating loss of $0.3 million in fiscal 2013, an increase of $2 million on a like-for-like basis.

We recorded an income tax charge of $85,000 in fiscal 2014 compared with a charge of $392,000 last year when we took a write-down of $444,000 in the value of deferred tax assets in the Company's UK controls subsidiary.

Reflecting the factors that I just outlined, Sevcon reported net income for fiscal 2014 of $909,000, or 19 cents per diluted share. This compares with a net loss of $1.1 million, or 32 cents per diluted share, in fiscal 2013.

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.

Matt Boyle:

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

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