

Sevcon, Inc.

Fourth Quarter 2012 Investor Conference Call

Wednesday, December 5, 2012, 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.

During the call, management will reference non-GAAP operating income. Non-GAAP operating income is a non-GAAP financial measure and is intended to serve as a compliment to results provided in accordance with the accounting principles generally accepted in the United States. Sevcon believes that such information provides an

additional measurement and consistent historical comparison of the company's performance.

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 by looking at the operational highlights of fiscal 2012 and Q4. Paul will follow with the financial review, and then as usual we'll open the call for your questions.

In overview, we concluded a year of solid revenue growth with a weak fourth quarter as the macroeconomic environment – particularly in Europe – finally caught up with both major segments of our business. For the first time this year, the ongoing weakness in our traditional off-road sectors was not offset by growth in our new on-road business.

Margins held up well in the year despite some of the swings in demand we experienced through different quarters.

We continued to invest in Sevcon's future growth by expanding our engineering and business development capabilities; this included adding to our engineering resource in the UK as well as the establishment of a Sales presence in Germany.

Looking at the fourth quarter specifically, the weakness we experienced, as I mentioned, was mainly driven by macroeconomics.

We saw broad softening in demand; in our traditional off-road, industrial business, controller shipments for all of our markets, with the exception of Fork Lift truck customers, were down from Q4 last year.

This marked a continuation of trends we saw developing earlier in fiscal 2012, primarily reflecting declining industrial and heavy construction activity in Europe and a slowdown globally in coal mining investment.

The on-road part of our business was particularly volatile in the fourth quarter, with some obvious seasonality along with technology adoption and the macroeconomy all affecting product demand. Sales to two-wheel applications improved, but shipments to four-wheel customers decreased from the fourth quarter last year. This was mainly due to curtailment of shipments for the mia city car, compared to the large orders fulfilled to that customer in Q4 a year ago.

Along with lower shipment volumes, we're seeing shorter order lead times than in the past, which has reduced both our visibility and our certainty for future quarters. On the positive side, our sales in the fourth quarter reflected our first shipments of Gen4 size 10 controllers to projects aimed at hybrid, proof of concept, applications.

The most significant bright spot this quarter was our two-wheel on-road business. Controller shipments for two-wheel applications were up year-over-year, driven by our presence on newly launched scooters and motorcycles like the Brammo Empulse and, more recently, the new line of products scheduled for launch in January 2013 by Zero Motorcycles – a cutting edge OEM based in California. Zero uses our Gen4 Size 4 and Gen4 Size 2 controllers fitted with special software catering for Zero's diverse on and off road applications.

As I said on our call last quarter, given the macroeconomic issues the world has been facing and their impact on our off-road business, our strategy is to establish and grow our presence in as many on-road EV applications as possible, with the scooter and motorcycle business being the latest example of that.

This strategy is what led us to our relationship with Renault for their Twizy city car, which was a major growth driver for us in fiscal 2012. Sales of the Twizy exceeded 8,292 units between its March 2012 launch and the end of September, making it, we believe, one of the best-selling all electric 4 wheel on-road vehicle in the world. It's also what led us to our relationship with Polaris and our presence on its EV Ranger ATV, which is one of the most popular vehicles of its type in the North American market.

There is no doubt that we're steering a difficult course in a tough environment, but we're confident in our strategy. At its core, this strategy is to remain focused on maintaining our profitability while still investing in our growth opportunities. These include opportunities like the scooter business that we believe are near at hand, as well as those driven by the fundamental need to reduce the world's consumption of fossil fuels, which we expect will again become a priority for policymakers and consumers once the global economy returns to more normal conditions.

This is why we're continuing to strengthen our engineering, sales and marketing capabilities, as well as our distribution and customer service footprint. We've also enhanced our intellectual property position this fiscal year by filing worldwide patents for a number of applications of

our motor control products and techniques. As a result, we've been able to continue to expand our portfolio of active development projects with Tier 1s and OEMS around the world.

On our call last quarter I mentioned that we had added five highly experienced automotive engineers to our UK-based R&D team. Our focus this past quarter was to strengthen our presence in Germany, where we started a new initiative targeting German vehicle makers with the appointment of Helmut Ollhaeuser as our new business development director based in Stuttgart.

Helmut joined us from Flextronics Automotive where he was senior director of design and engineering with commercial responsibility for R&D centers in Germany, Canada and China. Helmut worked with key clients including Ford, Daimler, VW, Audi and BMW as well as related Tier 1 suppliers. With Helmut providing strong local representation for us, we are far better positioned to increase our business with the German OEMs in the quarters ahead.

The best measure of our success in business development is the growing number of projects we have underway with OEMs and Tier 1 suppliers in Germany and elsewhere in Europe as well as in Japan, China and North America. As we've stated previously, our policy is not to discuss specific customer relationships until the vehicles are commercially introduced and shipping in volume.

At a general level, our pipeline at the moment includes a wide range of active projects. At one end of the spectrum are projects focused on specific products. Among them is the relationship I mentioned last quarter with a European OEM that's using our most powerful AC motor

controller – the newly introduced Size 10 – for peak torque load sharing in a new hybrid supercar they’re developing.

We also continue to work on some potentially important new products with OEMs and Tier 1s in the industrial off-road sector. Among them are projects related to hybridizing existing internal combustion engine-driven off-road vehicles to meet upcoming emissions standards.

At the other end of the spectrum are projects focused on providing OEMs or Tier 1 suppliers with integrated systems that include not only the motor controller, but all the related electrical power management devices up to, and in some cases including, the motor and gearbox. The applications in this category range from next-generation four-wheel electric city cars like the Twizy, to hybrid, plug-in hybrid and pure electric passenger cars and commercial vehicles.

The macro economy will continue to play a key role in shaping the future trajectory of our business. Our plan is to remain focused on the areas within our control – ensuring that we have the engineering and sales resources we need to fully capitalize on our future opportunities, while at the same time maximizing the profitability in our business model. We look forward to reporting our progress in executing on these objectives in the quarters ahead.

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. This segment essentially broke even in fiscal 2012 after delivering modest levels of profitable revenue in recent prior years.

Reviewing Sevcon's financial performance for the fourth quarter of fiscal 2012 and starting with the Income Statement, revenues were 8 million dollars, compared with 9.4 million dollars in the same period in fiscal 2011.

As Matt said, lower sales in our traditional off-road markets, as well as in our capacitor business, were not offset by growth in demand for our Gen4 controllers in the on-road market. Foreign currency exchange rates reduced revenues in the fourth quarter by 300,000 dollars or 3%, year-over-year, due to the stronger dollar versus both the British Pound and the Euro.

Looking at the controls business segment, sales were lower this quarter in two of our three main geographic markets. Excluding foreign currency effects, revenues were down 37% from the fourth quarter last year in Europe. As Matt mentioned, this was entirely due to Q4 sales last year related to the mia city car, which was starting up first production.

Fourth-quarter sales were down in North America by 9% although our Far East market was up 89% over Q4 last year. The growth in the Far East was principally in China and Japan where we are seeing recovery

after the Tsunami in 2011. In North America, as in the third quarter of 2012, the declines were centered in our traditional off-road markets, other than some growth in sales to Fork Lift Truck customers; two-wheel on-road sales were also up, compared with Q4 2011.

Gross profit for the fourth quarter of 2012 was 32.6% of sales, compared with 32.1% recorded in Q4 last year. In the fourth quarter of 2012 we took a 285 thousand dollar charge for obsolete inventory; excluding this charge, gross profit was 36.1%, or 4% higher than last year.

Turning to operating expenses, we continue to benefit from a low-cost manufacturing model. Outsourcing our production to third parties allows us to add capacity while minimizing the addition of fixed costs. Our operating expenses consist primarily of product development, engineering, sales-related expenses and general and administrative expenses, including compensation and direct R&D costs. The majority of our recent reinvestment in the business, which Matt described, has been focused in these areas.

Operating expenses for the fourth quarter decreased by 728,000 dollars, or 26% compared to the same period last year. Three percentage points of this decrease was due to favorable foreign currency effects. Operating expenses were also reduced by 794,000 dollars, or 28%, due to a one-time curtailment gain associated with the freezing of our UK defined benefit pension plan at the end of the quarter. In addition, our fourth-quarter operating expenses were offset by 41,000 dollars in UK government grant income. Excluding currency and grant income and the one-time pension gain, operating expenses

increased by 187,000 dollars, or 7%, compared to the same period last year. As noted last quarter, this increase largely reflects additional engineering staff hired in 2012.

With regard to the freezing of our UK defined benefit pension plan, we replaced this plan with a defined contribution arrangement effective on the first of October 2012.

Reflecting our strong focus on product development, Engineering and R&D expenses as a percentage of total sales were 11.9% in the fourth quarter of fiscal 2012, compared with 9.3% in Q4 last year.

Sevcon's operating income for the fourth quarter of fiscal 2012 was 518,000 dollars, net of 148,000 dollars in positive foreign currency effects. This compares with operating income of 202,000 dollars in the same period last year. Fiscal 2012 fourth quarter operating income included the benefits of 794,000 dollars associated with the freezing of the company's UK pension plan, partially offset by a charge of 285,000 dollars in the quarter related to obsolete inventory. Excluding these two items, non-GAAP operating income for the fourth quarter of 2012 was 9,000 dollars.

We recorded an income tax provision of 253,000 dollars or 47% of pre-tax income for the fourth quarter of 2012, compared with 155,000 dollars in Q4 last year. The high effective tax rate in the fourth quarter reflects the impact of a reduction in the Income Tax rate in the UK from 25% to 23% resulting in a write down of UK deferred tax assets and hence an additional Income Statement tax charge in the quarter.

Sevcon's net income for the fourth quarter of 2012 was 285,000 dollars, or 8 cents per diluted share, compared with 58,000 dollars, or 2 cents per diluted share, in the fourth quarter of 2011.

I'll turn now to our results for the fiscal year as a whole. Sevcon's total revenues for fiscal 2012 were 35.5 million dollars – up nearly 10% from 32.3 million dollars in fiscal 2011. In our Controls segment, sales were up 13% before the impact of foreign currency exchange rates which reduced revenues by 3% year-over-year, due to the stronger dollar versus the British pound and the Euro. Looking further at the 13% growth in our Controls segment, we saw modest gains of 3% in our traditional off-road, industrial applications. At the same time, however, our on-road two-wheel and four-wheel market increased 70% year on year. This reflects increasing adoption of electric scooters, motorbikes and city cars as discussed in our Q3 call a few months ago.

Gross profit for fiscal 2012 was 34.3% of sales, compared with 35% in 2011; however, as mentioned earlier, the obsolescence reserve of 285,000 dollars taken in Q4 2012 impacted our gross profit percentage. The impact of this charge reduced the gross profit percentage by 0.8 points in the year.

Operating income for fiscal 2012 increased to 1.5 million dollars from 1.1 million dollars in the prior year. Operating income for fiscal 2011 included one-time gains of 451,000 dollars profit from the sale of a surplus U.K. facility and 600,000 dollars of U.K. government grant income. Operating income for fiscal 2012 included UK government grant income of 200,000 dollars. In addition, as I mentioned earlier, the benefit associated with the closure of our UK pension plan increased

this year's operating income by 794,000 dollars. Excluding these items from both periods, non-GAAP operating income for fiscal 2012 was up 487,000 dollars from fiscal 2011.

Sevcon's net income for fiscal 2012 was 1.2 million dollars, or 35 cents per diluted share, compared with 712,000 dollars, or 21 cents per diluted share, in fiscal 2011.

Looking briefly now at cash flow and working capital items for the full fiscal year and excluding currency translation, receivables and inventories decreased by 93,000 dollars and 1.3 million dollars, respectively, which generated cash in the year. Payables and accrued expenses decreased by 700,000 and 310,000 dollars, respectively, which reduced cash in the year. The number of days receivables increased by 2 days from 62 days at September 30, 2011 to 64 days at September 30, 2012.

Turning to the balance sheet, Sevcon ended the fiscal year with cash and cash equivalents of 2.8 million dollars, compared with 1.8 million dollars on September 30, 2011.

In terms of our liabilities, our liability for pension benefits in the US and the UK increased from 7.6 million dollars at the end of fiscal 2011 to 10.3 million dollars at September 2012. This increase, which largely relates to the Company's UK pension plan, was due to the lower discount rates which are used to measure the plan's present and future pension obligations. The reduction in the discount rate was largely due to the affect of quantitative easing in the U.S. and U.K. by central banks which has driven down yields on government bonds. However, as mentioned earlier, we have taken action to minimize future increases in

our pension liability by closing our UK defined benefit plan to future accrual.

Finally, we closed fiscal 2012 with 1.8 million dollars in short- and long-term debt. This compares with 1.9 million dollars at the end of fiscal 2011.

As a reminder, we currently have a 3.5 million dollar secured revolving credit facility with RBS Citizens Bank. We also have 1.5 million dollars of bank overdraft facilities with RBS Nat West Bank available to our UK subsidiary companies. These facilities were unused at both September 30, 2012 and the prior year end.

Wrapping up, fiscal 2012 was a year of double-digit growth and continued profitability and strategic progress for Sevcon. Mindful of the current economic headwinds, we're optimistic about the long-term prospects for our business. We've significantly expanded our presence in the on-road EV market – both in terms of actual product shipments and our relationships with a growing number of the world's leading automotive OEMs and Tier 1 suppliers. We look forward to continuing this progress in the quarters ahead.

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

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