Sevcon, Inc.
Second-Quarter 2015 Investor Conference Call
Thursday, May 7, 2015, 9:00 a.m. ET

Management's Prepared Remarks

David Reichman:

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 two. Paul will follow with the financial review, and then we'll open the call for your questions.

The second quarter saw us continue to build momentum in our markets. Sales were up 13% from the second quarter of fiscal 2014. Foreign exchange was a major factor, which decreased both reported revenues and expenses. Nearly all of our growth this quarter was driven by increased customer demand for the flexible and easily adaptable power train solutions we have been developing for an expanding range of on-road applications. Although the majority of our incremental Q2 on-road sales were for electric and hybrid vehicle applications, we see growing demand for our next generation of products in other electrification applications such as hybridisation in off road sectors for improved performance and efficiency.

I'll provide a more detailed update on our electrification strategy after discussing the quarter's results.

Looking at those results in terms of market sectors, and starting with off-road industrial, our aerial work platform and fork-lift truck business remained somewhat flat in the second quarter compared with the same period last year. Sales in the mining sector remained very slow, as was our airport ground support business.

Although we expect the level of product demand in our industrial off-road markets to continue to reflect underlying macroeconomic trends, we are working to accelerate our growth in these areas. In February, we were joined by Pietro Tagliavini a recognized business development expert in the Industrial sectors of our business.

Later this calendar year we plan to release a new generation product designed for off-road industrial applications where we see real potential for growth. We look forward to having Pietro lead this part of our business as we pursue these opportunities.

Before I turn to the on-road business, a quick update on our newest off-road sector. Now that we're offering a new line of high voltage, low power inverters into the market, our products are beginning to gain traction with OEMs and Tier 1 suppliers in the agricultural and construction equipment sectors in Europe and South America.

There are a number of important agriculture and construction applications that involve higher battery voltages but have modest requirements for power. This is the area which our new HVLP inverter was designed to address. Much like our emerging marine business, we expect Agricultural and Construction projects to contribute more significantly to our top and bottom lines during the next few years.

Now turning to the on road sectors, in contrast to quarter one, when sales in both the two-wheel and four-wheel on-road sectors were up double digits from the prior year, sales in the two-wheel sector were down 15% in quarter two. Although this decline was largely due to the timing of shipments for one customer in particular, we've seen global volatility in the two-wheel market over the past few quarters, so the underperformance in two-wheel was not a surprise.

Our quarter two sales in the four-wheel sector nearly doubled year-on-year. This growth was largely due to product shipments for bus and truck applications in Europe as well as the recognition of engineering revenues and the overall progress we made on the electrification project with the large German manufacturer of trucks, buses, engines and transportation solutions that we mentioned on last quarter's conference call. This contract initially focuses on a bespoke controller and motor subsystem we designed for heavy vehicle start/stop applications.

Driven by the success of that program, we're now supplying them and others with HVLP and Gen4 Size 10 motor controllers for some advanced heavy vehicle electrification projects that have significant potential growth implications for us. We recorded a small amount of product revenue associated with these new projects in quarter two.

Elsewhere in the 4-wheel, on-road market, our Chinese joint venture continues its good start. As we've discussed previously, the JV is initially targeting on-road electric and hybrid vehicle applications, marketing and selling principally to Chinese Tier 1 automotive suppliers. As we anticipated, these initial sales are leading to larger shipments related to pre-production orders. We expect to see larger production orders and volume shipments related to a number of projects in China that we believe will come to fruition as fiscal 2015 progresses. Looking ahead longer term, we expect the JV 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.

In terms of geography, our quarter two sales were up mid-single digits year-on-year in the U.S. Sales in the Far East were up slightly while sales in Europe showed a 29% improvement compared with quarter two last year. These geographic results generally reflected the market dynamics that I just outlined.

Of note, our business in the U.S. included significant product volumes shipped to Seakeeper, a manufacturer of gyro stabilizers for leisure yachts and commercial marine applications. These sales were partially offset by the continued decline in the global mining vehicle sector. Our growth in the Far East was primarily driven by our Chinese joint venture, and the strong performance in Europe was largely due to our expanding Gen4 Size 10 and HVLP business in trucks as well as the customer sponsored project development with the German OEM.

Looking forward, we’re working on a substantially expanding pipeline of projects related to the global desire for electrification. Most important for the long term, we’re gaining momentum in pursuit of these major growth opportunities, focusing not only on traction applications, but also on ancillary powertrain systems in motor vehicles and various industrial power applications.

These projects cover all of our geographic territories and market sectors. We will continue to invest in the development of these electrification solutions from both an engineering and sales perspective over the coming quarters, recognizing that we are beginning to reap the rewards of our investments in engineering over the past several years – both in terms of company growth now and in our new project pipeline.

It’s our policy not to discuss specific customer relationships until we’re in commercial production and shipping in volume. Overall, however, we are confident in our outlook for continued top-line growth and further design wins.

In summary, we see the operating results that Sevcon delivered in the second quarter as an indicator of the performance we can expect for the foreseeable future.

We believe that our traditional off-road industrial markets will continue to be a proxy for global economic trends and against that backdrop, we have initiatives underway to address this and accelerate our growth in these sectors including those I mentioned earlier. In the on-road sector, our higher investment in our engineering and technical innovation both in the past and now has enabled us to forge strong partnerships with some of the largest companies in the world.

We have the opportunity to write the next chapter of Sevcon's growth by capitalizing on the opportunities we see emerging in electrification.

Our electrification strategy is to leverage our experience and knowledge to develop core technology platforms which can be applied and sold across multiple, higher-growth markets as the world transitions to electrification. We remain in an investment phase to allow us to capitalize on the growing number of electrification projects in our sales funnel. Sevcon's flexible, adaptable solutions strategy will create a wide variety of customer-specific products that, with a common platform approach, can lower production costs through larger volumes, protect our present margins, and create opportunities for organic growth.

We look forward to reporting continued growth and improved profitability as fiscal 2015 progresses. 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.

Reviewing Sevcon’s financial performance for the quarter and starting with the Income Statement, total revenues increased 13% to $10.3 million dollars, from $9.2 million dollars in the same period in fiscal 2014. As Matt mentioned, this growth reflects customer demand for the products we’ve been developing for an expanding range of applications in the on-road sector. Foreign currency fluctuations decreased reported sales by $833,000, or 9%, mainly due to a stronger U.S. Dollar compared with the Euro and the British Pound than in the second quarter of fiscal 2014.

In terms of geography and excluding foreign currency effects, our Q2 sales growth was largely driven by Europe where revenues increased double digits from the same period last year. This was primarily due to engineering revenues from our electrification project with a large German on-road OEM. In North America we saw mid-single digit growth coming from the significant product volumes shipped to Seakeeper. These increases year-over-year more than offset a reduction in sales for North American mining applications. Mining continues to be challenging due to the global decline in this sector and in coal mining in particular.

Our second-quarter sales in the Far East were up slightly year-over-year. 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. As a reminder, the financial statements of the joint-venture company have been consolidated within Sevcon in Q2.

Turning now to operating expenses, we are benefitting 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 Q2 increased by $481,000 from the second quarter of fiscal 2014 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 strong top-line growth. In addition, the increased operating expense year on year reflected lower grant income in Q2 compared to the prior year period. The Company recorded grant income of $23,000 in the second quarter of 2015 compared with $157,000 in the second quarter in 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 $327,000, or 10%, due to the stronger U.S. Dollar compared with the Euro and the British Pound than in the second quarter of fiscal 2014.

Our operating expense includes engineering and R&D expense, which are reported net of grants received. R&D expense, net of grants, was 12.6% of sales in the second quarter of fiscal 2015, compared with 11.8% in Q2 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

We generated operating income for the second quarter of fiscal 2015 of $674,000, up from operating income of $196,000 in the same period last year. There was a non-cash charge to income in the second quarter of $200,000 to record the change in the fair value of foreign exchange contracts accounted for as cash flow hedges.

We reported an income tax charge of $65,000 this quarter, or 9.2% of pre-tax income, compared with a benefit of $23,000 in Q2 last year. The low effective tax rate in Q2 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 low corporate income tax rate in the U.K. and the on-going availability in the U.K. of favorable R&D tax credits, which further reduces our effective U.K. and global Income Tax rate.

After dividends paid and accrued of $114,000 to holders of Series A convertible preference shares, Sevcon reported net income attributable to common stockholders of $539,000, or 16 cents per share, for the second quarter of 2015. This compares with $162,000, and 5 cents per share, in Q2 of fiscal 2014 when we did not pay any dividends. Excluding the $159,000 after-tax impact of the non-cash charge for the change in the value of foreign currency contracts, net income for the quarter would have been $698,000, or $0.20 per share

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 $719,000, and accrued expenses and accrued taxes decreased by $196,000, all of which decreased cash during the period. Accounts payable decreased by $930,000 in the second quarter which increased cash during the period. The Company invested $299,000 in tooling, test and R&D equipment during the quarter.

The number of days' receivables was 3 days lower at 63 days at April 4, 2015 than at the end of Q2 last year.

In terms of the balance sheet, Sevcon ended the second quarter with cash and cash equivalents of $8.6 million dollars including the rights issue funds. This compares with $11.2 million dollars in cash at the September 30, 2014 year-end and $1,728,000 of bank loans. The $2.6 million reduction in cash in the half year to April 4, 2015 included the repayment of the $1.7 million dollar loan provided by Citizens Bank, $42 thousand dollars of preferred stock dividends paid, $98 thousand dollars of common stock purchased and retired, $592 thousand dollars of capital expenditure and $212 thousand dollars related to the effect of exchange rates on cash.

With regard to the repayment of the $1.7 million dollar loan with Citizens Bank, we have retained the $3.5 million dollars 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 $1.5 million dollars bank overdraft facility with RBS Nat West Bank available to our U.K. subsidiary companies. This facility was unused at the end of the second fiscal quarter.

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.

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