Sevcon, Inc.
Second-Quarter 2014 Investor Conference Call
Wednesday, May 7, 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 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 comments on the second quarter. Paul will follow with the financial review, and then we'll open the call for your questions.

Sevcon's financial results continued to improve in quarter two. Sales were up 14% from the second quarter of fiscal 2013. On a sequential basis, sales increased 1% from quarter one of fiscal 2014. This continued our consistent trend of sequential top-line growth since what appears to be a low point in quarter one of fiscal 2013.

Looking at the business geographically, sales for the quarter increased mid single digits in both Europe and the US. With a strong quarter in the Far East, where we posted high double-digit growth, year-over-year. This growth continued to be driven primarily by aerial work platform and fork lift truck demand in Japan and China.

In addition to seeing solid growth in our traditional off-road industrial, construction sectors in Asia, we are beginning to benefit from our new business initiatives in the on-road sector in Asia, primarily in China. Our sales in quarter two did not reflect any shipments associated with our joint-venture agreement with Risenbo Technology Co., Ltd, which we announced on our call last quarter.
Risenbo is a subsidiary of a Chinese Tier 1 automotive supplier based in Hubei Province. We received the required government approvals in China and the JV agreement became effective, later than planned, early in our fiscal third quarter. We and Risenbo each own a 50% stake in the joint venture, which is being led by me as the Sevcon-nominated chair.

The JV puts us in partnership with an established and respected player in the Chinese automotive industry, and better positions us to serve the country's growing electric vehicle demand. We're initially targeting on-road electric and hybrid vehicle applications, marketing and selling principally to Chinese Tier 1 automotive suppliers.

As we said on our Q1 call, the electric scooter and motorcycle market is still in its early stages and likely to be lumpy from quarter to quarter. We've developed highly competitive controller technology for motorcycles and scooters in the 125 to 550 cc equivalent range, and we expect two-wheel applications to continue to be a growth driver in the quarters ahead.

Our year-over-year growth in demand for four-wheel on-road product applications was slower in quarter two than in the sequential first quarter. However, we did see significant sales growth this quarter in China, driven by our ongoing business with a Chinese distributor related to four-wheel electric city cars and quadricycles. Demand for these small urban vehicles is growing in China in response to local and provincial air-quality-related incentive programs.

Looking forward, we expect that our joint-venture with Risenbo, coupled with our other new business initiatives in China, 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 sales in the U.S. this quarter continued to be driven mainly by demand in the off-road sector for aerial work platform, forklift truck and mining vehicle applications. We also continued to see growth in on-road and our aftermarket business in the U.S. As we said on our call last quarter, this business focuses mainly on providing low-volume, end-of-life product support for aerial work platform customers. Selling through a single third-party distributor allows us to serve our U.S. aftermarket customers more efficiently than in the past.

In Europe, our sales growth for the quarter continued to be driven primarily by demand in two areas – aerial work platform applications in the industrial off-road sector, as well as applications for four-wheel off-road recreational vehicles and on-road city cars, where our Size 8 controllers have proven to be an outstanding solution for our European customers. Although the economy is still far from robust, this was our fourth consecutive quarter of year-over-year sales growth in Europe.

Overall, our new business pipeline has never been stronger. It's our policy not to discuss specific customer relationships until we're in commercial production and shipping in volume. Looking at the pipeline in general, we're encouraged by the progress we're making with a group of customers working on hybrid electric vehicle technologies.

One of them is a manufacturer of hybrid powertrain conversion systems in the U.S. We also have some encouraging hybrid vehicle projects underway in Europe. These include two projects in their early stages in Germany that could become significant opportunities for us.

Our pipeline also includes products that target the off-road industrial sector -- Gen 4 and new High Voltage Low Power products that we've designed to capitalize on opportunities related to what we've turned the electrohydraulics sector. New customers and some existing OEMs are looking to replace older and less efficient hydraulic systems with electrical systems. This has the potential to substantially improve efficiency, save energy and reduce total cost of ownership in a variety of commercial and industrial applications.

This worldwide "electrification" trend has significant growth implications for Sevcon. As just one example, working with OEMs and the Agricultural Industry Electronic Foundation, we've launched a range of products for the agricultural equipment and machinery market.This market presents us with high volume and high value potential opportunities. New tractor sales are predicted to be around 1.4 million units by 2015, with equipment sales set to be even greater. We believe that electrohydraulics motor controller sales in agricultural equipment market could ramp up to many thousands a year by the end of the decade.

Given this ambitious R&D agenda, we're continuing to expand our sales and engineering capabilities. We're also making significant investments in order to protect the intellectual property we're developing. We have recently applied for and received several new patents.

Sevcon is in a growth mode strategically, which will continue to drive growth in R&D expense. At the same time, however, we remain committed to managing the business in as thoughtful and conservative manner as we can. As an example, we are continuing to pursue UK government grant opportunities as a means of supplementing our internally funded R&D programs.

Overall, our business environment continued to improve in quarter two, which marked our fifth consecutive quarter of sequential revenue growth and our third straight quarter of growth, year-over-year. We're continuing to hear positive comments from our customers about the conditions in their businesses. There is a sense that underlying demand is slowly gathering strength in the majority of our markets worldwide. Our portfolio of customer relationships is expanding.

Although we're investing in Sevcon's future growth, our business continues to benefit from having a low-cost, flexible manufacturing model. As a result, we believe that Sevcon is positioned to deliver significant margin leverage on incremental sales as conditions in our markets improve.

We believe that Sevcon's future has never been brighter. We've said in the past that at some point we believe the market will begin a meaningful shift towards larger electric and hybrid vehicles – that is, passenger cars, trucks and buses. That inflection point may well be closer than many people think, and our product roadmap has the potential to put us in the sweet spot for this next phase of EV market growth.

The key strategic challenge that we have is scaling the business to capture this opportunity on a timely basis, whether organically or through acquisitions. Meeting this challenge means that we will need a stronger balance sheet to fuel accelerated growth. We are considering raising equity capital by means of a rights offering or other approach. Paul and I are working closely with the board to develop a capital allocation and investment strategy that will help us to achieve our goals.
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 second quarter of fiscal 2014.

Reviewing Sevcon's financial performance for the quarter and starting with the Income Statement, total revenues increased to $9.2 million from $8 million in the same period in fiscal 2013.

As Matt said, in our controls business segment, sales in our traditional aerial work platform and fork lift truck markets were up this quarter, compared with Q2 last year, as were sales for on-road applications. Sales in the two-wheel on-road sector were up substantially year-over-year, while sales in the four-wheel on-road sector were only slightly higher.

In terms of geography and excluding foreign currency effects, revenues increased 7% from the second quarter last year in North America. Our North American sales continued to be driven by product demand in the traditional areas of aerial work platform and fork lift truck markets as well as on-road EV applications the growth for which together more than offset lower year-over-year sales in the mining sector.

Our second-quarter sales in the Far East were up 82% year-over-year, driven by stronger product demand for aerial work platform applications in China and Japan.

Sales in Europe increased 5% from quarter two last year, also reflecting stronger aerial work platform business, as well as continued modest growth in product demand for 4-wheel on-road EV applications.

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.

We are continuing to successfully leverage this model. Reflecting our cost savings initiatives during the past year, which have reduced our cost of sales, as well as improved sales mix, gross profit for the second quarter of 2014 improved 180 basis points to 39.3% of sales, from 37.5% in quarter two last year.

Total reported operating expense for Q2 decreased by $64,000 from the second quarter of fiscal 2013, when we recorded a one-time restructuring charge of $605,000. Excluding the restructuring charge, the increase in operating expense of $541,000 year-on-year largely reflects continued investment in engineering and research and development resources in response to the strong top-line growth since last year. In addition, the Company recorded grant income of $157,000 in the second quarter of 2014 compared to $38,000 in the first quarter in the prior year; this grant income was recorded as a reduction of research and development expense in each year.

Our reported operating expense includes engineering and R&D expense, which are reported net of grants received. R&D expense, net of grants, was 12% of sales in the second quarter of fiscal 2014, compared with 13% in Q2 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

Operating income for the second quarter of fiscal 2014 was $196,000. This compares with an operating loss of $463,000 in the same period last year, which included a one-time restructuring charge of $605,000.

We reported a small income tax benefit of $23,000this quarter, compared with a benefit of $638,000in Q2 last year. Our effective tax rate for the first six months of 2014 was 13.1% which 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 also the availability in the UK of favorable R&D tax credits, which further reduces our effective UK Income Tax rate.

Sevcon reported GAAP net income of $162,000, or 5 cents per diluted share, for the second quarter of 2014, compared with $62,000, or 2 cents per diluted share, in Q2 of fiscal 2013.

Turning now to cash flow and working capital items, receivables increased by $1.7 million from the second quarter last year and both inventories and prepaid expenses were essentially flat with the prior-year period.

Accounts payable increased by $1.1 million reflecting the higher activity year-on-year and both accrued expenses and accrued taxes were also essentially flat with the prior-year period.

The number of days' receivables was 66 at March 29, 2014 versus 63 at March 30, 2013.

On our call last quarter we discussed an approximate $500,000 receivable from one of our customers in France, which entered into legal administration protection for a minimum period of six months in early January 2014. The French court appointed administrator is currently seeking a buyer for the business and the deadline for formal bids to purchase all or part of its activities expired in late April. The court administrator is currently evaluating those bids and further information should be available in early June. Also in late April, the Commercial Court in Lyon in France gave Sevcon the option to recover from the customer the entire inventory of material represented by the $500,000 receivable. The inventory concerned represents current saleable product and, in the opinion of management, could be sold by the Company's French subsidiary to alternative customers in a reasonable timescale. Although we are pursuing full payment of the debt, given the legal uncertainties, it remains unclear as to whether this receivable can or will be repaid. As we said last quarter, the full amount of the receivable was recorded on the balance sheet at March 29, 2014.

In terms of the balance sheet currently, Sevcon ended the second quarter with cash and cash equivalents of $1.5 million, compared with $1 milliona year earlier. Finally, we closed the second quarter of fiscal 2014 with $1.8 millionin short- and long-term debt. This compares with $1.8 millionalso, a year earlier.

As a reminder, we currently have a $3.5 millionsecured revolving credit facility with RBS Citizens Bank. $1.7 million of this facility was drawn down at the end of Q2, which represented the majority of the $1.8

million in short and long-term debt just mentioned. This revolving credit facility was extended as of September 30, 2013 and will expire on June 14, 2017 when the principal will be payable in full. We also have a $1.5 millionbank overdraft facility with RBS Nat West Bank available to our UK subsidiary companies; this facility was unused at the end of the second quarter of fiscal 2014.

Now, turning to our income statement results for the first six months of fiscal 2014. Sevcon's sales for the six-month period were $18.2 million, compared with $14.7 million in the same period last year.

Gross profit for the six-month period was 40.8% of sales, compared with 35.8% of sales a year earlier, reflecting better sales mix and cost savings achieved from the restructuring exercise in the second quarter last year. Sevcon's operating income was $906,000, in the first half, compared with an operating loss of $1,648,000 for the six-month period last year, after charging $605,000 in one-time restructuring costs. Our net income for the first half of this year was $650,000, or 19 cents per diluted share, compared with a net loss of $1,240,000, or 37 cents per diluted share, in the same period last year.

In conclusion, and in line with Matt's comments, with improved sentiment in our customer base, our lower cost structure and conservative balance sheet, we are confident that Sevcon is well-positioned for growth and improved profitability in fiscal 2014. We look forward to reporting our progress in the quarters ahead.

Operator, you can now open the call for questions.

Matt Boyle:

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

# # #