Sevcon, Inc.
Third-Quarter 2015 Investor Conference Call
Thursday, August 6, 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 three. Paul will follow with the financial review, and then we'll open the call for your questions.

Sevcon's sales in quarter three grew 7% year-on-year, despite weak conditions in some of our traditional off-road markets and unfavorable foreign exchange rates. Our growth was mainly driven by sales of our powertrain solutions for an expanding range of on-road applications. It also reflected higher product volumes shipped to Seakeeper, a manufacturer of marine gyro stabilizers.

This growth was partially offset by ongoing weak conditions in the global mining vehicle sector. In addition, foreign currency fluctuations cut our sales growth by approximately 50%, compared with Q3 Fiscal 2014 exchange rates.

Against this short-term backdrop, we're continuing to build momentum in our markets. We are seeing steadily growing product demand not only for on-road electric and hybrid vehicle applications, but also for applications in off-road sectors such as marine and agriculture.

Taking the longer view, many traditional internal combustion and mechanical systems are being replaced by electrical solutions that improve efficiency, reduce emissions, and lower overall cost in both off-road and on-road applications. Our OEM partnerships that are focused on this trend toward electrification are beginning to transition from prototype to volume production. We expect to remain in an investment phase to allow us to capitalize on the growing number of electrification projects in our sales pipeline. We also continue to consider acquisitions of intellectual property and other products that could allow us to take advantage of customer opportunities more quickly than if we were limited to internal development. Our vision is for Sevcon to become the leading supplier of electrification technology to our target industrial and automotive markets.

I'll talk more about our progress in achieving this vision after discussing quarter three in more detail.

In terms of geography, sales in the United States were particularly strong -- up 21% year-over-year. Sales in the other two regions were down mid-single digits in reported sales but up mid-single digits in volume. The reduction in reported sales being entirely due to currency. This reflected the market dynamics that I just discussed. The 4-wheel on-road and marine sectors generated growth in the United States and Europe while increases in volume shipments across all but one sector to Far East customers turned into lower recorded sales due entirely to currency.

Now turning to our results in each end-use sector, in our industrial off-road markets, our sales this quarter continued to reflect underlying macroeconomic trends. The weakness in global mining was joined, we believe temporarily, by the Chinese fork lift truck sector. The Aerial work platform and airport ground support sectors were essentially flat in reported terms but volumes were up low double digits, year-over-year.

The bright spots in off-road this quarter, again, were our emerging marine and agriculture businesses. Our new line of high voltage, lower power inverters is opening up applications for us in these markets as well as in construction equipment that involve higher battery voltages but have modest requirements for power.

Our HVLP products are being employed by OEMs and Tier 1 suppliers in both the agricultural and construction equipment sectors in Europe and South America. During the second half of calendar year 2015 we plan to release a next-generation product designed for off-road industrial applications where we see real potential for growth. Similar to our marine business, we expect agriculture and construction to contribute more significantly to our top and bottom lines during the next few years.

Turning now to the on-road business in quarter three, we continued to see steady growth in the 4-wheel sector, as well as lumpiness from quarter to quarter in the 2-wheel sector. Following flat year-over-year growth in quarter two, our quarter-three sales in the 2-wheel market were up 89% from the prior year, driven mainly by product shipments to electric motorcycle OEMs in Europe and the United States.

Our quarter-three sales in the four-wheel sector grew 52% year-on-year. This growth was mainly driven by two projects. The first is with a U.S. manufacturer of electric vehicles, which is using our controllers for an all-electric passenger drivetrain designed for the Chinese market.

Our second on-road growth driver this quarter was 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.

As we've mentioned on previous conference calls, this contract initially focused on a bespoke controller and motor subsystem we designed for heavy vehicle start/stop applications. In addition we're now supplying this customer and others with HVLP and Gen4 Size 10 motor controllers for advanced heavy vehicle electrification projects. We continued to record modest product revenues associated with these new projects in quarter three, and we believe their future growth potential is significant.

Another focus for us in the 4-wheel, on-road market is our Chinese joint venture, which is initially targeting on-road electric and hybrid vehicle applications, marketing and selling principally to Chinese Tier 1 automotive suppliers. We expect to see a transition to production orders and volume shipments related to a number of projects in China over the next few quarters. 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're seeing accelerated growth in a category that we call Other EV. Our quarter-three sales in the other EV sector were up 32% from the prior year. This growth was driven by product shipments to a wide range of customers for numerous applications, including recreational vehicles, golf carts and utility vehicles. It is another indication that electrification is appearing in a wide variety of applications and geographies. For fiscal 2015 to date, other EV sales are up 24% year-over-year, comprising 14% of our total sales for the nine-month period.

It's our policy not to discuss specific customer relationships until we're in commercial production and shipping in volume. Overall, however, we believe that Sevcon is well positioned for further design wins with an expanding base of blue-chip customers.

I'll conclude my prepared remarks with some comments on the business outlook. Looking first at our traditional off-road industrial markets, we believe these markets will continue to be a proxy for global economic trends. We have initiatives underway to accelerate our growth in these sectors, and these initiatives are progressing well.

In the on-road sector, our ongoing investments in engineering and technical innovation have enabled us to forge strong partnerships with some of the largest companies in the world. Our first generation partnerships were focused on the industrial off-road sector. The second generation was, and continues to be, centered on electric and hybrid vehicles for electrification applications.

Our next-generation partnerships are now focusing on opportunities related to the global demand for electrification. These opportunities relate not only to traction applications, but also ancillary powertrain systems in motor vehicles and various industrial power applications.

More simply put, our electrification strategy helps customers lower emissions, generate electricity and go faster.

Our success in establishing these partnerships and building our electrification project pipeline demonstrates that we are beginning to reap the rewards of our recent investments in engineering, sales and marketing. Our partnerships are creating lasting relationships that get our products "designed in" and help us grow as our customers grow.

Going forward, we expect to remain in an investment phase to allow us to capitalize on the growing number of electrification projects in our sales funnel. We are taking the long view while staying focused on the bottom line, anticipating that our quarterly earnings may not be linear for the next two or three years as we prepare for Sevcon's next cycle of robust growth.

Nearer term, in light of our current market momentum and the operating leverage we have created in our business, we look forward to reporting continued growth and improved profitability in the fourth quarter of 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.

Reviewing Sevcon's financial performance for the quarter and starting with the Income Statement, total revenues increased 7% to $10.3 million, from $9.7 million 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 and higher product volumes shipped to Seakeeper. Foreign currency fluctuations decreased reported sales by $846,000, or 8%, mainly due to a stronger U.S. Dollar compared with the Euro and the British Pound than in the third quarter of fiscal 2014. Excluding the impact of currency fluctuations, revenues increased 15%.

In terms of geography, our Q3 sales growth was largely driven by the United States where revenues increased approximately 20% from the same period last year. This was primarily due to growth in the 4-wheel on-road and marine sectors. These year-over-year increases 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.

Sales were down approximately 5% in both Europe and the Far East, mostly reflecting the decline in the fork-lift truck market.

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 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 Q3 increased by $564,000 from the third 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 Q3 compared with the prior-year period. The Company recorded grant income of $58,000 in the third quarter of 2015 compared with $132,000 in the third 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 $341,000, or 10%, due to the stronger U.S. Dollar compared with the Euro and the British Pound than in the third quarter of fiscal 2014.

Our operating expense includes engineering and R&D costs, which are reported net of grants received. R&D expense, net of grants, was 13.3% of sales in the third quarter of fiscal 2015, compared with 10.8% in Q3 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

We generated operating income for the third quarter of fiscal 2015 of $261,000, up from operating income of $213,000 in the same period last year.

We reported an income tax charge of $83,000 this quarter, or 22.9% of pre-tax income, compared with a benefit of $34,000 in Q3 last year. The low effective tax rate in Q3 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 ongoing 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 $110,000 to holders of Series A convertible preference shares, Sevcon reported net income attributable to common stockholders of $171,000, or 4 cents per share, for the third quarter of 2015. This compares with $222,000, and 7 cents per share, in Q3 of fiscal 2014 when we did not pay any dividends. Excluding the $105,000 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 $66,000, or $0.02 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 $1.2 million, which decreased cash during the period. Accounts payable, accrued expenses and accrued taxes increased by a combined $807,000 in the third quarter, which increased cash during the period. The Company invested $496,000 in tooling, test and R&D equipment during the quarter as we invest in capitalizing on the electrification trend Matt spoke about.

The number of days' receivables was 3 days lower at 63 days at July 4, 2015 than at the end of Q3 last year.

Sevcon ended the third quarter with cash and cash equivalents of $8.5 million including the rights issue funds. This compares with $11.2 million in cash at the September 30, 2014 year-end and $1,728,000 of bank loans. The $2.7 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, $1.1 million of capital expenditures and $85,000 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 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 third 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.

# # #