Sevcon, Inc.
Second-Quarter Fiscal 2016 Investor Conference Call
Tuesday, May 17, 2016

Management's Prepared Remarks

Matt Roache:

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, Matt. Welcome everyone. We appreciate your joining us this morning.

Looking at the second quarter overall, we reported strong revenue growth due to the acquisition of Bassi, which more than offset slower sales in the traditional controllers and capacitors segments. The lower traditional sales were due entirely to continued weakness in the industrial side of the business as a result of macro-economic conditions. Sales to our on- road customers were very slightly lower in the second quarter compared to last year.

Overall sales were up 28% for the quarter. Excluding FX, they would have been up by 30%.

We reported a loss of $0.43 per share for the quarter, but that included a $1.1 million, or $0.28 per share, charge for acquisition-related expenses.

Starting with our traditional business. We reported $9.2 million in revenue, which was down from $10.3 million a year ago. Excluding FX, that business would have been down 9%.

Looking at these results by end-use sector, our industrial off-road markets further deteriorated as customers found themselves with excess inventory following the end of calendar 2015, particularly in the US and Far East. Fork-lift trucks and mining were significantly impacted down by double digits, offsetting a slight increase in airport ground support and aerial work platforms sectors.

Turning now to on-road… Sales in the second quarter were down very slightly from those recorded last year. As we've discussed previously, this business will be inherently lumpy from quarter to quarter due to the timing of orders as we ramp up this business.

After recording three consecutive quarters of double digit growth in the 2-wheel sector, sales were down 39% in Q2.

However, Four-wheel sales were up 17%. This year we experienced a shift from product sales to engineering services sales. Last year we had a particularly strong quarter of product sales, especially in Eastern Europe where some of our customers experienced a substantially adverse change in their economic environment which meant sales did not recur in 2016. This reduction in product sales was offset however by recognizing revenues from engineering services.

An increasingly important element of our revenue comes from Engineering Services.

Many new customers, mainly on-road vehicle manufacturers, require a bespoke product to meet their specific needs. They pay us to re-engineer existing Sevcon products to provide them with a reliable solution. This process results in a shorter time to market and lower development costs for our customer. Our experience allows us to complete projects faster than the competition, and with known system performance.

We generally account for engineering services on a "percentage of completion" accounting method. As a result, our revenue for engineering services is a function of the number of hours worked by individuals on a project at specified rates as a proportion of an agreed program of work.

We currently are conducting engineering services on several projects, all of which go into production in 2019 and beyond. A multi-year project is very intense in terms of hours worked for the first 12 months as we develop the product and software. Subsequent time is spent on the refinement of the initial development, product testing, the validation of the product to safety standards and product certification. We believe our progress on an engineering services contract is a good way to assess the likelihood that a production program will commence at some point in the future.

In the second quarter we secured another in a series of multi-year, multi-million Dollar on-road design contracts from an automotive OEM. The contract is for the development of the controller for performance cars to allow electrification of the drive system. The contract covers engineering time and materials and is likely to continue for four years due to the extensive test and qualification period of these on-road design contracts. There is a follow-on non-binding production forecast that amounts to over $40 million over a five-year period commencing in 2020. This design win gives us confidence for significant sales growth in the future

Paul will talk a bit more about how we account for engineering services. We look forward to increasing the number of contracts with automotive OEMs as our reputation grows in the four-wheel market.

Turning to traditional sales by geography, sales in the United States were down 14% driven by a combination of the excess off-road inventory in the channel that I discussed earlier as well as general macro economic issues.

Sales in Asia were down 11% due mainly to lower sales to Chinese Industrial customers. Again we expect industrial demand in China to follow similar macro economic trends as in the rest of the world.

Sales in Europe declined approximately 5% year-over-year. We have seen signs of improvement in Europe. Last year we recorded sales from a set of East European customers whose economic conditions significantly deteriorated through 2015 meaning there was no recurring revenue in 2016.

Our Chinese joint venture continues to be on track to begin production shipments by the end of calendar ’16. We’re initially targeting four-wheel on-road electric and hybrid vehicle applications in what is becoming the world’s largest market for two- and four-wheel electric vehicles.

In our Other EV market sales were essentially flat, lower marine sales were offset by higher sales to recreational and utility vehicle customers.

Turning now to the performance of Bassi… They reported $4 million in sales for the first two full months since the January 29 acquisition. February and March actually represented record sales months for Bassi. We do expect double digit growth from Bassi off the $16 million in revenue that they reported in 2015, as well as operating margins in the range of 15%.

As we discussed on our prior call, adding Bassi’s state-of-the-art battery charging technology and power management capabilities to Sevcon’s advanced control technologies significantly strengthens our ability to deliver the more integrated solutions that our markets and our customers are demanding.

Bassi offers a low-cost line of low frequency chargers for simple lead-acid battery applications. The portfolio also includes high frequency chargers for battery technologies such as Lithium-ion. Bassi is also developing a line of high-frequency chargers with wide input and output voltage ranges that are highly efficient and compact, with exciting potential for induction charging applications.

Bassi conducts its own manufacturing out of a combined headquarters and production facility near Bologna, Italy. Their manufacturing is highly vertically integrated, with all necessary processes on site.

Combining with Bassi provides many exciting growth opportunities. We will be able to offer customers a broader product portfolio that eliminates motor controller/battery charger interoperability concerns, enabling us to secure a greater share of the on-road and industrial electrification markets. We also will be able to deploy Sevcon's marketing and sales resources to accelerate standalone sales of Bassi's products and solutions. We've already moved some Bassi inventory into Sevcon's US organization and look forward to selling Bassi product through the existing sales channels.

Conversely, we can pursue opportunities to cross-sell our own offerings along with Bassi's in each company's respective markets.

The integration of Bassi is proceeding very well. In addition to the sales integration, we have been focused on improving production throughput in order to generate further sales. As part of that effort, we've added a new production line in recent weeks. We also plan to incorporate the Sevcon ERP system into Bassi within the next fiscal year.

The Bassi executive team, which continues to operate the business in Italy, is excited about being a part of Sevcon and is looking forward to the growth opportunities that it affords us together.

Before I turn the call back to Paul for a detailed look at the financials, I'd like to wrap up with a look ahead. Our Industrial business will continue to follow the macro economic cycles around the world.

Our on-road business will continue to be lumpy, but the activity in our pipeline has never been stronger. Contracts like the one announced yesterday will, we believe, lead to production in the future. The fact that we are developing, in partnership with the OEM, a product specifically for them portends very well for the long term.

We are thrilled thus far with our Bassi acquisition, and we expect continued top and bottom line growth from that business for the remainder of the year. The integration is proceeding well, and we expect to drive even greater growth and profitability from that business in the years ahead.

We look forward to reporting future successes to you as we capitalize on many opportunities related to the global demand for electrification. With that, I'll turn it over to 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 28% to $13.2 million, from $10.3 million in the same period of fiscal 2015. As Matt mentioned, this included $4.0 million in sales from Bassi in the two months since closing that acquisition on January 29th this year.

Foreign currency fluctuations decreased reported sales by $253,000, or 2%, for the quarter, mainly due to a stronger U.S. dollar compared with the Euro and the British pound than in the second quarter of fiscal 2015. Excluding the impact of currency fluctuations, revenues increased 30%.

In terms of geography, our overall Q2 sales increase was largely driven by the United States and Europe, where revenues increased by approximately 45% and 27%, respectively, from the same period last year. These are Bassi's two primary geographic markets, as it sells just under 2/3 of its products to the US, about a third to Europe and a small amount to the Far East. Overall sales on Asia were down approximately 9% due to the weakness in the on-road and off-road sectors.

Matt mentioned that we had recognized in the quarter, engineering services revenue from a new multi-year multi-million dollar order from a high-performance on-road vehicle OEM. I'd like to spend a moment to discuss engineering services to provide you with more color on our revenues.

We generally account for engineering services using a "percentage of completion" accounting method. This method requires us to be able to estimate the stages of project completion on an on-going basis, and also to estimate the remaining costs to complete a project. Using percentage of completion accounting allows us to recognize profits earned on a project in each accounting period in which the project continues to be active and in which we make progress on the agreed program of work.

Aa Matt mentioned, we are currently conducting engineering services on several projects and overall 7 percent of our revenues in Q2 was from engineering services.

Turning now to operating expenses, our traditional business benefits from our low-cost manufacturing model. We rely on third parties for the majority of our controller production. Outsourcing to trusted manufacturing partners allows us to add capacity while minimizing the addition of fixed costs. Bassi, as Matt mentioned, conducts its own manufacturing.

Our operating expense includes engineering and R&D costs, which are reported net of grants received. In the controls and capacitor divisions combined, our engineering and R&D expense, was 12.7% of sales in the second quarter of fiscal 2016, compared with 13.3% in Q2 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

On a reported dollar basis, total operating expense for Q2 increased by $1.9 million from the second quarter of fiscal 2015. This included $0.6 million of costs from two months of Bassi operations including non-cash amortization expense arising from fair value accounting adjustments and also the amortization of intangible assets recognized from the business combination. In addition, we recognized $1.1 million of expense associated with the Bassi acquisition. The balance of $0.2

million, a 5% increase, year-on-year, reflects investment in sales and engineering resources including the hiring of additional staff. Our continued investment in additional resources reflects increased project activity, particularly in on-road markets. Foreign currency fluctuations decreased reported operating expense by $138,000, or 3.6%, due to the stronger U.S. dollar compared with the Euro and the British pound than in the second quarter of fiscal 2015.

Sevcon reported an operating loss for the second quarter of fiscal 2016 of $1.67 million, compared with operating income of $674,000 in the same period last year. As just mentioned, the Q2 operating loss includes $1.7 million of costs directly related to Bassi, being $1.1 million of acquisition costs and $0.6 million of operating costs for that business.

We reported an income tax benefit of $90,000 this quarter, or 5.4% of the pre-tax loss of $1.7 million, compared with an income tax charge of $65,000, or 9.2% of pre-tax income, in Q2 last year. The lower than usual effective tax rate in Q2 is largely a result of the acquisition costs of $1.1 million not being an allowable expense for income tax purposes.

After dividends paid and accrued of $122,000 to holders of Series A convertible preference shares, Sevcon reported a Q2 net loss attributable to common stockholders of $1.69 million, or 43 cents per share, including 28 cents for expenses related to the acquisition of Bassi. This compares with income of $539,000, or 16 cents per share, in Q2 of fiscal 2015. The prior-year quarter included a $159,000 after-tax non-cash charge for the change in the value of foreign currency contracts.

Beginning this quarter, we will be reporting the results of the newly acquired Bassi business as a separate Chargers business segment. We will also continue to report separately the results of each of our traditional Controllers and Capacitors business segments. We've already discussed the revenue contributions of each segment, so I'll just quickly discuss the operating income or loss in each segment. For the Controller and Capacitor segments, there was a combined reported Q2 operating loss of $1,850,000. This includes $1.1 million of acquisition-related expenses and, as noted earlier, revenues in Q2 2016 were $1.1 million lower in these businesses than in the prior-year period. This compares with $674,000 of operating income in the Controller and Capacitor businesses in the second quarter of fiscal 2015.

For the last two months of the quarter, the Charger segment reported operating income of $266,000 after a non-cash amortization charge of $203,000 relating to intangible assets and a further $98,000 relating to the amortization of adjustments to the fair value of assets on acquisition.

Let's turn now to cash flow and working capital items. In our forthcoming 10Q, our consolidated statement of cash flows will detail the cash movements generated by operating activities by both the Controller and Capacitor segments for the six month period to April 2nd and the cash movements for the Charger segment for the two month period post-acquisition, to April 2nd. The combined assets acquired and liabilities assumed on January 29th with the Bassi business will be disclosed separately on one line under investing activities in the consolidated statement of cash flows.

For the combined business segments and periods just outlined, and excluding the impact of foreign currency, trade and other receivables decreased by $1.8 million which increased cash during the period. Inventories and prepaid expenses and other current assets increased by a combined $2.6 million, which decreased cash during the period and accounts payable, accrued expenses and accrued taxes decreased by a combined $3.5 million, which also reduced cash during the period. The Company invested $783,000 in tooling, test and R&D equipment during the period as we continue to invest in capitalizing on electrification opportunities.

The number of days' receivables was 2 days higher at 63 days at the end of Q2 2016 than at the end of the last fiscal year.

Sevcon incurred net new borrowings in the six month period to April 2nd of $15.5m of which $10.8 million was used as part of the acquisition price of Bassi and $1.7 million for acquisition and debt issuance costs. The Company acquired $1.6 million from the Bassi acquisition and ended the second quarter with cash and cash equivalents of $6.7 million. This compares with $8 million in cash, at year-end 2015.

The net $7.6 million reduction in cash year to date comprised $5.2 million of cash used by operating activities just outlined, including the $1.4 million of acquisition costs, $0.8 million invested in property, plant and equipment and $0.4 million of dividends paid and stock repurchased.

We also have a $1.3 million bank overdraft facility with RBS Nat West Bank available to our U.K. subsidiary companies which was unused at the end of Q2 and at the end of the second fiscal quarter last year. This overdraft facility was renewed for a further period of 12 months in July 2015 although, in common with most overdraft facilities in Europe, it can be withdrawn on demand by the bank.

With that, Matt and I are available for your questions.

Matt Boyle:
Thank you all for joining us today. We look forward to speaking with you on our next call.