Sevcon, Inc.
Third-Quarter Fiscal 2016 Investor Conference Call
Thursday, August 4, 2016

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, Executive Chairman Ryan Morris 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.

Looking at the third quarter overall, revenues increased 34% from the prior year due to the contribution from our Bassi acquisition, which more than offset slower sales in the traditional controllers and capacitors segments. The lower legacy sales were due to continued weakness on the industrial side of the business as a result of macro-economic conditions. Sales to our on-road customers were slightly lower in the third quarter compared with last year. At the same time, our on-road pipeline is growing and provides us with great confidence in our future. I'll provide more detail on that in just a few minutes.

We reported a Q3 loss of $1.5 million, or $0.38 per share. The loss was mainly driven by three elements; $500,000 from foreign currency effects following the significant drop in the British Pound and Euro after the Brexit vote, and Paul will say a little more on Brexit in a few minutes. Another $700,000 was from the amortization of intangible assets and fair value adjustments arising from the business combination with Bassi and $300,000 was due to higher than initially planned investment in the business as we seek to capitalize on an increasing number of electrification opportunities.

It's still early days for the Bassi acquisition, but the integration is proceeding according to plan and the potential we see in the business is even greater than we first anticipated. You may remember that we had expected double digit growth from Bassi from the approximately $16 million in revenue that they reported in calendar 2015. We are excited by what we have seen thus far and now expect the growth figure will be north of 20% -- with operating margins at approximately 15% before non-cash amortization charges.

For Q3, Bassi reported $5.1 million in sales which was another record quarter. As we go into a traditionally quiet period for the charger business in August, we have a very healthy backlog.

In terms of the integration, we are focused on improving production throughput in order to capitalize on sales growth. We also plan to incorporate the Sevcon ERP system into Bassi within the next fiscal year.

Let me provide you with some more context around revenues for the quarter.

In the controller and capacitor reporting segments combined, we recorded $8.8 million in revenue, which was down from $10.3 million a year ago -- a drop of 14%. Excluding FX, that business would have been down 7%.

In terms of geography, sales in the United States were down 18% from a year ago. We saw continued softness in demand in both industrial and on road from last year. The picture did improve from Q2, but comparing demand from last year, Industrial was mainly lower due to the construction sector. In addition, in the on road market a significant customer last year using our controllers for an all-electric drivetrain designed for the Chinese market decided to move drivetrain production to China, causing pause on demand from us.

Sales in Asia were down 58% due mainly to an Aerial work platform customer in the region who last year provided us with a large stocking order prior to moving to an indirect sales channel.

Sales in Europe increased by 16% year-over-year. We have seen signs of some improvement across western Europe which rose 23%, as controller shipments to customers, including Polaris, drove on-road performance in that market. The improvement was offset by lower capacitor sales from ICW for railway signaling projects in the region.

Our Chinese joint venture continues to be on track. In Q3, we received a contract from a supplier of electric motors for the development of a controller for on road applications. We expect to ship prototypes of these controllers in Q4. We could achieve these challenging timescales because of the work we've already completed on Generic Gen5 High Voltage controls. In other projects we have had another quarter of testing with one substantial Chinese OEM and we expect to begin production shipments by the end of calendar '16. In general, with the JV 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.

Looking at these results by end-use sector, our industrial off-road markets continued to be weak. Aerial work platform, fork-lift truck and mining were all down by double-digits. While the performance in these sectors is not where we would like it to be, the overall rate of decline has decelerated, and we're seeing signs of improvement, especially with Fork Lift Truck.

Other EV had a strong quarter, increasing in all geographies except the US, which was down slightly. In this segment we have many non-traction related customers and opportunities. In the quarter we made good progress on the project for the marine applications at Seakeeper for their next generation stabilizer.

Turning now to on-road… Sales in the third quarter were down very slightly from sales 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.

Sales in the 2-wheel sector returned to growth, up 27% in Q3, mostly due to increased business to an electric motorcycle OEM.

Four-wheel sales were down 16%, largely due to the break in production in the US associated with the change in manufacturing location to China to which I referred earlier.

As I have mentioned on prior calls, an increasingly important element of our on-road revenue comes from Engineering Services. Many new customers 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 customers. 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 are very focused on translation of our pipeline of opportunities into projects. Getting more projects gives us the real potential of future production. Project announcements both of award and progress are indicators of success. One such project win this quarter was in China for a manufacturer of electric motors, who will use our Gen5 system in combination with their motors on hybrid drivetrains for on road applications.

In order to convert opportunity into projects we have to upscale our engineering resource. Over the past several years this has been a real challenge. However, we now feel, that to a large extent that challenge has been met and we are attracting additional engineering talent, especially for our on road opportunities.

During the quarter we recorded engineering revenue equivalent to 4% of the controls segment revenues from two major projects, compared with 3% in Q3 of last year. These projects included work for a leading international supplier of commercial vehicles and transport solutions as well as a luxury automotive manufacturer of high-performance sports cars. Our pipeline also includes projects for a leader in stabilizing technology for the yacht and commercial marine industry, and the aforementioned manufacturer of electric motors for automotive applications.

I’d like to provide some additional information about our pipeline to give you a better sense for what we expect following the development stages for these projects.

Two of these four projects are expected to go into production in fiscal 2017, one goes into production in 2019 and one in 2020. The duration of the production phase for the projects ranges between five and seven years. We expect total production revenue from these projects to be approximately $166 million over the five-to-seven-year production lives. We'll then be adding on revenue for spares in the five to 10 years following the completion of production.

In general, to move from the development stage -- where as I mentioned we receive engineering revenues on a percentage of completion basis -- to production, we need to hit three key milestones for our customers.

The first milestone is the initial sample of the product and proof of concept. At that point, we're about half the way to production. The second milestone is performance testing that proves the product works within the customer's vehicle. And the third milestone is the creation of production tooling for the product and completion of software for the customer. At that point it may take as few as three months and as many as two years until the actual vehicle goes into production.

During fiscal 2017, we expect to hit five major milestones across these four customers. We believe we will hit the first milestone of the year in the first fiscal quarter. This is for an initial proof of concept for one of the projects. We then expect to hit the next milestone for this particular project in Q3 of fiscal 2017.

We then have three anticipated milestones in Q2 of 2017, for each of the other three projects. These include a proof of concept milestone, a performance testing milestone, and a final tooling milestone. Again, two of the four projects are then expected to go into production during fiscal 2017.

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 is beginning to stabilize, albeit at a lower rate than we would like. We expect that it will continue to follow the macro economic cycles around the world.

Our on-road business will continue to be lumpy, especially 2-wheel, and we should see a performance uptick with 4-wheel given what we see in our pipeline. Our pipeline is strong and it portends very well for the long term. We are now investing in resources to turn potential into reality, the recent cash raise being an important part in our plans.

The integration of our Bassi acquisition is progressing as planned, and we expect continued top and bottom line growth from that business for the remainder of the year and 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 34% to $13.9 million, from $10.3 million in the same period of fiscal 2015. As Matt mentioned, this included $5.1 million in sales from Bassi. Foreign currency fluctuations decreased reported sales by $792,000, or 8%, for the quarter, mainly due to a stronger U.S. dollar compared with the Euro and the British pound than in the third quarter of fiscal 2015. Excluding the impact of currency fluctuations, revenues increased 42%.

In terms of geography, our overall Q3 sales increase was largely driven by Europe, where revenues increased by approximately 16%, due to a strong performance in France. In the U.S., sales decreased by 18%, due to softness in demand in both industrial and on-road, as Matt mentioned. Overall sales on Asia were down approximately 58% due to lower sales to industrial customers.

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% of sales in the third quarter of fiscal 2016, compared with 14% in Q3 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 Q3 increased by $1.7 million from the third quarter of fiscal 2016 which is largely accounted for by the inclusion of the Bassi unit in 2016.

Sevcon reported an operating loss for the third quarter of fiscal 2016 of $931,000, compared with operating income of $261,000 in the same period last year.

We reported an income tax benefit of $60,000 this quarter, or 4% of the pre-tax loss of $1.6 million, compared with an income tax charge of $83,000, or 23% of pre-tax income, in Q3 last year. The lower than usual effective tax rate in Q3 is largely a result of our UK business representing a higher proportion of the pre-tax result in Q3 2016 than in the prior year. In the UK we benefit from a very low effective tax rate due to the favorable tax treatment of the R&D activity that we conduct there.

After dividends paid and accrued of $93,000 to holders of Series A convertible preference shares, Sevcon reported a Q3 net loss attributable to common stockholders of $1.5 million, or 38 cents per share. This compares with income of $171,000, or 4 cents per share, in Q3 of fiscal 2015.

Let's turn now to cash flow and working capital item movements in the quarter. Excluding the impact of foreign currency, receivables, inventory, and prepaid expenses and other current assets increased by a combined $4.5 million, which decreased cash during the period. Accounts payable, accrued expenses and accrued and deferred taxes increased by a combined $2.5 million in the third quarter, which increased cash during the period. The Company invested $0.3 million in tooling, test and R&D equipment during the quarter as we continue to invest in capitalizing on electrification opportunities.

The number of days' receivables was 7 days higher at 68 days at the end of Q3 2016 than at the end of the last fiscal year; this is largely due to the longer credit periods in the Bassi business reflecting payment terms in Europe.

Sevcon ended the third quarter with cash and cash equivalents of $4.2 million. This compares with $6.7 million in cash, at the end of Q2. The net $2.5 million reduction in cash year to date largely comprised the cash used by operating activities just outlined and $200,00 of preference share dividends paid.

We also have a $1.2 million bank overdraft facility with RBS Nat West Bank available to our U.K. subsidiary companies which was unused at the end of Q3 and at the end of the third fiscal quarter last year. This overdraft facility was renewed for a further period of 12 months in July 2016 although, in common with most overdraft facilities in Europe, it can be withdrawn on demand by the bank.

Subsequent to the end of the quarter, we closed on a $10.2 million private placement which raised $9.6 million net of costs. We issued 1,124,000 units, each consisting of one share of common stock and half a warrant to purchase one share of Sevcon common stock, at a price of $9.12 per unit. The warrants have an exercise price of $10.00 per share, subject to adjustment, and will be exercisable for a period of five years from the date of issuance. We plan to use the proceeds for working capital and general corporate purposes.

Lastly, before we turn the call over to questions, I'd like to comment briefly on Brexit. The largest potential issue that we see is around the requirement for the UK to re-negotiate trade deals with those

European countries remaining in the EU, and also to re-negotiate deals with countries that have been negotiated by the EU as one body, and which the UK currently benefits from. In addition, the potential levy of import tariffs on the movement of products to or from the UK in trading with other EU countries may impact our business. We do not know at this stage whether and how much those tariffs might be, but to provide you with some context around this potential effect, we currently import into the UK approximately $12 million of products from Poland annually, which today pass between Poland and the UK free of any duties or tariffs. In addition, we currently export more than $5 million of product annually from our UK businesses to other EU member states, again free of tariffs at present. We have contingency plans to address these issues which we will deploy if necessary.

Matt Boyle:

Thanks Paul. I'd like to hand the call over now to Ryan, our new executive chairman, who has a few words to say before we take questions.

Ryan Morris:

Thanks Matt. Let me just briefly introduce myself as I'll be on the future calls. I'd just like to say that I'm a very long-term thinking idealist that enjoys pollution free air as much as anybody. And frankly, I couldn't be more excited about the importance of the problem that Sevcon is solving as a company. I'm also an investor and an engineer that knows that the world is not going to change until the economics work and that price performance is better for our customers. But thanks to the declining costs of key enabling technologies like the lithium ion battery and visionaries like Elon Musk with Tesla leading the way, I believe that it's very clear that now is the timing for change and when the world is finally going to see this come to fruition. This is great news for Sevcon thanks to some astute moves made by the management team here over the last few years that's strategically positioned the company to benefit quite a lot from this changing landscape. As Sevcon builds upon its traditional industrial businesses and enters these newly enabled on-road markets, I intend to help the company and help management take things to the next level - so I'm extremely honored to be able to take this role. And I will just put it out there, I think our strategy is going to be to make it very clear to the market what we're going to do and to deliver on that. And as a first step for that by the next quarter you're going to see from us a very clear roadmap of what we intend to do over the next three to five years. And I'll turn it back to Matt and Paul as I look forward to supporting them more in the future.

After Q&A

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