Sevcon, Inc.
Third-Quarter 2014 Investor Conference Call
Wednesday, August 6, 2014, 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 the business. Paul will follow with the financial review, and then we'll open the call for your questions.

Sevcon's financial results continued to improve this quarter. On a year-over-year basis, sales were up 11% from quarter three of fiscal 2013. Sequentially, we extended our trend of consistent top-line growth since the recent low point in quarter one of fiscal 2013, as quarter three sales increased 5% from quarter two.

On a geographic basis, our sales for the quarter generally tracked global economic trends. We recorded double-digit sales growth, year-over-year, in both the Far East and the US, while sales in Europe were flat.

As in quarter two, sales growth in the Far East was driven primarily by the demand from traditional sectors and from on road applications in China.

The stronger sales in the US primarily reflected increased shipments for hybrid on-road vehicles, as well as shipments for applications in our other EV category, both of which I'll discuss in a moment.

In Europe, quarter three sales were flat year over year. This was largely a consequence of higher sales to the Aerial work platform market offset by lower aftermarket sales, reflecting our shift this past year to a third-party distribution model, as well as lower demand in the fork-lift truck market.

In Asia, although Sevcon's growth continues to be fueled mainly by demand in our traditional off-road industrial and construction sectors, our new business initiatives in the on-road sector are beginning to bear fruit. We continue to expand our portfolio of development programs with large Asian OEMs in the region.

The majority of these projects are for scooter, motorcycle and quadracycle applications, reflecting interest in Twizy type vehicles as well as electric scooters and motorcycles in the 125 to 550 cc equivalent range throughout the Far East. These on-road EV markets are still in their early stages.

Our sales for quarter three in the two-wheel, on-road sector were down double digits year-over-year, following mid double digit growth in quarter two. We expect this business to continue to be lumpy from quarter to quarter going forward.

Looking now at the four-wheel, on-road sector, across all geographies, Sevcon's total sales were up middle-single digits in quarter three, year-over-year. A significant portion of this growth was driven by shipments to a company called XL Hybrids – a U.S. based manufacturer of hybrid powertrain conversion systems for commercial vans and trucks.

XL Hybrids is one of a number of customers that we are working with on projects related to hybrid electric vehicle technologies. Several of these projects are in Europe, including two in Germany that could become significant opportunities for us over time. Our quarter three sales for four-wheel, on-road applications also reflected a seasonal increase in our business in France with Renault for their Twizy electric city car.

We made significant progress this quarter on several projects focused on four-wheel on-road applications in the Far East – one of them with a supplier for a mid-sized electric passenger car being developed by a large government-owned automaker.

As we discussed on our conference call in May, early in quarter three we received the required government approvals in China for our joint venture with Risenbo Technology Co., Ltd, and the JV agreement became effective. Risenbo is a subsidiary of a Chinese Tier 1 automotive supplier based in

Hubei Province. We and Risenbo each own a 50% stake in the joint venture, which is being led by me as the Sevcon-nominated chair.

By partnering with an established and respected player in the Chinese automotive industry, we are now better positioned to capitalize on that country's growing electric vehicle demand. The JV is initially targeting on-road electric and hybrid vehicle applications, marketing and selling principally to Chinese Tier 1 automotive suppliers.

Our JV activity in quarter three largely focused on building our commercial infrastructure, including facilities, staffing, training and supply chain work. We anticipate making our first shipments to customers and recording our first sales in China during the current fourth quarter. Paul will discuss our expectations for JV-related start-up costs in a few minutes.

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.

I mentioned earlier that we recorded higher quarter-three sales in the Other EV category. This growth was primarily a consequence of strong shipments for recreational vehicle applications in the U.S. We also recorded our first shipments to a U.S. manufacturer of gyro stabilizers for leisure yachts and commercial marine applications, part of our growing electrification demand.

Looking forward, we feel good about our new business pipeline. It's our policy not to discuss specific customer relationships until we're in commercial production and shipping in volume. In general, however, in addition to the hybrid vehicle projects that I mentioned, our pipeline also includes products that target the new for us off-road industrial sectors. These products include our Gen 4 controllers as well as new high voltage/low power products for the electrohydraulic market.

Electrohydraulic provides us with a near-term entry point for capitalizing on the worldwide trend toward electrification of ancillary powertrain systems, not only on motor vehicles but in commercial and industrial traction and power applications.

That is, replacing outdated, inefficient systems such as hydraulic steering and hoisting and components such as belt-driven cooling pumps, superchargers, turbochargers and cargo refrigeration units with electrically powered solutions. We also have opportunities in new functionalities such as start-stop and regenerative braking to meet increasingly stringent MPG and emissions standards.

From a technical standpoint, electrification is now feasible for these applications due to the advent of the lithium ion battery in commercially viable forms. The consequence of this is that the customers traditional engineering skill set moves from mechanical to electrical as electrification gains acceptance.

We have a growing number of supplier and OEM relationships aimed at this opportunity. Many of these relationships are focused on developing integrated subsystems that leverage our unique hardware and software capabilities in power management and inverter technology as well as motor controls.

Put simply, we believe that Sevcon's future is brighter than ever. Quarter three marked our sixth consecutive quarter of sequential revenue growth and our fourth straight quarter of growth, year-over-year.

Looking ahead near term, the positive comments we are hearing from our customers suggest that our business environment will continue to improve. We are adding new relationships to our portfolio of customers.

At the same time, 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.

As we said on our call last quarter, our key strategic challenge is scaling the business to capture our growing opportunities on a timely basis, whether organically or through acquisitions. Among them are the applications for electrification which I just mentioned.

Capturing these opportunities requires us to strengthen our balance sheet. As a consequence, capital structure and capital allocation are key strategic priorities for Sevcon at both the board and management levels.

We are actively executing against these priorities, and the rights offering that we discussed conceptually on our call last quarter is now under way. Paul will discuss the offering in more detail.

There are substantial opportunities today to expand our business both organically and through acquisitions, particularly in new markets for us, like China, and in the electrification of systems. To successfully achieve the organic growth, we need to increase resources such as headcount in engineering and sales.

In addition, we are regularly reviewing plans and seeking to grow the business profitably, which could include acquisitions. We believe that, when we identify a possible acquisition, it would be desirable to have the resources at hand to complete any transaction quickly.

We are looking forward to reporting the results of the offering on our call next quarter.

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.

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 third quarter of fiscal 2014.

Reviewing Sevcon's financial performance for the quarter and starting with the Income Statement, total revenues increased 11% to $9.7 million, from $8.7 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 showed double digit growth this quarter compared with Q3 last year, as did sales for on-road applications, principally in the Far-East. Whilst we saw overall sales growth of 12% in the on-road sector of our business, this reflected a mixed result from sales to manufacturers of two-wheel and four-wheel vehicles.

Our sales for the quarter in the two-wheel, on-road sector were down 39%, following 32% growth in the second quarter. We expect this business to continue to be volatile from quarter to quarter going forward. In the four-wheel, on-road sector and across all geographies, total sales were up 54% in the quarter.

In terms of geography and excluding foreign currency effects, sales generally tracked economic trends across the territories in which we operate. Revenues increased 18% from the third quarter last year in North America. This growth being driven by increased sales to the four-wheel on-road sector, to manufacturers of off-road recreational vehicles, and to the new sector Matt mentioned earlier -- gyro stabilizers for leisure yachts and commercial marine applications. Together these areas more than offset a reduction in sales to the mining sector.

Our third-quarter sales in the Far East were up 38% year-over-year, driven by stronger product demand for aerial work platform and fork lift truck applications in China and Japan.

Sales in Europe were largely flat compared with quarter three last year – largely a consequence of lower aftermarket sales. This reflects our shift in the past year to a third-party distribution model, as well as lower demand in the fork-lift truck market.

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.

Total reported operating expense for Q3 increased by $419,000 from the third quarter of fiscal 2013. This increase largely reflects continued investment in sales and marketing and engineering and research and development, including the hiring of additional staff, in response to the strong top-line growth, as well as the impact of adverse currency movements compared to the prior year. In addition, the Company recorded grant income of $132,000 in the third quarter of 2014 compared to $40,000 in the third 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 10.8% of sales in the third quarter of fiscal 2014, compared with 11.2% in Q3 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

As Matt mentioned earlier we now have the required government approvals for our Chinese joint venture to start trading and we anticipate initial shipments to customers in the current quarter. The activities of the joint-venture company in the third quarter were limited to the investment of initial capital by each party, the sourcing of business premises and the hiring of engineering and sales and marketing staff. This activity will result in us recognizing in our fourth quarter our share of the related initial business establishment costs, which will reduce Sevcon's net income for the quarter by approximately $150,000, after tax. The financial statements of the joint-venture company have been consolidated within Sevcon in Q3.

Operating income for the third quarter of fiscal 2014 was $213,000 compared to $293,000 in the same period last year. Adverse foreign currency movements reduced our third quarter operating income by $94,000 compared to Q3 last year; excluding foreign currency, operating income was comparable with the prior year quarter.

We reported a small income tax benefit of $34,000 this quarter, compared with an income tax charge of $47,000 in Q3 last year. Our effective tax rate for the first nine months of 2014 was 7%. This lower rate 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 and global Income Tax rate.

Sevcon reported GAAP net income of $222,000, or 6 cents per diluted share, for the third quarter of 2014, compared with $171,000, or 4 cents per diluted share, in Q3 of fiscal 2013.

Turning now to cash flow and working capital items and excluding the impact of foreign currency, receivables increased by $800,000 and inventories and prepaid expenses increased by a combined $1.4 million in the first nine months of 2014, all of which reduced cash during the period. Accounts payable, accrued expenses and accrued taxes increased by a combined $400,000, which increased cash during the period.

The number of days' receivables was 66 at June 28th, 2014 versus 65 at year ended September 30th, 2013.

On our call last quarter we discussed an approximate $550,000 receivable from SITL-Brandt Motors, one of our customers in France, which entered into legal administration protection for a minimum period of six months in early January 2014. 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 $550,000 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.

In late June 2014 the Commercial Court in Lyon announced that it had approved the acquisition of SITL by Cenntro Motor Corporation, a Nevada based manufacturer of all-electric vehicles. Cenntro, which is an existing user of Sevcon controls, has since announced that it will inject an initial $20 million of working capital into the former SITL operation. They will create a new French company which will serve as the European headquarters of the Cenntro Motors Group.

We are currently seeking to engage with Cenntro Motor Corporation to discuss the recoverability of the outstanding receivable and the future supply of controls for electric vehicle manufacture. Although we are pursuing full payment of the debt, given the on-going 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 June 28, 2014.

In terms of the balance sheet currently, Sevcon ended the third quarter with cash and cash equivalents of $1.3 million, flat with a year earlier. Finally, we closed the third quarter of fiscal 2014 with $1.7 million of long-term debt compared with $1.8 million a year earlier.

As a reminder, we currently have a $3.5 million secured revolving credit facility with RBS Citizens Bank. $1.7 million of this facility was drawn down at the end of Q3, which represented the long-term debt just mentioned. This revolving credit facility was extended as of September 30th, 2013 and will expire on June 14th, 2017 when the principal will be payable in full. We also have a $1.5 million bank overdraft facility with RBS Nat West Bank available to our UK subsidiary companies; this facility was renewed for a further period of 12 months in July 2014 and was unused at the end of the third fiscal quarter.

Last week we finalized and filed with the SEC, a rights offering of Series A Convertible Preferred Stock intended to raise $10 million before expenses. As we announced in mid-July, the record date for the offering was July 25th.

The rights offering gives all of Sevcon's existing shareholders the opportunity to participate. The net proceeds will be used for general corporate purposes and growth, including funding Sevcon's ongoing research and development, product commercialization initiatives and acquisitions of other businesses.

The preferred stock, which has a Stated Value of $24 per share and carries a 4% cumulative annual dividend, will be convertible at any time at the holder's option into shares of Sevcon's common stock at an initial conversion price of $8 per share, representing a conversion ratio of three shares of common stock for each share of preferred stock.

Sevcon will also be able to require conversion at any time after five years if the closing sale price of the common stock has exceeded $15.50 for 20 out of 30 consecutive trading days. The subscription price is $21.50 per whole share which is equivalent to $7.17 per share of common stock on an as-converted basis, a 7.3% discount from the closing sale price of $7.73 per share on July 28th, 2014. The subscription rights, which will be listed for trading on NASDAQ under the symbol SEVRR, will expire on September 8th, 2014, unless Sevcon extends the rights offering period.

The company has received standby commitments from Meson Capital LP, whose managing partner is Ryan J. Morris, a director of Sevcon, and Walter M. Schenker, another director, to purchase shares of Series A Convertible Preferred Stock not subscribed for by other stockholders up to an aggregate amount of $1.15 million, less any amount they invest to purchase shares upon exercise of subscription rights. A majority of other directors and officers have indicated their intention to participate as well.

Stockholders of record on July 25th will shortly receive the prospectus and subscription rights, together with information about the process for exercising the rights.

Now, turning to our income statement results for the first nine months of fiscal 2014. Sevcon’s sales for the nine-month period were $27.9 million, compared with $23.3 million in the same period last year; a 20% increase year-on-year.

Gross profit for the nine-month period was 39.5% of sales, compared with 36.4% 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 $1.1 million, compared with an operating loss of $1.4 million for the nine-month period last year, after charging $605,000 in one-time restructuring costs. Our net income for the first nine months of this year was $872,000, or 25 cents per diluted share, compared with a net loss of $1,116,000, or 33 cents per share, in the same period last year.

In conclusion, 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 the remainder of fiscal 2014 and continuing in 2015. We look forward to reporting our progress in the quarters ahead.

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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