Sevcon, Inc.
First-Quarter 2015 Investor Conference Call
Wednesday, February 4, 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 releases issued yesterday afternoon, you can find them 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 one. Paul will follow with the financial review, and then we'll open the call for your questions.

Sevcon is off to a solid start in fiscal 2015. Sales were up 10 percent from the first quarter of fiscal 2014. Foreign exchange was a major factor this quarter, primarily due to the strength of the U.S. Dollar versus the Euro and British Pound. Adjusted for currency, our total sales for quarter one increased 13 percent year-over-year.

Geography

In terms of geography, sales were up mid-single digits this quarter in the U.S. and Far East and up double digits in Europe. In contrast to quarter four, when our growth was driven primarily by product demand in the off-road industrial sectors in the Far East and the U.S., the major growth driver in quarter one was on-road product shipments in these two regions as well as in Europe.

Although the majority of this demand was related to four-wheel EV and hybrid applications, we recognized initial engineering revenue in Europe for an integrated starter generator project with a large German manufacturer of trucks, buses, engines and transportation solutions. This follows our investment two years ago when we started a business development team in Germany led by Mr. Helmut Ollhauser and is another example of execution on our electrification strategy. Customers are embracing Sevcon's modular, easily adaptable powertrain solutions that only our engineering expertise and application knowledge can provide. These highly flexible products allow us to address ever more applications. Outside of Germany and Eastern Europe, our European business remained weak.

In the U.S., in addition to higher shipments for on-road vehicles, a new marine application in our "other Electrification" category continued to be an important source of revenue this quarter. We're continuing to ship significant volumes to Seakeeper, a U.S. manufacturer of gyro stabilizers for leisure yachts and commercial marine applications.

In the Far East, our growth reflected shipments by our new joint venture in China, as well as four-wheel, on-road product demand from our Chinese distributor.

Markets

Looking at our results in terms of market sectors our aerial work platform and fork-lift truck business was essentially flat in quarter one compared with the same period last year, with sales in the mining sector remaining very slow.

Although growth in industrial demand remains less than robust and lumpy from quarter to quarter, we believe we've picked the right partners to work with in the right places in the market. In the industrial markets where demand was higher, we had presence; in areas where there was modest growth we still had presence, but to a lesser extent.

Demonstrating the lumpiness that we discussed on our call last quarter, when sales in our on-road businesses were down double digits, year-over-year, our sales in both the two-wheel and four-wheel on-road sectors were up double digits in quarter one. Although we expect on-road sales to continue to be lumpy from quarter to quarter going forward, we are solidly on track toward meeting our goals for long-term growth.

Our sales in the two-wheel sector were up mid double digits in quarter one, although off a relatively small base. This growth was driven by higher shipments to electric motorcycle OEMs in the U.S. Our business with electric motorcycle and scooter customers in Europe and Asia was essentially flat, year-over-year.

Our sales in the four-wheel sector were up high double digits in quarter one. This growth was primarily due to growing pre-production and early production shipments of products for hybrid passenger car and commercial vehicle applications in the U.S. and the Far East as well as initial engineering revenue in Europe for an integrated starter generator project with a large German manufacturer of trucks, buses, engines and transportation solutions.

More specifically, our business with U.S. based XL Hybrids is continuing to grow. XL Hybrids is a developer of retrofit hybrid electric powertrain systems for commercial and municipal fleets.

Our shipments for pure electric passenger car applications through our distributor in China also continued to grow this quarter.

Our joint venture in China is initially targeting on-road electric and hybrid vehicle applications, marketing and selling principally to Chinese Tier 1 automotive suppliers. As you'll recall, the JV shipped its first product prototypes and recorded its first sales in China during the fourth quarter.

As we anticipated, these initial sales led to larger shipments related to pre-production orders in quarter one. We expect to see larger production orders and volume shipments related to a number of projects in China that we believe will to come to fruition as fiscal 2015 progresses. Looking ahead longer term, we expect that our joint venture 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.

As I mentioned earlier, our new electrification project with a German commercial vehicle OEM also was an important factor this quarter. We recognized initial engineering revenues related to our controls for an advanced integrated starter generator – the key component in a new start/stop system being developed for heavy trucks and buses in Europe.

Looking ahead to quarter two and the second half of fiscal 2015, our opportunity pipeline is continuing to grow.

On our call last quarter we announced an important new customer relationship – an agreement with a Tier-1 automotive supplier based in Southeast Asia, to supply advanced controllers for a new line of hybrid electric 4-door passenger cars.

We expect to recognize initial revenues in quarter two for shipments of our first product prototypes for fleet test vehicles under the contract, which has the potential to generate up to $50 million of revenue through 2020. Thereafter, we will supply controllers as ordered by the customer, with production shipments expected to begin in the first quarter of 2016.

With respect to the company's other new business opportunities, it's our policy not to discuss specific customer relationships until we're in commercial production and shipping in volume. Overall, however, we begin quarter two with solid confidence in our outlook for continued top-line growth.

We're working on an expanding pipeline of projects related to on-road hybrid passenger cars and commercial vehicles with customers in Europe and Asia. Perhaps even more important, we're gaining momentum in pursuit of what we envision as Sevcon's next major growth opportunity. Namely, the electrification of ancillary powertrain systems in motor vehicles and various industrial traction and power applications.

To capture this opportunity we're developing integrated subsystems with products such as our Gen 4 controllers and new high voltage/low power products that enable a growing range of electrification solutions. These highly efficient solutions are helping our customers meet increasingly stringent miles per gallon and greenhouse gas emissions standards worldwide.

A prime example is the start-stop program in Germany. We're developing electrification solutions in other areas as well. For example, we're developing solutions to electrify hydraulic steering and hoisting systems, and to help replace outdated ancillary components such as belt-driven cooling pumps, superchargers, turbochargers and cargo refrigeration units.

We believe that our core technology platforms can be applied and sold across multiple, higher growth markets as the world transitions to electrification. Tactically, we are using our technological excellence and strong presence in traditional off-road markets to enter new higher growth sectors and territories. Our key strategic challenge is scaling the business to achieve our potential. As system electrification becomes more widespread, we anticipate growing both organically and through acquisitions.

We look forward to reporting continued growth and improved profitability as fiscal 2015 progresses. 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 first quarter of fiscal 2015.

Reviewing Sevcon's financial performance for the quarter and starting with the Income Statement, total revenues increased 10% to just under $10 million dollars, from $9 million dollars in the same period in fiscal 2014. This increase reflects the startup of new electrification programs with on-road OEMs and volume production with new customers. Foreign currency fluctuations decreased reported sales by $268,000, or 3%, mainly due to a stronger U.S. Dollar compared with the Euro and the British Pound than in the first quarter of fiscal 2014.

In terms of geography and excluding foreign currency effects, our Q1 sales growth was largely driven by Europe where revenues increased double digits from the same period last year driven in part by the initial engineering revenue from the large German on-road OEM contract that we announced yesterday and that Matt mentioned earlier. In North America we saw mid-single digit growth coming from the marine stabilization application with Seakeeper that we discussed on the call last quarter as well as improved sales for Airport Ground Support and controls to on-road OEMs. These increases year-over-year 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.

Our first-quarter sales in the Far East were up slightly year-over-year, although, 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. As a reminder, the financial statements of the joint-venture company have been consolidated within Sevcon in Q1.

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 Q1 increased by $605,000 from the first quarter of fiscal 2014 reflecting increased investment in sales and engineering including the hiring of additional staff. This investment in additional resource was in response to the higher order intake and strong top-line growth. Foreign currency fluctuations decreased reported operating expense by $93,000, or 3%, due to the stronger U.S. Dollar compared with the Euro and the British Pound than in the first quarter of fiscal 2014.

In addition, the Company recorded grant income of $24,000 in the first quarter of 2015 compared to $115,000 in the first quarter in the prior year; this grant income was recorded as a reduction of research and development expense in each period.

Our reported operating expense includes engineering and R&D expense, which are reported net of grants received. R&D expense, net of grants, was 12.0% of sales in the first quarter of fiscal 2015, compared with 10% in Q1 last year. This continuing level of expenditure reflects our on-going commitment to product development and improvement.

There was operating income for the first quarter of fiscal 2015 of $282,000 compared to operating income of $710,000 in the same period last year. The $428,000 reduction in operating income year-on-year was due to the $605,000 increase in operating expense mentioned earlier partially offset by a $177,000 increase in gross profit arising from the higher sales recorded.

We reported an income tax charge of $40,000 this quarter, or 13% of pre-tax income, compared with a charge of $121,000, or 20% of pre-tax income, in Q1 last year. The low effective tax rate in Q1 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 U.K. and the on-going 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 $111,000 to holders of Series A convertible preference shares, Sevcon reported net income attributable to common stockholders of $171,000, or 6 cents per diluted share for the first quarter of 2015. This compares with $488,000, and 14 cents per diluted share, in Q1 of fiscal 2014 when we did not pay any dividends.

Turning now to cash flow and working capital items and excluding the impact of foreign currency, in the first quarter of 2015, receivables, inventory and prepaid expenses and other current assets increased by a combined $871,000 which decreased cash during the period. Accounts payable and accrued expenses decreased by a combined $645,000 in the first quarter which also reduced cash during the period. The Company invested $293,000 in test and R&D equipment during the quarter.

The number of days' receivables was consistent at 63 days at January 3, 2015 which was the same as at the end of Q1 last year

In terms of the balance sheet currently, Sevcon ended the first quarter with cash and cash equivalents of $8.1 million dollars including the rights issue funds and a small remaining bank loan of $15,000 in the Company's U.K. capacitor business. This compares with $11.2 million dollars in cash at the September 30, 2014 year-end and $1,728,000 of bank loans. The $3.1m reduction in cash included the repayment of the $1.7 million dollars loan provided by Citizens Bank, payment of the $0.7 million dollars of expense associated with the capital raise in September 2014 and $0.3 million dollars of capital expenditure in the quarter. The remaining $0.4 million dollars was accounted for by working capital movements.

With regard to the repayment of the $1.7 million dollar loan with Citizens Bank, we have retained the $3.5 million dollars 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 $1.5 million dollars bank overdraft facility with RBS Nat West Bank available to our U.K. subsidiary companies; this facility was renewed for a further period of 12 months in July 2014 and was unused at the end of the first 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.

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