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SEV - Q2 2012 Sevcon Inc Earnings Conference Call

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## CORPORATE PARTICIPANTS

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**Matt Boyle** *Sevcon Inc. - President & CEO*

**Paul Farquhar** *Sevcon Inc. - VP, Treasurer & CFO*

## CONFERENCE CALL PARTICIPANTS

**Orin Hirschman** *AIGH - Analyst*

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the Sevcon second-quarter earnings conference call. Today's call is being recorded and webcasted. My name is Donna, and I will be your coordinator today. At this time all participants are on a listen-only mode.

I will now turn the call over to your host for today, Mr. David Calusdian, with the investor relations firm Sharon Marrill. Please proceed.

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### David Calusdian - Sharon Merrill Associates - IR

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 our 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.

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### Matt Boyle - Sevcon Inc. - President & CEO

Thank you, David, and welcome, everyone. We appreciate you joining us on our call this morning. We have three items on the agenda. Since some of you may be new to Sevcon, I'll begin with a brief business overview. Paul will then follow with the financial review. Keep in mind our policy is not to provide financial guidance. I have some brief concluding comments, and then we will open the call for questions.

I'll begin our introduction to Sevcon by summing up who we are and what we do in two sentences. We see ourselves as the world leader in drivetrain controls for electric vehicles, with more than 50 years of experience in the field. We're a high volume producer for global customers, we are growing and we are profitable.

From an investment perspective, we have positioned Sevcon as well, only a few pure plays in the electric vehicle or EV industry. Unlike others in this space, we are not in or just emerging from an R&D phase. We have an established and profitable base business that's designed and manufactured



EV motor controls since the 1960s. We have a pedigree and a track record based on both our million units produced, shipped and used successfully by customers around the world.

Based on this experience, we've developed a formidable intellectual property and trade secret franchise over the years, along with strong manufacturing partnerships and worldwide sales and distribution network. Until just a few years ago, our products were used almost exclusively in off-road construction, distribution, mining, airport ground support and utility applications.

Since then by investing the cash we have been generating in research and development, we have been able to design and build the most advanced products available for improving the efficiency and performance of electric motors in a variety of on-road transportation applications.

We have also developed strong customer relationships with automotive OEMs and Tier 1 suppliers around the world, along with manufacturing and logistics infrastructure capable of supporting production of hundreds of thousands of vehicles a year. The sense of excitement, we hope to convince you of today, stems from the fact that during the past 24 months we have seen new opportunities develop in the on-road sector that have the potential to transform our business and dramatically increase our scale.

The key question, of course, is how has a company of Sevcon's relatively small size go about penetrating a market that is complex and potentially as large as the global market for on-road electrically powered mobility.

When you think on-road electric vehicle, the first thing that may come to mind is probably a passenger car, like the Toyota Prius, the Nissan Leaf, or the Chevy Volt. But in terms of numbers of EVs on the road, the real unit volume today and over the next few years is in the smaller end of the market, applications such as scooters, motorbikes, small four-wheel drive ATVs, and electric city cars.

One of the things that differentiates Sevcon is that we have a product portfolio today that spans all of the requirements for power in these smaller-size on-road EV applications as well as the high-powered applications like the increasing number of electric buses, trucks, and high-performance passenger cars.

Marketing the two-wheel EV market makes strategic sense for us for two reasons. Firstly, it provides us with immediate high-volume product demand. Second, unlike the electric and hybrid passenger car domain, it is a market in which the major OEMs have decided not to develop their motor control technology in-house but to outsource it to trusted partners, the leader being Sevcon.

As a result, we have been able to capture significant and growing share of the global market for electric scooters, motorcycles, quad ATVs, and city cars. Among the on-road applications we have been able to publicly announce recently, we are currently manufacturing and selling products in volume for the Renault Twizy city car, the Polaris EV Ranger ATV, various scooter applications like Peugeot's e-Vivacity and soon-to-be launched Empulse sportbike that is designed in Oregon by Brammo.

In essence, what we have is a brand-new market for an existing technology, a technology with which we have 50 years of experience. The best way to describe what we do is that our control system sits between the battery or some other power source, like a fuel-cell, and the electric motor. Our technology increases control system power density and helps maximize the efficiency of the power source when it turns the motor that drives the vehicle.

The customer designing the vehicle, whether it's an OEM or a Tier 1 supplier, is typically looking for an integrated system that includes not only the motor controller but all the related electrical power management devices, up to and often including the motor and gearbox. This is exactly what we can provide, and it spans nearly the entire electrical system on the vehicle, apart from the power source.

For strategic reasons, several years ago we decided to avoid getting into battery and fuel-cell technologies. But from that point on chargers, displays, DC/DC converters, motor controllers, and integrated motors and controllers are all part of our product portfolio.

What differentiates Sevcon from a technology perspective -- our black magic, if you will -- is the core IP that we have in software for heat management and motion sensing. Today's critical challenge in EV power system design is to take this existing technology, which originated in the off-road

equipment world, and make it work in the very different world of onboard mobility, where you have vastly different performance requirements and a much greater degree of variability and unpredictability in how the motor is used.

For example, in stop-and-go urban driving, how do you accurately sense the rapid cycles of acceleration and deceleration, and adjust the motor's performance in real time to maximize battery life? How do you build a controller that can handle the tremendous amount of heat created in this type of application. I believe that we have the industry's best and most cost-effective solutions to these challenges.

In terms of specific products for the on-road market, our approach is largely customer-driven and responsive to their design requirements. Highlighted by our new Gen4 range of electric motor controllers, the products we offer today cover a broad range of sizes from 4 kilowatt for a two-wheel 150 cc motorbike, to our new 300-kilowatt Gen4 Size 10 designed for heavy-duty applications in large vehicles ranging from SUVs to full-size trucks and buses.

In the middle, the Gen4 Size 8 is broadly equivalent to a 136 brake horsepower internal combustion engine and has a unique patent-applied-for sensing technology, also making it suitable for 100%-electric four-door sedans.

In addition to providing these products directly, we are also generating a growing stream of engineering revenue from a number of global OEMs. Along the way, through acquisition and with our own internal development resources, we have added the relevant suite of related power management products, including gauges and displays, DC/DC converters, and battery chargers. For the future, we are working with Tier 1 and OEMs in various stages of the design and product qualification process for on-road EV applications.

As I mentioned, another factor we believe differentiates Sevcon is our experience in volume production. That is, manufacturing, quality control, and distribution capabilities developed, refined, and proven in the off-road world but equally important to customers in the on-road EV market as it is developing today.

We outsource the majority of our production to three outstanding partners. Together they manufacture for us in three locations -- Krakow in Poland for Europe, Shanghai for the Far East, and Juarez for North America -- with local Sevcon support staff permanently assigned to each site.

Dual sourcing and manufacturing enables us to minimize risk and maximize our competitiveness, while meeting our customers' most stringent engineering requirements. At the same time, reflecting the growing size and worldwide nature of our customer base, we provide global sales, distribution, and service coverage from our own facilities in France, Japan, Korea, the US, and the UK, a footprint that puts us as close to our customers as possible.

During the second quarter we announced an additional -- an initial cooperation agreement with Flextronics to provide hybrid and electric vehicle drivetrain systems to automotive OEM customers in Germany and other central European countries. The agreement enables the companies to combine our motor controllers and onboard systems integration products with Flextronics Automotive's high-voltage DC/DC converter, charger, and battery management technology. The goal is to develop complete drivetrain solutions for hybrid and pure electric vehicles ranging in size from two-wheel scooters to passenger cars and trucks.

We have also agreed with Flextronics Automotive to jointly pursue product marketing and sales outreach to automotive OEM customers, with Sevcon designated as Tier 1 supplier and Flextronics as manufacturer for all combined product sales. Partnering with Flextronics will enable us to scale our business to meet growing product demand in Germany and Central Europe far more rapidly than we could on our own.

The final factor that I believe differentiates us from other players in the EV supply industry is that we have an advantage of a profitable base business to serve our platform for growth. Driven in part by growth in this part of our business, our operating income was \$695,000 for the second quarter of fiscal 2012, and \$947,000 for the first half of the year.

With that, I will turn the call over to Paul Farquhar, our CFO, for his review of our financial performance in the quarter. Paul?



**Paul Farquhar** - *Sevcon Inc. - VP, Treasurer & CFO*

Thank you, Matt, and good morning, everyone. The base business that Matt just mentioned, which comprises our controls business segment has been consistently profitable for the past few years. We have been able to reinvest these profits in adding to our engineering and sales capabilities. These investments have enabled us to penetrate the on-road sector of the EV market and position Sevcon for future growth.

We also operate a capacitor business segment that has consistently delivered modest levels of profitable revenue over the years. Sevcon's performance in the second quarter of fiscal 2012 was consistent with this model.

Turning to the numbers, Sevcon's net sales in the quarter were \$10.1 million, up 30% from the \$7.8 million in the same period last year. This growth was driven by increased shipment volumes of our Gen4 controller into both the new on-road market as well as our traditional markets, slightly offset by lower shipments from the capacitor business.

Foreign currency exchange rates were broadly similar to those a year ago, with FX decreasing reported sales in the second quarter by 3% year-over-year.

In our controls business segment, we continue to see solid demand growth in all geographic markets that we serve. Shipments were up 52% from the second quarter last year in the Far East, 40% in Europe, and 19% in North America. This growth was driven by the addition of new customers, primarily for on-road EV applications, and initial volume production shipments for newly introduced on-road and off-road vehicles.

We feel good about the progress we have made in efficiently scaling our operations to meet this growing demand. Our reliance on outsource manufacturing allowed us to add capacity without adding fixed costs. Gross profit for the second quarter improved to 35.9% of sales from 34.5% in Q2 last year, net of any foreign currency effects.

Now turning to our operating expenses, these consist primarily of product development engineering, sales related expenses, and general and administrative expenses including compensation and direct R&D costs. And this is where we focused the majority of our recent reinvestment in the business.

Operating expenses for the second quarter of fiscal 2012 increased by \$446,000, or 44% from the same period last year. However, for the second quarter of fiscal 2012, operating expenses were offset by \$110,000 in UK government grant income. And for Q2 last year, operating expenses were offset by \$383,000, also due to research and development grants from the UK government.

Adjusting for the impact of these UK government grants each year, the ongoing year-over-year increase in operating expenses was \$173,000, and this reflected compensation expense for recently hired engineering staff.

Reflecting our strong focus on product development, R&D expenses as a percentage of total sales were 9% in the second quarter of fiscal 2012, compared with 12% in Q2 last year.

Sevcon's operating income for the second quarter was \$695,000 compared with \$658,000 in the same period last year, when we recorded a gain of \$451,000 from the sale of a surplus property in the UK. Excluding the gain on the property sale and adjusting for the impact of grant income in each period, operating income was \$980,000 higher than last year.

We recorded an income tax provision for the second quarter of 25%. This compares with 13.7% in Q2 last year. The increase was due to a number of factors, chief among them being that the gain on the sale of the UK property in 2011 that I mentioned earlier was not subject to tax and in addition last year, there were both charges and credits related to the treatment of deferred tax assets in the US and in the UK.

Sevcon's GAAP net income for the second quarter of fiscal 2012 was \$470,000 or \$0.14 per diluted share, compared with \$505,000 or \$0.15 per diluted share in the second quarter of fiscal 2011.

Now turning to the balance sheet, Sevcon ended the second quarter with cash and cash equivalents of \$1.3 million compared with \$1.8 million on September 30, 2011. We have only \$1.8 million in short- and long-term debt. The decrease in cash of \$0.5 million was the result of \$295,000 of cash used by operating activities for the six-month period, and capital expenditures in the period of \$272,000.

We reported net income of \$755,000 for the first six months of fiscal 2012, and excluding currency translation, receivables increased by \$1.9 million and inventories were up by \$39,000, both of which reduced cash during the period. Payables increased by \$1 million during the period, and accrued expenses decreased by \$516,000.

The number of days sales in receivables in the first six months of fiscal 2012 increased by 1 day from 62 days at September 30, 2011 to 63 days at March 31, 2012.

As a reminder, we currently have a \$3.5 million secured revolving credit facility with RBS Citizens Bank, and we also have a \$1.4 million bank overdraft facility with RBS Nat West Bank available to our UK subsidiary companies.

Before turning the call back over to Matt, I will briefly summarize our income statement results for the first six months of fiscal 2012, which again reflect the strong growth we are seeing in the on-road EV sector.

Sevcon sales for the six-month period were \$18.6 million, up 27% from \$14.7 million in the same period last year. Gross profit improved to 35.5% of sales from 34.5% a year earlier. Operating income increased to \$947,000 from \$691,000 for the first six months last year when we recorded a gain of \$451,000 from the sale of a surplus property in the UK.

Net income for the first half of the year was \$754,000 or \$0.22 per diluted share, compared with \$510,000 or \$0.15 per diluted share in the same period last year.

This concludes our financial review, and I will now turn the call back over to Matt.

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**Matt Boyle - Sevcon Inc. - President & CEO**

Thank you, Paul. I'll close our prepared remarks with some brief comments on our plans for the business. Near-term, our widening range of Gen4 controllers continue to be used by OEM and Tier 1 customers on projects in European, Asian and North American markets. We hope that will continue.

We plan to continue expanding our capabilities in engineering and sales, with a goal of winning additional on-road EV business as well as broadening our distribution and customer service footprint. At the same time, we hope to see already released projects like the Brammo Empulse, Renault Twizy and others are successful in order to continue our growth.

Longer term, at some point we believe the market will begin a meaningful shift towards larger vehicles. That is passenger cars, trucks and buses. We have a product roadmap that has the potential to put us in the sweet spot there as well. We feel good about the progress we have made and look forward to reporting continued improvement in the quarters ahead.

With that, we will be happy to take your questions. Donna, can you proceed for the Q&A now?

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## QUESTIONS AND ANSWERS

### Operator

Thank you. Ladies and gentlemen, we will now be conducting a question-and-answer session. (Operator Instructions) Orin Hirschman, AIGH.



**Orin Hirschman** - AIGH - Analyst

Hi, good morning. Congratulations on the progress. In terms of the seasonality in the business, can you comment on in terms of were there any initial stocking, large stocking orders this quarter that could affect continued progress on the sales volume throughout the year; meaning more like an extraordinary shipment or an initial stocking shipment?

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**Matt Boyle** - Sevcon Inc. - President & CEO

Not that we're aware of, Orin, no.

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**Orin Hirschman** - AIGH - Analyst

Okay, has one of the -- you mentioned it'll be the first project, a Tier 1 project I believe with Renault in Europe. Has that project actually started shipping in volume yet, or that is yet to come into volume?

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**Matt Boyle** - Sevcon Inc. - President & CEO

Well, our prepared modus operandi is that we don't talk about projects with customers until they are in production and we have shipped to the customer. So in response to your question, yes, it has started production, and yes, we have started shipping to them.

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**Orin Hirschman** - AIGH - Analyst

Okay. You mentioned also additional hiring to grow the business. Is that going to have a major impact in terms of the profitability? I think a lot of shareholders that have been here for a while are feeling like you just finally hit some reasonable level of profitability. Can you kind of comment on that balance?

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**Matt Boyle** - Sevcon Inc. - President & CEO

I don't foresee us having to add the sort of levels of engineering staff that would seriously impact our ability to earn money. They are not that expensive.

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**Orin Hirschman** - AIGH - Analyst

And just one or two additional follow-ups. In terms of looking forward for the rest of the year, do you think you can continue to show some level of sequential progress, of some level?

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**Matt Boyle** - Sevcon Inc. - President & CEO

I don't get into guidance and I don't forecast. That is in the lap of the gods sometimes. So I would like to decline that, to answer your question.

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**Orin Hirschman** - AIGH - Analyst

Okay. Is there any reason, though, why there shouldn't be continued growth of some sort on a year-to-year basis?

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**Matt Boyle** - Sevcon Inc. - President & CEO

Yes, once again, it is in the luck of the cards most of the time, and I don't like forecasting anything.

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**Orin Hirschman** - AIGH - Analyst

Okay. Okay, one last question. Just in terms of how the government grant money comes in, clearly I believe if I am doing the correct calculation, it increased your EPS by \$0.02 or \$0.03 this quarter, compared to what it would have been without it? I don't know if you can confirm that number, if I'm on the right track here?

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**Paul Farquhar** - Sevcon Inc. - VP, Treasurer & CFO

Yes, it is Paul Farquhar here. The amount of the grant income in the second quarter was \$110,000. That would be about \$0.02 -- \$0.02 to \$0.03 after-tax.

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**Orin Hirschman** - AIGH - Analyst

How should we view -- on a go-forward basis, how should we view that grant money in terms of coming in on a quarterly basis?

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**Matt Boyle** - Sevcon Inc. - President & CEO

It is very much project driven, Orin, and it is mostly on customer milestones that are met by the customer. So it is very difficult for us to predict.

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**Orin Hirschman** - AIGH - Analyst

Okay, thank you very much. Again, congratulations on the progress.

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**Matt Boyle** - Sevcon Inc. - President & CEO

Thank you.

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**Operator**

(Operator Instructions) Mr. Boyle, it appears there are no further questions. Therefore, I will turn the call back over to you for any closing remarks.

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**Matt Boyle** - Sevcon Inc. - President & CEO

Thank you, Donna. Thanks to everyone for listening. I look forward to speaking with you again next quarter, and that concludes our call. Thank you.

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**Operator**

Ladies and gentlemen, thank you for your participation. This does conclude today's teleconference. You may disconnect your lines at this time, and have a wonderful day.

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