Sevcon, Inc.
Third Quarter 2012 Investor Conference Call
Tuesday, July 24, 2012, 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 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.

Matt Boyle:

Thank you, David. Welcome everyone. We appreciate your joining us this morning.

I'll begin our prepared remarks with a business overview. Paul will follow with the financial review which, in line with our policy, will not include guidance. I'll have some brief concluding comments on the business outlook, and then we'll open the call for your questions.

I'll start the overview with our positioning statement. We see Sevcon as the global leader in drivetrain controls for electric vehicles. We have more than 50 years of experience in the field. We're a high-volume producer serving many of the world's largest OEMs and Tier-1 suppliers as customers. We're growing and we're profitable.

Unlike other companies in our space, we're not in, or just emerging from, our research and development phase. We have an established and profitable base business that has designed and manufactured electric vehicle, or EV, motor controls since the 1960s. We've developed strong manufacturing partnerships and a global network for sales, distribution and service. This network provides coverage from our own facilities in France, Japan, Korea, the U.S. and the U.K., which puts us as close to our customers as possible.

We outsource the majority of our production to two outstanding partners. Together, they manufacture for us at 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. Leveraging these assets, we've produced, shipped and serviced more than a million units of product during the past five decades.

In the past, our products were used nearly exclusively in off-road applications related to construction, distribution, mining, airport ground support, and utility operations. That's now changing, and the growth in our business is increasingly being driven by shipments for on-road EVs like scooters, motorcycles, small four-wheel drive ATVs and electric city cars. Looking ahead longer term, our product portfolio and development pipeline targets high power EV applications in larger vehicles like buses, trucks and passenger cars.

When people think about EVs, what typically comes to mind is a hybrid or plug-in passenger car like the Toyota Prius, Chevy Volt or Nissan Leaf. We've made the strategic decision, however, to focus first on the smaller and less widely publicized end of the EV market – from scooters to ATVs to city cars. There are two reasons for this.

First, scooters, motorcycles and, more recently city cars, constitute the only market that's currently experiencing global, high-volume product demand – for example, the hundreds of thousands of electric scooters being produced and sold into markets in Asia every year. Second, unlike in the electric and hybrid passenger car domain, it's a market in which the major OEMs have decided not to develop their motor control technology in-house, but to outsource to trusted partners, the leader being Sevcon.

When I'm asked to explain the purpose of our technology in terms a layman can understand, I typically answer by saying that our control systems sit between the battery – or some other power source, like a

fuel cell – and the electric motor. Their main function is to help the vehicle maximize the efficiency of the power source when it turns a 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 the focus for our product portfolio, which does not include batteries or fuel cells, but does encompass a full range of chargers, displays, DC/DC converters motor controllers and integrated motors and controllers.

What differentiates our technology is the core intellectual property that we have in software for heat management and motion sensing. Investing the cash the business has consistently generated to fuel our R&D programs, we've been able to adapt this technology, which we developed for off-road industrial applications like forklift trucks, aerial work platforms and mining vehicles, to the very different world of on-road transportation. On-road vehicles 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, our controls accurately sense the rapid cycles of acceleration and deceleration, and adjust the motor's performance in real time to maximize battery life.

Our policy is not to discuss specific customer relationships until the vehicles are commercially introduced and shipping in volume. As we've previously announced, we're currently manufacturing and selling

products in volume for the Renault Twizy electric city car, which is currently being marketed in Europe. We're also shipping product for the Polaris EV Ranger all-terrain vehicle and a range of utility and all terrain vehicles being manufactured in China, Europe and the US.

Looking specifically at the third quarter, as Paul will discuss, shipment volumes in our core business, the Controls segment, were up 18% year-over-year. Although global weakness in construction and mining activity led to soft product demand for traditional off-road, industrial applications, this was more than offset by strong growth in demand for our new Gen4 range of AC motor controllers for the on-road vehicles I've just listed. The Gen4 line covers a broad range of sizes from 4KW for a two-wheel 550cc motorbike to our new 300KW Gen4 Size 10 designed for heavy duty applications in large vehicles ranging from SUVs to full-sized trucks and buses.

Our higher power range of controls includes the Gen4 Size 8 and Gen4 Size 10. The 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 a 100% electric four-door sedan.

A third-quarter milestone was the release of our most powerful AC motor controller – the Gen4 Size 10 – which we introduced at the Electric Vehicle Symposium in Los Angeles. We're currently working with a European OEM that's using the Size 10 for peak torque load sharing in a new hybrid supercar they're developing. With a peak power output of 300kW, the Size 10 motor controller is suitable for large electric and hybrid trucks and buses as well.

I'll talk about some of the other projects in the pipeline after Paul reviews 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 segment that has consistently delivered modest levels of profitable revenue over the years.

Reviewing Sevcon's financial performance and starting with the P&L, revenues in the third quarter of fiscal 2012 were 8.9 million dollars – up 8% from 8.2 million dollars in the same period in fiscal 2011. As Matt said, this growth was primarily driven by increased demand for our Gen4 controller in the new on-road market, offset by lower sales in our traditional off-road markets, as well as lower sales in our capacitor business. Foreign currency exchange rates reduced revenues in the third quarter by 7% year-over-year, due to the stronger dollar versus the British pound and the euro.

In terms of geography, our results in the controls business segment were mixed this quarter. Excluding foreign currency fluctuations, revenues were up 29% from the third quarter last year in Europe, but down 12% and 5% in the Far East and North America, respectively. The growth in Europe was driven primarily by shipments of controls to Renault for the Twizy city car. The declines in the Far East and North America were centered in our traditional off-road markets, where there

was lower product demand for construction, distribution, mining, aircraft ground support and utility applications.

Gross profit for the third quarter of 2012 was 33.3% of sales, compared with 39.2% in Q3 last year, net of a small foreign currency impact. The decrease was mainly due to sales mix issues and lower recovery of overhead costs.

Turning to operating expenses, these consist primarily of product development engineering, sales-related expenses and general and administrative expenses, including compensation and direct R&D costs. The majority of our recent reinvestment in the business has been focused in these areas. Relying on outsourced manufacturing allows us to add capacity while minimizing the addition of fixed costs.

Operating expenses for the third quarter of fiscal 2012 decreased by 124,000 dollars or 4%, from the same period last year. Three percentage points of this decrease was due to foreign currency effects. Our third-quarter operating expenses were offset by 49,000 dollars in UK government grant income. Adjusting for the impact of UK government grants in Q3 2012, the ongoing year-over-year decrease in selling, research and administrative expenses was 75,000 dollars. This included compensation expense for recently hired engineering staff.

Reflecting our strong focus on product development, R&D expenses as a percentage of total sales were 10.7% in the third quarter of fiscal 2012, compared with 11.4% in Q3 last year.

Sevcon's operating income for the third quarter was 35,000 dollars, which included 41,000 dollars in favorable foreign currency effects. This

compares with operating income of 177,000 dollars in the same period last year.

We recorded a benefit from income taxes of 99,000 dollars for the third quarter of 2012, compared with an income tax provision of 21,000 dollars in Q3 last year. The benefit this quarter was largely due to the availability of R&D tax credits to Sevcon's U.K. subsidiary companies and the reduction in the U.K. corporation tax rate from 26% to 24%, effective April 1st, 2012.

Sevcon's GAAP net income for the third quarter of 2012 was 156,000 dollars, or 5 cents per diluted share, compared with 144,000 dollars, or 5 cents per diluted share, in the third quarter of 2011.

Looking quickly at the balance sheet, Sevcon ended the third quarter with cash and cash equivalents of 1.8 million dollars, compared also with 1.8 million dollars on September 30, 2011. We also have 1.8 million dollars in short- and long-term debt.

With regard to the liability for pension benefits, on July 11th the UK subsidiary Sevcon Limited commenced a consultation period with the members of the UK pension plan, seeking approval to close the plan to future accrual. The consultation period of a mandatory minimum of 60 days, will conclude this September. If agreement is reached to close the plan to future accrual then the subsidiary will replace the present final salary plan with a defined contribution arrangement.

I'll turn now to our results for the fiscal year to date, which continue to be driven by growth in the on-road EV sector. Sevcon's revenues for the

nine-month period were 27.5 million dollars – up 20% from 22.9 million dollars in the same period last year.

Gross profit was 34.8% of sales, compared with 36.2% for the first nine months of fiscal 2011.

Operating income increased to 982,000 dollars from 868,000 in the same period last year. Operating income for the prior year included one-time gains of 451,000 dollars from the sale of a surplus U.K. facility and 600,000 dollars of U.K. government grant income compared to $159,000 of grant income in Q3 this year. Excluding these items from both periods, operating income for the first nine months of fiscal 2012 was $1 million higher than last year.

Sevcon's net income for the first nine months of this fiscal year was 910,000 dollars, or 27 cents per diluted share, compared with 654,000 dollars, or 20 cents per diluted share, in the same period last year.

Looking briefly now at cash flow and working capital items, excluding currency translation, receivables increased by 210,000 dollars and payables and accrued expenses decreased by 1 million dollars and 600,000 dollars, respectively, all of which reduced cash in the nine month period. Inventories declined by 678,000 dollars, which generated cash in the same period. The number of days sales in receivables in the first nine months of fiscal 2012 increased by 1 day from 62 days at September 30, 2011 to 63 days at June 30, 2012.

As a reminder, we currently have a 3.5 million dollar secured revolving credit facility with RBS Citizens Bank. We also have 1.4 million dollars of

bank overdraft facilities with RBS Nat West Bank available to our UK subsidiary companies, which were unused at June 30, 2012.

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

Matt Boyle:

Thank you, Paul.

I'll close our prepared remarks with some brief comments on our plans for the business. The major driver right now is the number of projects we have underway in Europe, China and North America. The majority of these projects are for on-road EVs. Just yesterday we announced that AUCMA Electric Vehicle Company in China has selected the Gen4 controller for its new electric light truck – the A-2 – which has a range of up to 90 miles. The A-2 was initially designed for municipal fleets in China, but AUCMA also expects to ship partially assembled trucks to the U.S., where they will be completed and sold from a base in California.

We're also working on some potentially important new products with OEMs and Tier 1s in the industrial off-road sector. There are emerging projects related to hybridizing existing internal combustion engine-driven off-road vehicles to meet upcoming 2017 emissions standards.

I said last quarter that we plan to continue expanding our capabilities in engineering and sales to generate and support projects like these, with the goal of winning additional on-road EV business. We're also continuing to invest in strengthening our distribution and customer service footprint. For example, during the third quarter we were

successful in recruiting five outstanding automotive electronics engineers to join our U.K. based research and development team.

Near term, we expect our growth to continue being driven by positive consumer response to small EVs like the Renault Twizy, Brammo Empulse and our growing portfolio of scooters and ATVs in the Far East. Looking farther ahead, we believe that EV volume production will begin shifting toward larger passenger cars, trucks and buses. With the Gen4 Size 8 and Size 10, as well as other products in our pipeline, we've positioned ourselves to take a leadership position in those applications, as well.

With our product portfolio strengthened with the new size 10, we believe we have the product range to help us grow. Although the business environment is challenging, we will continue to invest in the key areas of engineering and sales and marketing for the future benefit of the Company.

We look forward to reporting continued 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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