Q1 2017 Earnings Call Transcript
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Call Participants

Ashish Agrawal  
*Chief Financial Officer and Vice President*

Kieran O’Sullivan  
*Chairman, Chief Executive Officer and President*

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Presentation

Operator  
Good day, and welcome to the CTS Corporation First Quarter 2017 Earnings Conference Call. As a reminder, today's conference is being recorded. At this time, I'd like to turn the conference over to Kieran O’Sullivan. Please go ahead.

Kieran O’Sullivan  
*Chairman, Chief Executive Officer and President*

Thank you, Lisa. Good morning. Thank you for joining us today, and welcome to CTS’ First Quarter 2017 Conference Call. Here are some notable items for the quarter.

First quarter sales were $100.2 million, up 3.6% from the same period in 2016. Gross margins were 34.2% compared to 34.6% in the first quarter of last year. Adjusted earnings per share were $0.26 compared to $0.26 in quarter one of 2016. Our total booked business increased from $1.518 billion to $1.538 billion. The transition of our manufacturing operations is tracking to our previously announced plans. Our CFO, Ashish Agrawal, is with me today's call. And will take us through the Safe Harbor statement. Ashish?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

I would like to remind our listeners that this conference call contains forward-looking statements. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking
statements. Additional information regarding these risks and uncertainties is contained in the press release issued today, and more information can be found in the Company's SEC filings.

To the extent that today's discussion refers to any non-GAAP measures relative to Regulation G, the required explanations and reconciliations are available in the Investors section of the CTS website.

I'll now turn the discussion back over to our CEO, Kieran.

Kieran O'Sullivan  
Chairman, Chief Executive Officer and President  

Thank you, Ashish.

First quarter sales were $100.2 million, up $3.4 million compared to the same quarter last year. Foreign currency impacted sales unfavorably by approximately $1 million. We also saw continued decline in our HDD volumes, as we expected with an impact of more than $1 million.

Gross margins were 34.2%, down 40 basis points compared to the first quarter of 2016. We were disappointed with this level of performance and we know we can do better. We were impacted by certain production rework issues that we resolved in the quarter. Separately in the single crystal production process, we continue to make efficiency improvements in line with our integration plans.

Our operating expenses, excluding restructuring were 21.2% compared to 21.8% in the same period in 2016, driven mainly by an increase in amortization costs due to the single crystal acquisition.

Our operational changes are on track for product transfers and qualifications at the receiving locations. We're building safety stock in line with our plans to ensure continuity of supply to our customers during the production transfer. As previously announced the transfer is expected to be completed in 2018. Additionally, our planning for the consolidation of the 2 sites in Illinois is progressing. Both sites will be consolidated into a new location near our corporate office in Lisle. Transition to the new location will begin in late 2017, which also supports our focus on simplification, one of our company's core values.

This year, we continue to implement system upgrades to improve and modernize our business effectiveness and efficiency. We have started planning and laying the foundation for the rollout of a new ERP system and we'll provide more information as plans develop.

We continue to gain traction with our customers globally and added nine new customers this quarter. Most of these customers were for single crystal applications in medical ultrasound and in defense. The balance were in traditional piezo applications, electronic components in industrial applications and two new automotive applications in Asia. The single crystal product line delivered solid wins for the quarter. The momentum here gives us confidence in delivering the growth targeted for this product line. Additionally, in the piezo product line, we had several medical wins with applications outside of ultrasound. These wins were for high-power applications that can withstand rigorous device sterilization procedures in cataract surgery and in muscle therapy.

We also delivered prototypes for using a pacemaker application. With our RF ceramic filters, we saw sales improvement and delivered prototypes for 5G cellular systems to two customers. Potential future revenues for these products are in the range of $2 million to $3 million,
annually. We developed the position switch for the appliance market with future potential revenue of $1 million. Finally, we delivered prototypes for our frequency module for used in autonomous vehicles. We had strong automotive wins driven by accelerated modules with existing customers and sensor wins, where we recently added one new application in the electric vehicle space.

We continue to target our first commercial win for the RF sensor product, as we work with several OEMs. Most recently, we were nominated for an innovation award in Europe for the products capability in diesel and gasoline particulate filter applications.

As discussed at the end of last year, we are now reporting total booked business instead of new business wins. Total booked business grew to $1.538 billion, up from $1.518 billion at December 31, 2016. Of this $263 million is expected to be shipped in the remainder of 2017.

We are targeting further progress in our end market profile this year in line with our strategy for products that Sense, Connect and Move. We continue to work our M&A pipeline to meet our growth objectives with a continued focus on international expansion.

Our end markets remain stable, though we did see some softness in the North American automotive sales in March, with industry reports putting the seasonally adjusted rate at a 16.6 million run rate, down from 17.5 million last year. This is the first time the rate dipped below 17 million this year. Recently General Motors and Ford announced plans for extended shutdowns at the assembly plants with on-hand days of inventory now above 80 days.

Our guidance for the full year 2017 remains unchanged. We expect sales in the range of $405 million to $420 million, representing growth of 2% to 6% over 2016. Adjusted earnings are expected to be in the range of $1.12 to $1.22.

With that, I will hand the call over to Ashish, to take you through the results in more detail.

Ashish Agrawal
Chief Financial Officer and Vice President

Thank you, Kieran. First quarter sales were $100.2 million, up $3.4 million compared to the same quarter last year. Foreign currency impacted sales unfavorably by $0.9 million in the first quarter. Sales to automotive customers were slightly higher by 0.4% and sales through electronic components -- sales of electronic components increased by 10.5% compared to the first quarter of 2016, partly as a result of the single crystal acquisition.

Gross margin for the quarter was 34.2% versus 34.6% in the same quarter a year ago. We continue our efforts to drive efficiency gains through material and labor productivity projects and the manufacturing transition announced in 2016 is progressing as planned. We expect to complete this transition in 2018. As we communicated in the past, the first full year of savings is expected in 2019.

SG&A expenses were $15.2 million or 15.2% of sales in the first quarter of 2017 compared to 15.4% of sales in the first quarter last year. Careful cost management is helping us absorb the additional amortization and SG&A expenses from the single crystal acquisition.

R&D expenses were $6 million in the first quarter of 2017 compared to $6.2 million in the same period last year.
In first quarter 2017, other income was $460,000. This was driven mostly by foreign currency balance sheet translation gains, as the US dollar depreciated against various foreign currencies.

Our effective income tax rate in the first quarter of 2017 was 30.6%. There were certain discrete items that reduced our tax rate in the first quarter. Consistent with our earlier communication, we are expecting our tax rate for the 2017 to be in the mid-30% range. We continue to evaluate the opportunities to improve our tax rate in 2018 and beyond.

Our first quarter 2017 earnings were $0.25 per diluted share. Included in this number is a $0.02 charge for restructuring expense and a $0.01 gain from foreign currency impact of balance sheet translations. Excluding these items, adjusted earnings per diluted share were $0.26 in the first quarter of 2017.

I’ll now cover a few items on the balance sheet. Cash and cash equivalents were $121.8 million at the end of first quarter of 2017 compared to $113.8 million at the end of 2016. Our long-term debt balance was $94 million, up from $89.1 million at December 31, 2016.

Debt to capitalization was 22.6% at the end of first quarter of 2017, up marginally from 22.1% at the end of last year.

Our controllable working capital as a percentage of sales was 13% in the first quarter of 2017, up from 12.1% a year ago. The primary driver of this increase is the buildup of safety stock, as part of our manufacturing transition plan.

Cash flow from operations for the first quarter was $9.8 million, a considerable improvement compared to $2.8 million in the first quarter of last year. Capital expenditures were $3.8 million compared to $2.9 million in the first quarter of 2016. We expect our CapEx levels for the rest of the year to be higher than our historical spend, as we work through the manufacturing transition, Lisle building consolidation and launch the ERP implementation project.

This concludes our prepared comments. We would be glad to take your questions at this time.
John Franzreb from Sidoti & Company. Kieran, can you just elaborate a little bit on the production issues you alluded to in your commentary? What were they and what's the duration of them?

Kieran O'Sullivan  
Chairman, Chief Executive Officer and President

Yes. First of all, John, the results, we fixed the issue in the quarter. And it's really molding which is an integral part of our process in some of the products we make. And we had some fusion issues with the resin that we needed to fix, that was outside the parameters. So we had product that we had to rework and we've taken care of it. And most of the impact is in the quarter. There might be a little bit of a bleed over into the second quarter, but we're getting the issue behind us. So it is fixed and resolved and, you know, just like we do with any product if we see something we have got a concern with. If we see it when we are doing product transfers, it is part of the restructuring. We want to make sure we are out there protecting our customers.

John Franzreb from Sidoti & Company, LLC

Okay. All right. And you kind of voiced some concern a little bit about the automotive outlook. You've referenced some closures that are coming. Can you talk a little bit about what your expectations are for the year? How it plays out? What your customers are telling you about the auto cycle?

Kieran O'Sullivan  
Chairman, Chief Executive Officer and President

Yes, where most of our concern is around North America because we had that dip in the cycle in March from the seasonally adjusted rate from 17.6% down into the 16% range. We don't think it's going to fall off, but we see some inventory levels that are high, 80 days is a lot. We'd like to see that more in the 60-day range. But -- and we -- when we plan for the year, we planned for some flatness in certain markets on the auto side. We feel good about Europe. Europe is taking off a little bit, but we don't have much business there. As we've said before, we're gaining share and that helps us in that kind of a flat-to-soft market. And Asia is pretty steady. There was a little bit of pull back from the tax changes in China, but it's not falling off. It's doing okay. And we expect that to get a little bit better during the year. So overall, we're prepared for some softness, but we planned for that in our planning for the year.

John Franzreb from Sidoti & Company, LLC

Okay. Can you just remind us how much of your revenue is exposed just to North American auto?
Ashish Agrawal  
**Chief Financial Officer and Vice President**  

John, we don’t break out the product line revenues by region. But roughly, for the overall business, mid-50% is exposed to the North American region.

John Franzreb  
**Sidoti & Company, LLC**  

Okay. And could you just talk a little bit about the new, I guess, you’re phrasing it total booked business at the end of the quarter. I think you said it was 263 is due to be shipped this year. How long of a cycle does that book business playout? Is it firm backlog, can you just provide a little more color on how we should kind of view that number?

Kieran O’Sullivan  
**Chairman, Chief Executive Officer and President**  

Yes. John, just going back to that last answer from Ashish, where we’ve said the 50% North America, remember, our business in North America is not only with the North American OEMs. We’ve got business with the Japanese and other OEMs in North America too. So their days of supply might be healthier. And the -- back to the booked business, first of all, John, if you look back to the transition, we reported new business wins. We’ve been very clear about that and what we’re doing as a management team to build the pipeline and build the backlog and we’ve had a good story, good momentum. We had another good quarter. And the reason for shifting first to the total booked business is, you can never tell from what we did in the quarter, how that played out. And we know that more than 60% of our business and some of our piezo business runs for more than a year, it runs for several years, especially in auto. So by changing to the backlog, you -- we can first of all, show you what's going on, what we ship in the quarter, what we are going to develop from that backlog going forward and the balance of the business is PO-based month-to-month, and typically -- and so it's giving you more visibility. So when you look at the cycle to your question, I'm coming to your question, when you look at the cycle. The auto light vehicle running for 4 years, 3 to 4-year periods, commercial vehicle running, you know, 5 to 7, and some of the traditional piezo products, it's a mixture in there. And some of that is PO-based, some of it's 1 to 2-year contracts. So it's going to go out over several years. And the mixture in there, you've got to digest that yourself.

John Franzreb  
**Sidoti & Company, LLC**  

Okay. All right. You know what? I’ll let somebody else ask questions and get back into queue. Thanks. Kieran.

Kieran O’Sullivan  
**Chairman, Chief Executive Officer and President**  

Hey, John. One last point on that, so when you get the backlog as well, the other thing we like about giving visibility to you and the other people on the call is, when market conditions change like exchange rates change, we can adapt our backlog, so you're still getting that very clear view of what we have in backlog or if an OEM gains more volume and share we can adapt to that as well or we get a higher penetration rate on a certain platform. So just trying -- we're trying to help you view that future.
So just on that thought, Kieran, I mean to put it in perspective. Can we get some of that data for over the past 2 years, you have it that far back?

Ashish Agrawal
Chief Financial Officer and Vice President

John, we haven't disclosed the data for the past years. What I would suggest is, as we continue report it going forward, use that information to build a little bit of how the backlog trend is developing.

Okay. Thanks again. I'll get back in the queue.

Ashish Agrawal
Chief Financial Officer and Vice President

We'll continue building from this point on. Our intention is to continue reporting going forward. We will not be looking at talking about 2016 Q1, Q2, those types of data points. We'll be reporting starting from Q4 of 2016 and we will report it quarterly going forward.
Okay. I did notice the pickup in inventory relative to sales booked and I presume that was due to the shift in manufacturing facilities. Is that going to increase still further? Or is it going to drop back as the year progresses?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

We are expecting further build for part of 2017 and then towards the end of 2017, you should start seeing a slight drop off with a further drop off in 2018. Our expectation is to use the full safety stock in 2018.

Okay. On the tax rate, it’s -- do we go back to the mid-30s on a 6 months basis and 9 months basis? Or are we going -- the differences move into the second, third, fourth quarters?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

I would think of it more from a second, third, fourth quarter standpoint, Ian. If we exclude the discrete item that we recorded in Q1, we are pretty much in that range for Q1 as well. So the total year will be slightly better. But Q2 through Q4 we are expecting to be in that normal range.

Okay, fine. Thank you very much. Those are all my questions.

Ashish Agrawal  
*Chief Financial Officer and Vice President*

All right. Thank you.

Operator

And we’ll take our next question. Caller, please state your name and your company.

John Franzreb  
*Sidoti & Company, LLC*

Again, this is John Franzreb from Sidoti. The electronic component revenue growth, I think was 10.5%, how much of that was organic?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

So John, you know that for competitive reasons we’ve been limiting the amount of financial information that we share on the acquisition. So we are really not talking about that anymore. I would say to you that, if you remember, we did the acquisition on March 11 of 2016. And we reported about $800,000 of revenue for that partial period in Q1. So that -- you could
correlate that to get a rough idea, but that's where we are. The underlying growth is pretty good in the electronic component space. And as Kieran mentioned, we did take a reduction in our HDD volume as well.

**Kieran O'Sullivan**  
*Chairman, Chief Executive Officer and President*

John, the other thing I would point out and just building on what Ashish said is, we look at our industrial markets for components. We had good progress there. The RF filters, which we have been working on for the last 2 years getting the products ready, we've built some nice momentum with that product and sales. And we see our future growth there as well. So there is some of the electronic component lying outside of the Single Crystal that are gaining nice momentum.

**John Franzreb**  
*Sidoti & Company, LLC*

Okay. Regarding your restructuring actions and the rollout of the ERP system. Can you just provide some color -- especially on the ERP system, what your thoughts are there, is it going to be disruptive? And restructuring actions, just a little bit more color, just a timing of the actions that you're doing currently.

**Kieran O'Sullivan**  
*Chairman, Chief Executive Officer and President*

So John, we're -- yes, first of all, we're still in the planning phase. And obviously, getting things approved internally and getting approved with our board. There are some things we'll be going through. If the implementation months were approved, we would start -- and Ashish can take you through in more detail but towards the end of this year and then full implementation next year. It's quite a project, as you know. You're dealing with our core systems, so we're very thorough and careful about that. And the other thing that goes with it, John, is -- it's going to increase our capital investment a little bit. We will see our CapEx, you know, spike a little bit this year, and next year and then get back to normal levels. But Ashish will give you more color on that.

**Ashish Agrawal**  
*Chief Financial Officer and Vice President*

Yes, I think you covered it very well, Kieran. The only additional color I would add is we are still working on the plans and I'm expecting that in the second quarter earnings call, we'll be able to provide a little more clarity on the timing as well as the range of CapEx that we are expecting to deploy for the ERP implementation.

**John Franzreb**  
*Sidoti & Company, LLC*

Well, okay. That's all I got. Thank you guys.

**Operator**  
[Operator Instructions] And we'll take our next question. Caller please state your name and ask your question.
Hendi Susanto  
*G. Research, LLC*

Hendi Susanto from Gabelli & Company. Ashish and Kieran, how do you view your full year guidance today versus 3 months ago? Anything changed in terms of your assumption and market views?

Kieran O’Sullivan  
*Chairman, Chief Executive Officer and President*

No, we're -- as we said in the prepared remarks, Hendi, we're reconfirming our guidance and we talked about some softness in the automotive market. We expect a little bit of that but we feel good, and we just want to get back as we said in the press release to improving our performance. You know, we’re unhappy that we stepped back a little bit on the gross margins and we've got it fixed, and we need to move forward. Always something to do.

Hendi Susanto  
*G. Research, LLC*


Kieran O’Sullivan  
*Chairman, Chief Executive Officer and President*

Thank you, Hendi.

Operator

We'll go to our next question. Please state your name and your company name and ask your question.

Ian T. Gilson  
*Zacks Investment Research Inc.*

This is Ian Gilson, again. You stated that revenue was impacted by just less than $1 million in the quarter. What was the impact of currency on the expense line?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

So Ian, the -- we have currency exposures in various countries where we have manufacturing operations. The primary ones being Mexico as well as to some extent in China. Before -- we haven't quantified the exposure for you, but the expense exposure is favorable. Revenue is unfavorable. On the operating earnings line, we were slightly favorable as a result of the currency.

Ian T. Gilson  
*Zacks Investment Research Inc.*

Okay. Because the Mexican peso peaked quite significantly during the first quarter and it was then backed off against the dollar. Living in San Diego, I see that impact more than most people, I'd guess.
Ashish Agrawal  
*Chief Financial Officer and Vice President*

Absolutely. That is obviously reflected in our financial statements. If you look at our Qs and Ks, you will also see that we are hedging certain currency exposures, Mexican peso being one of them.

Ian T. Gilson  
*Zacks Investment Research Inc.*

Okay. When are you going to file the 10-Q?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

It should be getting filed either later on this afternoon or first thing tomorrow morning.

Ian T. Gilson  
*Zacks Investment Research Inc.*

Okay. What were the actual shares as to at the end of the quarter on a primary basis?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

I'm sorry, say that again.

Ian T. Gilson  
*Zacks Investment Research Inc.*

The actual share count at the end of the quarter?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

I believe it was basic 32.8 million and on a diluted basis, it's 33.36 million.

Ian T. Gilson  
*Zacks Investment Research Inc.*

There is not much change from the weighted average for the quarter?

Ashish Agrawal  
*Chief Financial Officer and Vice President*

Oh! I see your question. I apologize. I was giving you the weighted numbers. I'll get back to you. It will be in the 10-Q, but I can get back to you in an e-mail as well, Ian.

Ian T. Gilson  
*Zacks Investment Research Inc.*

Okay, great. Thank you very much. And that’s it from me.
Operator

It appears there are no further questions at this time. I would now turn the conference back to Mr. O'Sullivan for any additional or closing remarks.

Kieran O'Sullivan  
Chairman, Chief Executive Officer and President

Great. Thank you, Lisa, and thank you, everybody for joining us on today's call. And as we said in the press release, we had a good solid quarter, but we know we've got work to do to improve for the balance of the year, which we're focused on and plans to execute, and we look forward to updating you at the end of the second quarter. So thank you for your time.

Operator

Ladies and gentlemen, that does conclude today's conference call. Thank you for your participation.

Ashish Agrawal  
Chief Financial Officer and Vice President

Thank you.