Universal Electronics Inc. Q2 2015 Earnings Call

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PRESENTATION

Operator: Good day, ladies and gentlemen, and welcome to the Universal Electronics' Second Quarter 2015 Results Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will follow at that time. [Operator Instructions] As a reminder, this conference call is being recorded. I would now like to turn the conference over to our host for today's call, Mrs. Becky Herrick. You may begin.

Becky Herrick: Thank you, operator. And thank you all for joining us for the Universal Electronics first quarter 2015 conference call. By now, you should have received a copy of the press release. If you have not, please contact LHA at (415) 433-3777.

This call is being broadcast live over the internet. A webcast replay will be available for one year at www.uei.com. Also, any additional updated, material, nonpublic information that might be discussed during this call will be provided on the Company's website, where it will be retained for at least one year. You may also access that information by listening to the webcast replay.

After reading a short Safe Harbor statement, I will turn the call over to Management.

During the course of this conference call, Management may make projections or other forward-looking statements regarding future events and the future financial performance of the Company, including the Company's ability to maintain and build its relationships with key customers; the Company's ability to anticipate the needs and wants of its customers and timely develop and deliver products that will meet those needs and wants, particularly the more advanced platforms of easy set-up and intuitive control; the continued success in winning new customers and growing its market share; the timing of new product rollout orders from the company's customers as anticipated by management, including the XFINITY® voice remote, the TiVo product and the smartphone software and hardware; the continued trend of the home entertainment industry in providing consumers with more advanced technologies; management's ability to manage its business to achieve its revenue and earnings as guided; and the other factors described in the company's filings with the U.S. Securities and Exchange Commission. The actual results the company achieves may differ materially from any forward-looking statement due to such risks and uncertainties.

Management wishes to caution you that these statements are just projections, and actual results or events may differ materially and the company undertakes no obligation to revise or update these statements to reflect events or circumstances that may arise after today's date.

For further detail on risk, Management refers you to the press release mentioned at the onset of this call and the documents the Company files from time to time with the SEC, including the annual report on Form 10-K for the year ended December 31, 2014. These documents contain and identify various factors that could cause actual results to differ materially from those contained in Management's projections or forward-looking statements.

Also, the Company references Adjusted Pro Forma, or non-GAAP metrics in this call. These Adjusted Pro Forma metrics are provided because management uses them in making financial, operating and planning decisions, and in evaluating the Company's performance. The Company believes these measures will assist investors in assessing the Company's underlying performance for the periods being reported. Adjusted pro forma metrics exclude amortization expense relating to intangible assets acquired, depreciation expense relating to the increase in fixed assets from cost to fair market value, other employee related restructuring costs and stock based compensation.

In management's financial remarks, it will reference adjusted pro forma metrics. A full reconciliation of these Adjusted Pro Forma measures versus GAAP is included in the Company's press release that was issued after the close of the market today.

On the call today are Chairman and Chief Executive Officer, Paul Arling, who will deliver an overview; and Chief Financial Officer, Bryan Hackworth, who will summarize the financials, and then Paul will return to provide closing remarks.

It is now my pleasure to introduce Paul Arling. Please go ahead, Paul.

Paul Arling: Thank you Becky, and thank you all for joining us today.

Our second quarter financial results were in line with our expectations as we achieved net sales of $147.6 million and EPS of $0.67.
It is important to note that 2014 represented the most successful year in UEI's history, making our 2015 results all the more impressive. However, we firmly believe this is just the beginning, as we remain committed to driving profitable growth for years to come.

In fact, we announced earlier today that we signed an agreement to acquire Ecolink Intelligent Technology, a leading provider of wireless security, sensing and home automation products and services.

This transaction opens up access to an exciting new opportunity for UEI in the emerging and rapidly expanding smart home market.
Ecolink has extensive experience in the home security systems industry, developing universal wireless sensors compatible with many of the most popular home security systems. Its comprehensive line of innovative, patented products provides UEI with a competitive advantage in the Home Security and Automation space.

Today's home is becoming more connected. Sensors and connected devices are being added throughout the house to alert monitoring stations and individual homeowners when a smoke detector goes off or when the front door has been opened. These two examples of connected home use cases were rated by consumers as being among the most desirable features of a Smart Home.
Today, Ecolink's innovative products offer the underlying technology necessary to drive the features that consumers demand in their Smart home environment.

The acquisition of Ecolink enables UEI to support our existing service provider customers with the home security products and technologies they are beginning to introduce and offer to their subscribers. Ecolink's product line mirrors the mission to which we have adhered for years – providing innovative solutions that simplify and connect the increasingly complex home environment.

The smart home represents a significant opportunity for us. According to data from ABI Research, the global market for home safety and home security sensors and connected devices is estimated to grow from $1.4 billion in 2015 to $4 billion in 2019. At the same time, Parks Associates estimates that over the past 4 years, cable and telco providers have successfully added home security and automation services to their offerings, gaining an estimated 14% share of professionally-monitored security systems in U.S. broadband households.

In short, with our long history of innovation and success in anticipating trends in consumer home entertainment control, UEI will be at the forefront of providing unique and innovative products to help consumers interact with their security and home automation services.

We are excited about the opportunities in this market, and we expect to have more to share in the next few months. In fact, we are currently working on several new products in this space that we will introduce with our industry partners in 2016.

As we innovate and expand our products and technologies into new markets, we are also driving growth in our existing markets. Our embedded software solutions continue to be adopted by more of the world's largest home entertainment companies.

In fact, just last week we announced we reached a new milestone – our QuickSet® solution is now included in more than 150 million devices around the world and accessed every time a consumer adds or replaces a new piece of AV equipment.

Industry-leading companies continue to adopt our products and technologies as they seek to provide consumers with an easier, more intuitive control interface for home entertainment control. The growing demand for more advanced control is complemented by an increasing desire for simplification. This is exactly where UEI provides the most value to our customers as we can help them accomplish both objectives.

In the past 12 months, we have seen a major shift in our industry, as advanced remote controls are becoming more broadly adopted throughout the world. Major players in the subscription broadcasting and consumer electronics industries are moving beyond "infrared-only" technologies to also include two-way radio frequency protocols like Bluetooth Low-Energy, RF4CE and even Wi-Fi, which enable a broader array of advanced features.

For example, at the beginning of the year Comcast chose UEI to supply its new XFINITY® voice remote control. The new remote uses voice commands to help consumers find what they want quickly, yet still support the traditional functions for changing channels and raising or lowering the volume on their television.

This remote is powered by our advanced control technology that enables easy home setup and configuration. While initial shipments to Comcast commenced in the second quarter, we are now shipping at higher volumes. In the first and second quarters we saw below average order volumes from some of our customers as they deplete existing inventories in advance of their new product rollouts. In the second half of 2015, we expect to see the benefits of the new product rollouts as customers begin to ramp into their new product releases.

As mentioned previously, UEI is actively in development or in the "design-in" stage with numerous customers looking to launch advanced intelligent controller platforms. Some will launch in the coming months and some over the next 18 months. This is creating an interesting and exciting transition in our industry.

While these changes can bring short-term interruption in orders -- as we've seen this quarter and last, and affect short-term movements in margin as larger customer sales increase as a percent of our overall mix due to their aggressive roll-out of these exciting new products -- the overall positive trend is becoming clear.

Our industry is moving toward advanced, two-way intelligent controllers, as well as sensors and services that are making the smart home a reality. We have worked for years on the technologies and features that anticipated this trend and our customers have now begun to implement the architecture that will support these advanced solutions. We stand uniquely positioned to capitalize on this exciting new trend in our industry and create new avenues of growth for our company.

With that, I would now like to turn the call over to our CFO, Bryan Hackworth, to discuss our financial results.

Bryan Hackworth: Thank you, Paul.

As a reminder, our results for the second quarter and first six months of 2015, as well as the same periods in 2014, will reference adjusted pro forma metrics.

Second quarter 2015 net sales were $147.6 million, compared to $146.3 million for the second quarter of 2014. Business Category net sales were $135.5 million, compared to $132.7 million. Consumer Category net sales were $12.1 million, compared to $13.6 million. As a result of the stronger U.S. dollar versus the euro and British pound, Consumer sales were adversely affected by $1.5 million.

Gross profit was $40.5 million, or 27.5% of sales, compared to a gross margin of 29.9% in the second quarter of 2014. The decrease in our gross margin rate is due primarily to the fact that a higher percentage of our sales were made to large customers who receive favorable pricing as a result of higher volumes. As mentioned previously, the stronger U.S dollar versus the Euro and British pound negatively impacted sales and gross margin dollars by $1.5 million. In addition, we've also experienced a decrease in chip & royalty revenue associated with the TV and mobile device channels. Certain of our OEM customers in the TV market have been losing market share and as a result, our sales have been adversely affected. We've made progress in the mobile device channel in the current year, primarily in China; however, the loss of a program with a significant brand name has also negatively impacted our gross margin rate.

Total operating expenses were $27.0 million, compared to $29.3 million in the second quarter of 2014. Breaking down our operating expenses: R&D expense was $4.0 million for both periods reflecting our continued investment in new products and technologies. SG&A expenses were $23.1 million, compared to $25.3 million.

Operating income was $13.5 million, compared to $14.5 million in the second quarter of 2014.

The effective tax rate was 21.5%, compared to 24.6%.

Net income for the second quarter of 2015 was $10.7 million, or $0.67 per diluted share, compared to $10.6 million, or $0.66 per diluted share, in the second quarter of 2014.

For the six months ended June 30, 2015, compared to the same period in 2014, net sales were $280.3 million, compared to $276.2 million. Gross margin was 27.9%, compared to 29.2%. Total operating expenses were $55.6 million, compared to $57.3 million. Operating income was $22.6 million, compared to $23.2 million. Net income was $18.2 million, or $1.13 per diluted share, compared to $17.0 million, or $1.05 per diluted share, in the prior year period.

Next, I'll review our cash flow and balance sheet at June 30, 2015.

We ended the quarter with cash and cash equivalents of $82.2 million, compared to $112.5 million at December 31, 2014. During the second quarter, we repurchased approximately 580,000 shares for $30.3 million representing an average price of approximately $52.00 per share. We expect to continue to buy back our shares over the next three months, particularly at the recent trading range of our stock, as the promising trends in our industry and our growing market position supports our positive long-term outlook.

DSOs were approximately 63 days at June 30, 2015, compared to 66 days a year prior. Net inventory turns were approximately 4.1 turns at June 30, 2015, compared to 4.6 turns a year prior.

Now, turning to our guidance… For the third quarter of 2015, we expect revenue between $164 and $172 million, compared to last year's third quarter revenue of $147.8 million. EPS for the third quarter is expected to range from $0.77 to $0.87 per diluted share, compared to $0.80 recorded for the third quarter of 2014. It is important to note that we expect our seasonality of sales and earnings this year will be different than in the past. Because of the exciting platform transition that we are in the midst of with some of our customers, our fourth quarter sales and earnings are currently expected to be much stronger than in the prior year. Based on the aforementioned positive trends in our industry and our growing market position, we are reaffirming our long-term financial outlook. We expect average annual sales growth of 5 to 10 percent and average earnings growth of 10 to 20 percent over the next 5 years.

I'd now like to turn the call back to Paul.

Paul Arling: We are proud of our performance so far in 2015, but we are even more excited about the opportunities ahead. As we get closer and closer to the day where home entertainment control is completely automated and intuitive, and incorporates more and more features, UEI is becoming integral to providing the innovations that support the world's largest consumer electronics, subscription broadcasting, smart device and smart home companies in implementing this transition. In fact, as more and more products, technologies and services are introduced within the home, UEI becomes even more integral to providing the connection and control capabilities to some of the world's leading companies who are making the smart home a reality.
No matter the type of device – whether it's embedded in a TV, set top box or now home safety and security systems – or whether it's being controlled by a traditional universal remote control or a smart device, UEI is at the forefront of creating these new ways to simultaneously enhance and simplify the home experience.

I'd like to now open it up for questions. Operator?

Q & A

Operator: And our first question comes from Steven Frankel of Dougherty & Company. Your line is open.

Steve Frankel: Good afternoon. Paul, maybe we'll start with the acquisition you announced today. When you talk about developing products, is this something you would be delivering in conjunction with your subscription broadcast customers?

Paul Arling: Well, the answer is yes. It goes beyond that. But certainly, our subscription broadcasting customers are interested with the infrastructure that they have now placed in your home, the IP backbone, IP connector boxes and of course cable modems, routers, et cetera, as well as the RF power of those nodes becomes relatively easy for them to add other services on top of that architecture. And it's something that we've been discussing with the major customers and we'll have more to talk about on that as time goes on. It's actually how we got to know Ecolink because we've been working with them on some of these projects.

Steve Frankel: And today, are the subscription broadcasters that are doing this doing it through the set-top box, or are they doing that through another piece of equipment today, and are you going to offer more of an integrated package?

Paul Arling: We're actually doing it through the entire architecture. Again they have an IP backbone, the boxes have a flavor of ZigBee RF4CE, which we've embedded in our remotes, and we're actually one of the world's largest purchasers of that type of chip. Because of a number of remotes we're doing with various providers of RF4CE, we've gotten a pretty strong position in that market. The new services are actually already being implemented. We already have some wins in this area, as I alluded to in the prior remarks. And we'll be talking more about that as time goes. But we're working with some major players in the industry. I don't want to underestimate the existing market for home security, which as we outlined in the call is quite sizeable. And the company that we've acquired, the people there have a great deal of extensive experience, decades of experience in building the products and expertise in the protocols that are necessary in that market, and also to translate from older sensors, window, door sensors, PIR motion detectors for security systems. They are the real experts in those products and can convert the proprietary protocols with yesterday, the sub-gig protocols in the things that can be understood by the networks of today and the networks instituted by our customer base, cable satellite and telco operators.

So I think there's a real good fit here for growth with these products. And as I said, we are even working with these guys on projects that are active today.

Steve Frankel: Could you give us a rough idea of what their revenue will be in 2015 and whether this is going to be accretive or dilutive to earnings?

Paul Arling: Yes. It's less than $10 million this year. Their sales, it will be accretive, mildly accretive at first, but of course the forecast is for it to be increasingly accretive as time goes on, but it's an accretive deal.

Steve Frankel: Right. And then, Brian mentioned that we're not going to have the normal sequential decline in revenue in Q4. What kind of sequential ramp in revenue might we think about?

Bryan Hackworth: We're not going to quantify that much, Steve. I thought it was important to make a comment about it, because as you've been with us for years and typically Q4 takes a dip versus Q3. And [sic] what I'm basically telling you is [that] the growth for Q4 over last year's Q4 should be strong. So I wanted to take the past history and apply it to this year's Q4.

Steve Frankel: Okay. And could you give us the customer concentration in the quarter?

Bryan Hackworth: We had two 10% customers, Comcast was at a little over 20% and DIRECTV was about 12%.

Steve Frankel: Okay, I'll pass the baton. Thank you.

Operator: Our next question comes from Mike Olson of Piper Jaffray. Your line is open.

Michael J. Olson: Hey, good afternoon. So, just a quick clarification on the Q4. I understand, you're saying Q4 year-over-year growth will be strong. Are you also in fact saying that it will be up sequentially or just saying it will be strong year-over-year?

Bryan Hackworth: I'm not going to get specific on that. I'm not saying it will be up, and I'm not saying it'll be down necessarily. I'm saying you're not going to see the dip you typically see as you've seen in prior years because if you take the prior year, you usually see a decent size dip from Q3 to Q4 and that just won't happen this year.

Michael J. Olson: Okay. And then, Paul, you talked about [how] advanced remote controls [have] been increasingly adopted and the Comcast deployment volume is increasing, so that sounds good. I would imagine that Comcast is a great reference customer to have and other service providers look to them as a leader in this space. Are you saying that you actually have deals in place for next-gen remotes with other service providers that [will] result in shipments still this year? And generally, what's kind of the pace of the deployments that you see from service providers or does it really vary significantly depending on each one?

Paul Arling: Yeah. So there is a lot of embedded in that. Comcast obviously is a leader, so operators across the world look at what is happening here in the U.S. and particularly with Comcast and see the success they're having and with this program, so [they] are very interested. It's a very high profile project, so that certainly has helped. There are number of projects at various stages of development, some will probably launch this year, others won't. They'll launch early next year and to the middle of next year. I mean, I guess the real point to make here is, we literally have at least a dozen that we're working on. And again, not all of them are completed, they'll be introduced, some of them are still at the RFQ or design stage. So they probably won't come until the middle of next year, maybe even toward the end of next year. And again, even that varies by operator. Some of them can have these projects done in six months, others take at least 12 months. So it varies customer by customer. But suffice to say there is a lot of activity in this area; they're not all doing the same things, but what is common to all of them is that they're typically on a IP backbone, they have a connected, cloud based system with two-way utilizes in some way, typically RF, Bluetooth, Bluetooth Low Energy, Bluetooth Smart, RF4CE, some form of two-way radio frequency, which allows us to do a lot of things that we weren't able to do three years ago with these products, including QuickSet and QuickSet 3.0, but also other services that they can provide – thus Ecolink.

So I think there [are] really a lot of interesting things going on right now in our industry. Comcast has been a leader here, but Liberty has been in Europe, there [are] a lot of companies here that haven't just been waiting for Comcast, they've actually been working on their own, and [they] are either about to introduce or will introduce early next year to the middle of next year a new platform.

Michael J. Olson: All right. Thanks a lot.

Paul Arling: Sure.

Operator: Our next question comes from Les Sulewski of Sidoti & Co. Your line is open.

Les Sulewski: Hi, just a follow-up on Ecolink. Is there an installation or a customer service component to this?

Paul Arling: Well, it typically, that's done by the – the operator or the service provider. But you know the products are you know unique, the products that we're doing. There is – there is not a service, if you're asking if there is a service revenue component, I don't think there is any substantial service revenue component to it.

Les Sulewski: And then also, I guess to follow-up on that, and then the guy you attracted to that acquisition is it mostly technology or are there solid price points component to the end-user?

Paul Arling: Well, it's a little of all of those, I mean we think that we can provide some benefits to them in that obviously the distribution path for some of these products we have great relationships for, so we can accelerate their growth. We also have a great cost position on some of the common parts that are required for these next generation services that provide some value. They have a lot of experience in this market and have a lot of innovative ideas. Many of which are covered under patent, for things like Universal translators, is the best way to call it or – as we used to call them the one-for-all security systems where there are a lot of homes that have the wireless sensors already installed, they operate on a sub-gig frequency. And that we can build translators to utilize those existing sensors to remove another barrier to sale for these security providers. If the customer doesn't want new window and door sensors installed, we can implement a translation utility for them, and these guys have mastered all of those protocols. So there was a lot of technology and patents involved in what they were doing, they're an innovative group, a small company but a very innovative group of people. And again similar in culture to UEI, where they're solving problems and coming up with innovative new ideas to solve issues that exist in these safety and security systems, just like we've done in home entertainment since the start. So, I think there was also a good fit there.

Les Sulewski: Thank you for that color. In regards to your inventory, there is some build out during the quarter, how can we look at that, especially looking at COGS over the second quarter, are we expecting a little bit of a higher margin prolife, moving into it with third quarter and fourth quarter.

Bryan Hackworth: Yeah, we don't give specific guidance on the margins. But the main reason for the increase in the inventory levels is because of the increase in the sales for the back half of the year and these – the platform transition is going very well. As Paul mentioned, we have a number of customers transitioning over and it requires more capital and requires more inventory to meet the demand.

Les Sulewski: Is there any possibility of a write-down from maybe scale inventory or inventory within that move?

Bryan Hackworth: No, they're beginning to increase inventories because we have POs, [it isn’t] anything to be alarmed about in terms of ENO. I mean, we always have some sort of ENO throughout the year but it's not going to be related to the platform transition.

Les Sulewski: Got it. Okay. Great. And then perhaps last one, perhaps guidance on CapEx for the full year?

Bryan Hackworth: Yeah, I think we're going to look – this year is a little bit of an anomaly because of the – it's good news, we have a lot of customers coming on board and again, as I mentioned previously, it requires capital. So, this year is a little bit of anomaly, we're probably looking at the low to mid 20s, $20 million for 2015, which last year I think it was $18 million.

Les Sulewski: Great. Thank you.

Bryan Hackworth: Sure.

Operator: And our next question comes from Ian Corydon of B. Riley and Company. Your line is open.

Ian Corydon: Thank you. Just another clarification on the Q4 guidance. Revenue is supposed to be up significantly year-over-year and earnings as well. Whereas in the third quarter at least at the midpoint of guidance earnings won't be up much despite sales being up 11% to 16%. Can we assume that the Q4 increase in the earnings is more due to leveraging and operating expenses versus some kind of the gross margin change from Q3 to Q4?

Bryan Hackworth: Yeah. I think that's – you could say that, I don't want to use specifics in between lines, we just don't do that. But I think for Q4, what's going to drive is really the top-line, we're going to be able to leverage it, in the sales of – are going very well with the platform transition. So we'll be able to lever that and we're confident that we can deliver a strong bottom-line.

Ian Corydon: Okay. Understanding that Ecolink is small. Can we assume that the guidance does include that? And then, if you can, can you talk about the margin profile and the seasonality of that business?

Bryan Hackworth: Yeah by default, if the guidance does include it, as Paul mentioned, we expected to be mildly accretive in the first year and then grow thereafter, so I – you can definitely say it's included. And right now, we're not going to give margin profiles on Ecolink.

Ian Corydon: Hard seasonality.

Paul Arling: Yes, not highly seasonal business.

Bryan Hackworth: Yes, not seasonal, as Paul mentioned currently it's less than $10 million.

Ian Corydon: Got it. Thank you.

Operator: And our next question comes from Daniel Sheyner of Atika Capital. Your line is open.

Daniel Sheyner: Thanks. Real close. Hey, guys. Thanks so much for taking the question. Actually, I think you partially answered it with the last question, I was just wondering, if you could quantify how much of the Q3 top line guidance is becoming from Ecolink?

Bryan Hackworth: It is minimal, it is – right now currently for full year, it's less than $10 million, so it's minimal

Daniel Sheyner: Got it. Thank you.

Operator: And our last question comes from Steven Frankel, Senior Analyst. Your line is open.

Steven Frankel: Paul, on a smart device category, is there any update on your mission to try to get attached to more smartphones especially in China?

Paul Arling: Yeah. Well, we've actually had a good year there. I mean in terms of the number of models, I don't have the exact number. But what typically happens as we start with a customer, where they put it one model or maybe two, and then, as time goes on, they increase that number. We've had that experience with most of our customers, including those in China. So there are still good results there. The sales effect is smaller than some of the advanced remote work we're doing and even as we would forecast the sensor work we're doing on the smart home side of things for safety and security products. The revenue is there just much greater, which is why we spend a lot of time about discussing that, but still good results there. The only negative was the loss of the major program this year, which did affect us.

Steven Frankel: Okay. Great. Thank you.

Paul Arling: Sure.

Operator: And I am showing no further questions at this time. I would now like to turn the conference back over to Mr. Paul Arling.

Paul Arling: Okay. Well, thank you everybody for joining us today and for your continued interest in UEI. Coming up next month, we'll be participating in the sixth annual Credit Suisse Small Mid Cap Conference in New York on September 16. So, we hope to see some or all of you there. Thanks very much, and good bye.

Operator: Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day.
