

IntriCon Corp. 2016 Second-Quarter Results Conference Call

**Moderator: Scott Longval
August 2, 2016
4:00 pm CT**

Operator: Good day and welcome to the IntriCon Second Quarter 2016 Results conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Scott Longval, Chief Financial Officer. Please go ahead.

Scott Longval: Thank you, operator. Joining me on today's call is Mark Gorder, IntriCon's CEO. Before we begin, I'd like to preface our remarks with the customary Safe Harbor statement.

Today's conference call contains certain forward-looking statements. These statements are based on current estimates and assumptions of IntriCon's management and are subject to uncertainty and changes in circumstances.

Given these uncertainties, you should not place undue reliance on these forward-looking statements. Actual results may vary materially from the expectations contained in today's call.

Important factors that could cause such differences include amongst others those set forth under the headings risk factors and management's discussion and analysis of financial condition and results of operations and our 10-K filing for the year ended December 31, 2015.

With that, I'd like to introduce Mark for a strategic look at IntriCon's second quarter.

Mark Gorder: Thank you Scott and thank you everyone for joining us today. I would like to begin by reviewing key highlights and results for the second quarter. After that Scott will cover the financials in more detail and then we'll take your questions.

By this time, most of you had a chance to review our second quarter press release. For the quarter, net sales of 17 million were consistent with the prior year period and the company's valued hearing health initiatives delivered year over year growth. The results were in line with our June 20, 2016 pre-release and reflect a timing shift in order from our largest medical customer.

Looking at our three businesses, sales and hearing health grew 7% over the prior year period, primarily due to contributions from PC Worth. During the quarter we experienced gains in value hearing aids, personal sound amplifier products and assisted listening devices.

These were partially offset by anticipated decreases in conventional channel sales. For some time we have been focused on opportunities in value hearing health versus the conventional channel. Shortly I will comment further on these efforts.

Our medical business sales decreased 4% in the 2016 second quarter compared to the year ago period, primarily driven by our largest customer Medtronic. Sales to Medtronic were lower as they managed the transition of their pending FDA approval and launch for the MiniMed 630G system.

Despite this timing issue, long term we believe we are well positioned for growth with Medtronic. In addition to the MiniMed 630G, we are also designed into the MiniMed 670G system which was recently submitted to the FDA for premarket approval.

Looking at our professional audio communications business sales declined 5% from the prior year period. We anticipate the revenue for the second half of the year in this business to be flat

with the prior year comparable period. In addition we are working on several notable opportunities that management believes will provide modest revenue growth in 2017.

I'll now briefly touch on other key initiatives, most notably in value hearing health. Over the past 12 months several institutions, including the US Food and Drug Administration, the President's Council of Advisors on Science and Technology, and most recently the National Academy of Sciences, Engineering, and Medicine, have recognized that untreated hearing loss in the United States is a pressing national problem.

By device costs and inadequate innovation and distribution channels are creating significant barrier to access for most Americans. Each institution individually has released statements indicating their support for improving hearing health access and affordability for consumers, thereby improving market penetration.

As a company we are aligned with the FDA, PCAST and NASEM's efforts to overcome barriers to device access and spur development in innovation and cost effective technology. All of these pivotal events point to a groundswell for fundamental change.

They highlight the need for an outcome based hearing healthcare model in which the best value added devices and software technology are combined with vary levels of practitioner intervention to provide the most efficient lowest cost solution to consumers across the country.

One recent initiative to improve affordability in the US market was equipping independent audiologists with the best value added devices at the best price by establishing Ear Venture, a joint venture with the Academy of Doctors of Audiology or the ADA.

While Ear Venture is not yet generated significant revenue it is an important strategic element in Intricon's approach. Over 450 AD members have now registered to join the Ear Venture program.

Ear Venture if focused on sales and marketing efforts to invert those members into consistent customer, as well as solicit non-registered ADA members to join.

In the United Kingdom our integration plan for PC Worth is proceeding on schedule. We completed the relocation and other corporate alignment efforts during the quarter. Over the last several months we have delivered initial devices to targeted National Health Service clinics and received positive feedback.

We're directing sales and marketing efforts at additional clinics during the second half of the year. While the ADA and MHS leadership have embraced our offering, which is a groundbreaking first step, in order to drive meaningful growth in both of these markets we must focus our efforts on educating practitioners and marketing directly to them.

To support our strategy, commitment and targeted focus on value hearing health in Mid Bay we raised \$3.7 million in net proceeds through a public stock offering. This is an important step in advancing our future plans by providing additional financial flexibility to aggressively explore initiatives to expand our offerings into alternative distribution channels that require less practitioner intervention.

These models have demonstrated the ability to scale more quickly than efforts in the traditional channels. Another key aspect of the raise was to add targeted shareholders in an effort to bolster the depth of our shareholder base aligned with our value hearing health strategy. As we move forward, it is important that we have trusted partners.

Lastly, while second quarter results were short of our expectations, we view the lower revenue levels as temporary and we have already taken measured actions to reduce operating expenses. These reductions, which will not impact the company's ability to execute strategic initiatives

should result in approximately 600,000 in annual savings, the majority of which we'll start to see in the 2016 fourth quarter.

Now I'd like to turn the call back over to Scott.

Scott Longval: Thank you Mark. I'll begin reviewing our second quarter financial results in more detail.

For the 2016 second quarter the company reported net sales of \$17 million compared to \$17.1 million in the prior year period. Intricon posted a net loss attributed to Intricon shareholders of \$1,490,000.23 per diluted share.

First net income attributable to Intricon shareholders of 506,000 or 8 cents per diluted share for the 2015 second quarter. Gross profit margins were 22.8% compared to 26.8% in the prior year second quarter. The decrease was primarily due to less favorable sales mix and slightly increased overhead expense.

Operating expenses for the second quarter were \$5 million compared to \$3.9 million in the prior year second quarter. The increase was largely due to the inclusion of PC Werth which we acquired in November 2015 and higher research and development investments.

Specifically, in 2016 we're committed to enhancing our DSP wireless connectivity and self-fitting software technologies that will provide for increased access to inefficiencies the hearing health distribution channel in medical biotelemetry markets.

Turning to other financial metrics, since Mark previously mentioned in May we raised \$3.7 million in proceeds from a public stock offering and in April we amended our credit facilities with the private bank, improving our liquidity and financial flexibilities.

Our debt of \$9.6 million increased sequentially from 11 - decreased sequentially from \$11.5, primarily due to the pay down with the funds we received from the public offering partially offset by PCW alignment efforts, new distribution channel investments and inventory build for the launch of several key value hearing health and medical programs.

Our total cash cycle days at the end of the second quarter was 85. This is an increase from 65 days at the end of the comparable prior year period. In terms of guidance, based on the information currently available, we anticipate third quarter net sales to be consistent with the 2016 second quarter levels, with a notably smaller net loss

Additionally, we anticipate fourth quarter net sales at levels that will achieve profitability. Now I'd like to turn the call back over to the operator so we can take your questions.

Operator: And at this time if you would like to ask a question please press star and 1 on your touch-tone phone. You may remove yourself from the queue at any time by pressing the pound key. Once again, to ask a question, please press star and 1. We'll pause for a moment to allow questions to queue.

And we'll go ahead and take our first question from Scott Billeadeau with Walrus Partners. Your line is open.

Scott Billeadeau: Thanks for taking the call. Hi guys, could you give us a little sense of, you know, given the quarter and the Medtronic deal, you know, what kind of visibility do you have from them if any, you know, at this time for that, you know, for that part of the business?

Mark Gorder: Hi Scott, this is Mark. We stay in, obviously, constant touch with Medtronic. We just had our VP of marketing and sales was out there last week. They continue to remain optimistic that they will get the approval shortly.

They will not, obviously, say a date. But, the demeanor out there that we experienced in the behind the scenes kinds of activities that we're starting to see would indicate that they anticipate approval shortly.

Scott Billeadeau: Great. And then second thing on the, you know, developing, you know, the markets particularly with PC Werth and with Ear Ventures, maybe kind of walk through what we should see for OpEx related to that. I mean, is there something coming off that you can then incrementally spend or will you at some point, you know, have a higher level of spending to support that in the near term or is that longer term?

Mark Gorder: I think with starting maybe with PC Werth we made some substantial investments in repositioning the business moving it. There were some relocation costs, some other costs in terms of acquiring the business and putting it in a proper position.

And I think at this point we don't anticipate significant increases in operating expense for the operation over there. Some of the focus is going to be on marketing in sales and to some degree those costs are already in place. We may have to get one or two more sales people over there. But it's not, you know, looking at the big pictures that's not a huge increase in operating costs.

So, I think the - in general we expect it to stay pretty steady. And then the focus is on driving hearing aid sales into the clinics which basically means getting the sales force to call out all the potential clinics in the UK.

I can give you a little update on what we're doing there. It's quite an extensive structure they have in the UK for the National Health Service for hearing aid delivery. There are about 230, I guess you would say, major departments or larger operations and then each one of those can have multiple clinics.

So there's about 450 actually audiology clinics. Some of them are small, some of them are larger. We've visited approximately 50 of these sites and we've had hearing aid demos. Twenty-five of those have products on trial and we're doing a number of focus groups starting soon in early fall to try to push our brand and our name within the community there.

So we're making good progress. There's a lot log way to go. But, we've got the business stabilized, we've got the infrastructure in place and we're starting to drive marketing and sales efforts into the clinics.

Scott Billeadeau: Great. And just maybe one follow-up on that. You said you've had some, you know, devices over there, they're testing. You know, what is the procedure there? Do you - do they test and then is there kind of a one big okay you're good to go or is it clinic by clinic? Or maybe give us a little feel for, you know, when do you get the go ahead to actually sell.

Mark Gorder: It's actually a two level process. The first process you have to get devices approved by the National system. And that goes - you get on the contract and it goes on their Web site and on their product list and then you're okay to buy. If you're not on that list you can't purchase a device or you can't sell a device.

So we got two products on the list back last fall approximate and we have another one that we're trying to get on this fall through that. It's called the ASG Group, which does the testing for the National Health Service as a whole.

And then we have to get out, as I said, and call on all these 230 departments and 450 clinics one at a time to try to get people to try your product. So there's a two level approach. First you have to get on the framework and then you have to go out and do the pick and shovel work to get sales.

Scott Billeadeau: Okay, great. Well thanks. I'll get back in queue.

Male: Thank you Scott.

Operator: And once again to ask a question it is star and 1. We'll go ahead and take our next question from Dick Ryan with Dougherty. Your line is open.

Dick Ryan: Thank you. As a follow-up, Mark, how many sales people do you have in the UK now and I think you said you may need to add one more? And what the experience level of the sales group?

Mark Gorder: We've got four now and Delain Wright who's our VP of Business Development, he's the gentleman that spent eight years in the UK running a hearing aid company for Siemens over there and he's the one that's managing putting in the sales force. So he's - from time to time, you know, from time to time he's looking at what the appropriate requirements are and he's added some new people since he's taken over there.

We have four total, we may add one more. And then I think five he feels is sufficient to cover the country.

Dick Ryan: And do you have a sense of when you might start getting a flow of order, whether it's a trickle or something more meaningful from the NHS?

Mark Gorder: It's probably going to take most of this year to really make headway. We're planning some extensive focus groups in October, November timeframe. And we feel that those are critical to get acceptance.

We're hoping to get some good publicity out of those focus groups and move a couple of the products that we have in there. Particularly they're very interested in our small open in the ear device, we call it an APT, A-P-T is our acronym for it, over there they call it the Kite, K-I-T-E.

And that one has been quite well received and most of the initial acceptance has been with the Kite. However, we have another very good device that we plan on adding this fall. It's a - what I consider a very high level outcome base behind ear hearing aid that we think will have good acceptance over there as well. And we expect to have that on there some time in the early fourth quarter.

Dick Ryan: Okay. In your commentary you said that focus is on marketing and educational efforts. Is that mainly to Ear Venture the 450 that have registered? And is this kind of, you know, a go it alone scenario to educate this group? And what's the - what are your efforts there so far?

Mark Gorder: Well we're switching over to Ear Venture now. There's about 1200 ADA members and we've signed up about 450, maybe a little bit north of that. And what we found is that we have targeted - we found certain customers that have accepted our business model. But there are others that don't because they're and I would say wealthier districts and they haven't felt the pressure from the Costcos and the online or mail order type devices yet.

But we have gotten several, I would say - I'd call them early adapters, who have worked this into their business and we're starting to get repeat orders. We don't have enough and it's going slower than we thought.

So what we're doing is we're going to work with the ADA and try to get a more focus at the Ear Venture Board level with people who are using the product and can help us get that idea that there is a good business model that could be successful into the member base.

Then we're also opening it up to non-members. At one of the recent board meetings we got approval to expand into non-members. So that opens up a lot more potential mentions. But this is - again, it's a - you've got to get into each individual audiologist and help them understand how to use a value model in their practice.

(Crosstalk)

Dick Ryan: Okay and on the other value channel, United, what's happening on that front?

Mike Gorder: They continue to make year over year progress. They had good growth in both units and revenue. So we're very pleased with where that's at. There's no sign that that's going to slow down. They continue to make investments in their program and work with us to upgrade software and device technology. We don't see that slowing down or going away.

Dick Ryan: Okay. And on the R&D front you mentioned self-fitting software and some DSP improvements, can you kind of bring us up to speed on, you know, what you're working on, the kind of timing you may have for the self-fitting software? And what sort of opportunities that would present to open up other channels as well

Mike Gorder: What we've - we're doing in the area of new technology is mainly around our wireless and our self-fitting technology. So we have two wireless technologies, we call them PL2 and PL3. One is command and control of a hearing aid via a 2.4 gigahertz system and the other is full streaming as well as command control, we call that PL3.

And then in addition, that can be integrated into self-fitting technology so as the user is making adjustments to their hearing profile via, for example, an iPad or a smart device, it simultaneously live updates the settings in the hearing aid.

So we think this is going to be critical to improve productivity and the consumer experience. So there's two aspects to this. You get productivity improvements because you can fit people more efficiently and better. And in addition, the consumer has a better experience because they're more in control of how their device is reacting in their listening environment.

We're doing some initial probes in the German market through a partnership called ((inaudible)) where we're going to test out this technology in that market to see how it's received. And with those trials we'll ultimately link the wireless hearing aids and the self-fitting software together and see how that develops the consumer experience.

So that's probably a 2017 effort by time we get all that done. We'll have some preliminary results on how the self-fitting technology works by the end of this year but the integration into the wireless will be a mid to late 2017 type activity.

And the interesting thing is that this - when this is done it really supports all the channels. It supports Ear Venture. It supports the United HealthCare. It supported the National Health Service. It'll support our efforts as we see going into the direct to consumer channel where things will have to be much more efficiently done than they are today to make that work.

So it's that aspect of putting the best technology at the best price into these channels. And I think we're very close to being able to do that in all of those efforts.

Dick Ryan: Okay. Thanks. And then on your guidance for Q3 it looks like you would not be factoring in Medtronics approval for Q3 or would you think that that's maybe a late Q3, Q4 timing event?

Scott Longval: Well, clearly we're not in control of that Dick. Medtronic's not in control of that right now, it's at the hands of the FDA. Obviously we've taken an approach where we want to be

conservative in what we put out there. And, you know, with that we put out flat quarter over quarter.

Dick Ryan: Okay. Thank you.

Scott Longval: Thanks.

Operator: And we'll go ahead and take our next question from Larry Haimovitch with HMTc. Your line's open.

Larry Haimovitch: Good afternoon Mark and Scott.

Scott Longval: Larry, how are you?

Larry Haimovitch: Great. How are you today?

Scott Longval: Very good.

Larry Haimovitch: So, my question is or my comment first of all is thanks for a lot of the very good color on what you're doing to get the hearing aid business really rocking and rolling. We talked about this a couple times and that is have you been able to figure out some metrics that we could all use to track the progress of the business?

I know you're interested in doing that. I guess it's just a matter of figuring out what would be useful metrics for us.

Scott Longval: Yes, Larry, this is Scott. That's a great question and we've talked about this in the past. We know and we understand we have to get to a point where we put some telling metrics out

there, some leading indicators on how we're performing. We're not in a position to do that but we do see that in the foreseeable future, something that we can have out there and have commentary and report on each and every quarter.

So, if you just bear with a little bit longer when we're figuring out what exactly those metrics are rest assured that we will have those out, again, in the foreseeable future.

Larry Haimovitch: Scott, is the challenge of doing that related in any way to being cautious with giving out competitor information or is it just a matter of figuring out what would be helpful for you guys as goals and therefore what would be metrics for us to look at as you progress?

Scott Longval: Depending on the market, really. I think there's a competitive nature to that. There's also a customer sensitivity component to that. So it's trying to tightrope both of those competing factors. And when we get to a point where we're comfortable with putting something out we will.

And, again, like is said, we understand that's very important to the investors so that they can continue to benchmark our progress and we will get that out there.

Larry Haimovitch: You, because you know, especially in the UK, we're very excited about what the possibilities are. You've got a nice finite number of calling points and a very large market and a very motivated buyer. So, it would be helpful to be able to know how that's progressing.

Scott Longval: True. Understood.

Larry Haimovitch: Great. Okay, thanks guys.

Scott Longval: Thank you.

Mark Gorder: Good comments Larry.

Larry Haimovitch: Thank you Mark.

Operator: And we'll go ahead and take our final question from Scott Billeadeau with Walrus Partners.

Your line is open.

Scott Billeadeau: All right guys, I think most of my follow-ups were answered. I guess the one thing, you know, kind of beating on the hearing health a little more is, you know, as you get into the Ear Venture, I mean, what - how much is in your control versus not at this point? I mean, it's not a matter of hiring five guys and have them go beat the doors.

I mean, is that a process that could work or does this need to kind of naturally mature, so to speak?

Mark Gorder: I think it's more to the latter, Scott, and here's the - when we conceived Ear Venture the idea was absolutely not to compete against the big six manufacturers. So went in with a value business mode where they have to model - it's an ecommerce model.

It's limited hand holding and with the idea that we're providing a very high quality outcome based device that allows them to compete in a market that's changing and where consumer preference is going to start driving the price down and they're going to have to be - they're going to have to unbundle the device from the professional services.

The leadership at the ADA believes strongly in this. And we have certain opinion leaders that are using the product and are integrating it into their business model. The problem is it's not enough yet. And - but strategically we feel we got to be in a position to take advantage of that change. And we're well positioned.

You're right, we can't control the whole thing but we have provided them a viable alternative to unbundle. And if you look at what's going on it the - with the FDA, with the PCAST and with the, it's the Institute of Medicine but that other acronym we had for it, they are all supporting move in this direction.

We think this is going to accelerate. Right now it's moving slowly, we're making slow, steady progress. We don't anticipate that there's going to be material revenue from this in the short term. But we feel very strongly we need to be positioned in these channels in order for us to be a force as the market emerges.

So we're very committed to doing this.

Scott Billeadeau: But to a certain extent it's almost, you know, given their - are most of these guys used to having a lot more hand holding from, you know, as opposed to hey going on the web buying a couple of, you know, buy in products. So, it's a little bit more you got to let their business model change but be there when it does. Is that kind of - is that - am I hearing that right?

Mark Gorder: You are hearing that right and what we're finding is that it's the younger more tech savvy audiologists that are embracing this model. There's a couple of really high profile ones that are driving this. And we don't anticipate that we'll ever get the - when we went into this initially we kind of divided the ADA into a 1/3, 1/3 and 1/3. And 1/3 we figure they're baby boomer age, their business models are very successful, they're not going to need to change.

Where we're targeting is the younger generation that are in areas that are more at risk. They see the need to unbundle and they're able to embrace this concept. And some of them are already successfully using it and have made repeat orders. Problem is it's not enough yet. We've got the early adapters but we've got to keep at it and build on that start.

Scott Billeadeau: All right, guys. Thanks much.

Scott Longval: Thank you very much.

Mark Gorder: Thanks Scott.

Operator: And we have no further questions at this time. I'd like to turn the program back over to Mark Gorder, Chief Executive...

Mark Gorder: Once again we appreciate your taking your time out of your day to join the call. We appreciate all the good questions and comments. In closing, I'd like to reiterate that I'm excited with the direction we are headed. I believe our value proposition is a compelling one.

Our position with Medtronic has never been stronger. Our technology pipeline, including advancements of wireless connectivity and self-fitting hearing aid software is robust and the need for disruptive hearing health channels is high.

We are committed to accelerating targeted investments that best position the company for long term success in the value hearing health and medical biotelemetry markets. We look forward to updating you on our progress next quarter and thank you again for participating in the call.

Operator: And this concludes today's program. Thank you for your participation. You may not disconnect.

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