Company: PadillaCRT

Conference Title: IntriCon 4rth Quarter 2018 Results

Conference ID: 7881455

Moderator: Matt Sullivan

Date: February 19, 2019

Operator: Good day, and welcome to the IntriCon Fourth Quarter 2018 Results Conference Call. Today's call is being recorded. At this time, I would like to turn the conference over to Scott Longval, Chief Financial Officer. Please go ahead, sir.

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 expectation contained in today's call. Important factors that could cause such differences include, among others, those set forth under the headings Risk Factors and Management's Discussion and Analysis of Financial Condition Results in our 10-K filing for the year ended December 31, 2017.

With that, I'd like to introduce Mark for a strategic look at IntriCon's 2018 year.

Mark Gorder: Thank you, Scott, and thank you everyone for joining us today. To start, I would like to welcome our shareholders to the call. I’m pleased with the meaningful progress we made in 2018 towards advancing our key growth initiatives, bolstering our medical leadership team and expanding our technology. I'm confident that we are entering 2019 in our strongest position to date.

We have the capital to pursue strategic initiatives and a well-developed infrastructure to support our efforts in medical and value hearing health. I believe that we are well positioned in the early stages of long-term sustained growth within our core markets.

The diabetes market is experiencing tremendous growth, with continuous glucose monitoring, a critical component to serving the needs of many diabetics. And as the value based hearing healthcare space emerges, we are at the forefront of providing affordable and accessible solutions to unserved or underserved hearing-impaired Americans.

I'd like to take the next few minutes to discuss the recent highlights in our core businesses. And then we'll turn the call over to Scott to review our financial performance in more detail, and to provide the annual guidance for 2019. We'll then open the call for your questions.

Starting with our financial results. In a press release issued at market close today, we announced another strong quarter, with record revenue of 30.8 million, up 41.1% from 21.8 million in the prior year period. The increase was primarily due to year-over-year revenue gains from our largest medical customer and growth in our value-based indirect-to-end-consumer hearing healthcare business.

More specifically, looking at our two core business segments, revenue on our medical business increased 64.8% in the 2018 fourth quarter over the same quarter in the prior year. The gain was primarily driven by the ongoing production of Medtronic's MiniMed wireless continuous glucose monitoring systems. We remain very well positioned with Medtronic as we enter 2019, providing key system components including the CGM systems, sensor assemblies and related accessories.

During the year, we expanded our infrastructure to support anticipated growth from current medical customers and future growth from increased business development. Expansion efforts in 2018 included a newly leased 37,000 square foot medical manufacturing and clean room facility in Minnesota, an additional 10,000 square foot medical assembly space in Singapore, 13 new molding presses, and a high-speed printed circuit board assembly line.

In addition to these investments, our current customers invested several million dollars in tooling and automation within our facilities. While we have begun limited production on certain products, we are still working with current medical customers to complete required validation and qualification of several key production lines.

To drive our business development initiatives, we are pleased to welcome Doug Pletcher to our leadership team, as Vice President of Medical Business Development. Doug has more than 25 years of executive management and business development experience in the medical device industry. In this new role, he is responsible for sales and marketing of new product platforms into the medical biotelemetry market.

Turning to our second core business segment. Hearing health revenue increased 10.3% over the prior year fourth quarter. As we've done throughout 2018, I'd like to drill down some additional detail in each of the three revenue streams that contribute to this business.

First, revenue from our value-based indirect end consumer segment, which comes from customers who sell to the end user through non-traditional models led our growth in hearing health during the quarter, with a year-over-year revenue improvement of nearly 80%. Growth stemmed from our key established partners, most notable our largest insurance customer. Within this revenue stream, we are focused on partnering with other formidable companies that can further accelerate growth of this vast unpenetrated space.

Second, revenue from our value based direct-to-end consumer business or Hearing Help Express, which sells products directly to the end consumer, was 1.5 million in the fourth quarter of 2018. Over the course of the year, we have tested various marketing and advertising campaigns to various levels of success.

We are now in the process of integrating our ethnographic research into our marketing and advertising strategy. In addition, we've begun to expand our direct sales effort to further accelerate revenue growth. We believe these efforts will drive revenue growth throughout 2019.

Legacy OEM revenue, which is product being sold into the traditional hearing health model, was 3.6 million in the fourth quarter of 2018, reflecting the anticipated continued decline. On the technology front, we continue to build our value hearing health technology portfolio, with wireless and self-fitting technologies.

Last month, we closed on the acquisition of Sentibo Smart Brain self-fitting software source code from Soundperience, better positioning our business to capitalize on the pending OTC hearing aid regulation. Sentibo's Smart Brain self-fitting software is designed to improve both channel productivity and the quality of first time fittings, resulting in lower prices, greater access and increased customer satisfaction.

Shifting to public policy. Progress is being made on the Hearing Aid Act of 2017. The Hearing Aid Act, which establishes - which enables adults with mild to moderate hearing loss to access OTC hearing aids without being seen by a hearing aid professional, is designed to increase access and reduce the cost of hearing healthcare in the US market.

Based on comments from various interested parties, including an October 2018 release from Senators Grassley and Warren, we anticipate draft guidance in the second half of 2019, with final regulations to be effective in the first half of 2020. We are scheduled to meet with the FDA and the FTC next month to discuss market dynamics, technology advancements and regulatory status.

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

Scott Longval: Thank you, Mark. I'll begin by reviewing our financial results in more detail. For the 2018 fourth quarter, we reported net revenue of 30.8 million, up 41% from the 21.8 million in the prior year period. The increase was primarily due to year-over-year revenue gains from our largest medical customer, and growth in our value-based indirect end consumer hearing health business.

Fourth quarter gross margins were 30%, consistent with the 30% in the prior year fourth quarter. Gross margins were constrained by excess capacity related to additional infrastructure investments. Operating expenses for the fourth quarter were 8.2 million, compared to 6.1 million in the prior year period. The increase stemmed from increased advertising investments at Hearing Help Express, and support costs related to key initiatives to drive overall business growth.

IntriCon posted net income attributable to shareholders of 868,000 or $0.09 per diluted share, versus 396,000 or $0.05 per diluted share for the 2017 fourth quarter. For the full year ended December 31, 2018, IntriCon reported revenue of 116.5 million, up 28.5% from the 90.6 million in 2017. Gross margins were 31.9%, up from 29.5% in 2017. The increase in margin was primarily due to increased volume throughout 2018.

Operating expenses were 30 million, compared to 24.2 in the prior year period. The increase stemmed again from increased advertising investments at Hearing Help Express, and support costs related to key initiatives to drive overall business growth. Net income attributable to shareholders was 5.5 million or $0.64 per diluted share, versus 2.1 million or $0.20 per diluted share in 2017.

Looking forward to 2019, we have four key priorities for the year. One, continue to meet the volume demands at Medtronic. Two, execute on business development activities led by Doug Pletcher, our new VP of Medical Business Development to leverage our core competencies and diversify our medical revenue base. Third, expand our direct sales effort at HHE, as we refine our marketing and advertising efforts. And lastly, work with formidable value-based hearing health market entrants to be their supplier OTC hearing aids and related technology.

In terms of guidance, IntriCon anticipates 2019 revenue to range between 128 million and 133 million. Gross margins for the full year 2019 are expected to be approximately 30% to 31.5%. In general, the company anticipates linear growth and margin improvement throughout 2019. However, this could be impacted by commercial product launch timing from our large customers.

In 2019, we anticipate gross margin to be relatively consistent despite headwinds, including excess capacity from our recent manufacturing expansion, impact of a pending long-term customer contract, an additional million dollars of depreciation, and mix shifts between product lines.

Longer-term, however, we believe we are well positioned for continuous growth from our core businesses. In addition to our revenue growth opportunities, we anticipate over time we'll be able to leverage our current manufacturing infrastructure and expand gross margins to the high 30% range.

Now, I'd like to turn the call back over to the Operator so we can take your questions.

Operator: Thank you. At this time, we will open the floor for questions. If you would like to ask a question, please signal by pressing Star 1 on your telephone keypad. If you're using a speakerphone, please make sure that your mute function is turned off to allow your signal to reach our equipment. And again, press Star 1 to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions. And our first question comes from Jon Block with Stifel.

Jon Block: Great. Thanks, guys. Good afternoon. Can you hear me okay? I'm actually just on the road.

Scott Longval: Yes. We can hear you loud and clear.

Mark Gorder: Pretty good. Hi, John.

Jon Block: Okay, great. Hey Mark, how are you? So I'm going to ask maybe a small handful. I guess just to kick things off, early this morning Medtronic talked about its NextGen-780, as well as long-term plans around the personalized closed loop or I guess what they're calling PCL. Guys, can you just talk if you're designed into both of these next-gen products and what Medtronic-780 rollout, which I believe is expected to occur over the next several quarters, means for you?

Scott Longval: Yes. A great question, Jon. It was exciting to listen to Medtronic talk about their business and kind of the robust growth they're anticipating coming from the diabetes group. And more importantly, the CGM piece of that business. They did mention that they will be releasing the 780G in their fiscal 2020. And that is a platform that we are currently designed in.

They talked a little bit more about some of the next-generation products. And I can't get into the specifics because they haven't made those public. But what I can tell you is, we are firmly in their pipeline as it relates to CGM, and we feel very strong about our position growing with them over the next several years.

Jon Block: Okay, great. That was really helpful. And then maybe let me shift more. For 2019 guidance, Scott, and the model, I just want to make sure I'm on the same page. When I look at your revenue guidance, the midpoint of around 130 million, it implies about 11 to 12 percent year-over-year growth.

When you say linear in the release and your comments, do you mean 11% to 12% roughly for each of the quarters year-over-year? I'm just thinking back to a really tough 2Q comp that you'll come up on in the second quarter. So maybe if you can just expand a little bit to make sure we're all on the same page there, and then I've got one more.

Scott Longval: Yes, it's a great question. As we think about growth, we're looking at sequential growth throughout 2019. So quarter-over-quarter, unless looking back into 2018. As you know, there were some kind of a bolus there in the second quarter of 2018, which you mentioned. And I think if you listened to the Medtronic call this morning, you can kind of connect the dots there. But as we look at again our guidance for 2019, we're looking at sequential growth from a revenue perspective and sequential improvement on gross margin quarter-over-quarter.

Jon Block: Okay. And the last one. You guys really got to my long-term gross margin question in the commentary, still saying high-30s longer-term. So I'll skip that one. Mark, I'll jump over to you. The DTC hearing of about 1.5 million in the quarter, that was flattish sequentially. I thought you guys did cite strengthening orders on the third quarter conference call in October into November.

I know there's a lag there of about 60 days, but I still would have expected that number to be up slightly Q-over-Q. So, can you talk about how the orders trended maybe in November, December and January, and just how you feel about picking that business up into 2019? Thanks, guys.

Mark Gorder: Good question, Jon. Yes, there's actually three legs on the stool to the DTC business. We have a mail-order portion of that that goes to our existing database. We've got an advertising and print media campaign that tries to drive new people into the database, and we're just starting to experiment with outbound telesales to drive even more new customers into the database.

What we found, I think as we mentioned in the middle of last year is where we were experimenting with some of these models, we - some things were going well, others were not going so well. We learned a few things about how we were handling bad debts in the middle of last year. That had a lingering effect probably well into the second half of 2018.

We think we've got the bad debt portion under control, but we are still experimenting with the right mix of mail-order advertising and print and outbound telesales. So what you're going to see us do in the first half of 2018, is try to drive more revenue in through outbound telesales. That's an experiment that we're going to be heavily involved with in the first half of the year.

The hearing aid numbers were starting to come up at the end of last year, but you won't see those until late in Q1. So we're still anticipating there would be some drag from the problems we were having at the end of last year into the first quarter of this year. I don't know, Scott, if you have anything to add to that.

Scott Longval: No, those are good comments.

Mark Gorder: Okay, but we anticipate - but Jon, we anticipate that if we can - as we experiment here, we are hoping that we'll come on a lever that we can step on that provides more predictable revenue growth, but we're not quite there yet. We're hoping that there are some outbound costs that will have some impact.

Jon Block: Okay, great. Thanks for the color, guys. I'll follow-up offline.

Operator: Thank you. Our next question comes from Andrew D'Silva with B. Riley FBR.

Andrew D'Silva: Hey, good afternoon. Thanks for taking my questions. A couple of quick bookkeeping ones. First, Scott, if you could just please let me know cash flow from operations, CAPEX, stock-based compensation, what they were for the quarter? And then maybe as it relates to guidance, you know, where does this fall in type of guidance you've issued previously? Is it more like the guidance issued in the first half of 2018 or the second half of 2018? It seems like the methodology changed at some point.

Scott Longval: Yes, let me - I'll start with some of the housekeeping items, Andy. So depreciation for the quarter was 800,000. Stock-based comp was 370,000. CAPEX was -- excuse me -- 3 million for the quarter. If we think about the guidance, one of the things that we've talked about on prior calls and we've talked about internally is, we're not really managing this business quarter-to-quarter.

As we're looking to enter into the value-based hearing health business, this is an opportunity that we see emerging over the next several years. And as we get into this and work on the - both on our direct-to-end consumer and indirect-to-end consumer, we're anticipating seeing lumpiness over time, or excuse me, from any 90 day period.

Over time, we fully expect to see topline growth and expansion on EBITDA and leveraging those models. So we thought it was more appropriate to begin to give guidance on an annual basis and update the group accordingly. Something else changed this year that we hadn't done in the past is begin to give us some color around gross margin. We think that is extremely important. As we've laid out in 2019, it's going to be relatively consistent with where we were in 2018.

And this is primarily because of the infrastructure we're putting in place to meet the demands that we see coming, not only in 2019, but also well into 2020 and 2021. So we thought it was important for investors to understand we're making these investments today to position ourselves to be a much longer - a much larger company. And as we think about gross margins longer term, we still believe those targets in the upper-30s hold true.

Andrew D'Silva: Okay. All right. That's fair enough. Maybe you can help me crosswalk the Q3 gross margins, which were about 160 basis points higher than the Q4. Most of the other segments seem to be pretty close from a topline standpoint. I'm just trying to figure out where the majority of the margin compression happened during the fourth quarter.

Scott Longval: Yes, we did a couple of things, Andy. We started - well, the first - Mark talked about our manufacturing facilities and how we expanded our footprint. We talked earlier about the 37,000 square foot expansion in the US, but we also expanded in the latter half of 2018 our Singapore facility, as we're beginning to prepare for growth over there within our medical business. So we endured some additional costs with getting that up and running and staffing accordingly.

We also saw some higher depreciation in the third quarter, or excuse me, in the fourth quarter that had some pressure on the margin. And then lastly, a little bit of a mix issue in the fourth quarter where we had a more favorable mix, even within our main customers that drove a slightly lower gross margin for the fourth quarter.

Andrew D'Silva: Okay. I see what's going on. That makes sense. And then in your prepared remarks, you also mentioned the pending long-term contract. I'm assuming that's included in the guidance. Is that with an existing partner or a new partner? And maybe just timing of when that should kick in or any color on that would be useful.

Scott Longval: Yes, great question. We did note that the pending long-term customer contract is included into our guidance in 2019, and we anticipate that to begin to impact the numbers here towards the end of the first quarter, and that is within a large existing medical customer.

Andrew D'Silva: Okay, perfect. And just one last one for me. Previously, you guys talked about a 3:1 return on sales and marketing tied to Hearing Help Express. Maybe just touching on the DTC model, has that number been recalibrated at all from the 3:1 return or is that still what we should expect in the long run?

Mark Gorder: I think in the long run, that's a good number. In the short run, it's been a little bit lower than that, but we still expect that as we expand expenditure in 2019, that we should be seeing that number. But I would comment too that we're expecting that our investment in outbound telesales is probably going to be one of the primary drivers for 2019.

Andrew D'Silva: Okay. All right, perfect. Thank you very much and good luck going forward.

Mark Gorder: Thank you, Andy.

Operator: Thank you. And again, ladies and gentlemen, if you would like to ask a question, please signal by pressing Star 1. Our next question comes from Dick Ryan with Dougherty.

Dick Ryan: Thank you. So, Mark, you mentioned increasing efforts in telesales. Obviously you've staffed up. What have you added from an employee count in your direct sales or your in-house telephone sales efforts?

Mark Gorder: Well, we've - when we took over the business, I think we had about 35 employees. We now have about 80 employees, and about 20 of those are dedicated to outbound telesales. We expect to increase that to 40 hopefully by the end of Q1. And our model that we're testing going forward, would have an outbound telesales cell of about 40 people.

Dick Ryan: Okay, thank you. Say, you're obviously monitoring the - what some of the other people are doing, since you're selling components into the direct - indirect channel and getting some good results there. What's your read? What are some of the people doing well or not well? And is that helping you sculpt your strategy once we get through the FDA process?

Mark Gorder: Great question, Dick. Yes, absolutely. The relationships that we have with the other players are helping guide us into how we should approach our DTC efforts. We see how they are faring with their advertising campaigns, how well they are doing with their outbound telesales, what kind of issues they're having with bad debt. All of these things, we're getting good, I would call G2, into the marketplace.

In addition, we're finding now that there's opportunities with some other rather large players coming into the market. As you recall, Bose got FDA approval for a version of a self-fitting hearing aid, which we think is very positive. We think - we have a relationship with Bose on the professional audio side. We provide microphones, microphone assemblies that go into Bose products in their NFL headset line and into the military.

But we think that they could potentially be a very good partner as they gauge how they're going to enter this emerging space. So having a foot in both camps, DTC with our Hearing Help Express operation, and a foot in the camp of these other people that are trying to disrupt the market, gives us great insight and helps us gauge how we're going to develop our technology platforms to support growth in the market as a whole.

Dick Ryan: Okay. And then you mentioned one of your priorities for 2019 is the - you know, kind of getting in with other entrants besides Bose, who may or may not have an interest. What - how else is the landscape looking from new entrants? What are you seeing there and from what industry dynamics are they interested in?

Mark Gorder: Well, what we're seeing on a - in the global market is quite interesting. We've had some incoming inquiries from Europe due to the fact that the large oligopoly is consolidating over there, as well as in the US. And a lot of these direct to consumer players today, they're going mainly through the professionals. But a lot of these groups that are dealing with professionals, we've got one interested party.

You've got Specsavers in the UK where they serve the drug store market. And they're starting to look at how do they potentially partner with somebody to gain a direct-to-consumer type offering. We've got some other inquiries too in Central Europe and Austria and in Switzerland. So we see that there is opportunity, not just in the US market for ITEC, but also globally. And we're very well positioned with our technology platforms.

Scott Longval: Yes, the only thing I would …

Dick Ryan: Oh, sorry about that.

Scott Longval: Oh no. The only thing I would add in the US market, there are a lot of people that obviously are looking at this space here. I think as the OTC legislation gets closer, we're going to have more and more that are sniffing around the market. I think to Mark's last point, I think is an extremely important point is, we are - we feel the best out there to serve these new entrants that don't have the breadth of technology, that don't have the manufacturing capabilities, and don't have the understanding of building high quality, low cost hearing aids.

So we think that puts us in a pretty unique position. And as this legislation gets closer, we know there's going to be more and more inquiries for people that aren't even on our radar today.

Dick Ryan: Okay, great. That's it for me. Thanks.

Mark Gorder: Thanks, Dick.

Scott Longval: Thanks, Dick.

Operator: Thank you. And we have no further questions in the queue at this time. I would now like to turn the conference back over to Mark Gorder, Chief Executive Officer for closing remarks.

Mark Gorder: Thank you, Operator. Once again, we appreciate you taking time out of your day to join the call. In closing, I'd like to reiterate that I'm excited with the direction we're headed. We continue to deliver solid performance, driven by our key medical and value-based hearing health businesses.

Furthermore, we continue to advance our direct-to-end consumer hearing health channel, enabling us to execute on our mission to provide affordable and accessible solutions to millions of unserved or underserved Americans. We look forward to updating you in the future. Thanks for joining our call.

Operator: Ladies and gentlemen, this concludes today's teleconference. You may now disconnect.