Company: IntriCon

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Operator: Good day everyone and welcome to the IntriCon Third Quarter 2018 Results conference Call. Today's call is being recorded. At this time, I would like to turn the call over to Mr. 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 statements. 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, among others, those set forth under the headings Risk Factors and Management's Discussion Analysis of Financial Condition and Results of Operations and 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 third quarter.

Mark Gorder: Thank you, Scott and thank you everyone for joining us today. To start, as this is first conference call since our equity offering, I would like to welcome our new shareholders. We are very excited about how the company is positioned and our opportunities ahead.

We believe we're in the early stages of long-term sustained growth within our core markets. While the diabetes market has experienced tremendous growth it remains vastly under penetrated on a global basis. Specifically continuous glucose monitoring is expanding and has become a critical component to serving the needs of many diabetics.

The value hearing healthcare space, which we believe could be a $3 billion market, is just beginning to emerge and we were at the forefront of executing on our vision to provide affordable and accessible solutions to un-served or underserved hearing impaired Americans.

In addition, we believe the forthcoming regulatory changes will provide further tailwinds. By this time most of you had a chance to review our third quarter press release. We're excited to announce the number of strong quarter as we continue to execute on our key growth initiatives.

The company reported net sales of $30.1 million, up 20.2% of $25.1 million in the prior year period. The increase was primarily due to year-over-year's revenue gains from IntriCon's largest medical customer and growth in the indirect to end consumer hearing business.

Looking at our two primary businesses, our medical business increased 25.1% in the 2018 third quarter from the prior year period. The gain was primarily driven by the ongoing production of Medtronic's MiniMed wireless continuous glucose monitoring systems.

The company remains very well positioned with Medtronic for 2018 and beyond, providing key system components, including CGM systems, sensor assembly, and related accessories. We anticipate system demand will continue to increase throughout the remainder of 2018 and into 2019.

To support the medical volume increases, we expanded our operations footprint earlier this year, leasing a 37,000 square foot manufacturing and clean room space located near our headquarters in

Arden Hills. During the quarter we continued the required validation and qualification of robotic assembly systems and began limited production at our new facility.

In conjunction with the volume increases, over the last several quarters, key medical customers have invested or made commitments to invest several million dollars in capital equipment. Furthermore, we also are increasing our molding capacity. Adding two more presses during the quarter bringing the year-to-date total to 13 presses.

Turning to hearing health, beginning this year to provide greater transparency within our hearing health business, we started providing more detail of the quarterly revenue. Specifically, we have broken out our three distinct revenue streams -- value-based direct-to-end consumer, value-based indirect-to end consumer and legacy OEM.

As a reminder, the value-based direct consumer is our Hearing Help Express business that solves products directly to the end consumer. In contrast, the value based indirect-to-end consumer revenue is from our customers who sell through the end consumer through the non-traditional models.

Lastly, legacy OEM revenue is product being sold into the traditional Hearing Help model. We believe this breakout will provide greater visibility to the progress we're making and our stated goal to drive growth in the value hearing health space.

Hearing health sales increased by 10% over the prior year third quarter, led by the companies value-based indirect-to-end consumer business which posted strong sales growth of 62.5%. Turning to the value-based direct-to-the-end consumer business, HHE, IntriCon continues to further its mission of delivering high quality hearing healthcare into the underserved market.

While HHE only posted revenue of $1.5 million for the quarter, we believe this is a temporary pause, as hearing aid order strengthened over the last several months putting the fourth quarter on pace to be a record quarter for HHE hearing aid orders.

Looking forward, we continue to test different advertising campaigns in targeted market segments. This will continue to be refined as we incorporate data from our ethnographic research. At the appropriate time, we intend to increase our marketing and advertising investments to further accelerate revenue growth.

Within our value-based indirect-to-end consumer business we're focused on partnering with other companies that can further accelerate growth of this vast un-penetrated space. On the technology front, we continue to build our value hearing health technology portfolio with wireless and self-fitting technologies.

During the third quarter we met with the FDA to introduce our Sentibo Smart Brain self-fitting software and show how it can help advance a high quality, low cost hearing healthcare ecosystem.

Sentibo 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.

Based on the positive feedback, we'll pursue 510K approval for a wireless over-the-counter or OTC self-fitting hearing aid, which could be marketed after the FDA finalizes regulations for our new category of OTC hearing aids as required by the FDA Reauthorization Act of 2017.

Shifting to public policy progress is being made on the Hearing Aid Act of 2017. In October, Bose Corporation received for an OTC self-fitting hearing aid under the new OTC product code despite to our knowledge not having a marketable product or the FDA finalizing the specifications of such product code.

In our opinion, this exemplifies the FDA's desire to enable the emergence of high quality and low cost hearing healthcare in the US market by fostering innovation and spurring competition. Furthermore, based on recent joint communication from Senators Grassley and Warren, the timing of such FDA OTC hearing aid regulation could come in late 2019 well before the August 2020 deadline.

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

Scott Longval: Thank you Mark. I'll begin by reviewing our third quarter financial results in more details. For the 2018 third quarter the company reported net sales of $30.1 million, up 20.2% from the $25.1 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 the value-based hearing help indirect-to-end consumer business.

We posted net income attributable to shareholders of $1.9 million or 22 cents per diluted share versus $1.3 million or 17 cents per share for the 2017 third quarter. Third quarter gross profit margins were 31.6% up from 30.8% in the prior year's third quarter.

The increase primarily stemmed from greater sales volume offset slightly by a less favorable sales mix in ramp up cost associated to our new manufacturing facility. Operating expenses for the second quarter were $7.5 million compared to $6.1 million in the prior year period.

The increase stemmed from increased advertising investments at HHE, support cost related to key investments to drive the business growth and certain cost associated with the public offering.

For the nine-month period ended September 30, 2018, IntriCon reported sales of $85.7 million, up 24.5% from the $68.8 million in 2017. We delivered net income attributable to shareholders of $4.7 million or 56 cents per diluted share versus $1.7 million or 23 cents per diluted share in 2017.

During the quarter we completed a public offering of 1,725,000 shares of our common stock. All shares in the offering were sold by IntriCon at a price to the public at $55 per share. Net proceeds from the offering after deducting underwriting fees, discount commissions and estimated offering expenses and stock repurchases from the board and management totaled more than $63 million. We used a portion of these proceeds to pay off bank debt and invested the remainder in short-term investment securities.

As we noted in the past, our rationale in raising capital will be multi-faceted. This transaction accomplished that. Allowing us to de-lever our balance sheet, reconstituting our shareholder base and providing capital to accelerate growth and be more opportunistic in pursuit of technology and strategic partnerships.

Lastly, in terms of guidance, given our competitive advantages, numerous opportunities for growth and strong financial position, we are extremely well positioned for continued success. Based on the information currently available, we anticipate 2018 fourth quarter net sales to range between $30 million and $31 million.

Accordingly, we're tightening our 2018 annual sales guidance to range between $115.7 million to $116.7 million. Now I'd like to turn the call back over to the operator so we can take any questions.

Operator: Thank you. If you would like to ask a question please press star 1 on your telephone keypad. If you are using a speakerphone it may be necessary to lift your handsets before making your selection. Again, it’s star 1 if you would like to ask a question.

We'll take our first question from Andrew D'Silva with B. Riley FBR.

Andrew D'Silva: Hi, good afternoon. Thanks for taking my questions. Just a couple quick ones here. Could you just maybe elaborate a little bit on how you intend on using the recent proceeds from the raise to help drive growth within direct-to-consumer hearing health channel?

Mark Gorder: Yes, thanks Andy for the question. As we talked about, we went through the offering the idea was to bring in capital whilst to accelerate growth. And we see that doing that in a couple of different fashions.

Obviously, we're furthering our technology portfolio, investing heavily in self-fitting technologies, methodologies associated to the self-fitting how we would deploy that in the DTC market. We also see opportunities to accelerate our marketing within our direct-to-consumer space with HHE.

So as we look into certain measurables that we're looking at very closely down, there’s indications that we're making traction, we are going to deploy more capital in terms of advertising.

And lastly, in our indirect-to-end consumer, you know, we're looking at ways of partnering with other large players in this space that we believe could help accelerate the penetration into this vastly underserved market. So, some of those partnerships would most likely require some co-investment.

So that's about, you know, a couple of the areas that we would look to deploy that capital.

Andrew D'Silva: Okay. And that makes a lot of sense. And then there's been a lot of noise in the market lately related to connected insulin pens and how they might move some market share away from insulin pumps. Is there -- have you had or heard anything about that from Medtronic or how do you view the change in the market right now?

Mark Gorder: Yes, I won't speak for Medtronic, I'll just speak for myself. We view that target population for instant pumps and connected pins are different. Patients that use insulin pumps are looking to personally manage their diabetics. I think when you look at products like continuous glucose monitors that's allowing technology to be more heavily used in managing in individuals blood sugar levels.

So, we think they're not really competing products in the marketplace.

Andrew D'Silva: Okay. Got it. And as far as gross margins grow, obviously, ramping up the new facilities. I'm sure it was part of the sequential dip from the second quarter. Should we expect that to rebound somewhat going into the back half of the year?

Mark Gorder: Yes. We really had two things going on there, Andy, and we talked about this previous the drag on gross margins getting the new facility up and running. We see some of that drag carried over into the fourth quarter and potentially maybe a little bit into the first.

But the other notable factor on the margin drag was the lower direct-to-consumer revenue from the sequential quarter. So that had a little pull down. Obviously we expect that to rebound in the fourth quarter and going forward.

So, from a sequential standpoint, we're anticipating seeing strengthening margins.

Andrew D'Silva: Okay. And just last question, it's just related to general news. One of Medtronic's other value added suppliers announced that there were some unfavorable inventory changes that were impacting them this year. Has there been any changes in any of your contracts with any of your clients that's material or is it kind of steady state as we think about modeling going forward?

Mark Gorder: Yes, and I won't talk about anyone customer but I would say overall there hasn't been any changes the way that we've conducted business with any of our large customers in terms of their requirements on working capital.

Andrew D'Silva: Perfect. Great. Thank you so much and good luck going forward this year.

Male: Thank you.

Male: Thanks Andy.

Operator: And as a reminder, it's star 1 if you would like to ask a question. We'll go next to Jon Block with Stifel.

Jon Block: Great. Thanks guys and good afternoon. Maybe a small handful for me and it sort of builds on that last question. So, in regards to the inventory with Medtronic, maybe if you can just comment on a high level where that stands with you guys.

There was noise intra quarter. Maybe where I'm trying to go with this question is roughly how many weeks on hand has Medtronic have at the sensors and is that optimal or is that sub-optimal and that still need to go higher in subsequent quarters?

Mark Gorder: Yes. Andy or Jon, thanks for the question. You know, I can't get specific into Medtronic and what inventory they have on hand. Again, I would just kind of reiterate based on discussions that we've had with one of our customers, we had not seen any sort of buildup that would result in any sort of unfavorable impact on us as we go forward into the fourth quarter and beyond in terms of what our customers may or may not be holding.

Jon Block: Okay. All right, and to shift gears more on the hearing side for direct-to-consumer HHE. I know you said it strengthened over the past seems like couple months and that seems positive for 4Q, but could you provide a little bit more detail? What caused the pause in the quarter specific to the third quarter?

I'm just curious if it was some different trialing or marketing initiatives that you tried out that didn't have quite the same return as you saw earlier. Maybe if you can just do a better job of laying out why you did experience some of that HHE weakness 3Q ‘18 versus 3Q ‘17.

Mark Gorder: Yes, Jon, I'll take that one. One of thing that we're doing as we try to build this business is we're trying to figure out the optimal model, the optimal formula for our advertising. And so we've got kind of three legs on the stool that we're using to drive new business into HHE.

It's our mail order business, it's our print media advertising and then we’re trying or expanding a new outbound telesales focus that we think can be very positive in driving leads. Some of the experimenting that we did resulted in some higher bad debt that we would have anticipated, and we made some adjustments to that, some of which worked and some of which didn't.

And I think we’ve worked through that issue. And as Scott said, the overall unit sales have been rebounding. And I think we'll go through this from time-to-time as we're experimenting and we're bringing leads in from new sources and trying to figure out what the optimal formula for handling those is.

So, we did experiment with our formula. It didn't produce the results we had hope, we corrected and we've driven the number of backup to where we're confident that it's going to be growing going forward.

And I would hope that or I would anticipate that we would see from time-to-time some additional hiccups as we're trying to learn the exact model for this going forward. Nobody knows what it is, it's an emerging market. And I think we're gaining knowledge every day and getting better at it.

Scott Longval: Jon this is Scott. I maybe just want to add one other comment to your question and Mark's response. If you recall, this business recognizes revenue roughly 60 days after we ship product.

Jon Block: ((Inaudible)).

Scott Longval: So really the results that we're seeing in the financial statements is written off from shipments from May, June and July. Where we saw a lot of the weakness was in May and June and we've now since seen that rebound. And, again, where we start feeling more confident and bullish going forward is, again, the last fourth months produced significantly higher orders and continue to trend in that direction.

Jon Block: Okay. And my apologies if you just answered that with that helpful commentary, but I just want to make sure we're on the same page. So when we think about the commentary that you laid out and we think about 4Q, are the orders really strong in 4Q or should we see that convert to the HHE hearing in 4Q?

And let me know if that made sense or I can clarify further.

Scott Longval: No, it does. I would say the answer is both. So we saw strengthen in the …

Jon Block: Okay.

Scott Longval: … orders over the last fourth months and in particularly in October. And we've already been up while it's only a few days here in November we're starting to see or continuing to see that same strength. So, as Mark talked about, we are kind of tweaking our methodology in terms of advertising, the channels that we go after.

And what we feel good about is, you know, clearly what we've been doing over the last three to four months has proven to be the right strategies. So, we have a lot of confidence that we'll be able to build that through the remaining eight weeks of the quarter.

Mark Gorder: And Jon to add what Scott was saying, you know, we're -- once we're confident that we have a good grasp on the formula we intend to get more aggressive in terms of advertising spend and marketing push into those three areas of mail order, print media and outbound telesales.

So, we will share that with the investment community as we start to rollout a more aggressive plan in 2019.

Jon Block: Okay, perfect. And maybe the last one from me and I can hop offline. But, you know, Bose on the announcement in the self-fitting technology I would think they need an ISO certified facility. I guess sort of two questions. One, is that correct?

And then, if so how do they do that or am I thinking about this maybe incorrectly if they could actually be an indirect-to-end customer for you guys somewhere down the road. Thanks for your time.

Mark Gorder: Very good question Jon. And, yes they do need a FDA certified facility, they do need devices that are 510K approved. And, yes, we are well positioned to serve companies like Bose in our indirect-to-end consumer business where we are private labeling those devices for our various customers.

So, we would welcome the opportunity to partner with Bose on such an endeavor if the opportunity arises.

Jon Block: Very helpful. Thanks for your time guys.

Operator: And with no further questions in the queue I would like to turn the call back over to Mark Gorder, Chief Executive Officer.

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 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 business.

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 un-served or underserved Americans.

We look forward to updating you on our full year results in February. Thank you again for joining the call.

Operator: This does conclude today's conference. We thank you for your participation. You may now disconnect.