HALF YEAR RESULTS 2018
30 JULY 2018

SUMMARY OF ANALYSTS’ PRESENTATION BY:
MARTY RAPP, CHIEF EXECUTIVE OFFICER
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Marty Rapp, Dialight’s Chief Executive, began by summarising the year.

The most critical issue facing Dialight since the second half of 2017 has been late product deliveries due to the continued inability of our manufacturing partner to adequately increase production output. We have taken targeted actions to improve our operational performance and these actions have produced significant improvements. We are now confident in our ability to support the normal Q4 spike in demand.

Our overall level of late orders has improved by 60% since the start of the year. The movement of final assembly of an increasing volume of products from our manufacturing partner back to our own facilities has been a significant driver of this improvement. We are currently producing approximately 37% of our total lighting volume in our own facility in Mexico and we are now rapidly ramping the volumes there. The current on time delivery for our High Bay product line at our Mexico facility is 85%. On time delivery at our manufacturing partner averaged 51% for the half year and was 55% for the month of June. There is sufficient capacity available in our facilities to move all remaining assembly operations from our manufacturing partner if necessary to continue to drive our operational performance to industry-leading levels.

Fariyal Khanbabi reviewed the financial performance of the Group in more detail.

The first half of 2018 has been impacted by the corrective actions taken to improve our operational challenges. The ability of our manufacturing partner to ramp up production has been insufficient since the inception of the relationship. The transfer in June of a significant proportion of the High Bay line back to our own facility in Ensenada has already resulted in a 25% reduction in High Bay late orders.

The extended lead times have impacted our revenue with Group revenue being 14% behind H1 2017 at £80.1m and on a constant currency basis it was 7% lower than 2017. The combination of the revenue decline and gross margin contraction resulted in underlying EBIT reducing to £2.9m in H1 2018.
The EBIT bridge clearly demonstrates what has happened in the first half of the year. Our revenue was impacted by the operational difficulties which translated to extended customer lead times.

Our gross margin reduced by 400 bps compared to H1 2017, but is in line with the second half of 2017 when the operational issues came to the forefront. The retention of our skilled production labour in advance of the ramp in production of High Bay and not scaling down our Ensenada facility despite low levels of production has resulted in additional costs. These actions coupled with continued use of air freight to mitigate the extended lead times impacted the Group at a gross margin level.

During this period we have had strong cost control discipline and have seen our operating costs reduce by £2.6m.

The Lighting segment represented 74% of the Group’s revenue and 60% of the Group’s underlying segmental operating profit. Revenues were 18% lower (12% lower at constant currency) compared with the prior year. The production delays adversely impacted the US region where our teams deferred from bidding on capital projects. This was partially offset with strong growth in Europe and in Australia.

Gross margin contracted by 500 bps to 37%. The major elements of the decrease are:

- 220 bps reduction due to duplicate plant running costs as we have maintained our facility in Ensenada pending the transfer of High Bay production back from our manufacturing partner;
- 120 bps reduction due to retaining our skilled production labour force in advance of production commencing in June 2018 at our own facility;
- 110 bps reduction due to raw materials markup charged by our manufacturing partner with no offsetting savings achieved in the period; and
- 50 bps reduction due to continued use of air freight to mitigate the extended lead times.

As the volume of in house production increases the negative impact of these additional costs will be mitigated.

Operating costs reduced by £4.4m compared to last year. This was due to sales related costs due to the lower revenues, strict cost control procedures coupled with a foreign exchange impact of £1.7m.

The result of lower revenues and contraction in gross margin, partially offset by lower costs, was that the overall underlying operating
profit in the Lighting segment reduced by 56% to £3.3m.

Our order intake, i.e. the value of orders received in the year, was also adversely impacted with a year on year decline of 10% at constant currency.

Dialight has built up strong sales capabilities across our three global regions. The first half of 2018 has seen the first benefit in the European Lighting business after rebuilding the sales team in 2017, delivering order growth of 22% at constant currency. This was partly offset by a decline in the European wind business due to one of our largest wind customers deferring their capital projects. Dialight’s APAC team continues to be successful in driving growth and building capabilities in the region, producing 24% order growth in the first half at constant currency. These regions operate with a narrow product range that are held in inventory, therefore were not as affected by the recent operational issues.

The US Lighting business has been most impacted with significant delivery issues and extended lead times, resulting in a decline in orders of 18% at constant currency. The team has deferred bidding on certain large capital projects which have short lead times due to the extended delivery from our manufacturing partner. The US also has 40% of its orders from customers’ maintenance budgets which are supplied from inventory at our distribution channels. The extended lead times have significantly reduced inventory within the channel and hence impacted order growth.

Signals and Components are high volume businesses operating within highly competitive markets. Reported revenue increased by 2% compared to the prior period. There remains significant competition from low cost producers but margins improved by 200bps as a continuous cost improvement programme mitigated the price erosion. Overall there was an increase in underlying operating profit of £0.6m.

The Group’s net cash position decreased by £5.5m in the half year from a net cash position of £12.8m at 31 December 2017 to a net cash position of £7.3m at 30 June 2018.

The main driver in the reduction in cash is a result of an increase in inventories. As
previously announced we expected the cash position to reduce as we built up raw material inventory as we transferred production back to our own facilities. There may be more cash utilised if further production has to be transferred from our manufacturing partner. There was an improvement in debtors due to strong cash collection across the Group. The cash generated from earning in the half year were utilised to fund capital expenditure relating to some production and testing equipment required for our own plant in Mexico.

The action that has been the most beneficial to our recovery is moving final assembly of our products from our manufacturing partner to our own facilities. Our overall level of late orders has improved by 60% since the start of the year mainly as a result of removing some of the final assembly from our manufacturing partner. Our own facility has been running High Bay production since the beginning of June and is already at 85% on time delivery after the first month of production. This move has increased our overall production output by 35%.

Marty Rapp reviewed the operational and strategic progress of the Group in more detail.

The product requirements for the markets we serve result in a low volume/high mix product portfolio. The variety demanded by our customers and applications means that it is difficult to accurately predict future demand to the part number level. By taking control of the supply chain we will be able to fulfill component shortages at our own facility. The industry wide shortages have continued and are expected to last well into 2019, however our knowledge of the market has enabled us to source our quantity requirements when needed.

Unfortunately, the improvements at our manufacturing partner have not been sufficient to address the Group’s production issues. Their on-time deliveries of our products have averaged 51% during the half year, only a marginal improvement from the low of 48% at the end of 2017. It has been necessary for us to take alternative actions instead of solely relying on our manufacturing partner to improve their operational performance.
We are currently producing approximately 37% of our total lighting volume in our own facility in Mexico and we are rapidly ramping the volumes there. The current on time delivery for the High Bay line at our own plant is at 85% after one month of production. There is sufficient capacity available in our facilities to move all remaining assembly operations from our manufacturing partner if necessary to continue to drive our operational performance to industry-leading levels.

We have taken a number of corrective actions at our own facility. We have a new site management team. We retained our labour force skilled in complex assembly processes. There has also been a number of upgrades made to the processes not only on the shop floor but in the whole materials management process.

The main premise of our move to contract manufacturing was to achieve material cost savings and labour efficiencies. To date, we have not seen sufficient evidence of these savings and efficiencies. From a quality and cost perspective our own facilities are significantly more competitive. Our own facility at Ensenada is running at 83% on time delivery for lighting products. The material cost savings that have been generated to date have been as a result of the work of our internal procurement team. We expect this will continue as we move production back to our own facility. Our internal labour force in Ensenada are skilled in complex assembly processes with cycle times on average 20% lower in our own facility than at our manufacturing partner.
Our recovery actions have resulted in use of a hybrid model, in which we can purchase assembled products from our manufacturing partner or assemble products in our own facility. When we assemble products in our own facility, we can purchase subassemblies from our manufacturing partner or from other newly qualified suppliers. Our newly qualified suppliers of subassemblies have adequate capacity to support our entire purchasing requirements, and we are now taking regular subassembly deliveries from our manufacturing partner and our other suppliers. This model gives us significant capacity and flexibility to scale our operations.

Our operational challenges are not all behind us, but we have recovered to a significant extent and are now resuming a more aggressive approach to return to growth. The markets we serve remain attractive, with conversion to LED technology being under 10%. Our extended operational difficulties have bruised our customer relationships and market share but we are confident that we can and will recover both.

Customers convert to LED lighting and buy Dialight’s products because doing so remains the most efficient way to drive down energy usage and total cost of ownership of their lighting. We are delivering the next generation of lighting solutions that not only reduce energy consumption further but create a safer working environment. Our products are specifically designed to provide superior operational performance, reliability and durability, reducing energy consumption and ongoing maintenance and delivering attractive return on investment to our customers. Our market proposition is compelling, with the sustainability benefits of reduced energy usage, lower carbon emissions, reduced maintenance and improved safety offering real value to our customers.

In parallel with development of our product strategy, we are developing plans for changes in the rest of the business to enable and support successful delivery of more significant growth, predominately in our operational and engineering footprint. The key theme of our expansion plans is moving to a more global:regional hybrid structure in recognition that we need speed that comes with proximity to our end markets and the fact that the industrial LED market has strong regional differences vs being a truly global market.
Within the industrial LED Lighting market, Dialight has historically focused on specific niches where hazardous location certifications are required. Within the last five years, Dialight has expanded its focus to include applications where its products can withstand environments such as high heat, high humidity, shock and vibration, dust, water and other challenges but hazardous location certifications are not essential.

Dialight is focusing on broadening its range of product offering to its existing customers, in sites where we are already supplying lights for their hazardous locations. These types of applications include warehouses, lighter duty assembly or manufacturing applications, cold storage, distribution centres and other industrial environments. We will initially focus this expansion in geographic regions where we already have strong direct sales resources. We are in the midst of developing our strategy to address this expanded market, which would require a significant increase in our capacity to develop new products.

The global annual LED lighting market is reported to be approximately £50bn, with the largest share being residential at 39%, and the industrial lighting market representing 8% at £2bn. Dialight currently serves in a £0.5bn market and has a 27% share of this market. We have significant opportunities to grow in the industrial lighting market by increasing our range of offerings to our existing customer base.

In summary, we have taken aggressive actions to improve our operational performance, reducing late orders significantly since the start of the year. This improvement is due to moving an increasing proportion of our product assembly back in-house. On-time delivery and cost performance of our internal assembly are both excellent. I am now confident that as we move toward our traditionally heavy fourth quarter we will be able to deliver our products on time and in the quantities needed. As previously guided our results for 2018 will be heavily weighted to H2 reflecting the continued resolution of these issues.

Our market proposition remains compelling with the sustainability benefits of reduced energy usage, lower carbon emissions, reduced maintenance and improved safety offering real value to our customers. We are now resuming a more aggressive approach to delivering growth, as we transition from recovery to growth. We remain excited by the Group’s prospects for the future.
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