2018 FULL YEAR RESULTS
25 FEBRUARY 2019

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

2018 was a challenging year for Dialight, but one in which we made significant progress to address the operational issues we faced at the start of the year. The most critical issue facing us was the continued inability of our manufacturing partner to achieve adequate production output, resulting in late product deliveries or lost orders. The primary focus during the year was improving our service levels, and I am happy to say that at year-end all product assembly was back in-house and performing as expected. While there is still work to be done to completely disengage from our manufacturing partner and achieve targeted service levels, our fate is back in our own hands. Our markets remain strong and growing, the Dialight brand is well respected in the market, and we have developed a clear and comprehensive growth plan that is centred on bringing technical and product innovation to our customers in a regionally-focused way.

We have made significant progress in upgrading, expanding and geographically diversifying our current operational footprint. The Lighting business has moved to a hybrid operations model with our own distribution centres. We have secured two new facilities in Tijuana, Mexico and Penang, Malaysia to provide sufficient capacity to meet our future growth aspirations. The Group’s operational performance improved markedly in the final months of 2018, giving us growing confidence in our strategy.

While we have placed top priority on the operational challenges, we have also maintained a strong focus on product development and have started establishing regional development centres which will expand our capacity to develop new products appropriate for local markets. We have made significant progress in better understanding our core markets and looking at ways to expand our available market. We are planning to launch three major products in 2019 that will significantly expand the Group’s served market. We have also made changes in the management team and structure in order to ensure that we have the necessary skills and experience to maximise the opportunities for the Group.
Fariyal Khanbabi reviewed the financial performance of the Group in more detail.

The Group had a difficult year as a result of operational issues that came to the forefront in 2017. The Group decided to outsource production of all lighting products in 2016, however our manufacturing partner was unable to ramp up production from the inception of the contract. We dedicated significant internal resources to support the transition including having a team permanently based at our contract manufacturer.

In August 2018, we saw a further deterioration in the performance of our manufacturing partner and this led us to terminate the contract on 27 September 2018. The timing of the termination was challenging during our busiest period of the year, as traditionally the lighting industry is heavily Q4 weighted. However, we believe that having control of our operations and expanding our current operational footprint will help us recover faster.

Group revenue was 6% behind 2017 at £169.6m and on a constant currency basis was 3% lower than 2017. The revenue was impacted due to the operational issues within the Lighting segment.

The EBIT bridge clearly demonstrates what has happened in the year. The operational issues affected the Group results in two ways. Firstly, the extended lead times impacted our Group revenue and secondly there were a number of additional costs that impacted our profitability.

We had a number of additional costs which adversely affected our performance, reducing gross margin by 130 bps compared to 2017. The reduced production output from our former manufacturing partner resulted in significant use of air freight to mitigate against late orders and we had raw materials markup charged by our former manufacturing partner. These costs amounted to £2.1m and have not been reported separately as non-underlying items. Overall revenues were only marginally down on 2017 and underlying EBIT was 18% lower than 2017 due to the margin reduction.

During this period, we have had strong cost control discipline and have seen our operating costs (excluding non-underlying) reduce from £57.0m in 2017 to £52.3m in 2018.

The Lighting segment represented 74% of the Group’s revenue and 65% of the Group’s underlying segmental operating profit. Revenues were 9% lower (6% lower at constant currency) compared with the prior year. The production delays adversely impacted the US region which was 5% below 2017 offset by growth in EMEA and APAC. The
Obstruction business although not significantly impacted by the operational issues, had revenues 32% (at constant currency) below 2017.

Gross margin contracted by 190 bps to 37.6%. The effects of our operational issues were evident in 2017 which had £2.4m of additional freight costs. The incremental costs over 2016 are:

- (110 bps) reduction due to raw materials markup charged by our former manufacturing partner with no offsetting savings achieved in the period;
- (20 bps) reduction due to continued use of air freight to mitigate the extended lead times;
- (150 bps) reduction due to retaining our skilled production labour force during the transition from our former manufacturing partner: offset by
- 90 bps increase due to elimination of dual plant running costs as we transferred to our facility in Ensenada

As the volume of in-house production increases and service levels return to a more normal level, the negative impact of these additional costs will be mitigated.

Underlying operating costs reduced by £4.7m compared to last year. This was due to sales related costs flexing with the lower revenues and strict cost control procedures.

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 24% to £8.5m (21% at constant currency).

Our order intake, i.e. the value of orders received in the year, was also adversely impacted with a year on year decline of 13% at constant currency. The APAC Lighting business delivered order growth of 21% (at constant currency). The US lighting orders were significantly impacted due to the operational issues resulting in a decline of 14% (at constant currency). The EMEA Lighting business is project driven with little revenue attained from stocking distributors. We had some large capital projects in the first half however, due to supply constraints we were unable to bid for many projects in the second half resulting in a 15% decline (at constant currency) compared to 2017. The order intake for the Obstruction business was 31% down (at constant currency) compared to the previous year.

Signals and Components is a high-volume business operating within highly competitive markets. This business continues to perform, with 3% revenue growth (6% at constant...
currency) and 15% EBIT growth (23% at constant currency) in 2018. There remains significant competition from low cost producers but margins have been maintained through diligent efforts in manufacturing and sourcing which mitigated any price erosion. Overall there was an increase in underlying operating profit of £0.6m.

The Group’s net cash position decreased by £15.7m in the year from net cash of £12.8m at 31 December 2017 to net debt of £2.9m at 31 December 2018.

The main driver in the reduction in cash is an increase in inventories. As previously announced, we expected the cash position to reduce as we built up raw material inventory prior to the transfer. The termination of our manufacturing partner contract resulted in all final assembly being transferred prior to the year end. We also purchased a significant amount of our manufacturing partner’s inventory which will be utilised during 2019. There was an improvement in debtors due to strong cash collection across the Group. The cash generated from earnings in the year was utilised to fund capital expenditure relating to some production and testing equipment required for our own plant in Mexico.

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

We have three main priorities for the coming year. We continue to be focused on improving and expanding our operational footprint. We are expanding our current market together with ensuring we have increased capacity of developing new products.

In September 2018 we terminated our agreement with our manufacturing partner to retake control of our manufacturing operations. By year-end, we had moved all final assembly back in-house. We are in the process of moving our equipment for machining and coating housings that currently resides in the facility of our former manufacturing partner back to our own facilities. By the end of the first half of 2019 we will have completely exited our outsourcing agreement. The separation process from our
manufacturing partner has been relatively smooth to date. We continue to negotiate our final exit, including remaining working capital balances, and whilst there is some risk, we are taking actions to minimise this.

As we returned production back to our own facility our on-time delivery improved compared to the normal level of service we would have experienced in the past. Our aim is to set a new standard rather than just return to the levels prior to outsourcing our manufacturing. Our target is to have greater than 95% on-time delivery in full, everywhere we compete. Our on-time delivery as we exited 2018 was 70%. This was impacted by the late orders that were transferred from our former manufacturing partner. The significant change in our ability to service our customers has been in faster turnaround of orders. In Q4 we were able to deliver orders with a 3-4 week lead time as opposed to our former manufacturing partner’s average lead time of 12-18 weeks.

There are three main actions being undertaken to further improve our operations base. First, we are continuing our move to a regional operations model. In Mexico, we have secured a new facility in Tijuana which is easily accessible from our current facility in Ensenada and close to the US commercial port of entry in Tijuana. This new building will house the CNC machines and paint line, owned by Dialight, which will be moved from our former manufacturing partner in the first half of 2019. In Malaysia, we are in the process of relocating the operations in our current facility in Penang to a new and larger nearby facility by the end of Q2 2019. This new facility will house our Signals and Components operations, lighting assembly, and sub-assembly manufacturing operations. We have not finalised a location for our EMEA operations facility but expect to secure a facility in Eastern Europe in the second half of 2019 that will be operational in 2020.

Second, we are establishing distribution centres within our assembly plants so that we can provide rapid collection, packaging and shipping of a diverse set of lights for a single order, allowing us to “ship in full” in the shortest possible time. This will ensure we have market leading customer response time.

Third, we are maturing the hybrid model, whereby we use a local supply base to produce the majority of our sub-assemblies but establish and retain internal capacity and capability ensuring we have the best possible mix of speed of response, fixed capital investment, and working capital usage.

We need to break out of the relatively small niche that we are in. We need to not only continue to provide the best products in our current niche, but to also offer a wider product range so that we become more relevant to our
customers and channel partners. Dialight pioneered the use of LED technology in the heavy industrial space, and was very successful in convincing “early adopters” to make the leap to LED to reap the advantages of energy efficiency, significantly reduced maintenance cost, and less frequent replacement and cost in doing so. This led to a high market share first in the US then Australia, but market share growth elsewhere has been difficult to achieve given the operational challenges and the fact that the products had been designed primarily to serve US market preferences.

The current product portfolio is serving a market of c.£0.5bn per annum, but we must enter a larger market space to provide adequate room to grow. The Dialight product range is well respected in the market, and there are many applications where customers would prefer the Dialight efficiency, product longevity, and toughness but just can’t afford to pay the price for our current products. We have been selectively using price reduction and feature removal to extend our served market, but there are limits to this strategy as broadly discounting prices of a premium product risks devaluing the product position.

We completed a comprehensive market analysis during 2018 in which we studied the broader industrial lighting market. In facilities where Dialight’s current products are being used there are a wide range of other lights with varying degrees of environmental protection and “toughness” requirements. We believe that there is a significantly larger opportunity for Dialight in applications where the customer would prefer to use a light of Dialight’s quality but can’t afford to pay for a traditional higher specification Dialight product, designed for use in more challenging applications. If we specifically design products to suit these “tough but not quite as tough as our current products” applications, there is a significantly expanded market of about four times the size of our current market, at c.£2bn per annum. We can offer these products to our current customers in the same facilities where we are already selling our existing lights, through the same sales channels. Importantly, from our analysis we believe we will be able to drive similar gross margins from these new, lower functionality products.

As part of our market analysis, we also found that the products used for similar applications differed to a more significant extent across the geographic regions than was previously understood. We have concluded that we can grow market share of our existing products and expand our product range, by offering products that are specifically designed to meet regional and local preferences for shape, performance, installation method and price. We believe that the opportunity to expand our served market is significant in all regions if we pursue this strategy.

In order to provide regionalised products and access an expanded market, we need to develop a significantly larger number of products quicker than we have done in the past. We are doing this by improving our internal new product development processes to be faster and more efficient, by establishing product development centres in the UK and Malaysia, and by using outside design firms to
help with some aspects of the product development process.

Achieving these growth and transformational plans requires different skills and experiences and we have recruited to make significant changes to the skill sets within the Group. In operations, we have a number of new managers who come with broad experience in larger global companies in areas including manufacturing, supply chain management, trade compliance and logistics. Our operations team is fully in place and is working to help us deliver the outstanding customer service experience and cost structure that we need for the future. We have recruited new senior leaders in Engineering and Product Management. They have experience in managing larger and more complex global networks of product lines and design centers feeding multiple manufacturing plants. We have restructured to provide the focus in our Technology organisation to maintain and grow our leading technology position and deliver the strategy described here.

None of these actions will have an immediate effect on our financial performance, but we are now on the path that will lead to a larger, faster, and more regionally responsive and balanced company. The first three of our large new product lines designed to allow us to serve a wider market will be launched in the year, and we also have updates and upgrades of our existing products planned, so 2019 promises to be an exciting year.

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