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Knowles Corp. (KN)

Q4 2021 Earnings Call

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Tyler Bomba

Analyst, Robert W. Baird & Co., Inc. (Broker)

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to the Q4 2021 Knowles Corporation Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session [Operator Instructions] Thank you.

[ph] Sloan Bowen (00:25), Investor Relations, you may begin your conference.

Unverified Participant

Thank you. Welcome to our Q4 and full year 2021 earnings call. I'm [ph] Sloan Bowen (00:34) and presenting with me on the call today are Jeffrey Niew, our President and CEO; and John Anderson, our Senior Vice President and CFO.

By now you should have received a copy of our earnings release and webcast slides. If you have not received both documents, they are available on the IR section of our website at knowles.com.

Our call today will include remarks about future expectations, plans and prospects for Knowles, which constitute forward-looking statements for purposes of the Safe Harbor provisions under applicable federal securities laws. Such forward-looking statements include comments about demand for company products, anticipated trends in company's sales, expenses and profits, and future financial outlook and involve a number of risks and uncertainties that could cause actual results to differ materially from current expectations.

The company urges investors to review the risks and uncertainties in the company's SEC filings, including, but not limited to, the Annual Report on Form 10-K for the fiscal year ended December 31, 2020, periodic reports filed

from time-to-time thereafter with the SEC, and the risks and uncertainties identified in today's earnings release. All forward-looking statements are made as of the date of this call and Knowles disclaims any duty to update such statements, except as required by law.

In addition, we have provided both GAAP and non-GAAP financial measures this quarter. All references on this call will be on a non-GAAP continuing operations basis, unless otherwise indicated. Please see our earnings release and webcast slides available on our website at knowles.com and in our current report on Form 8-K filed today with the SEC for reconciliations to the most directly comparable GAAP measures.

And with that, let me turn the call over to Jeff who will provide the details of our results. Jeff?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

Thanks, [ph] Sloan (02:18), and thank you to everyone for joining us today. For those of you who joined us on our Investor Update in November, we're very pleased to report another strong quarter that demonstrates our progression toward our midterm financial targets. As we commented during the update call, we have made significant strides in transforming the company to focus on the highest growth end markets with an eye towards improving adjusted EBIT margins and driving strong free cash flow. As we look back at 2021 and certainly our fourth quarter results, we feel confident and validation in our strategy and look forward to continued progress and success in 2022.

With that, let me begin with a summary of our Q4 results. We generated revenue of \$234 million, which came in at the higher end of our guidance range, driven by strong market dynamics in Hearing Health and Precision Devices. This result was achieved even with the challenging supply chain backdrop we noted last quarter. What is most encouraging about our result was the continued execution on margin expansion. Specifically, our fourth quarter gross margin was over 43% or 130 basis points above the high end of guidance range.

We also delivered adjusted EBIT margins of 22%, which we believe demonstrates the operating leverage the company has in our business model. In total, we produced fourth quarter earnings per share of \$0.48, also above our guided range. Lastly, we continue to drive impressive free cash flow, as John will detail in a minute.

To summarize, another quarter for our strategy to focus on higher margin products and markets is yielding strong adjusted EBIT margins with exceptional free cash flow.

For our full year 2021, results were strong as well, and now I would like to take a minute to highlight our accomplishments. As we noted at our Investor Update, Knowles is positioned to create shareholder value through top line growth, margin expansion and free cash flow generation. We're proud to say that 2021 is the latest proof point of execution against our plan and we believe there are significant runway for more of the same success ahead.

Let's start with the shift we have made on product mix and how it's improved margins over the past few years. As we noted at our Investor Update, the clear byproduct of our strategy can be seen in the growing percentage of revenues above 40% gross margin. From 2017 to year-end 2021, we have increased that percentage from 49% to 70%, an improvement of over 20 points.

Now let me detail a few of the key drivers and the actions that drove the improvement. First, as mentioned, we continue to optimize the mix of our business. In Audio, we have a particular focus on growth in non-mobile ear, IoT and computing applications as well our Hearing Health businesses. In Precision Devices, our high

performance capacitor and RF filtering businesses both continue to expand margins. John will speak to the margin impact, but I'd note that our opportunity in the top line for these growing end markets is attractive, especially considering our leading market positions.

Second, Knowles continues to capitalize on favorable market dynamics and we're gaining share within our Hearing Health market. In the fourth quarter and for 2021, Knowles fired on all cylinders in this market with share gains and new product introductions along with strong end market growth.

Third, Precision Devices continues to be an outperformer. Investments in both high performance capacitors as well as RF filters across a wide variety of markets are paying dividends in revenue growth, margin expansion and free cash flow. As you could see from our financial results, execution against our strategy since 2017 has shown consistent progress as we have fundamentally transformed the company.

Similar to our Investor Update, I would like to highlight the margin, free cash flow and earnings growth we have generated despite revenue growth over the same period that was moderated by strategic exits from lower margin business. We've driven significant operating leverage over the past four years as well and have never been in a better position to drive shareholder value.

We have grown our adjusted EBIT margins by more than 500 basis points over the past four years, which has translated into an EPS CAGR of 15%. This was achieved with a revenue CAGR of just under 4%, which is impacted by global supply chain disruptions and our strategy to focus on higher value products.

Equally important, our free cash flow margins has improved by nearly 10 percentage points, which we plan to deploy to future M&A and share repurchases.

In total, we completed 2021 with exceptional adjusted EBIT margins and the highest free cash flow since we have been an independent company. This is certainly something we're proud of, but the exciting takeaway is what the operating leverage means for value creation in the quarters and the years to come.

Now let me provide some additional detail on each of our product segments. Starting with Precision Devices, we continue to outperform with another quarter and full year of record sales for this segment. Total revenues for the year were just north of \$201 million or 16% higher compared to 2020. In the fourth quarter, Precision Devices generated very strong results with revenue up nearly 40% compared to a year ago. On its own, the growth is impressive and illustrate our market-leading position across a number of attractive end markets.

That said, we [ph] adjust (07:45) this part of the results of our Precision Devices segment [indiscernible] (07:48) profitability. Specifically, segment gross margins were up 630 basis points compared to a year ago, and this is not happening in one product category or end market. It is very diverse across markets such as medical, defense, EV and industrial.

Now let me turn to our Audio segment, which, as I noted earlier, faced a tougher environment on the top line given broader supply chain issues and the timing of customer product launches. In our MEMS microphone business, revenue was pressured for the reasons mentioned, but gross margins were favorable as we continue to shift our mix away from lower margins products and markets.

Additionally, we're well-positioned with a number of technology initiatives and new product launches that we expect will augment our revenue growth in the years ahead.

Our Hearing Health business continues to be strong as the global market recovered and our company took additional share. The Hearing Health business also benefited as we saw a recovery in the Audio file demand in the second half and our recent product launches continue to ramp with our largest customers.

Similar to our other businesses, Hearing Health also drove significant operating leverage, which we believe will continue in 2022. Overall, despite a tougher environment due to supply issues, I am pleased with the potential for profit expansion we have built into the business when supply chain issues and customer product timing turns more favorable.

John will give you more detail on the Q1 outlook in a minute, but I'll conclude my prepared remarks with a review of our midterm expectations by highlighting a few things that we spoke about at the Investor Update.

First, I have high conviction that the company can grow our top line in the mid to high single-digits. Looking at 2021 in retrospect, clearly there are a range of macro factors that impact each of our two segments differently. We have visibility in the midterm demand dynamics across both segments and we expect to drive growth opportunities through our market-leading position.

Second, as I've highlighted throughout my remarks, we continue to execute and outperform on our profitability goals. We maintain our conviction to achieve gross margins above 43%. As I mentioned, our shift in mix has already contributed meaningfully to the progress and we expect will continue to be positive in the years to come.

With the background of revenue growth and gross margin expansion, we believe there is continued opportunity to leverage our existing footprint and infrastructure to drive adjusted EBIT margins. This gives us confidence we're on track to achieve our midterm model of 22% to 24% adjusted EBIT margins and 15% to 17% free cash flow margins.

In summary, I am very proud of 2021 results delivered by the entire Knowles team and I'm even more excited about the opportunity we have ahead of us to achieve continued progress and drive value for shareholders.

With that, let me turn the call over to John to review our financial results. John?

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

Thanks, Jeff. We reported fourth quarter revenues of \$234 million, down 4% from the year-ago period, driven by lower shipment volumes in Audio, partially offset by higher revenues in Precision Devices. Audio revenues of \$176 million were down 13% from the same period a year ago, driven by timing of new customers, new product launches, a challenging supply chain, and our focus on higher value MEMS microphones in connection with our margin improvement initiatives. The decline in MEMS microphone revenues was partially offset by increased shipments into the Hearing Health market. The Precision Device segment delivered revenues of \$58 million, up 40% from prior year, driven by strong organic growth in defense, medtech and industrial end markets and an acquisition completed in the first half of 2021.

Fourth quarter gross profit margins were 43.3%, 130 basis points above the high end of our guidance range and up 530 basis points from the same period a year ago. Audio segment gross margins improved 290 basis points over 2020 levels driven by lower factory spending and favorable product mix related to an increased percentage of shipments into the ear, IoT and Hearing Health markets. Precision Devices segment gross margins were 49.2%, a record for this segment, and up almost 13 percentage points from the prior year, driven by productivity

gains, improved factory capacity utilization and an acquisition completed in the first half of 2021 as well as favorable inventory reserve adjustments.

Our gross margin expansion throughout 2021 demonstrates the impact of our strategy to deliver high value differentiated solutions to a diverse set of end markets. Total company gross profit margins finished at 41.7% for full year 2021, 270 basis points above 2019 pre-COVID levels.

R&D expense in the quarter was \$20 million, down \$1 million versus the prior year. SG&A expenses were \$30 million, \$3 million above the prior levels, driven by higher incentive compensation cost and the impact of the acquisition completed in the first half of 2021, partially offset by lower legal expense.

For the quarter, adjusted EBIT margin was 22%, up 370 basis points from the prior year, driven by higher gross profit margins. EPS was \$0.48, which was \$0.03 above the high end of our guidance due to higher gross profit margins and a lower effective tax rate, partially offset by higher incentive compensation cost. For full year 2021, we delivered adjusted EBIT margins of 20.1%, up 530 basis points from 2019 levels, driven by higher gross margins and improved operating leverage.

Now I'll turn to our balance sheet and cash flow. Cash and cash equivalents totaled \$69 million at the end of the quarter. We generated cash from operations of \$66 million in the fourth quarter, \$11 million above the high end of our guidance range due to higher EBITDA and lower-than-expected net working capital. Capital spending was \$20 million in the quarter and we repurchased 1.1 million shares at a total cost of \$25 million. For full year 2021, free cash flow was \$134 million, representing more than 15% of revenues. We repurchased 2.1 million shares in 2021 at a total cost of \$44.5 million, fully repaid our convertible notes, and we exited 2021 with essentially no net debt.

Moving to our guidance for the first quarter of 2022. We expect total company revenue to be between \$197 million and \$203 million, down slightly at the midpoint versus the same period a year ago. Our revenue guidance reflects the potential negative impacts related to continued supply chain constraints and COVID-related absences in our North American manufacturing facilities.

Revenue from the Audio segment is expected to be down approximately 10% from Q1 2021 due to lower demand for MEMS microphones as we continue to be negatively impacted by global supply chain shortages, partially offset by increased demand in the Hearing Health market. Precision Device revenue is expected to be up more than 40% over prior year levels, driven by broad-based strength in defense, medtech and industrial markets and the acquisition completed in Q2 2021.

We estimate gross margins for the first quarter to be between 39% and 41%, up 100 basis points from the year-ago period, driven by favorable mix as we expect a higher proportion of shipments into non-mobile markets. R&D expense is expected to be between \$18 million and \$20 million, down \$1 million from prior-year levels due to a reduction in incentive compensation cost. We are projecting selling and administrative expense to be between \$25 million and \$27 million, up \$1 million from the year-ago period, driven by the acquisition completed last year.

We're projecting adjusted EBIT margin for the quarter to be in the range of 17% to 18% and expect EPS to be within a range of \$0.29 to \$0.31 per share. This assumes weighted average shares outstanding during the quarter of 96.8 million on a fully diluted basis.

We're forecasting an effective tax rate of 13% to 17% for the quarter and full year 2022, which is lower than previous expectations as we recently received an extension to our tax holiday in Malaysia through the end of 2026.

For the quarter, we expect cash generated from operations to range between zero and \$10 million, in line with normal seasonal patterns. Capital spending is expected to be approximately \$10 million.

I'll now turn the call back to our operator to open the line for questions. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Anthony Stoss with Craig-Hallum. Your line is open.

Anthony Joseph Stoss

Analyst, Craig-Hallum Capital Group LLC

Hi guys. Nice execution on the December quarter. John, let me start with you on – for the March quarter gross margin guide down a bit sequentially even on higher PD and Hearing Health. Can you maybe give me a little bit more detail on why that is and then also any thoughts you might have on kind of gross margins for the remainder of the year? And then I have a follow-up for Jeff.

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

Sure. Yeah, Tony. In terms of the sequential decline in gross margin is really two factors – lower capacity utilization in our MEMS microphone business and then we are actually seeing sequentially some unfavorable mix with lower compute and Hearing Health. And compute and Hearing Health both are above average gross margin. So, it's those two factors. And so just let me comment on the compute portion. The factory utilization is pretty straightforward. That's kind of a usual thing. Seasonally that we operate a lower level in Q1 in terms of capacity utilization. But the compute market is weaker for us in Q1 and right now what we kind of see is that returning to, I would say, pre this quarter level in Q2. The bookings are indicating that there will be increase and back to normalized level in compute in Q2.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

Yeah. Tony, in terms of the second part of your question too is what do we see looking out, we do see sequential improvement going into Q2 and over the remainder of the year. And keep in mind, even at the midpoint of our guidance for Q1, it is 100 basis points higher than the year-ago levels. So, while we're really pleased with the gross margin we delivered in 2021, we do think there is room to progress further.

Anthony Joseph Stoss

Analyst, Craig-Hallum Capital Group LLC

Got it. Thanks. So, this is a follow-up for Jeff. Normally you'd comment about the millimeter wave division. I didn't hear anything in your prepared remarks. I'm just curious kind of your view on that for 5G infrastructure and then also I'd love to hear your thoughts on true wireless earbuds and kind of growth of that in your more IoT type businesses.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Sure. So, first on the RF filter business, if I look at 2020 to 2021 and 2022, it grew reasonably, what do you call it, amount in, what do you call it, in 2021. We think we had, like, it was about \$35 million in 2020 going to well over \$45 million in 2021. And I think we're poised to have a real breakout year in RF filtering in 2022. A lot of our growth in PD is going to come from RF filtering. But I would just say this. There is some telecom in this, but the majority here is defense. I think we've really got some nice design wins. I would say our acquisition of IMC that we did in the end of first quarter or second quarter of last year is really panning out really well. We are really pleased with this acquisition. Again, it broadened our product portfolio and allowed us to do more stuff with more customers. We are starting to see more sales synergy with this opportunity. And so, we're expecting some pretty significant growth out of the RF filtering business.

Specifically to telecom, I think I will say what I said over the last couple years, which is we've got a number of design wins that are going into production this year. I think the challenge here is, Tony, is it's a lot with the second tier people who are working on stuff that's going to go on the home or in the house or in a small cell, right.

It's very hard for us to gauge the real rollout and what – they're telling us big numbers. But I got to be honest with you. I'm kind of skeptical of what – based on what I read in the marketplace and what we see about the real rollout going on, this is more of a wait and see, but we do have some design wins that could generate not huge revenue, but \$5 million to \$10 million worth of revenue in telecom in 2022.

Anthony Joseph Stoss

Analyst, Craig-Hallum Capital Group LLC

Q

Okay. If I could squeeze in one more just on the supply chain issues that everybody is facing. I'm curious your thoughts on when it might ease, does it keep easing each quarter, does it last unto 2023? Any thoughts would be helpful.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Yeah. Here's I kind of see it is the supply chain thing is impacting us in Q1 and Q2, for sure, based on what we know we got coming in. I think as we go to the back half, there is a two-pronged approach here that we see. One is, we think that the supply chain will get better in the back half and we will get more wafers. Now that being said, we have multiple wafer suppliers. And as we can introduce new products, we are using different wafer suppliers to kind of trying to balance the load. So, in some places, we have not enough; in some suppliers, we have more than we need. So, I think you're going to start to see as we go into the back half, even independent of the supply chain disruptions that are caused by – we have secured enough wafers in total, but we got to make sure the mix with new product comes over maximizing the number of wafers we get.

Anthony Joseph Stoss

Analyst, Craig-Hallum Capital Group LLC

Q

Got it. Thanks for the detail, Jeff. Appreciate it.

Operator: Your next question comes from the line of Tristan Gerra with Baird. Your line is open.

Tyler Bomba

Analyst, Robert W. Baird & Co., Inc. (Broker)

Q

Hi. This is Tyler on for Tristan. Thanks for taking my questions. First, could you talk about the puts and takes of what you're seeing in the smartphone market, notably China, which I know is a market that you've deemphasized in the past few years? How are inventories there, how do you see the trends developing in the China market for the rest of the year?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Yeah. I mean, I think the trend for the China market, I think there's been a lot of discussion that China is doing better. I think the real challenge in the China market, the end market has been, with COVID, a lot of the Chinese suppliers are highly focused on the emerging markets like India, Brazil, Indonesia. I think they are focused on a lot of these markets and they have been dealing still with a fair amount of COVID-related issues.

So, I think we are hopeful that it is getting better. We are hopeful as we look towards the rest of the first half and into the second half, our China business will be better, but I'm going to preface this with the statement that, again, I don't want to run mobile [ph] under the bus (23:49) because there may be a day where we come out with products that are very high gross margin and not commoditized in the mobile market, but we are deemphasizing selling to the mobile market.

And just to kind of say this is, in 2021, we had about little over 22% of our total company revenue came from mobile, and that's down pretty significantly, it was over 30% a couple years ago. I would say that we're probably in the neighborhood of 20% this year, maybe even a little lower this year. And I'm going to draw you to Q4, right, because when you look at the 43% gross margin, I think that's a proxy for where we want to be on an annual basis. And I'd say that the mix was optimal. In other words, we didn't sell a lot of commoditized mics. We sold more of our ear, IoT, compute to Precision Devices, Hearing Health. And you see what it does to our gross margin and it's very powerful. And so, we look at that – I look at it Q4 as if you look and say, well, you are at your midterm model already for a quarter, but that's kind of ideally where we want to be in two to three years on an annual basis as we continue to deemphasize commoditized products.

Tyler Bomba

Analyst, Robert W. Baird & Co., Inc. (Broker)

Q

Great. As my follow-up, maybe you could talk about some of the biggest growth margin drivers you are seeing this year, maybe certain types of products or mix or anything like that?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Yeah. I mean, John has got a good thing in terms of margins here, we talk about. Think of our business like four quadrants, right. You got mobile as one quadrant. You got ear, IoT, compute, MEMS' microphone, other category. And then you got the Precision Devices quadrant and then you got Hearing Health quadrant. A year ago, we say those were all roughly the same size. Now actually mobile is probably the smallest now of those four quadrants.

And it's also, at this moment, the lowest gross margin. And so, as we sit there and look at the other markets and we kind of put this in the midterm update that we gave or the Investor Update, we expect those other four quadrants to grow faster than the mobile at above the corporate average gross margins. And if we can sit there and continue to see this mix shift, it's very easy to sit there and go – we talk about mobile growth zero to 2% over the three-year period and then you can go through the list what Hearing Health grows at, what Precision Devices grows at, what [indiscernible] (26:21) grows at that we can get the 43% gross margin just through mix shift. So, mix shift is a big portion. We are still working on obviously productivity improvements to improve gross margin, but

you could see again the Q4 power of mix and how it affects our gross margin and our profitability and you see it in our EPS and our operating margins.

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

A

I would just add, the other thing that we're really seeing is obviously we're seeing increases in input costs, whether it's wafers, whether it's labor, whether it's other materials. We have been reasonably effective at passing those costs on through higher pricing, especially in the high value microphone area and in the PD and HHT businesses. So, that's been another opportunity and action for increase in gross margin.

Tyler Bomba

Analyst, Robert W. Baird & Co., Inc. (Broker)

Q

Thanks so much. I appreciate you taking the questions.

Operator: Your next question comes from the line of Bob Labick with CJS Securities. Your line is open.

Bob J. Labick

Analyst, CJS Securities, Inc.

Q

Good afternoon and congratulations on the strong execution. There's been a lot in the news lately, and we've talked about it on previous quarter, too, but just wanted kind of the latest update on the OTC hearing aid market. Any thoughts on the timing of that market opening up and maybe kind of put that together with an update on the automated balanced armature line, if those would be ready and would go into the OTC market or into a different market?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Yeah. So, let me give you the BA line update first. So, line is operating, not running at full capacity quite yet, but it is operating and producing parts. We sold parts off the line in Q4 and we'll continue to sell in Q1 and continue to ramp it through the first half with the goal of hopefully by later this year sometime in the back half getting to full capacity utilization. I would sit there and say and I'll come all the way around back to the OTC market in a minute. Obviously, we're pursuing the true wireless market with balanced armature and I think we're seeing some success here in terms of design wins and things will go in production. But we're also seeing that there is interest from the OTC market as well as some of our Hearing Health customers in using product off the automated line. And this is a big technology development for us that it's going to pay strong dividends over the years to come. And it's taken us longer than we expected, but where we are today, go forward, I think this is going to be a contributor.

Now, specifically to the over-the-counter market, I think I said this before. We got to see how this develops. I think this is a great opportunity for us, right. We are very well-positioned to take advantage in the over-the-counter market. It does not appear to us that the content is lower. So far, we're seeing people who are doing things like this, in terms of the pricing they put to the end market is very similar to hearing aids, but it's really targeted people who have mild hearing loss, right. And that is where today there's very low penetration. I mean, if you look at – I'm always giving my pyramid, right, where there's 70%, 80% penetration of people who have profound hearing loss, roughly 50% with moderate, but 5% to 10%. And there's millions of people who have this.

So, I think we're pretty optimistic that over the midterm, the over-the-counter market can develop to bring people with mild hearing loss and who otherwise wouldn't have had a hearing aid. That's number one. Number two is, once they're brought in, once you lose hearing over time as you age, they'll get their first real hearing aid from the

traditional channel at an earlier age. And this is all going to drive more demand. So, that's how kind of why we see our Hearing Health business is GDP plus. I mean, we used to say GDP, now it's GDP plus. What that means yet in terms of the absolute numbers, hard to say, but it's definitely an upside to where we are today.

Bob J. Labick

Analyst, CJS Securities, Inc.

Okay. That's great. Very exciting. Thank you. And then, I guess, just for my other question. Obviously, Precision Devices acquisitions have been a great use of capital for you. So, maybe if could talk a little bit about that pipeline, if there's any expectation this year, and kind of what's the idea of capital structure, you are net debt free right now. Is it just using free cash to make acquisitions what might you lever up, et cetera?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

Well, I think the one challenge I'll say and maybe I'll let John kind of speak a little bit to this a little bit more. But the one challenge is the valuations are quite high in the marketplace. And I got to be honest, we don't see ourselves trying to overpay. And I would say the things that we're looking at I don't think we're looking anything that is huge in terms of – the funnel is okay, but I would just say what you can kind of see is we're starting to generate more cash without debt and in Q4 it's kind of an indicator we paid off the convert that we had in cash. We bought a fair number of shares back in the quarter as well. And so, I think what you're going to see is going forward and I think we'll spend a little bit more time probably on the next call talking about capital allocation and what that means. But we're looking for acquisitions. And it may not be mutually exclusive that we need to do M&A or share buybacks or, again, return capital to shareholders. We think there is possibility here with the amount of cash we're generating from our core that we're capable of doing both. [indiscernible] (32:04)

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

Yeah. I mean, just to kind of summarize it, we delivered very strong cash flow in 2021, \$133 million or north of 15% of revenues, already close to the range – at the low end of the range of our midterm financial target. We believe we can continue to deliver similar percentages in [ph] 2020 (32:23) with expansion in the midterm.

And then in terms of capital deployment, think of 2021, we had three major activities. We repaid our convertible notes that Jeff mentioned. We also spent about \$80 million on a key strategic acquisition in our PD business. And we repurchased \$44 million worth of our stock. And at the same time, we're exiting 2021 with no financial net debt. So, basically the debt repayment is kind of behind us. So, our priority is really after that are unchanged. We'll continue funding organic growth initiatives and we'll look for accretive acquisitions primarily in the PD segment. And then it's a matter of return of capital and through share repurchases and, as Jeff said, we'll try to outline and get some parameters around that return of capital on the next call.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

And let me just add one last thing is I think you've kind of seen with our kind of strategy in our MEMS microphone business of going after higher margin business. What you're seeing is the trending down of CapEx towards the lower end of the ranges that we've given. You remember three, four years ago, we used to talk about 6% to 7%, 6% to 8%, and we had a year that we're 9%. Now we are kind of trending below that 6% to 8%. We're in the 5% range. And I think that's another just sense of like how we're investing the capital, right, and what we're doing with it and how we're returning now even as we paid down the debt, returning, what do you call it, capital to shareholders through share buybacks.

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

A

And Bob, the one question I didn't answer, you asked about what is the ideal leverage. Obviously, it will depend on the acquisition opportunities, but we're going to be disciplined and we'll maintain an investment-grade-like balance sheet. So, kind of maximum leverage 2.5 to 2.6 kind of range.

Bob J. Labick

Analyst, CJS Securities, Inc.

Q

Okay. Super. That was great detail. Thank you very much.

Operator: Your next question comes from the line of Chris Rolland with Susquehanna. Your line is open.

Christopher Rolland

Analyst, Susquehanna Financial Group LLLP

Q

Hey guys. Thanks for the question. Regarding shortages, I just wanted to drill down there a little bit more. You mentioned frontend. I was wondering what could your revenues have been had you been able to get supply? Do you have enough frontend supply to meet everything for the second half when you typically have more volume running through there as well? And then lastly, do you have any backend issues or are you running into customer kitting issues? And can you share some of those anecdotes with us?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Yeah. Sure. So, let me just first cover Q1. I think we're dealing with two issues: one that's probably a little bit more temporary and one that's kind of been around for a while. First, the one that's been around for a while and continue to linger is the supply chain issues and getting enough frontend wafers. I would say, overall, we're getting enough wafers. I would say where we have our products is not optimized for where our wafers are being necessarily produced today. We're going to continue to work on that and, as the year goes by, I kind of mentioned, we do expect some improvement. But on the reverse side, we also expect that we'll introduce new products that utilize, what do you call it, frontend material where we have more capacity.

So I think that's going to be a big help. And as I see the back half of the year today, I think we're very well-aligned. Now, this is within our MEMS microphone business. So, this is less than 50% of probably our projections for this year.

Within PD and Hearing Health, we don't have huge problems with supply chain. We're not as reliant on third parties in order to provide, like example, we stamp a lot of metal parts, we have our own stamping operation, that's just one example. But we are facing one issue in our PD business, they're having a fabulous first quarter, based on the guide, they're up significantly year-over-year, but majority of their manufacturing is in North America and we've been averaging on a weekly basis between 5% and 15% absenteeism in the factories with direct labor. This is definitely impacting the Q1 number, right. So, I got supply chain on MEMS, I've got Omicron in North America, I would say this is probably impacting us probably than in the tune of \$5 million to \$10 million in Q1.

And so our main issues, again, PD and Hearing Health, we're not seeing a lot of issues relative to supply. I would say my concern in North America right now is relative to Omicron, right, in terms of absenteeism. But that should come to an end. We're starting to see things come down, we expect that by the end of Q1 that should be taken care of.

For the back half of the year, as you asked, I think it's about the mix, right. In other words, it's optimizing with our new product introductions that we use, the fabs where we have excess capacity versus where we don't so that we kind of better balance our wafer supply.

Christopher Rolland

Analyst, Susquehanna Financial Group LLLP

Q

Thank you, Jeff. Appreciate it. And then the next question is just given these concerns, given that wafer seem a little tougher to get, given we have shortages, everyone's kind of seeing this as well, does this actually help your pricing dynamic? And then secondly, a quick one, accounts receivable up pretty substantially in December. Maybe just talk about that as just related to your largest customer?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Well, [indiscernible] (38:16) comment specific to our largest customer [indiscernible] (38:18) that specific, but John can give some commentary.

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

A

Yeah. They are simply timing issue, Chris. We had a higher percentage of our sales in the last month of the quarter, which will get collected typically 45 to 60 days later. And so, that's all it is.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

If you look at the shape for Q4, we had a lot of sales in Q4.

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

A

In the last month of Q4.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Sorry. In December of Q4, sorry. And so, it's not been collected yet. So, I don't...

[indiscernible] (38:45)

John S. Anderson

Chief Financial Officer & Senior Vice President, Knowles Corp.

A

No, I don't see any credit risk there. It's just literally timing.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

And then in ASPs, I think you kind of brought pricing, here is what I say is, I think this kind of follows that four quadrant thing, where you have talked about commoditized mic and then you talk about mobile, ear, IoT. You sit there and you talk about, what do you call it, PD and HHT. In three of the four quadrants, we seem to be reasonably well of ASPs of flat to up, right, and we're able to pass on some of the wage inflation, some of the

wafer cost. But PD and HHT don't really have a lot of wafer cost. I mean, this is more wage inflation that we're trying to pass on.

So, in the area where we have more commoditized product, I would sit there and say it's better than it was before, and I will give you the one indicator. If [indiscernible] (39:37) ask me about ASPs. If you remember 2016, 2017, we are averaging 8% to 10 % reduction in ASPs on mature products. Last year, it was around 3% on mature products. This year we're thinking it's going to be sub-2% on mature products. So, you could see this. And to the extent that we have less of the business that, obviously – it makes it much easier for us to sit there and go, look, here is our price. If you want to buy from us, this is the price.

Christopher Rolland

Analyst, Susquehanna Financial Group LLLP

Awesome. Thanks, guys. Yeah, I had assumed there was linearity. But thanks, guys. Really appreciate it.

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

Yeah.

John S. Anderson

*Chief Financial Officer &
Senior Vice President,
Knowles Corp.*

Sure.

Operator: Your next question comes from the line of Suji Desilva with ROTH Capital. Your line is open.

Suji Desilva

Analyst, ROTH Capital Partners LLC

Hi Jeff. Hi John. Nice execution on the gross margin here. So, maybe you could talk about the Hearing Health business. I know you talked about the over-the-counter. But the core business, you talked about share gain opportunity. What's driving that and is that sustainable?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

Yeah. I think it is. I think there's a couple things driving this. I think one of the thing, I'm going to throw a shout-out here, Suji, to our operations team. I mean, they have just really done a fabulous job navigating COVID over the last 24 months. I can't say enough to our facilities in Asia, they have just done a fabulous job with navigating this. And in some cases, some of our competitors maybe struggled a little bit more with this type of stuff and we have always been in the hearing aid market, the strong and steady operational portion of supplier. And so, I think that's number one, I think front and center.

Secondly, I think one of our things that we did as we think about this reallocation of where we want to be more with our higher gross margin markets, Hearing Health is above the corporate average. And I would say I would also put a shot-out to our Hearing Health R&D team. They have executed really well on new products with our customers. And that's is all the backdrop of the fact that, what do you call it, that there is it's a [ph] slow smoke (41:47), but MEMS microphones are becoming a bigger and bigger portion of the Hearing Health market and we have an outsized share in that portion of the market. So, you couple all these three things together, great new

NPIs, new products execution, incredible operational execution coupled with more shifts on the microphone side towards MEMS microphones.

And I'll give you one more thing. I think we have done a lot even with the automated line. I mentioned this before. A lot of the learnings from the automated line are now starting to integrate into the manual lines for balanced armature for the hearing aid market, which is making our performance even better. And so, as I said, these guys are hitting on all cylinders. And so, it leading to share gain, right. And we do think it's sustainable because think of the Hearing Health market, they introduce a new product, these things typically go for 24 months minimum as long as 48 month platforms and we've won lot of these platforms that start production over the last two years that are going to be in production for the next two to three years.

Suji Desilva

Analyst, ROTH Capital Partners LLC

Q

Okay. Great, Jeff. Very helpful color. And then on the notebook market, I'm just curious what metric do you think about for the growth opportunity there? Is it penetration of MEMS mics? Is it your share in the MEMS mics in the notebook, the number of mics per notebook? What's the growth opportunity there and how should we frame it?

Jeffrey S. Niew

President, Chief Executive Officer & Director, Knowles Corp.

A

Yeah. So I would sit there and say is there is some ability to increase the number of mics, but I would say probably more interesting over the midterm, it's higher performance. Again, I go back, this takes a little time. Two years ago, pre-COVID, nobody was using that microphone on that laptop and people used to put them in and they say, check the box, I got a microphone in case you ever want to use it. Now everybody is using it and we're seeing kind of like customers come to us and talking about high performance mics for their business laptops first, but eventually it's going to be for consumer laptops, right.

And so, I think over the longer term, there's going to be some ups and downs in this market and, right now, we're kind of going through I would say a little bit of a slowdown here in Q1, but we're expecting it to rebound in Q2. But for longer term, I think it's about higher performance mics. And again, we're very well-positioned to take advantage of that.

Suji Desilva

Analyst, ROTH Capital Partners LLC

Q

Okay. Great. Thanks, guys.

Operator: There are no further questions at this time. I'll turn the call back over to the company for any closing remarks.

Unverified Participant

Thank you all so much. On behalf of Jeff and John, appreciate everyone's time. And if there is follow-ups, please let us know in the Investor Relations, and we look forward to seeing and talking to you all in the future. Thanks so much.

Operator: This concludes today's conference call. Thank you for joining. You may now disconnect.

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