# Spartan Motors
## Q3 2016 Earnings Conference Call
## November 3, 2016

Officers
Juris Pagrabs; Spartan Motors; Group Treasurer, Director of IR
Daryl Adams; Spartan Motors; President, CEO
Rick Sohm; Spartan Motors; CFO

Analysts
Steve Dyer; Craig-Hallum; Analyst
Mike Shlisky; Seaport Global; Analyst

Presentation

Operator: Good day, and welcome to the Spartan motors third quarter 2016 results conference call and webcast. Participants will be in listen-only mode. (Operator instructions) After today's presentation, there will be an opportunity to ask questions. (Operator instructions) Please note that this event is being recorded.

I would now like to turn the conference over to Mr. Juris Pagrabs, group treasurer and director of investor relations of Spartan Motors. Please go ahead, sir.

Juris Pagrabs: Thank you, Sherry, and good morning, everyone, and welcome to the Spartan Motors third quarter 2016 earnings call. I am Juris Pagrabs, and joining me on the call today is Daryl Adams, our president and chief executive officer, and Rick Sohm, our chief financial officer.

For today's call, we've included a presentation deck which will be filed with the SEC and is also available on our website at spartanmotors.com. You may download the deck from the investor relations section of the website to follow along with our presentation during the call.

Before we start today's call, please turn to page two of the presentation for our safe harbor statement. You should be aware that certain statements made during today's conference call, which may include Management's current outlook, viewpoint predictions and projections regarding Spartan Motors and its operations, may be considered forward-looking statements under the Private Securities Litigation Reform Act of 1995.

I caution you that, as with any prediction or projection there are a number of factors that could cause Spartan's actual results to differ materially from projections. All known risks that Management believes could materially affect the results are identified in our forms 10K and 10Q filed with the SEC. However, there may be other risks that we could not anticipate. For today's call Daryl will provide an operational review of the third quarter followed by a financial review from Rick, and then we plan to return to closing remarks before proceeding to the Q and A portion of the call.

As a reminder, last quarter our delivery services vehicles business segment changed its name to Fleet Vehicles and Services to more accurately reflect our end-user target customer, including our large fleet staff, or walk-in customer, walk-in van customer, and our growing cargo management systems customers. Today's press release with a form 10Q filed with the SEC reflects this segment name change.

At this time, I'm pleased to turn the call over to our CEO, Daryl Adams, for his opening remarks which begin on slide three.

Daryl Adams: Thank you, Juris. Good morning, everyone. And thank you for joining us on Spartan Motors third quarter 2016 conference call. I'm pleased to report another solid quarter of growth and profit improvement for Spartan Motors. Revenue for the third quarter rose 9% to $148.7 million versus last year. For the third quarter 2016 we've reported $2.7 million or $0.08 per share. That is up $8.5 million or $0.25 per share year over year.

I'm extremely proud of all the Spartan team members. They've embraced our turnaround plan, and as a result of their efforts, we've achieved our most profitable nine-month ending September 30 since 2009. Our fleet vehicles and services segment posted significantly higher revenue and operating income growth year over year, which was driven by higher unit volume, favorable mix and a continued strength in our Saltillo and Kansas up-fit business.

Especially chassis and vehicle segment saw sales and operating income decline primarily due to lower unit shipments year over year, resulting from a customer implemented one-time inventory adjustment related to its dealer on-hand inventory. Shipments to this customer are expected to return to pre-adjustment levels in the current fourth-quarter as evidenced by the increase in our backlogs to $20.1 million from our second quarter low of $12.2 million.

Our emergency response segment continues to make good progress for returning to profitability which is a top priority of our turnaround plan. Following the guideposts of our Spartan production system we are hyper focused (inaudible) manufacturing principles, continuous improvement and, of course, getting the right talent in key areas such as procurement and quality.

As a result, we are seeing improvements in quality inventory reductions and material cost reductions. Year over year, the operating loss for the quarter improved by $1.8 million despite the quarter including a legacy one-time product repair campaign reserve of $1.7 million, Rick will cover in more detail during his remarks.

Please turn to slide four. As you recall, last quarter we announced two new ER programs. The Spartan Select and 180 truck programs, both designed to streamline the ordering process, reduce production times and improve operational efficiencies. As a reminder, Spartan select program was created for OEM partners, for customers that build their own bodies on Spartan custom cab and chassis.

The Spartan Select chassis offers the most commonly selected options combined to easily order packages.  This program will allow us to manufacture a custom chassis with less lead time, and reduces the complexity to order, engineer and build a custom chassis.

The 180 truck program is designed to provide the market with faster order fill and recycle times for custom apparatus is in the midst of a full production launch.  Currently, the program language has been abandoned and instead been transitioned into the S180 line of custom comforts as go to market with custom trucks delivered in half the time of any competitor.  Today, the S180 truck line offers several pre-engineered pumper models that are based on the most commonly ordered option packages.

By reducing complexity, we were able to streamline the ordering, engineering and production processes, thereby cutting delivery time to as little as 180 days.  The product line continues to gain attention.  Dealers are excited and showing increased support.  We expect 10% to 50% of our apparatus shipments in the fourth quarter to be S180 trucks.

Our first 180 truck will be delivered to Reese Fire Rescue supporting the village of Reese, Michigan in the coming weeks, replacing a truck that was out of service, which is one of an aging fleet.  The S180 abbreviated building delivery time, our Michigan roots and dealer CSI support were deciding factors in this purchase by Reese, Michigan.

Please turn to slide five.  Last month, our fleet vehicle and services segment was one of six vehicle manufacturers who received a USPS prototype contract award to build six next generation delivery vehicles.  We will design, develop, build and deliver these prototypes in 12 months.

The contract award of $3.6 million is to help offset the prototype cost.  We are currently in discussions with an OEM chassis manufacturer and hope to partner with them and other key suppliers to help offset the prototype costs.

The prototypes are declared to be delivered to the USPS in September 2017.  USPS will then test the prototypes for six months in a range of different climates, topography, population centers and delivery environments.  We expect them to award the production contract to the Company's vehicle that passes the test in the first half of 2018. The schedule, of course, is all dependent on whether the USPS approves an appropriate funding for the next generation delivery vehicle program, which has not been funded to date.

Please turn to slide six.  Last quarter, we announced the production of the first new Chevrolet medium duty gasoline powered truck being manufactured in Charlotte, Michigan.  In partnership with General Motors and Isuzu Commercial Truck of America, in addition the seven Chevrolet cab over models that Spartan will manufacture based on Isuzu's existing M-series design new construction continues at a swift pace on Spartan's new Charlotte campus building, which will host Isuzu's new F series class 6 on highway cab over commercial truck assembly operation.

Breaking ground on an 85,000 square-foot building in April 2016 with our partner from Isuzu Commercial Truck of America present, we were pleased to share that the completion of this building and ground is expected to conclude within the next several months. The facility represents the continuation and expansion of the highly successful and symbiotic relationship between the two companies. Concurrent with the $5.5 million investment, Spartan expects to leverage core competencies we've built in the contract manufacturing and assembly areas in order to ensure profitable expansion of the Isuzu relationship.

Please turn to slide seven. Demand for our last model delivery vehicle continues to gain momentum. Earlier in the year, we received an order for over 1500 Reach partial delivery vehicles, which is extremely exciting. Reach is a class 3 or 4 vehicle custom designed by Spartan for best in class utility durability and fuel efficiency.

Reach is currently being produced in a highly efficient flexible manufacturing line in Charlotte, Michigan. These units are expected to be delivered in 2016 to support peak holiday season.

Now I will turn the call over to Rick to discuss Spartan's financial results for the third quarter.

Rick Sohm: Thanks, Daryl. Please turn to slide nine. As Daryl mentioned, we are pleased to report continued quarterly progress and a significant increase in net income for the third quarter of 2016. Our improvement includes a favorable impact from implementing lean manufacturing and continuous improvement initiatives across all our production facilities. Revenue for the quarter increased 8.9% to $148.7 million from $136.6 million.

Our gross margin improved 270 basis points to 12.1% of sales from 9.4% a year ago, primarily due to a favorable product mix, which included a higher proportion of sales from higher-margin parts and accessories. Third-quarter operating income rose $3.1 million to 2.6 million from a loss of $0.5 million last year.

The quarter included a legacy product repair campaign reserve of $1.7 million, restructuring charges of $0.3 million and an asset impairment charge of $0.4 million for the ER division. Operating margin for the quarter improved 200 basis points to 1.7% from a -0.3% a year ago.

Moving to slide 10, our adjusted operating income improved 35.1% to $5 million from $3.7 million in the prior year. The prior year third-quarter included adjustments of $2.2 million relating to asset impairment charges, $1.4 million in product recalls, and $0.5 million in restructuring charges. Our adjusted net income was $3.4 million or $0.10 per share, compared to $1.3 million or $0.04 a share last year.

Now let's take a look at results by operating segment starting with our FBS segment on slide 11. FBS reported revenues of $78 million compared to $54.2 million last year, an increase of 43.9%. Revenue was driven by increased vehicle sales, primarily from Reach, and continuing to grow our vehicle up-fit business.

Operating income rose hundred 34% to $9.6 million or 12.3% of sales, from $4.1 million or 7.5% of sales a year ago. Increase is largely due to higher up-fit volumes as units were pulled ahead from the fourth quarter to meet customer demand.  We are currently fulfilling a large up-fit order that we expect to extend through November 2016.  While we expect this business and this customer to be an important part of fleet vehicle services' future growth, we do not currently have a follow-on order.

Additionally, as a result of the USPS contract award, as Daryl mentioned earlier, we do expect increased R&D cost during Q4.  As result of this increased R&D cost, together with more normal up-fit volumes, we expect Q4 operating margins for FBS to return to more normalized levels. Our backlog remains strong at $102.2 million compared to 107.7 million at the end of the September 2015 quarter.

Moving to slide 12 and the SCV segment, third quarter 2016 revenue totaled $28.6 million, down 26.1% from $38.7 million.  Motorhome chassis revenue declined 31.1% to $22.3 million from $32.4 million, primarily due to the lower unit shipments resulting from a customer implemented one-time inventory adjustment related to its dealer and on hand inventory.

Shipments to this customer are expected to return to pre-adjustment levels during the third and fourth quarter.  You can see this in our increased backlog from a second quarter low of $12.2 million to quarter end number of $20.1 million.

As we noted last quarter, we continue to see an increase in our market share as result of becoming the sole chassis supplier for a major customer and being added to additional models at another major customer.  The months of June, July and August have been the first three months that the industry showed reductions in class A diesel retail sales.

This has caused the total year to date class A diesel market to be down 3% year-over-year. Although our backlog at $20.1 million on September 30 has rebounded nicely from June levels, we will continue to watch the class A diesel trends mostly during the fourth quarter to see if this trend will continue into 2017.

Operating income from the third-quarter decreased 63% to $0.9 million from $2.4 million in the prior year, driven by the lower sales volumes I mentioned earlier, which contribute to our operating margin decreasing 320 basis points to 3% for the quarter.

Let's move on to slide 13 and ER segment.  Revenue declined $1.6 million to $42.1 million from $43.7 million due to fewer shipments of complete fire apparatus and custom cab and chassis compared to last year.  The operating loss for the quarter decreased $1.8 million to $3.8 million, from $5.6 million last year.  Included in the current third-quarter operating loss is the product repair campaign reserve of $1.7 million, an asset impairment charge of $0.4 million, and restructuring charges of $0.3 million.

Adjusted operating loss improved to $1.4 million from an adjusted operating loss of $2.3 million a year ago.  The operating loss in the prior year of third quarter includes a product repair campaign reserve of $0.6 million, an asset impairment charge of $2.2 million, and restructuring charges of $0.5 million.

Backlog remains strong at $149.8 million compared to $145.1 million in September 2015. As we said previously, we are not necessarily looking to grow the ER business, but rather return the ER business to profitability.

Turning to our balance sheet on slide 14, Spartan's balance sheet continues to improve and grow stronger. We ended the third quarter with $40 million in cash, up from $20.9 million at the end of the third quarter of 2015. Our total liquidity improved 82% or $41 million, to $90.3 million from $49.6 million a year ago.

Working capital management and maximizing cash levels to support our future growth and maximize shareholder value continued to be high priorities for our management team. On October 31, we repaid our $5 million senior note due December 1, 2016 with cash on hand, and we entered into a new three-year $100 million revolving credit facility with essentially the same terms as our previous $70 million facility.

Please turn to slide 15 and we will discuss our outlook for the remainder of the year. As we detailed in this morning's press release, our outlook for the rest of the year remains strong. Order intake is strong as evidenced by our current backlog of $272.1 million. As Daryl mentioned earlier, we received the USPS award to build fully functional prototypes for the next generation delivery vehicle program. As a result, we expect to incur increased research and development costs relating to this program in the current fourth quarter.

Despite this, as well as the fourth quarter typically being our sales volume quarter, we expect to see year-over-year operational improvements resulting in a profitable quarter, which will represent our fourth-quarter, an achievement not accomplished since 2009. This allows us to maintain our previously stated 2015 midpoint EPS guidance of $0.23.

We expect 2016 results as follows. Our revenue in the range of $570 million to $590 million, which is unchanged from our previous guidance. Operating income in the range of $8 million to $10 million, including restructuring charges of $0.5 million to $1 million, which is also unchanged from our previous guidance.

Income tax expense will likely be reduced to essentially zero, which has changed from our previous guidance of a range of $1 million to about $1.2 million. Finally, earnings-per-share in the range of $0.20 to $0.25, unchanged from previous guidance and assuming 34.5 million shares outstanding.

At this point, I will turn the call back over to Daryl for his closing remarks.

Daryl Adams: Thank you, Rick. Please turn to slide 16. In summary, I'd like to emphasize that we are pleased with the progress we have made to date. Results of the nine months ended 2016 were the strongest since 2009.

Highlights include: Sales were up 8.6% to $444.9 million from $409.8 million. Operating income was up $10.2 million to $7.7 million from a loss of $2.7 million. Adjusted operating income increased 111% to $12.4 million from $5.5 million. Net income improved $15.2 million to $7.7 million or $0.22 per share, and a loss of $7.5 million or $0.22 per share.  Adjusted net income rose 249% to $9.4 million or $0.27 per share from 2.7 or $0.08 per share.

While we have made notable progress, we are one-third of the way in implementing and executing our turnaround plan.  Our path to profitability is becoming clear and more opportunity exists.

We plan to continue following a disciplined data-driven approach to managing the business and to follow our 2016 focal points. Our top priority remains to return the ER segment to profitability, and we believe we are on track to be profitable on a run rate by the end of 2017.

As we told you last quarter, we expect to be profitable each quarter in 2016, and we are confident in our ability to achieve that goal and meet or exceed our guidance for 2016.  Our management team is firmly established and our employees are truly excited about the direction Spartan is heading.  We remain fully focused on improving the business and increasing shareholder value.

Thank you.  Operator, we are now ready to take questions.

Questions

Operator:  (Operator instructions).  Steve Dyer; Craig-Hallum.

Steve Dyer:  Thanks, good morning and congratulations on another nice quarter.  You talked a little bit about the FBS segment, which was strong again and backlog was down, which I don't think was totally unexpected.  How comfortable are you as you look into next year in terms of the visibility that you have?  It sounds like it is lumpy.  Any other color there you can give us to guide us as to thinking about what next year might look like?

Daryl Adams:  Steve, I think the difference between our fleet business and our ER business, we just don't have the visibility to the backlog.  In firetrucks, we have a year worth of visibility.  I think with our fleet business, we are happy if we have five months to six months of visibility.

I think it is a little bit too early for a good look at 2017, but we believe most of the major customers as we talked about last mile delivery, have robust capital budgets, that they will be spending more of these vehicles.  I don't think we have a great visibility yet, but we expect by our fourth-quarter call we'll have a good idea of what the year looks like.

Steve Dyer:  Okay.  That is helpful.  In terms of the USPS delivery cost, can you quantify, Rick, what you are thinking for Q4, and more fully, I know you haven't announced a partner yet, but how we should be thinking about layering those costs into next year?

Rick Sohm:  I think, as Daryl mentioned, we are talking to most of our major suppliers.  We will probably try get some visibility and agreements in place by the end of the year.  I think that the spending right now is not very large, less than half a million dollars or so that we would expect to spend in the fourth quarter.  Then once we reach some of the agreements with our partners we will be able to better articulate the path forward in 2017.

Steve Dyer: Got it. Okay. Then maybe just the broader question about capital allocation. The balance sheet obviously continues to improve, you bought stock back opportunistically earlier this year. How do you think about your priorities there and to get to a point where M&A starts to become more of a thought going forward?

Rick Sohm: I think we have been pretty consistent in the past saying we have to get our house in order and build a solid foundation. I think we are making some real good progress here in 2016. We have been opportunistic with our capital with the share buybacks you mentioned, and we will continue to look at it that way. As we continue to generate more profits and cash, then some of the M&A activity may start to appear on our radar screen.

Rick Sohm: Got it. I will leave it there for now. Thank you.

Operator: Mike Shlisky; Seaport Global

Mike Shlisky: Good morning, guys. I wanted to start off with some questions on the field fix program you had in the quarter, or I guess it was some kind of charges you took for some issues with some fire trucks. I guess that came out of the blue. I don't recall you mentioning it last quarter. I guess, what has happened since the last two months that caused you to take that charge? Is it going to make you have to have a more cautious warranty reserve going forward?

Daryl Adams: Mike, I will address the first half and then let Rick address the warranty accrual subject. We did not mention it last quarter and that is because we did not know about it last quarter. It is something that came up early in this quarter. Once we got into it, understood it, we just wanted to make sure the fire trucks were safe and the firefighters that use them were safe.

It is something we needed to take care of and that is basically what happened. We wanted to get it into this year and make sure that we covered it. I will let Rick talk about the accrual.

Rick Sohm: Yes, Mike, I think it is a relatively large population of vehicles that go back, you mentioned it correctly, this is kind of a legacy or quality issue that goes back a number of years. That is what led to the charge of about $1.7 million for the quarter.

Mike Shlisky: So you have to change your approach going forward? I mean, this is like the third -- at least the last five quarters you've had this kind of thing three times. Not calling this a one-time item and not changing your future warranty practice, I'm just not sure how that is supposed to work.

Rick Sohm: I think, unfortunately, there is something of a history here of perhaps not enough validation and design work done up front. We spent a lot of money and resources on bulking up our engineering teams here and doing more validation work ahead of time, so we think we are getting to a clean point in terms of our quality. Unfortunately, this is one of the legacy issues we have had to deal with over the last couple of years here.

Daryl Adams: Yes, Mike, I think to also add, I think if you been on the calls, you've heard of a number of changes we have had in management, and one of those were engineering. Right? Because of the issues. We are asked by our board as well. We just had a meeting yesterday. 2016 is when the new engineering team has been in place here. So everything going forward from that are things that we're designing and validating. Prior to that these issues come up and we need to clean them up and deal with them. That is what we are doing.

Mike Shlisky: Okay. I guess and bottom line with the different engineers and new design changes, and the new faster production program, at this point you don't feel the need to increase your warranty (inaudible), at least temporarily, and then maybe true-up on the other side later?

Rick Sohm: Items like this, Mike, we are addressing on a case-by-case basis. We feel good about our general warranty reserve policy, and we deal with these one-off campaigns on a case-by-case basis, but based on what we know today, we feel comfortable with our accruals.

Mike Shlisky: All right. Okay, I just also wanted to confirm a housekeeping item of what is and what is not included in your operating margin, operating profit guidance, for the year. You do include your million dollars of restructuring has an impact to your operating profit, but I want to make sure you exclude these charges that we just talked about and your other small asset impairment stuff as well, correct?

Rick Sohm: Yes, that is the difference between the GAAP and the adjusted numbers. That is correct.

Mike Shlisky: So the adjusted operating profit but just not adjusting for restructuring is the guidance?

Rick Sohm: The guidance includes the restructuring charges.

Mike Shlisky: Okay, got it. Got it. All right. I also wanted to check, you've got one customer that you said apparently took down some order activity or shipment intake during the quarter. Is it elevated inventory or inventory issues, is there something you think might be an issue with any other customers? Given some pretty robust transfer over the last couple of years, is it still, is it just to just one customer? Or I'm getting the sense that there might be other issues that are coming.

Daryl Adams: Mike, we appreciate the question. We like to try to emphasize -- I think you are talking about the specialty chassis segment.

Mike Shlisky: The motorhomes, exactly.

Daryl Adams: Right, we get dumped into the entire RV segment. I think we need to continue to guide to the listeners that we are class A motorhome, diesel segment only, which is much different than the entire RV business. With our customers and the insight we've received from them, we think we don't see a major downturn. We see it from our market share we are increasing. We see nice orders going forward, which is shown by the backlog in that division.

Mike Shlisky: Okay. I've just got two more quick ones here. First, on the Postal Service deal, I know at this point it is obviously a small deal, but is the revenue you're getting supposed to completely cover your cost? So is your effort to try and find a partner here going to help you to get a profit on those so you can actually take down your cost by having somebody else take them on? I guess the other part of the question is, can the award be awarded to more than one company?

Rick Sohm: Yes, maybe I will start with the last part of your question first, Mike. Yes, the USPS has the ability to allocate awards over multiple participants. We think that that may actually occur. The $3.6 million is not meant to make these vehicles profitable for the program participants. It is to help defer costs. Hence, our desire to find not only a major chassis partner but a series of suppliers we can partner with to help offset those development costs.

Mike Shlisky: Okay. I guess were you awarded the award in an effort to fully offset costs that you might've just had on your own?

Rick Sohm: No, that $3.6 million is not meant to defer or offset all costs.

Mike Shlisky: Okay, okay. Then my last question I just want to ask about, GM, I see you guys getting your first trucks off the line there. I just wanted to get a sense at this point what run rate do you think you are running at, versus its peak or average operating level. And if you are not there yet, at what point do you see the Chevy program fully operational up and running at its normalized run rate?

Rick Sohm: Yes, I think that we have started in the last quarter, our Chevy builds. I don't know that we are at peak run rate yet, but we see that ramping and continuing to ramp over the first half of 2017, Mike.

Mike Shlisky: Perfect. Excellent. I will pass it along, guys.

Juris Pagrabs: Mike, this is Juris. Just want to clarify your question regarding the GAAP guidance. To be clear, our guidance that we provided is strictly on a GAAP basis, not adjusted, so it does include the restructuring charges, the asset impairment, and repair campaigns. Okay?

Mike Shlisky: That is all included.

Juris Pagrabs: That is correct, in the GAAP guidance.

Mike Shlisky: Okay, perfect. Thank you.

Operator: (Operator instructions). Please, sir.

Daryl Adams: If there aren't any other questions, I want to thank everybody for participating on the call today. We look forward to talking to you at the fourth quarter at the beginning of the year. Thanks, and have a great day, everyone.

Operator: The conference has now been concluded. Thank you for attending today's presentation. You may now disconnect.