Paul Scott interviews the CEO & CFO of Somero Enterprises (SOM)

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Key: **Paul Scott ("PS")**
Jack Cooney ("JC"), CEO of Somero
John Yuncza ("JY"), CFO of Somero

PS:
Hello, I'm Paul Scott. Today I am talking to the Directors of Somero Enterprises, ticker SOM, which is an American-based company which has been listed on AIM since 2006. At 132p per share, the market cap is about £74m.

Quick disclaimers: I am *not* giving financial advice or recommendations. I *do* hold shares personally in the company, and I am *not* charging a fee.

So we have got today the CEO Jack Cooney, and John Yuncza the CFO on the line. Welcome gents and thank you very much for letting me talk to you today.

JC:
Well thank you, we appreciate the opportunity.

JY:
Thank you Paul.

PS:
Excellent, okay. So we have got about 14 questions sent in by my blog readers, so first question, fairly predictably, 'Given that your headquarters and main operations are in America, please could you explain why Somero listed in the UK on AIM back in 2006?'

JC:
Yes. In 2006 before we listed on the AIM, we were owned by a private equity company called The Gores Group, out of California in the US. They had brought other companies public on the AIM, and they thought that that would be the best fit for us, given the size of the company at that time.

So that is how we started our journey on AIM and it has been a wonderful journey. We think it is the right fit for us, because we have ... at our size, we wouldn't fit well on the NASDAQ in the US market, and I believe we are the right size for the AIM. And we have been very, very pleased with the calibre of the investors and the shareholders we have got. They are very quick to understand the value proposition of Somero. And on top of that we get a NOMAD that can give us guidance to make sure that we are staying within governance and all of the issues that we have. So it has been a very, very pleasant experience for us.

PS:
Okay, that sounds good. So from your tone on that answer, it sounds like you don't have any plans to change your listing status to anywhere else?

JC:
No we do not.

PS:
Okay, great. Next, could you give us, just for anyone who is not familiar, perhaps you could give us a quick overview of the business?

JC:
Yes. We make and sell laser-guided concrete screeding equipment. And laser-guided concrete screeding equipment uses a process called wide placement, which means that we can put down slabs flatter, and four to five times faster than the other method of spreading concrete, which is basically a manual method.

We sell and service all of our customers direct, and we have customers in 93 countries around the world. There are tremendous benefits to having a laser screeded floor in terms of the flatness, so that if you are putting up tall racking, you are able to get to the racking on the top and not have it be crooked, which makes the warehouse inefficient. The wide placement in floors reduces construction joints significantly, and therefore cuts down dramatically on the maintenance of the concrete floors, and the maintenance on the equipment that is transporting all of the goods and products that come with it.

PS:
Okay. Could you touch on the competitive position?

JC:
Yes. We had our first competitor in 1989, he was a Somero customer out of Holland, and basically anybody can reverse engineer our equipment, any mechanical piece of equipment. And we still have competitors today, and we anticipate that we will always have competitors.

The difference that we have seen is that when a competitor copies a piece of equipment, he thinks of himself as an equipment manufacturer. So he copies a piece of equipment, puts it in his product line, and sends it out in his brochure. For us we are much more than just an equipment company, because what we do is we provide a piece of equipment to our customer, but we also supply the education, the training, and the ongoing technical support to make his business highly successful. Because our customer *only* does concrete floors, that is his *whole business*, and that is our only business.

So it is up to us to not only just sell him a piece of equipment, but to make sure he uses it so that he can meet the specifications, the flatness specifications, that building owners want, and to be a highly successful business. And that is what separates us from the other people who are just making machines. What also goes along with the technical support is that since we sell in 95 countries/93 countries around the world, we have 24/7 phone support. And in that period of time we will guarantee that you will get a certified engineer on the phone in ten minutes, and we have a translation system built into our phone system, so we can talk to people in 65 different languages. That is not something that any of our competitors have.

PS:
I see, okay. And what sort of market share would you say that you currently have?

JC:
From a market share standpoint we have got at least 99% of it. There is very little information on how many machines our competitors have sold, because generally they sell so few.

PS:
Wow, yes okay. I know you always get asked this question, but surely the Chinese would just as you say reverse engineer it and copy it wouldn't they? Is that not happening?

JC:
Oh yes. There is a number of Chinese manufacturers who have reverse engineered one of our machines, and they are having difficulties getting it to operate continuously. And remember concrete is perishable, it sets up in an hour, so if the machine breaks down on site, the operator only has an hour to find out what the problem is, and fix it. And if he doesn't, then you have to stop the job site, and that doesn't make the building owner or the main contractor very pleased.

PS:
I see, okay. Turning next to your most recent trading update which was on 7 January, congratulations on an excellent update. You said in it that EBITDA, for 2015 this was, was materially ahead of market expectations. Was there any particular reason why you quoted EBITDA instead of profit before tax which most investors prefer I think?

JY:
It is more consistent with our historical trading updates where we have historically focused on EBITDA, and that is the metric that we have become accustomed to sharing as the barometer. There is really ... the conversion from EBITDA down to the profit before tax, is very consistent with our historical conversion, so there is nothing untoward about that.

PS:
I see, okay. Just a bit of feedback, more than a question from me as a UK investor, I tend ... and a lot of other people tend to be rather sceptical about EBITDA, because a lot of companies use it to give an inflated perception of profits, where they are capitalising a lot of their development costs. So I checked your figures, and that is absolutely *not* the case with you, your depreciation and amortization charges are very small aren't they?

JY:
That is correct. We are not a terribly capital intensive business. We don't have much in the way of capex annually, nor depreciation or amortization.

PS:
Okay, great. Now in terms of the outlook statement, you also made positive noises about the outlook for 2016, I think with the caveat obviously that it was early in the year for you to be sure. My question on that, on the outlook for this year, is that we are hearing quite negative forward looking data coming out of the US and China at the moment, so how and when do you think this economic downturn will affect you?

JY:
So with regard to the US market, obviously there is a lot of discussion regarding the state of the US economy, but when you really focus in our market which is the non-residential construction market, which is where our customers participate, there is very bullish

expectations for that spend level going forward. And the reason being, there is a significant amount of pent up demand from the previous recession, where there was a lot of investment that did not occur. So if we look at a number of different data points that are out there, from a non risk spending perspective, the American Institute of Architects forecasts 2016 growth at similar levels to what we have seen in 2015. And on a longer term view they have called for 5 or 6% growth through to 2019.

Another data point to look at is the non-residential construction spending, which typically trails residential construction. In the US, the housing market, housing starts in the US in 2015 were roughly *half* of the level of the housing starts at the peak which was in 2005. So there is a significant amount of pent up demand in terms of housing construction. So there are a lot of reasons to be confident about the trajectory for the non residential construction.

The other piece of being a direct sales organisation, we have a lot of direct contact with our customers and get a feel for their project backlogs as they look forward to the next 6 to 12 months. And there is a high confidence level from our customers, the amount of work that they have, for the foreseeable future. So there is a lot of reasons for us to be quite confident about the US market.

PS:
Okay, oh that is encouraging. So I can stop watching CNBC then, and worrying about the world coming to an end?! (laughs)

JC:
We have Paul! (all laugh)

PS:
Probably wise, probably wise! Following on from that, one reader, called Brackendale, has asked a question. He has said that, in his perception the share price is being held back by fears of a collapse in profits, similar to what happened back in 2008, and the subsequent two or three year aftermath, so he is saying obviously your business is highly cyclical. So do shareholders just have to live with extreme cyclicality or was 2008 a bit of a one off?

JC:
Well 2008, Paul, was definitely different, because prior to that recessions had occurred in the US but not necessarily in Europe for example at that time. And there is no doubt this last recession occurred in many, many parts of the world, and it was much more severe than any of the previous recessions.

So none of us know *when* things are going to change in the future. What we *do* know is that it is probably not going to be as severe as the last time, and the **US economy right now is *extremely healthy***. What occurred in 2008 was an absolute shock to everybody. The business was going along just fine at that time, and out of the blue came the financial crisis.

So I wish that any of us knew exactly what was going to happen in the future, but that is not something that I believe is knowable, or if anybody does know it, it would be sure helpful if they could tell us!

But I can tell you right now, we see very healthy economies all around the world in our segments, as John has mentioned. And as we mentioned in the update, we have seen some very, very positive signs in Europe now, this will be the third year, last year will be the third year that we have seen positive signs in Europe. So it sure doesn't feel like there is anything to be concerned about in the near future.

PS:
Okay. And in terms of managing the cyclicality of your business, given that you have had a few years to adapt after the last financial crisis, have you been able to re-engineer the business in a way to moderate, or have you been able to variabilize more of your costs perhaps, in anticipation of future downturns? (edit: my apologies – really badly worded question!)

JY:
So Paul, I guess one of the advantages we have with our business is that our biggest spend is really personnel costs. So a large percentage of our costs are in fact variable. So we are able to adjust our cost structure to react to market conditions, and we would do that in the future as well. So that part of it provides a lot of flexibility with regard to resetting our cost structure. Obviously we continue to look at ways to improve our recurring revenues, to create more stability going forward, and that is a big element of our strategic planning. So we are continuing looking at ways that we can enhance that to reduce the impact of the cyclicality. But we *are* a cyclical business and we will manage it to deal with those environments as they occur.

JC:
But Paul there is one other thing I think that is important to mention on that, when we went into that last downturn, we had a significant amount of debt which the private equity firm left us with. So the stock price dropped very, very low last time, because we believe an awful lot of people didn't think we were going to survive. This is a very different balance sheet that John has put together, and not only do we not have any debt, we have a *minimum* of $10 million worth of net cash that we will keep on the balance sheet. So whenever we do go into the next downturn, we are going to be in a substantially better position than we were last time.

PS:
Yes, that is a very good point. Okay. These questions are not in any particular order here, so we are jumping about a bit. But the next one, Dennis asks about your institutional shareholders, he notes that Polar Capital have been selling down their 9% shareholding. So his first question is 'Do we know *why* they were selling?'

JC:
No, we don't really have any information on why our shareholders sell. We don't think it is our place to ask them, and they certainly don't tell us. What we do know is that we do have conversations with them, we meet them on the road show, and in general what we hear from everybody is that they had very large holdings, they are still very supportive of the company, and will continue to remain shareholders in the long term.

To use their terms, that evidently for fund managers trimming is a normal part of their business when they go through an upturn. I am not a stock trader, so I can't tell you whether that is right or wrong.

PS:
Okay, thanks for that. Next question is from Ken. He asks about the $4 million that you have spent, or are spending, on a new headquarters. And he said he is a bit worried that you might

be building a big glitzy head office. And does this mean that administration costs are likely to spiral out of control?

JY:
So with regard to the last question, the impact it will have on the P&L is negligible. There really is not an increase in our operating costs associated with the new building. In many respects it is really just swapping out lease expense and operating costs for a depreciation expense on the new building. The driver for having the new building in place at Fort Myers was to provide us with adequate space to do training for customers that come in. Our current lease facility does not have really a good learning classroom set up, as well as an actual product demonstration capability, because we don't have the space here. So that really solved that problem, and we were able to find a good deal on the property here in Fort Myers.

As far as the overall investment in the spend for the building, that is funded purely through our operating cash flow, and we are about a quarter of the way through the spend and with three quarters remaining in 2016. But the project for me is very much on track, and we expect to be in the new facility in April of next year.

PS:
Okay, thanks for that. Right, next question is also from Ken. He asks about the Chinese markets. I think in one of your previous results announcements you referred to the fact that China uses a colossal multiple of concrete that America uses. So that market is clearly the largest one in terms of potential. So could you talk to us a bit about how things are going for yourselves with regard to China?

JY:
Sure. So China obviously in 2015 we did experience challenges in the marketplace which were driven primarily by some of the money flow slowdown, which was the velocity of money from the building developers and the banks down through the general contractors and the subcontractors. Throughout 2015 we continued to see interest in our machines, and we continued to do all the things that we had committed to do in terms of developing broader awareness and acceptance of wide placement methods, as well as flatness standards. So all those things remained intact and the interest level was there. From the customers' perspective, we did see some hesitancy to purchase some machinery, given concerns over the money flow issues.

So to kind of address that issue, we have instituted a medium term financing programme for our customers which provides them an ability to pay for our machines over 12 to 24 months, through a financing programme that we offered in the last quarter of this year. That has been a positive, and has certainly I think helped solve one of the issues that we have experienced, and that is something that we are hopeful will be a positive impact going forward as well.

PS:
Okay. With that financing facility, are you providing the finance and taking on the bad debt risk yourself, or are you arranging finance through a third party financier?

JY:
No, we are undertaking and underwriting the risk ourselves. To compensate us for the risk we have basically earned an 8 to 10% interest rate on the financings. But what we have which ensures collection, is an electronic ... an EFT capability on our machines, which is embedded

in the operating system, which will shut down the machines when a customer fails to make a payment. So that has been an effective tool that we have very good experience with in the marketplace. And as far as establishing a third party financing option, that is something that ... we have a relationship with the Bank of China that we are continuing to promote, and continuing to develop, and we will always look for other opportunities to get third party financing in place.

PS:
Okay. Looking at worst case scenarios, if the Chinese economy completely collapsed overnight, just for the sake of argument, what would be the maximum exposure that you would have in terms of writing bad debt write-offs for China?

JY:
The absolute maximum exposure would be in the $2.5 million range. But the reality of it is, I think the way we are approaching this long term financing programme is, we are taking a very measured approach to it. We are not going to get too far ahead of ourselves on this, we believe it is a balanced risk and it is part of continuing to develop the marketplace, and we believe that we will earn a fair return on that investment.

JC:
I think it is important what ... there is obviously a lot of chatter and noise going on around China, but when we talked about the low penetration that we have in China, let me give you an example of how you can calculate that penetration. Now we went back and took all of the machines which we had sold in America since we started in business, which is going to be 30 years ago now. We mentioned before that China has *30 times* the concrete consumption of the United States.

So while we have been in business, we have sold 4,400 machines here in the United States. And if you take something like China that potentially is 30 times bigger, that means over that span of time, 30 years from now, in China, we *would have* sold 132,000 machines. To date, the five years we have been selling machines in China, we have sold 187. So we have two tenths of 1% penetration rate in China. And even if that 30% number is off by 50%, we then only have four tenths of a percent penetration rate.

So everybody keeps talking about 'Gee, China's growth is down to 6.5%'. If China didn't grow at all for the foreseeable future, the opportunity in that construction segment is *so large*, that we have a long, long way to go, because the penetration is so small.

PS:
So how do you crack China then, given that it is such a massive market opportunity?

JC:
We do it the same way we have done every other country we went into, Paul. When I came here in 1997 we had one machine and we sold it in the United States, and we sold it in the UK. Since then we have grown the business to sell in 93 countries. In every country you go into, they are using manual methods, and you have to go through the same process of taking contractors who are doing it manually, and converting them to the laser screed technology and training them. You have to talk to building owners and architects and engineers, and get them to adopt the flatness specifications. As you do that, those building owners and those architects specify it on smaller and smaller floors because they see the overall benefits of it.

Now that growth has given us some advantages in China, because the B&Qs and the IKEAs and the Prologis's who have used flat floors and laser screeded floors in other parts of the world, when they go to China they want them, and they ask for them. Then we are able to say 'Okay, here is the contractor you should talk to, because here is the one that we have trained through our system, and they are highly capable of getting you the kind of floor you want'.

So it is a long, long term investment in China. There is no sense of ... we are going to have ups and downs in it, and we understand that, that doesn't change the investment and the activities we make, because we have done this in all the other countries before.

PS:
I see, yes, makes sense. Okay. We have got four more questions. So Mark asks 'Have you got any use planned for your surplus cash pile?'

JY:
So Paul, the plan is to maintain, as Jack mentioned before, the $10 million cash reserve on the balance sheet. And then excess cash over and above that, obviously we always look for investment opportunities either in the business, or by chance if there is an opportunity for an acquisition, would be things that we would look at first. Absent of those opportunities, we would look to ... once we get to a meaningful excess cash number, we would look to distribute that back to shareholders in the most efficient way possible, which would be in the form of a special dividend, or a combination of a special dividend and a share repurchase. Realistically, meaningful excess cash, so it is probably not until we get through 2016 and into early 2017 before we have that discussion.

PS:
Yes, okay, thanks for that. Now another Paul asks 'Would you say that you possess a disruptive technology that will enjoy major substitution effects even during a recession?'

JC:
Yes, it is definitely a disruptive technology. It has caused the entire concrete floor industry, in every country we have been in, to change dramatically. Because it speeds up the construction process, it brings higher quality floors, it lowers the maintenance cost. It has absolutely changed the industry in every country we have brought it to, so it definitely is disruptive.

PS:
Okay, excellent. A couple of last questions. Oh another Paul, we have got lots of Pauls today, this one asks 'Could you use your expertise in floor levelling to expand into other growth areas?'

JC:
We do get into other growth areas, for example in the United States, the parking lots outside of all of these buildings traditionally have been made out of Asphalt or Macadam. And we have put together a patented software system that can be put onto our machines, you buy the system, and that allows us to build concrete parking lots which are *heavily contoured*. They are contoured for two reasons, one the terrain of the parking lot may not be perfectly flat, and also when you build a parking lot, you build it so that everything slopes to the drains that are in there, to drain the water out of the parking lot. So this has brought a significant increase to our business in the United States. Other parts of the world are a little bit slower in adopting the

concrete floors. We have got a couple of systems in Norway, we have got them in Denmark. We do *not* have any in the UK as of yet, and we have got one of them in China, and we have got a number in Australia. So it is definitely ... there are other avenues to get through, and we pursue them constantly.

PS:
Okay, thanks for that. Last question. Another reader asks 'What is the end game? Will the company eventually be sold or will it just remain independent forever?'

JC:
Well that is up to the shareholders, the shareholders own the company. If the shareholders decide that they want to sell it, and a majority of them comes to our board of directors, then we are obligated to do that. From our perspective, this company is going to remain a public company forever unless the shareholders tell us to do otherwise.

PS:
Okay, brilliant. Nice straightforward answer! Great, well that is all the reader questions asked. Thanks *very* much indeed for making yourselves available to answer all these queries, I know the shareholders in the UK really appreciate it. So any closing remarks, any final points you want to make that we haven't already covered?

JC:
Yes. I would like to thank all your shareholders for taking the time to send in the questions, we think that is just fabulous. And I want to thank you for taking the time to put this together and record it and communicate it to our shareholders. So we are more than happy to answer any questions, any time you have, please feel free to contact us. Our phone numbers are on the website, and you can call us whenever you want, and we would be glad to answer whatever questions you have. We are going to be over the first week in March, our annual report will come out 1 March, and we look forward to seeing anybody that is interested in talking to us.

PS:
Excellent, sounds brilliant. Well thanks very much again gents, so we will wrap it up.

Audio ends.