Knowles Corporation (KN)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

<table>
<thead>
<tr>
<th>Price ($) (5/21/20):</th>
<th>14.39</th>
</tr>
</thead>
<tbody>
<tr>
<td>52WK H-L ($) :</td>
<td>23 - 11</td>
</tr>
<tr>
<td>Market Cap (mil) :</td>
<td>1,321</td>
</tr>
<tr>
<td>Shares Out (mil):</td>
<td>91.8</td>
</tr>
<tr>
<td>Avg. Daily Vol (mil):</td>
<td>0.99</td>
</tr>
<tr>
<td>Dividend ($) :</td>
<td>0.00</td>
</tr>
<tr>
<td>Yield (%):</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Price Target ($) : 22
L-Term Rev. Gr Rate Est: 22
L-Term EPS Gr Rate Est: 22
Debt/Cap: 17.1%
ROE: (2.9)%

Rating: Higher Risk
Outperform: FY Dec
2019A 2020E 2021E
Q1 0.05A 0.00A 0.14E
Q2 0.14A (0.01)E 0.22E
Q3 0.32A 0.13E 0.34E
Q4 0.28A 0.26E 0.30E
Total 0.81A 0.37E 1.00E

Suitability: Higher Risk

EPS (Net): Our above estimates are on a pro forma basis including stock comp. Our 2020 and 2021 PF EPS excluding stock comp estimates are $0.52 and $1.33 respectively.

<table>
<thead>
<tr>
<th>Headquarters</th>
<th>IPO/Founded</th>
<th>Dec</th>
<th>2019A</th>
<th>2020E</th>
<th>2021E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Itasca, IL</td>
<td>2014/1946</td>
<td></td>
<td>854.8</td>
<td>706.4</td>
<td>877.4</td>
</tr>
<tr>
<td>Management</td>
<td></td>
<td></td>
<td>3.4%</td>
<td>(17.4)%</td>
<td>24.2%</td>
</tr>
<tr>
<td>President &amp; CEO</td>
<td>Jeffrey S. Niew</td>
<td></td>
<td>14.9%</td>
<td>8.6%</td>
<td>17.6%</td>
</tr>
<tr>
<td>CFO</td>
<td>John S. Anderson</td>
<td></td>
<td>39.0%</td>
<td>36.4%</td>
<td>38.2%</td>
</tr>
<tr>
<td>VP, IR</td>
<td>Michael J. Knapp</td>
<td></td>
<td>1.07</td>
<td>0.52</td>
<td>1.33</td>
</tr>
</tbody>
</table>

Company Description

Knowles was formerly a wholly owned subsidiary of Dover, a global, diversified industrial manufacturer. On May 23, 2013, Dover announced the spin-off of Knowles into a separate, publicly traded company. The spin-off was completed on February 28, 2014.

Knowles was founded in 1946. Headquartered in Itasca, Illinois, Knowles had approximately 8,500 employees across its facilities in 12 countries across the globe exiting 2019, with over 75% of employees located in Asia. The company is a pioneer and market leader in the acoustic market. The company offers two broad categories of products: Audio, including acoustics like microphones and balanced armature speakers, signal processing technologies, and software and algorithms for the mobile, IoT and ear markets; Precision Devices, including oscillators and capacitor products for the medical and life sciences, telecommunications infrastructure, defense and aerospace markets. Knowles introduced the world’s first miniature microphone and receiver for hearing aids in 1954, and the first surface mount MEMS microphone in 2001. Knowles has over 500 patents.

Revenue Profile

Revenue ($ in MM) & Gross Margin Trend

Sources: Company Reports, Baird
Competition
Competitors include STMicroelectronics, AAC Technologies, Goertek, and InvenSense in the mobile consumer electronics market, and Sonion, Rakon, Kyocera, and Epson Electronics in the hearing health market.

Quick Summary
■ Key themes include continued lack of end-demand visibility, with 2Q expected to be notably weak for Knowles’ Hearing Health business, along with the continued impact of production disruptions on gross margin, which nevertheless are expected to track flattish in 2Q QoQ.
■ We expect this year for Knowles to be even more second-half weighted than in past years, with a seasonally-improved demand outlook for the second half enhanced by the ramp of 5G phones, along with gross margin expansion driven by improved supply chain flows and mix.
■ Opex reductions into the second half are significant and expected to provide significant back-half EPS leverage, extending into next year.
■ Balance armature speakers remains a significant new product story, despite a 1-2 month delay.
■ Quarter results. Knowles reported 1Q20 pro forma EPS (ex stock comp) of $0.03, in line with the preliminary result range of $0.00 - $0.04 from Apr. 13. GAAP EPS was ($0.10).
■ 1Q20 revenue was $163 million, down 30% QoQ and as previously reported.
■ 1Q20 pro forma gross margin was 35.7%, down 320bp QoQ, and above our 35.0% estimate and consensus of 34.9%.
■ Guidance. No 2Q20 revenue, EPS, or gross margin guidance provided.
■ Reiterated Outperform rating and $22 price target.

Investment Thesis
Reiterated Outperform rating on significant and ongoing revenue diversification highlighting Knowles’ rapidly improving fundamentals, as smartphones have declined from two-thirds of revenue to 30% and the higher-margin Ear and IoT segment continues to expand as percent of revenue. Revenue growth opportunities ahead include wireless headsets, IoT including smart speakers, DSP-based solutions (Intelligent Audio) both in smartphones and IoT applications, and Precision Devices notably 5G-related mmwave products.

Risks & Caveats
■ Significant customer concentration. Knowles’ largest customer, Apple, accounted for 22% of total revenue in 2019. The loss of or a significant decline in the level of orders from Apple or Samsung could derail Knowles’ revenue growth target, similar to what the company has experienced with Nokia and BlackBerry.
■ Slowdown in key end markets. Knowles generates a substantial portion of its total revenue from sales of products used in smartphones and tablets. If significant slowdown occurs in either of these two key end markets, Knowles’ financial results could be adversely affected.
■ Foreign currency exchange rate. Knowles engages with suppliers and customers from a variety of geographical backgrounds and therefore has material foreign currency exposure. Unfavorable changes in the exchange rate between US$ and related foreign currencies would negatively impact Knowles’ reported results.
■ Pricing pressures and mix improvement opportunities. The added value of new product features is critical to offset ASP erosions inherent to older-generation products. Pricing pressures are pervasive in the MEMS market, due to its heavy consumer electronics exposure. To the extent that Knowles fails to innovate and introduce new product features offsetting pricing, revenue and profit margin could be negatively impacted.
■ Competition. Knowles competes against AAC Technologies, Goertek, InvenSense, and STMicroelectronics for orders from consumer mobile OEMs. If Knowles’ product offerings are unable to catch up with competitors’ in terms of performance or pricing, the company’s market share could potentially come down.

Supplemental Information
Valuation. Our $22 price target on KN shares is based on the stock trading at ~17x our 2021 PF EPS estimate (excluding stock comp) of $1.33, higher than the company’s 15x five-year median multiple, given Knowles’ ongoing revenue diversification away from smartphones and improving mix.


Key Term:
MEMS microphone serves a variety of acoustic applications that require small size, high sound quality, performance and reliability. MEMS microphones usually feature built-in ADC (analog-to-digital converter) circuits.
Knowles Corporation
May 22, 2020

Appendix - Important Disclosures and Analyst Certification

Approved on 22 May 2020 10:20EDT/ Published on 22 May 2020 10:25EDT.

Appendix – Important Disclosures and Analyst Certification

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