CPI INTERNATIONAL HOLDING CORP.

FISCAL YEAR 2015 FINANCIAL RESULTS CONFERENCE CALL
December 11, 2015
11:00 a.m. ET

Operator: Good day, everyone, and welcome to the CPI International Fiscal 2015 Financial Results conference call. My name is Lauren and I will be your conference coordinator for today's call.

At this time, all participants are in a listen-only mode. We will be facilitating a question-and-answer session at the end of today's call. If you require assistance at any time during the call, please press star followed by 0 and a coordinator will be happy to assist you.

As a reminder, this call is being recorded for replay purposes. I would now like to turn the conference over to Amanda Mogin, Director of Investor Relations for CPI International; please proceed.

Amanda Mogin: Thank you, Lauren. Hello and welcome to CPI International's conference call for fiscal 2015. Here is today's agenda:

First, our Chief Executive Officer, Joe Caldarelli, will discuss our sales and orders for the year as well as our recent acquisition of ASC Signal Corporation. Next, our Chief Financial Officer, Joel Littman, will discuss our key financial metrics for fiscal 2015. Then, Joe will discuss our expectations for fiscal 2016. And lastly, our President and Chief Operating Officer, Bob Fickett, will join us for the question-and-answer session at the end of this morning's call.

Before we proceed any further, there are some administrative details that we do need to cover. Please bear in mind that today's presentation includes forward-looking statements within the meaning of the Securities and Exchange Act of 1934.

These statements are based on our best view of our markets in our business as we see them today, as well as on certain assumptions, and actual results can change as market conditions change. Please interpret these statements in that light.

Additional information regarding risks and uncertainties related to our business are included in the Safe Harbor statement in yesterday's press release and in our filings with the Securities and Exchange Commission.

Today's presentation, under Securities and Exchange Commission rules, also includes non-GAAP financial measures related to EBITDA and cash flow. A presentation of the most directly comparable GAAP measures and a reconciliation of each of these non-GAAP financial measures to the most directly comparable GAAP measures are available in yesterday's press release, which has been posted on our website. Interested parties can access the press release by going to www.cpii.com and opening the press release entitled CPI International Announces Fiscal 2015 Financial Results.

As this morning's call will focus on CPI's results for the fiscal year, please consult the press release tables if you are looking for information about our financial performance in the fourth quarter.

And with that, I would now like to turn the call over to Joe Caldarelli to discuss CPI's recent performance.

Joe Caldarelli: Thank you. Good morning and welcome to CPI's year-end call for fiscal 2015. The fundamental long-term demand for CPI's government and commercial products has remained sound, our operations have continued to run smoothly, and this year's activity levels more closely resemble our normal run rate for CPI than did last year's extraordinary levels.

In fact, fiscal 2015 sales, orders and year-end backlog levels were the second highest in our history, even when the contributions from the newly acquired CPI ASC Signal Division are excluded.

Sales in the defense and communication markets, which are CPI's two largest markets, were also higher than in all years other than our exceptional 2014.

Nonetheless, the year had its challenges. The timing of orders for certain defense and communication programs was uneven this past year, impacting sales to a degree.

We discussed this topic extensively on previous calls, so I won't spend too much time on it today. Let me just say that several CPI divisions are reporting that a number of multimillion dollar defense and communication orders which had been expected to be booked in fiscal 2015 have been pushed out until the first half of fiscal 2016.

One of the largest to these orders, an approximately $10 million order for new power grid products to support the Aegis radar systems, was received by our Econco Division in October, just a few weeks after the end of the fiscal year. We expect more of these delayed orders to be booked in the first half of this year.

As we've discussed in the past, order delays are not uncommon in our business. They present us with near-term challenges but do not impact the long-term health of our business and do not change the underlying demand for CPI's products.

Several key metrics for the recently completed year reflect the continued stability and diversify of our business:

Approximately 1/3 of 2015 sales were for spare and repair programs with the other 2/3 going to support new sockets and systems. This has been a fairly consistent ratio for the past six years. Having a large base of spare business and repair business provides a stable recurring revenue stream over the long term.

Many of CPI's spare and repair programs are in the defense market. On average, approximately 54 percent of our defense sales in the past three years have been for spares and repairs.

In the communications market, CPI's military communications or our milcom business remains healthy. In fact, milcom sales in the past two years were notably higher than in any preceding period, even in the years when we were shipping significant products for the WIN-T Increment One program. Milcom sales represented more than 40 percent the CPI's total communication sales of fiscal '15.

A notable amount of communication sales in the past year were for solid state products. Over the past several years, we have built up our portfolio of solid state products and technology, both organically and by acquisition, so that we can continue to offer customers the technology that best fits their needs no matter if it's solid state or vacuum-based. CPI's total solid state product sales have had an average growth of approximately 35 percent per year over the past four years, and they now represent nearly 10 percent of fiscal '15 total company sales.

Approximately 1/3 of CPI's sales in this past year were to customers' outside the United States. We sold products to customers in approximately 100 countries during the year. Combining the global reach of CPI's sales force with the customer focus of our service centers in 20 countries, we remain able to quickly response to customers' needs in every part of the world.

Now, I'd like to discuss the newest addition to the company. In mid-September, we acquired ASC Signal Corporation for approximately $50 million. ASC manufactures large-aperture antennas and controllers for radar, satcom and HF communication applications.

ASC's fixed and mobile antennas are used in high-capacity commercial and military satellite communications uplinks, in air-traffic control radar systems and in weather radar systems. We've very excited about this acquisition as it is a very solid, established and well-known business that offers – that offers defense and communication products to many of the same customers that we serve in our other businesses.

The addition of ASC to CPI expands our portfolio of satellite communications equipment and broadens our advanced antenna offerings to include a wide range of larger antennas for a comprehensive array of applications.

ASC is being managed as a standalone business with its own sales force and its existing management team. We expect our new CPI ASC Signal Division to generate approximately $50 million in annual sales and to generate adjusted EBITDA margins that are comparable to the rest of CPI.

As it was part of CPI for only approximately two weeks before the end of the fiscal year, ASC contributed approximately $3 million of both orders and sales to CPI's defense and communication markets in 2015.

Let's now turn to CPI's orders and sales for the year. We booked orders totaling $437 million in 2015, a 4 percent increase as compared to $421 million last year. Orders in the two largest markets, defense and communications, increased. Orders in the medical market decreased.

CPI's sales in fiscal '15 totaled $448 million, a 6 percent decrease as compared to last year's record $475 million. Defense sales were basically unchanged while communications and medical sales decreased.

We ended the year with $320 million in backlog.

Our book to bill ratio was slightly negative for the year, in part due to the timing of orders and shipments for Aegis radar systems. We received record orders for this program in fiscal '13 and '14 exceeding our strong Aegis sales during those years and bringing shippable backlog into 2015 and beyond.

In contrast, 2015 Aegis orders decreased from those record levels, but our sales for the program were higher than ever – higher than ever. We continue to see a solid future for this program as evidenced by the approximately $10 million order that our Econco Division received in October.

Let's now look at the details of our defense market performance during the year. Our defense orders in fiscal '15 totaled $176 million. This was a 6 percent increase from last year, which was primarily driven by higher orders for a number of radar programs including certain naval and foreign programs. In addition, orders for radomes to support an airborne electronic warfare program also increased.

We generated $181 million defense sales in 2015. Sales in this market were flat because an increase in sales for certain naval radar and airborne electronic warfare programs was offset by a decrease in sales for a recurring radar program with fluctuating activity levels and for a completed electronic warfare program.

As I mentioned a minute ago, sales for Aegis radar systems were at record levels for fiscal 2015.

While we continue to see some unpredictability in order timing, the defense market remains reasonably stable and strong for CPI. All indications are that this situation will remain the same for the foreseeable future.

Turning to the communications market, CPI's communications orders in 2015 totaled $161 million. This was a 15 percent increase from last year and it was due to higher orders to support military satcom programs, such as WIN-T, and higher orders to support the advanced tactical common data link, or TCDL, antenna programs.

This increase was partially offset by delayed orders for radomes for naval milcom applications and lower orders for certain types of commercial communications applications, particularly direct-to-home broadcast and fixed satellite services, due to variations in the timing of large orders for these applications.

We were pleasantly surprised by the strength of the milcom business in 2015. Orders for CPI's milcom products were at one of the highest levels in our history. The reason for this surge in milcom activity for CPI was not attributable to any particularly large program, rather it was primarily due to orders for the sustainment of, and upgrades to, legacy milcom programs, including the WIN-T program on which we shipped approximately $55 million in products in the 2008 to 2011 timeframe.

A number of the sustainment orders came in during the second half of the year, and so the corresponding sales would take place in fiscal 2016.

Communication sales in fiscal 2015 were $166 million, decreasing 8 percent from last year's record sales levels. We recorded lower sales for both commercial communications and milcom programs.

In commercial communications, we made sizeable shipments in 2014 for a number of large infrastructure programs for direct-to-home and fixed satellite service applications. As expected, these programs have not yet recurred, resulting in lower commercial communication sales in the most recent year.

In addition, this business is feeling some effects from the slowdown of the Russian economy and sanctions against Russia. Certain programs for Russian customers have been delayed as a result of these factors.

In the milcom business, lower sales are primarily the result of an expected decrease in shipments of advanced TCDL antenna products for a specific large program. As you may recall, we received an order totaling more than $25 million for advanced TCDL products a couple of years ago, and shipments against that original order have been completed. We have since received subsequent smaller orders for the same program and are continuing to shipping against those follow-on orders.

Overall, CPI's communication business remains healthy and fairly stable, although the programs making up that business can vary significantly from year to year. Going forward, with the recent acquisition of ASC Signal to CPI, the communication market will become CPI's largest end market.

The last market I'd like to address today is the medical market. CPI booked $69 million in medical orders in fiscal 2015, 3 percent less than we booked last year. Lower orders for x-ray imaging products were partially offset by higher orders for MRI products.

CPI's medical sales in 2015 were $68.1 million, a 7 percent decrease from last year's levels. This decrease was also the result of lower sales for x-ray imaging products. Again, higher orders for MRI products partially offset this decrease.

The medical market has become somewhat more susceptible to global government spending constraints and global economic conditions. In fiscal '15, we saw some slowdowns in our medical business in Asia, partly due to customer overstocking and softening economic conditions in certain Asian countries, and we heard concerns from European medical customers about the recent weakness in the Euro's buying power for products sold in U.S. dollars. These factors resulted in lower activity levels in our x-ray imaging business during the year.

In summary, conditions within CPI's three largest markets are reasonably stable and demand remains sound. We are addressing some challenges relating to global economic conditions within the commercial markets and order timing delays within the government and defense-oriented markets.

I will discuss how we expect these challenges to affect fiscal 2016 a little later in this morning's call. First though, here's Joel Littman to discuss CPI's financial performance during the most recent year.

Joel Littman: Thanks, Joe. I will primarily discuss CPI's profitability and liquidity results for fiscal 2015 this morning. Our results for the fourth quarter are available in the tables of the press release that we issued yesterday afternoon. The press release also provides the definitions and reconciliations of the non-GAAP metrics covered in this morning's remarks.

Fiscal 2015 was a reasonably good year financially which suffered from comparisons to fiscal 2014's unprecedented sales and profitability results.

In addition, as you may recall, we executed a successful refinancing in April of 2014 that resulted in increased outstanding debt and higher cash interest expenses. Because this transaction was completed in the third quarter of last year, the increase in debt and interest expenses related to this transaction had a bigger impact in fiscal 2015 than they did in fiscal 2014.

The first metric that I'll discuss this morning is net income. CPI generated net income totaling $4.9 million in the most recent year, as compared to net income of $9.1 million in the prior year.

The primarily reason for the decrease in net income was a lower sales level and less profitable mix of products sold in fiscal 2015, and the $4.3 million increase in CPI's interest expense resulting from the April debt restructuring.

Partially offsetting these items was the absence in fiscal 2015 of the $7.2 million loss in debt extinguishment related to the April 2014 debt restructuring transaction. This charge had negatively impacted fiscal 2014.

CPI's adjusted EBITDA for fiscal 2015 totaled $79.1 million, or 17.7 percent of sales. This was a decrease from fiscal 2014's adjusted EBITDA of $89.8 million, or 18.9 percent of sales.

Like our net income results, our adjusted EBITDA was negatively impacted by lower sales and a less profitable product mix in the most recent year.

It is important to note that CPI has continued to generate adjusted EBITDA margins in the mid to high-teens despite the 6 percent decrease in our sales in fiscal 2015. We have maintained a flexibility to adjust our expenses as necessary in order to remain solidly profitable, even during less optimal times. We expect to maintain similarly strong adjusted EBITDA margins for the foreseeable future.

As of the end of fiscal 2015, CPI's cash and cash equivalents totaled $37.5 million, decreasing from the $50.6 million we had on hand as of the end of fiscal 2014.

The main reason for this decrease was the acquisition of ASC Signal Corporation for approximately $50.4 million in September.

Approximately $23 million of the purchase price was funded using CPI's cash on hand. To help fund the remainder, we entered into a second lien credit agreement in September of $28 million and immediately borrow the entire amount available.

In fiscal 2015, we made debt interest payments totaling $32.3 million and debt principal payments of $3.1 million. CPI continues to generate strong cash flows and make the required interest and debt principal payments.

In fiscal 2015, CPI generated cash flow from operating activities that totaled $20.6 million. Including payments for capital expenditures and excluding a handful of unusual other items, adjusted free cash flow for the year totaled $16.6 million.

Our adjusted free cash flow was lower than expected, primarily due to the timing of sales and collections from customers at the end of the fiscal year. We believe this is a near-term issue and we expect higher adjusted free cash flow levels going forward.

CPI remains solidly profitable and financially healthy. We continue to maintain the financial resources necessary to run our business effectively while servicing debt and leveraging organic and strategic opportunities to grow our business and expand our product and service offerings for customers.

This brings me to the end of my prepared remarks this morning. Joe will now discuss our financial expectations for fiscal 2016.

Joe Caldarelli: Thank you, Joel. At this time, we expect 2016 to be another reasonably normal year for CPI. We do not foresee any imminent changes to market conditions or customer demand.

The challenges facing us in the coming year are familiar ones, namely, managing the ongoing fluctuations in the timing of defense orders and remaining flexible to adapt quickly to the economic challenges that some of our foreign customers are facing.

Our financial projections for fiscal 2016, which include a full-year of contributions from ASC Signal, are as follows: total sales of between $510 million and $535 million, adjusted EBITDA of between $90 million and $95 million, and adjusted free cash flow totaling more than $20 million.

The delays in orders in the back half of fiscal 2015 have pushed some of the corresponding shipments out of the first part of this year. Therefore, we expect the second half of fiscal 2016 to be notably stronger than the first half.

That concludes today’s remarks. Thank you for your time this morning. Operator, please open up the call for questions.

Operator: Ladies and gentlemen, at this time, if you have a question, please press star then the number 1 key on your touchtone telephone. If your question has been answered or you wish to remove yourself from the queue, please press the pound key.

Our first question comes from Donovan Chaney from Wells Fargo. Your line is open.

Donovan Chaney: Have any comment about the media reports that Veritas has hired an investment bank to run an auction for you guys?

Joe Caldarelli: No, we don’t, but, you know, we are owned by private equities so we're always for sale.

Donovan Chaney: Fair enough. Thank you.

Operator: Once again, ladies and gentlemen, if you have a question at this time, please press star then 1 on your touchtone telephone. One moment for questions.

And I’m showing no questions at this time. I would like to turn the call back over to Mr. Joe Caldarelli for closing remarks.

Joe Caldarelli: Well, thank you for listening to us this morning. We look forward to talking to you again in February. Thank you. Have a good day.

Operator: Ladies and gentlemen, thank you for your participation in today's call. This does conclude the program. You may all disconnect. Everyone, have a great day.

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