CPI INTERNATIONAL HOLDING CORP.

FY 2016 FINANCIAL RESULTS
CONFERENCE CALL
December 15, 2016
11:00 a.m. ET

Operator: Good day, everyone, and welcome to the CPI International Fiscal 2016 financial results conference call. My name is Tiara 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, please press star followed by the number zero and a coordinator will happily assist you. As a reminder, this conference is being recorded for replay purposes only.

I would now like to turn the call over to Amanda Mogin, director of investor relations for CPI International. Please proceed.

Amanda Mogin: Thank you, Tiara. Good morning and welcome to the CPI International conference call for fiscal year 2016. We will be focusing on our year-end results from this morning's call. Please refer to the tables at the end of the press release we issued yesterday for CPI's Q4 results.

Here is the agenda for our call. First, Joe Caldarelli, our chief executive officer, will discuss our sales and orders for the year and business conditions in our largest markets. Next, Joel Littman, our chief financial officer, will discuss our key profitability and liquidity metrics for fiscal 2016 as well as our plans for CPI's capital structure. Then Joe will discuss our expectations and financial projections for fiscal 2017. And lastly, Bob Fickett, our president and chief operating officer, will join us for the question-and-answer session at the end of our prepared remarks.

Before we proceed, however, there are some administrative details that we 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 and our business as we see them today, as well as on certain assumptions, and actual results can change as market conditions change. Please interrupt 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 to our Web site. Interested parties can access the press release by going to www.cpii.com and opening the press release entitled "CPI International Announces Fiscal 2016 Financial Results."

Now I will turn the call over to Joe Caldarelli to discuss CPI's performance in fiscal 2016.

Joe Caldarelli: Good morning. Thank you for joining us today. As you may recall, fiscal '16 got off to a slow start for us, but the second half of the year was strong. Q3 and Q4 both set new sales records and Q4 included the highest single quarter orders level in our history. We ended the year with record annual orders and sales, as well as respectable backlog with which to start fiscal '17.

The delays in the placement of government-funded orders that we experienced in the first half of the year settled somewhat as the year progressed. In fact, for the year in total, orders in each of CPI's three largest markets were at or very close to record levels. Sales in our defense and communication markets also reached new highs.

In fiscal '16, CPI's business remained diversified, healthy and stable as evidenced by several key revenue metrics. First, approximately one-third of our sales during the year supported spare and repair programs. The remaining two-thirds supported new sockets and systems. We've maintained this balance for several years even as CPI's total sales have grown, and it provides us with a stable foundation and a platform for growth. Our spare and repair business fosters deep, long-term customer relationships and consistent recurring revenue each year, while our new business offers opportunities to expand our base.

In particular, our defense business remains a large and solid source of recurring revenue. Spare and repair sales have averaged more than 50 percent of our sales in the defense market in the past three years.

Second, we have maintained CPI's traditionally diverse mix of customers and programs which provides stability to our revenue streams.

In fiscal '16, sales continue to be almost evenly split between government and commercial programs. In addition, approximately one-third of our sales were to foreign customers in more than 100 countries, with the remaining two-thirds going to customers in the United States. Notwithstanding the acquisitions we have made, these ratios have remained fairly consistent for several years, indicating that CPI's name and reputation remain well known, respected and desired by government, defense and commercial customers around the globe.

The last metrics that I want to address are related to our communications market which is now CPI's largest application. In fiscal '16, nearly half of our communication sales were for military communications, or milcom, programs. This business has thrived and grown significantly in the past few years. In fact, at 100 million, our milcom sales in fiscal '16 were double what they were just five years ago. This growth is partly due to the continued strength of the long-term milcom programs that we support, but it's also been driven by the expansion of CPI's product portfolio.

Recent acquisitions have added radome and antenna products to our communications offerings, and we have also significantly built out CPI's portfolio of solid state amplifier products in the past several years. Solid state products represent nearly 10 percent of CPI's total sales in fiscal '16, with the majority of those sales going to support communications applications.

The growth of our portfolio of solid state communication products allows us to offer customers the technology that best fits their needs without prejudice, whether it be solid state or vacuum electron device based, expanding the available markets that CPI can serve and enabling us to capture more business in the communications market.

Let's now turn to our specific orders and sales results. In fiscal '16, we booked orders totaling 501 million, an increase of 14 percent from the 437 million booked last year. Orders increased in each of CPI's three largest end markets, with the most significant increase in the communications market.

CPI's sales in fiscal '16 total 495 million, an increase of 10 percent from the 448 million shipped last year. Sales increased in the defense and communications markets.

The ASC Signal business that we acquired in September 2015 contributed approximately 50 million in defense and communications orders, and approximately 47 million in defense and communications sales in fiscal '16. Excluding contributions from ASC Signal, our total orders grew approximately 4 percent, and our total sales grew approximately 1 percent, in fiscal '16.

We ended the year with a healthy 326 million backlog. As expected, our book-to-bill metric improved in the second half of the year.

Let's take a closer look at CPI's orders and sales in our largest end markets, beginning with defense, which consists of radar and electronic warfare programs. As you know, our defense business is a large, stable and secure business comprised of numerous recurring long-term programs. We have excellent longstanding relationships with primes and government agencies, providing a solid platform for growth as allied militaries leverage existing and emerging technologies to address new threats. CPI has been a valued partner and a key supplier in many defense programs for decades, giving us good long-term visibility.

With a particular -- within a particular period, however, our ability to predict the timing of a program is more challenging. Although our programs' underlying requirements may remain steady, it is not uncommon for delays in government funding or paperwork to push orders for programs out of one quarter or year into another. In the first half of fiscal ‘16, we experienced delays in the placement of orders for a number of government programs. While we are still experiencing delays for certain programs, these delays eased somewhat in the second half of the year and several significant previously delayed orders were placed.

One of the largest of these orders was the approximately $9.5 million multiyear contract we recently announced to support a unique application on a new generation of advanced weather satellites. We will deliver the first flight models in 2019.

We had originally expected the contract for the Meteorological Operational Satellite, or MetOps to be awarded last spring, but various administrative matters delayed it until late September. This type of delay has become fairly routine in government funded markets.

During the year, we booked 177 million in defense orders, a slight increase from the 176 million we booked in the prior year. Orders for a number of radar programs, including the Aegis radar system, increased ,as did orders for an airborne electronic counter-measure system. In particular, orders to support air traffic radar systems increased, partly due to orders from ASC Signal. The large MetOps radar contract that I mentioned a minute ago also contributed to the increase in orders. These increases were partially offset by lower orders for an airborne radome program and certain other radar programs, largely as a result of the timing of orders for these programs.

CPI’s defense sales in fiscal ‘16 totaled 186 million, a 3 percent increase from the 181 million we recorded a year earlier. This increase was primarily driven by higher sales to support various radar applications, including sales from ASC Signal and sales to support Aegis and other radar systems. In fact, Aegis sales in fiscal ‘16 were the highest in CPI’s history.

As you can see, notwithstanding near-term timing uncertainty for some programs, the defense market remains solid and stable for CPI.

In the communications market, the situation is more dynamic and we have experienced strong growth from the introduction of new products and programs, both organically and through acquisitions, and from strength of existing products and programs.

CPI's communications market includes commercial communications and milcom programs. In fiscal '16, milcom represented approximately half of our total communications orders and sales. CPI is very well established in the global communications market and we have an industry leading installed base of more than 50,000 high-power, vacuum electron device-based communications amplifiers and more than 15,000 solid state-based communications amplifiers worldwide.

We also have a broad and deep technology portfolio to quickly address each customer's unique requirements for amplifiers, radomes and antenna products. As a result, we are well positioned to take advantage of growth opportunities created by the ongoing global demand for greater and faster data delivery. We are leveraging the strength of our entire communications product portfolio to address the global thirst for broadband services, including for in-flight connectivity.

In fiscal '16, CPI's communications orders totaled 217 million, increasing 35 percent from 161 million in the previous year. Both commercial communications and milcom orders increased and these increases were spread throughout CPI's operating divisions. Orders from CPI's ASC Signal division were responsible for approximately 60 percent of the year-over-year growth. In addition, we enjoyed higher demand for radomes to support shipboard milcom programs from our Radant Technologies Division, higher demand for advanced tactical common data link, or TCDL, antenna products to support UAV programs from our Malibu Division, and higher demand for amplifier products to support satellite communication programs from our Satcom Division.

Communications sales in fiscal '16 totaled 210 million, an increase of 27 percent from the 166 million we generated in the prior year. Both commercial communications and milcom sales increased. This growth was attributable to sales of antenna products from ASC Signal Division and increased sales of high-power Satcom amplifiers from the Satcom Division.

CPI's communications market performed very well in fiscal '16. Our position remains strong and we see sizeable opportunities for continued long-term growth in this market.

Our medical business consists of medical imaging and radiation therapy applications. As we've discussed on recent calls, CPI's medical imaging business primarily supports foreign customers and is dependent both on the general health of foreign economies and on foreign governments' ability to invest in medical imaging infrastructure at a particular point in time.

In fiscal '16, challenging economic conditions in Asia, Europe and South America hampered our customers' ability to sell and install medical imaging products in those regions. As a result, some of these customers found themselves overstocked with CPI products and in need of lower quantities than they had previously expected.

Unsettled economic and political conditions also led to lower levels of investment in medical imaging infrastructure by foreign governments, such as in Russia, Turkey and South America, further depressing our customers' need for products from CPI during the year. As a result of these factors, orders and sales from our medical imaging products, including X-ray imaging and MRI products, were lower in fiscal '16.

Encouragingly, the outlook is stronger for our medical imaging business going forward. We are introducing several new X-ray imaging products with a wide range of features. These include lower-end radiographic generators to address the more price sensitive parts of the market in which we have typically not competed, as well as high-end cardio-angio generators for special procedures and mobile generators to address the needs of our expanding customer base.

We also believe that the overstocked conditions that some of our customers wrestled with in fiscal '16 have been worked out and that fiscal '16 was the floor for our medical imaging business. As a result, we expect our medical imaging business to grow going forward.

In fiscal '16, our medical orders totaled 80.8 million, increasing 17 percent from the 69 million in the prior year. The primary reason for this increase was the placement of multi-year orders for certain of our radiation therapy products in fiscal ‘16. Offsetting this increase, orders for our medical imaging -- medical X-ray imaging and MRI products decreased in the most recent year.

CPI’s medical sales totaled 59.6 million in fiscal ‘16, decreasing 12 percent from 68.1 million. This decrease was driven by lower sales of X-ray imaging and MRI products to foreign customers for the reasons I mentioned earlier. Sales of radiation therapy products increased during the year.

While fiscal ‘16 was a challenging year for our medical business, we expect to do better going forward. We believe that the combination of the conclusion of customer overstocking issues, the introduction of new diagnostic imaging products and the continuing stable radiation therapy demand will result in improved medical market performance in the coming year.

In summary, fiscal ‘16 had some challenge initially but concluded on a strong note. Delays in the placement of government-funded orders in the first half of the year eased in the second half. Our defense business remained strong and steady. Our communications business grew significantly, with continuing strength in existing products and programs augmented by new products and programs. Our medical business worked through some economic headwinds and is launching new diagnostic imaging products to drive future growth. In addition, the new ASC Signal Division has been successfully integrated into CPI and made significant contributions to our orders, sales and profit for the year.

And now I’d like to turn the call over to Joel to discuss CPI’s financial performance in fiscal ‘16.

Joel Littman: Thanks, Joe. I will focus my remarks this morning on CPI’s results for the fiscal year. For the fourth quarter results, please consult the financial tables at the back of yesterday’s press release. The press release also contains the definitions and reconciliations of the non-GAAP financial metrics that I will cover this morning.

Let’s begin by examining CPI’s recent profitability results. In comparison to the previous year, CPI’s net income and adjusted EBITDA results increased in fiscal

2016. These increases resulted primarily from higher sales volume during the most recent year, in large part due to the inclusion of a full year of sales from the new ASC Signal Division.

In addition, the relative strength of the U.S. dollar in comparison to the Canadian dollar had a favorable impact on our profitability in fiscal 2016. As you know, CPI's sales are primarily made in U.S. dollars. But we do have sizeable Canadian dollar expenses because we have two large manufacturing facilities outside Toronto. Therefore, there is a beneficial effect on CPI's profitability results when the U.S. dollar strengthens against the Canadian dollar.

Our net income results also benefited from lower acquisition-related expenses. As you may recall, last year we had significant expenses resulting from the acquisition of ASC Signal, which closed in the fourth quarter, as well as the Radant Technologies earn out, which has since been fully paid out.

In fiscal 2016, CPI generated net income totaling 5.7 million, or 1.2 percent of sales. This was as 16 percent increase from the 4.9 million in net income, or 1.1 percent of sales, generated in the previous year.

The positive factors that I discussed a moment ago were offset in part by higher interest expense, due to the 28 million of additional debt in September 2015 that was used to partially fund the ASC Signal acquisition, and higher income tax expense in the most recent year. Income tax expense increased from 4.8 million to 8 million in fiscal 2016, due primarily to higher foreign income and foreign tax credit limitations.

CPI's adjusted EBITDA in fiscal 2016 totaled 86.1 million, increasing 9 percent from the prior year's 79.1 million. The positive factors I discussed earlier were partially offset by the inclusion of a full year of operating and expenses for ASC Signal.

Our adjusted EBITDA margin in fiscal 2016 totaled 17.4 percent, as compared to 17.7 percent in fiscal 2015. Our margins remain consistent with our longstanding expectations for adjusted EBITDA margins in the mid to high teens.

As you can see from our net income and adjusted EBITDA results, CPI remains solidly profitable.

CPI also remains a dependable generator of cash and we've produced healthy positive cash flows during the year. As of the end of fiscal 2016, our cash and cash equivalents totaled 50.2 million. This was an increase from the 37.5 million on our books as of the end of the previous year, despite the 10 million earn out that we paid to the previous owners of our Radant Technologies Division during fiscal 2016.

We remain comfortable with the level of cash that we have on hand and confident in our continued ability to generate healthy levels of cash with which to make required debt payments.

For the year, CPI generated cash flow from operating activities totaling 26.1 million. Our free cash flow, which subtracts cash capital expenditures, totaled 20.2 million. Adjusted free cash flow, which excludes certain other items that are listed in the tables of yesterday's press release, totaled 29.1 million.

Our adjusted free cash flow guidance was 20 million for the year. At 29.1 million, our adjusted free cash flow exceeded this guidance, primarily due to lower capital expenditures and lower cash income tax payments.

CPI remains financially healthy, stable and profitable. We have significant financial resources and are able to generate reliable levels of cash. We possess the means necessary to continue to support our existing customers and grow the business while continuing to satisfy our debt obligations.

Let's take a few moments to discuss our debt obligations and capital structure. As you know, CPI has sizeable debt levels. As of -- as of the end of fiscal '16, we had 302 million outstanding on our first lien term loan, 28 million on our second lien term loan and 215 million in our 8.75 percent senior notes. These amounts exclude original issue discount and unamortized debt issuance cost.

If we do not repay or refinance at least 65 percent of our senior notes before next August, our revolver will mature. If we do not repay or refinance at least 65 percent of our senior notes before next November, our term loans will also mature.

For the past several months, we have been exploring a number of options with our bankers to address CPI's capital structure. These options range from addressing only the upcoming maturity dates on our senior notes to replacing our entire capital structure. We plan to repay or refinance our senior notes so that the maturity dates for our revolver and term loan are extended until 2021.

To ensure that we have access to the necessary funds with which to repay or refinance our senior notes, we recently entered into an agreement with UBS, under which the bank has committed to provide CPI with up to 245 million in bridge financing that we can use to refinance our senior notes as well as our second lien term loans. We will only access the bridge financing if we are unable to repay our senior notes through other financing sources.

I will now turn the call back over to Joe to discuss CPI's expectations for fiscal 2017.

Joe Caldarelli: Thank you, Joel. After a somewhat challenging start, fiscal '16 was ultimately a healthy year. We expect fiscal '17 to be a stronger year. We anticipate growth in our orders, sales and profit levels in the coming year.

At this time, it looks like the quarterly trends of fiscal '17 will be similar to this past year, with the back half of the year outpacing the front half. This is due to some ongoing delays from the placement of orders, as government and defense funding is often slow at the beginning of the government's fiscal year. That appears to be the case again this year.

We expect market conditions to remain largely unchanged in the coming year. Therefore, we expect the defense business to remain stable, our communications business to continue to grow and our medical business to improve for the reasons I discussed earlier.

Our financial projections for fiscal ‘17 are: total sales of between 510 million and 530 million, net income of between 6 million and 9 million, adjusted EBITDA of between 89 million and 94 million, operating cash flow of more than 28 million and adjusted free cash flow totaling more than 22 million. For guidance on what the -- what items are excluded from our adjusted EBITDA and adjusted free cash flow calculations, please refer to the definitions of these non-GAAP metrics in the 10-K we filed yesterday.

This concludes our prepared remarks this morning. We appreciate your time and attention. Operator, please open up the call for questions.

Operator: Thank you. Ladies and gentlemen, at this time if you would like to ask a question, please press star then one on your touch-tone telephone. If your question has been answered or you wish to remove yourself from the queue, please press the pound key. One moment for questions. And again, if you would like to ask a question, please press star then one on your touch-tone telephone.

At this time, I’m showing no questions. I would like to turn the call back over to Joe for closing remarks.

Joe Caldarelli: Thank you. We’d like to thank all of you for joining us and wish you a happy holiday season. We look forward to talking to you all again in February. Thank you.

Operator: Ladies and gentlemen, this does conclude the program for today. Please thank you and have a good day.

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