CPI INTERNATIONAL HOLDING CORP.

FIRST QUARTER 2015 FINANCIAL RESULTS CONFERENCE CALL
February 11, 2015
11:00 a.m. ET

Operator: Good day, everyone. And welcome to the CPI International First Quarter 2015 Financial Results conference call.

My name is Candice and I will be your conference coordinator for today's call.

At this time, all participants are in 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 zero and a coordinator will be happy to assist you.

As a reminder, 'today's conference 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, Candice. Good morning, and welcome to the CPI International conference call for the first quarter of fiscal 2015.

Here is our agenda for this morning's call: first, Joe Caldarelli, our Chief Executive Officer, will discuss CPI's sales and orders results, and business conditions in our three largest end markets. Second, Joel Littman, our Chief Financial Officer, will address several of CPI's key financial metrics for the quarter. Third, Joe will then discuss our financial projections for 2015 and lastly, Bob Fickett, our President and Chief Operating Office, will join us for the question and answer session at the end of today's call.

Before we get underway, there are some administrative details 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 business as we see them today, as well as 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 is 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 website.

Interested parties can access the press release by going to www.cpii.com, and opening the press release entitled, CPI International Announces First Quarter 2015 Financial Results.

And now I will turn the discussion over to Joe Caldarelli.

Joe Caldarelli: Good morning, and welcome to this morning's call. CPI's performance in the first quarter was in line with our expectations, representing a solid start to what we expect to be a good year.

Our market conditions remain relatively stable. During the quarter we recorded sales and backlog numbers that exceeded the levels generated in the same quarter of every prior year except for 2014.

As we discussed with you in December, we do not expect fiscal '15 to duplicate the unusually strong activity that we saw last year but we do expect it to be a healthy year for our business.

Our Q1 sales totaled $111 million as compared to the record $124 million in the year-ago quarter. We generated sales in our two largest markets, defense and communications, that were higher than our same-quarter sales for every year other than 2014, demonstrating that we are still seeing reasonable activity in these markets.

We also booked a decent level of orders in the most recent quarter. Our Q1 orders totaled $102 million as compared to $121 million booked in 2014. Orders decreased slightly in most of our end markets with the most sizeable decrease being in the defense market.

The defense market is experiencing delays in the placement of some orders that are consistent with the generally unpredictable nature of government business that I'm sure you've already heard about from others.

As of the end of the quarter, our backlog remains sounds at $300 million.

Let's take a deeper look at our largest end markets, starting with defense. As you know, our defense business is made up of more than 100 radar and electronic warfare programs, making it our biggest and most secure market. The large majority of our defense programs are long-term recurring programs, with some programs recurring more regularly than others.

Some, like the Aegis radar systems, recur on a consistent and fairly predictable basis, although the level of demand for these programs can vary from year to year. For example, orders for Aegis radar systems were significantly higher in 2013 and 2014 than they had been in prior years, and included orders for new shipbuilds as well as orders to restock existing systems on previously deployed ships.

In comparison, many of our other defense programs recur more intermittently, with the timing depending on the customer's needs, inventory levels and funding availability at a particular moment in time.

We generally see some activity in these programs during most, but not all, years and not on a predictable or defined schedule.

At present, orders for some of our consistently recurring defense programs are delayed or being placed at lower levels than last year. Current indications are that this is in line with the programs' normal fluctuating activity levels. For example, although orders for Aegis radar systems were lower in Q1, we still expect this program to continue to be a strong performer for the fiscal year.

Additionally, a number of the intermittently recurring defense programs are experiencing delays in order placement. The reasons for these delays appear to vary by program, and do not seem to be unusual or systemic in nature.

In Q1, orders in the defense market totaled $40.8 million, decreasing 26 percent from last year's quarter. The primary reason for this decrease is the timing for recurring defense programs. Orders for certain radar programs, including Aegis, and for certain electronic warfare programs were lower, mainly as a result of timing of the placement of orders for those programs.

Our Q1 defense sales were also impacted by these timing related issues, although not to the same degree. Sales in this market were 42.7 million in Q1, decreasing 6 percent from last year's quarter due to lower sales for a radar program that regularly experiences fluctuations in demand levels, as well as lower sales for an airborne EW program.

We may see future business for this EW program but we have completed our participation in the current iteration of the program. Partially offsetting these decreases, shipments for the Aegis radar systems increased in the most recent quarter.

Although predicting the exact timing of our defense business is a bit of a challenge, we remain confident that long-term demand for radar and electronic warfare programs remains healthy and market conditions for our products are generally stable.

In our second largest market, communications orders decreased 2 percent to 38.6 million. As with our defense market, this decrease was largely the result of order timing. Orders for commercial communications program were lower. Specifically, orders to support direct to home broadcast applications decreased because we received a couple of large DTH orders in last year's quarter that did not repeat in this year's quarter.

In contrast, orders to support milcom applications increased, particularly orders for tactical common data links, or TCDL, antennas.

Our communications sales decreased 20 percent to 40.6 million in Q1 as a result of lower commercial communications and milcom shipments. It's important to note that our communication sales in Q1 of 2014 were our highest sales ever in this market.

Despite the sizeable drop from last year's record sales, our Q1 2015 communications sales levels remains solid. Within the milcom segment of our communications market, the sales decrease was largely due to the completion or near completion of shipments for certain military satcom, advanced antenna and telemetry programs.

Within the commercial communications segment, in the year ago quarter, sales of Ka-band products to support fixed satellite services were very strong due to the shipment of orders for Ka-band products that we booked in fiscal 2013.

As we discussed in previous calls, these orders did not repeat in fiscal 2014 and so the sales did not repeat in the most recent quarter. Sales of radomes from our Radant Technologies Division increased in the most recent quarter.

Conditions within the communications markets are still generally favorable and with the addition of the Radant business last year, and the recent interest in newer Ka-band technology, we have the ability and the opportunity to grow this portion of our business over the next several years.

The third and last market that I'd like to discuss today is the medical market. Overall this market is relatively stable with some areas of growth and some areas of relative softness. In particular, the medical imaging sector remains strong for us. Demand for x-ray imaging products has grown, especially in Asia, as countries in that region are building out their medical infrastructures. Bookings for radiation therapy products are somewhat softer, however, due in part to the timing of large orders.

In Q1, our medical orders were essentially unchanged with 16.7 million. Lower radiation therapy orders were offset by higher orders for x-ray imaging and MRI products. We still expect to receive significant radiation therapy orders later this year.

Our medical sales decreased 6 percent to 18.9 million. This decrease was primarily due to a decrease in shipments of radiation therapy products. Sales of x-ray imaging products increased, particularly in Asia.

In conclusion, although our orders and sales are lower than last year's record results, business conditions remain reasonably stable and fundamental demand for our products continues to be solid.

We are continuing to see satisfactory activity levels in our major end markets and are successful managing the inconsistent program timing within the defense and communications market.

Now I'll turn the call over to Joel to discuss our financial performance during the quarter.

Joel Littman: Good morning. My comments today will focus on CPI's profitability and liquidity in the first quarter of fiscal 2015 as compared to the same quarter of fiscal 2014.

Please note that this year's first quarter was one week shorter than last year's first quarter.

As usual the definitions and reconciliations of the non-GAAP metrics mentioned in my prepared remarks are available in the financial table of the press release that we issued yesterday afternoon.

As you know, in April of 2014, CPI completed a debt restructuring transaction, which among other items, increased our outstanding debt by 171 million. Primarily as a result of this increase in our borrowing, our interest expense increased 1.8 million in the first quarter of fiscal 2015 as compared to the same quarter of the prior year, which impacted our net income results in the most recent quarter.

CPI's net income totaled 3 million in the first quarter of fiscal 2015 versus 3.1 million in the same quarter of fiscal 2014. The decrease in net income was primarily the result of lower sales and the increase in interest expense and was almost entirely offset by lower income tax expense.

In the most recent quarter, income tax expense benefited from several discreet tax benefits. The most significant of these tax benefits were for a California income tax refund for amended prior-year tax returns and the expiration of the statute of limitations for uncertain tax positions.

Our adjusted EBITDA totaled 21.3 million, or 19.2 percent of sales, in the first quarter. In comparison, last year's quarter included adjusted EBITDA of 23.1 million, or 18.7 percent of sales. The primary reason for the decrease in our adjust EBITDA dollars was a lower sales level in the most recent quarter.

Despite the lower sales, you can see that our adjusted EBITDA margins have remained strong at 19.2 percent. We continue to carefully manage our expenses in order to maintain a healthy bottom line.

At the end of the first quarter, CPI had cash and cash equivalents totaling 58.1 million. This is an increase from the 50.6 million in cash and cash equivalents that we had on our balance sheet at the end of fiscal 2014.

We remain comfortable with our cash position and our ability to continue to generate cash. For the 12 month period that ended on January 2nd, we generated cash flow from operating activities totaling 49 million and adjusted free cash flow totaling 45 million.

Our LTM adjusted free cash flow was higher than our annual guidance due to favorable timing for certain cash payments and receipts, including for accounts receivables and taxes.

Our recent cash flow levels are more than sufficient to meet our ongoing debt obligations, and we remain confident that we have the necessary resources to continue to provide our customers with the high quality products and industry leading support and services for which we are known.

Our recent profitability and liquidity metrics show that CPI remains a financially healthy company. We continue to generate positive cash flows and we are on track to meet our guidance for the year.

I will return the call to Joe, to discuss the details of our guidance for the year.

Joe Caldarelli: Thank you, Joel. Our first quarter results were in line with our expectations. Customer demand remains solid, our backlog is good and not withstanding somewhat unpredictable order timing, the long-term market outlook remains fundamentally unchanged.

Therefore we remain confident that we will achieve the financial projections that we discussed with you on our December call.

For fiscal 2015, we continue to expect CPI to achieve total sales of between 450 million and 475 million, adjust EBITDA of between 80 million and 84 million, and adjusted free cash flow totaling more than 21 million.

That concludes today's prepared remarks. Thank you for your time this morning.

Operator, let's open up the call for questions.

Operator: Thank you. Ladies and gentlemen on the phone lines, if you would like to ask a question at this time please press star, followed by the number one 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.

And our first question comes from the line of Donovan Chaney of Wells Fargo. Your line is now open.

Donovan Chaney: Good morning and thanks for taking a few questions.

Joe Caldarelli: Sure.

Donovan Chaney: Kind of a big picture question. The defense budget outlook seems to be improving a little bit, at least sort of on the surface as we seem to be going from kind of a definitely down environment to a flat to maybe up environment, at least if you look at sort of the base budget over the last couple of years.

Could you guys maybe talk a little bit about the tone from your customers and whether they seem, you know, your customers seem a little more optimistic now, or did they just sort of, it is business as usual with not a lot of optimism?

Joe Caldarelli: Yes, I don't think the optimism has filtered down to the agencies where the orders would be placed from. I think the agencies are still operating largely hand-to-mouth and largely on the "delay orders as much as we can" basis.

So I agree with you that the tone is improving but it hasn't yet, and I wouldn't, realistically I wouldn't expect that to translate into anything tangible for a meaningful period of time until people at the agencies actually have definitive additional funding or security of funding availability.

Donovan Chaney: That makes sense. Also related to the defense budget, I know this quarter you guys mentioned timing of orders as relevant. Now I know that's usually the case to some extent but Q1, your Q1 of this year, the government's Q1, we also had the continuing resolution effect from most of October, November and into early December, did that also play a role in the timing of some of your orders?

Joe Caldarelli: It's hard to say again, you know, realistically what happens way upstairs, it's hard to translate to what happens down at the agencies. And certainly we did see a fair bit of drag out during the last several months.

Whether that's driven by the continuing resolution or just the general unpredictability and the general drag out that's been going on for two, three years right now, it's very difficult to pinpoint but certainly I can confirm that we are continuing to see delays in the placement of orders.

And again I remind you that contrary to expectations, the prior couple of years we were surprised by the pull-in and the increase size of certain orders, and to some extent I would characterize where we are today as being back to normal and what's happened in the last couple of years being a pleasant surprise.

Donovan Chaney: OK. That's helpful. A couple more quick questions… I know you guys have a sizeable cash balance and a cash flow outlook for this year looks good, could you maybe comment on any plans for that cash? Either the balance sheet cash or, kind of, what your free cash flow priorities would be - is that's term loan repayment? Is it looking for more acquisitions? It just seems like you've got a lot of dry powder there.

Joe Caldarelli: Yes, there's really no change in our philosophy. It always has been to maintain sufficient cash on hand to avoid any nasty surprises and we're comfortable with the current level. And, as you know if you've watched us, and you watched us for a while, we continue to look for appropriate acquisitions at an appropriate valuation so that they are accretive. And we continue to do that as well.

We're not going to do anything dramatic that would jeopardize our position but we have the ability to do something should the opportunities arise. So for the time being we're not planning on making any specific decisions one way or the other. We're continuing to look for opportunities. If we find that the cash balance is growing, and the opportunities aren't really there, then we'll pay down the term loan.

Donovan Chaney: That's great. That's very helpful. Thank you.

Joe Caldarelli: Thank you.

Operator: Thank you. And our next question comes from the line of Ryan Spitz of Stone Harbor Investments. Your line is now open.

Ryan Spitz: Good morning. Just a couple of questions, you reiterated your previous guidance. I guess if you annualize the first quarter sales, it looks like you'd be a little low over the 450 number at the bottom end of the range, and could you help us think about the cadence of revenue through the rest of the year? And if that's based on any improvement on the order environment? Thanks.

Joe Caldarelli: Yes, several of our units are expecting things to pick up in the mid part of the year. So yes, you're actually right, we do expect the mid part of the year to be a bit stronger. Some of that is already in backlog, some of that is predicated on some of these orders we've been following for a while freeing up.

And we are seeing some of that. So right now we've seen really no losses of such. We've seen largely postponement of placement of orders. And so, yes we are counting on certain orders being placed that have been delayed out of Q1 and being able to ship some amount of that in Q2, 3 and 4.

Ryan Spitz: OK. And then I know in the release you mentioned this quarter was a week short of last year. Could you perhaps quantify the impact there?

Joe Caldarelli: It's hard to quantify directly, but it's not directly proportional. Certainly in orders placement is hard to say that something might have come in if we'd had an extra week.

In terms of revenue, we worked one week less, so from a revenue perspective, to the extent we had backlog, we could have produced more if we had an extra week.

The one that's unusual by the way is last year, this year is a normal length quarter. Correct, Joel, I got that right?

Joel Littman: Yes, every six or seven years we have to add an extra week.

Ryan Spitz: OK. Terrific. And that's all for me. Thank you.

Operator: Thank you. Again, ladies and gentlemen, if you do have a question at this time, please press star followed by the number one key on your touchtone telephone.

And we're showing no further questions at this time.

I'd like to turn the conference back over to Mr. Joe Caldarelli for any closing remarks.

Joe Caldarelli: Well thanks very much, folks. And we look forward to talking to you again in better weather in May. Thank you very much.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does concludes today's program and you may all disconnect. Have a great day everyone.

END