CPI INTERNATIONAL HOLDING CORP.

FIRST QUARTER 2012 FINANCIAL RESULTS CONFERENCE CALL
February 10, 2012
11:00 a.m. ET

Operator: Good day, everyone, and welcome to the CPI International First Quarter Fiscal 2012 Financial Results Conference Call. My name is Karen and I'll be your coordinator for today's call.

At this time, all participants are in a listen-only mode. We'll be hosting a question-and-answer session at the end of today's conference. 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, this 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, Karen. Good morning, and welcome to CPI International's conference call for the first quarter of fiscal year 2012. Our speakers and topics for today's call are as follows:

First, Joe Caldarelli, CPI's Chief Executive Officer, will discuss our performance and our major end markets and our expectations for those markets this year. Then, Joel Littman, our Chief Financial Officer, will discuss some of our key financial metrics for the quarter and our expectations for cash flow for the remainder of the year. And lastly, Bob Fickett, our President and Chief Operating Officer, will join Joe and Joel for the question-and-answer session.

Before this morning's call gets underway, there are some administrative details to which I would like to attend. 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 and actual results may 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 as well as measures that combine results before and after the February 11th, 2011 acquisition of the company by Veritas Capital.

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 First Quarter 2012 Financial Results.

And now, here is Joe Caldarelli.

Joe Caldarelli: Good morning and welcome. I'm pleased to report that CPI has begun fiscal '12 with a solid Q1 that was driven primarily by well-performing core programs. Our promising start to the year demonstrates the continuing underlying strength and stability of our recurring base business. Although we expect to have some difficult comparables this year given that fiscal '11 contained certain programs that had a significant positive impact on our results, we are pleased with the state of our core business and its prospects for the foreseeable future. Overall, our three largest markets are healthy and our business is growing within this defense, medical and communications markets. Our backlog remains high at 252 million. Our book-to-bill ratio continues to bode well for future sales growth and we're looking forward to a busy productive year.

In comparison to the year ago quarter, our total sales grew 4 percent to 93 million. Sales increased in our defense, medical and communication markets.

In Q1 of this year, we booked 97 million in orders generating a healthy book-to-bill ratio of 1.05. Q1 of 2011 included a 6.9 million order for a one-time counter-IED program hence our orders in the recent quarter represented a slight decrease. If we exclude that nonrecurring one-time program in the year ago quarter however, our order level of Q1 of fiscal '12 was 6 percent higher than it was at the same time last year.

Let's take a look at our orders and sales on a market by market basis starting with our defense market. In Q1, orders in our defense market increased 10 percent to 49.9 million. Our defense market encompasses our business in radar and electronic warfare applications. The growth in orders in this market was due primarily to increased demand for products to support a number of radar programs, particularly the Aegis weapon system and radars for certain missile systems.

We have supported these well-established radar systems for many years and while the order levels have fluctuated from year-to-year depending on the status of new builds and the spare stocking levels for these systems, both Aegis and this other radar systems have been and are expected to remain dependable recurring business for CPI for a long time.

The increase in orders for our radar programs was partially offset by a 6.9 million decrease in orders related to the one-time program I mentioned a moment ago. We discuss this counter-IED program extensively on our fiscal '11 call in December so I'll limit my remarks on it today. You may recall that the program provided 18 million in both sales and orders in fiscal '11 and it's expected to provide neither sales nor orders this fiscal year.

Q1 sales in our defense market increased 8 percent from the year ago quarter to 34.3 million. This increase was due to higher sales to support radar systems in the U.S. and internationally.

Overall, we continue to expect stable steady business in our defense market. We have not heard of any significant threats to our major defense programs in the ongoing U.S. Defense budget discussions, and notwithstanding the absence of last year's one-time counter-IED program, we are looking forward to a solid year in this market.

Let's move on now to the medical market. Orders in the medical market decreased by 7 percent to 12.7 million in the most recent quarter while sales increased 14 percent to 19.3 million.

The largest component of our medical market consists of products to support x-ray imaging applications. In Q1, orders and sales for x-ray imaging applications increased, particularly for customers participating in Russian tender programs. Overall, our medical imaging business, which you might recall had been a bit slow to recover from the 2009 economic downturn, is picking up nicely.

According to feedback from our x-ray imaging customers, they believe they are now benefiting from the stronger economy and they increasingly feel that they are returning to business as usual. As a result, we anticipate a stronger year for x-ray imaging applications.

The second large component for our medical market business encompasses products to support radiation therapy applications.

In Q1 of last year, we received a large order for these products earlier than we normally do. The order itself is not unusual but the timing of it was. We typically receive our large radiation therapy orders in Q2 and Q4. In fact, we have since received a similar large order in this year's Q2.

As a result of the unusual timing of this order last year, however, our orders and sales to support these applications were lower in Q1 of fiscal '12 in comparison to last year. Notwithstanding the unfavorable Q1 comparables have resulted from this irregular timing, we expect our radiation therapy business to be stable and healthy this year.

The third component of our medical market is our MRI business which has always been very lumpy and uneven. Orders and sales for MRI application decreased in the most recent quarter. We do not have higher expectations for the MRI business in the near future and we believe that uneven pattern will continue.

The last of CPI's major markets that I'd like to discuss today is the communications market. Those of you that have been following CPI for some time know we were awarded the WIN-T military communications program in late 2007. Increment One of WIN-T was expected to last approximately four years and as expected is now drawing to a close. We participated heavily, shipping approximately 55 million in products for it and its related programs during the past several years.

The conclusion of Increment One of the WIN-T program is a key contributor to the decrease in orders, particularly milcom orders, that we experienced in our communications market in Q1. At 25.3 million orders in the communication market were 16 percent lower than a year ago. As previously discussed on our fiscal ’11 conference call, we expect our WIN-T business and, by extension, our milcom business in fiscal ’12 to be lower than they have been for the past several years.

Partially offsetting the decrease in our milcom business, we saw some growth in areas of our commercial communications business. Specifically, orders for direct-to-home broadcast applications increased in the first quarter of this year. We expect commercial communications to continue to benefit from strengthening economies around the world and from the continuing insatiable demand for bandwidth.

Communication market sales, on the other hand, increased by 5 percent to 32.2 million. This increase was led by sales to support commercial communications applications particularly fixed satellite services and direct-to-home broadcast applications. Overall, notwithstanding the completion of WIN-T Increment One, we’re expecting another good year in our core communications business.

In summary, due to the timing of some large programs in fiscal ’11, the first quarter of fiscal ’12 has some unfavorable comparison. Nonetheless, our sales increased during the quarter. Our backlog is high. Our book-to-bill ratio was encouraging and we’re enjoying healthy business and favorable market conditions in radar, x-ray imaging, radiation therapy and commercial communications applications. Fiscal ’12 is off to a promising start.

This year, we’re focusing on our stable core business of long-lived programs, many of which are poised for continued growth. We remain on track for solid year. I’ll talk about our projections for this year a little later in this morning’s call.

And with that, I’ll turn the call over to Joel to discuss our financial performance in Q1.

Joel Littman: Thanks, Joe. My remark this morning will concentrate on CPI’s profitability and liquidity metrics in the first quarter of fiscal 2012. I will discuss our net income, adjusted EBITDA, cash, free cash flow and adjusted free cash flow. The definitions and reconciliations of the non-GAAP metrics I will be discussing are available in the financial tables of yesterday afternoon's press release.

I'd like to start with the discussion of CPI's profitability in the most recent period. As you know, CPI was acquired by Veritas Capital in February of 2011. This transaction as well as the refinancing that we undertook in connection with the acquisition resulted in an increase in certain expenses in the most recent period which in turn impacted our net income results. In particular our depreciation and amortization expenses increased by 4.7 million, due primarily to the reevaluation of our assets in connection with the acquisition.

In addition, our interest expense increased by 3.1 million as a result of the refinancing. The significant increases in these expenses in the first quarter of fiscal year 2012 as compared to the same period of the prior year contributed to our recording a net loss of 1.6 million for the period. Our net income in last year's first quarter was 2.2 million.

In comparison to this year, 2011 first quarter contained 2.7 million in strategic alterative transaction expenses. These are nonrecurring costs for services from investment bankers, attorneys and others in conjunction with the acquisition and we did not record similar expenses in the most recent quarter.

Our adjusted EBITDA results exclude nonrecurring and transaction related expenses among other items. In the first quarter of fiscal 2012, our adjusted EBITDA totaled 12.7 million or 14 percent of sales. This is a decrease from our adjusted EBITDA of 13.2 million or 15 percent of sales in the same quarter of the prior year. The decrease is principally due to an unfavorable Canadian dollar to U.S. dollar exchange rate that caused an increase in the U.S. dollar cost of our Canadian operations in the first quarter of this year.

The approximately 1 million unfavorable impact of the increase in Canadian cost on our gross profit and operating expenses is partially offset by the favorable impact of our increase sales level had on the gross profit in the first quarter of fiscal 2012 as compared to the same period a year ago.

We consider adjusted EBITDA to be one of the key measures of our continuing financial performance. In general, we expect to generate adjusted EBITDA margins in the mid to high teens on an ongoing basis. The first quarter is generally the weakest quarter of our fiscal year due primarily to fewer working days as a result of the Thanksgiving and December holidays and related factory shutdowns. That was the case this year and we expect adjusted EBITDA and adjusted EBITDA margins to improve in the remaining quarters of fiscal year 2012.

Let's move on now to our liquidity measures. During the first quarter of fiscal 2012, our cash and cash equivalents rose by 4 million to approximately 39 million. For the 12-month period that ended December 30th, 2011, our cash flow from operating activities totaled 6.5 million. During that period, we generated a free cash flow totaling negative 2.2 million.

As the 12-month period encompassed the February 2011 acquisition, our free cash flow for this period included significant strategic alternative transaction expenses and cash outlays, including payments for the accelerated vesting of restricted stock awards that were cashed out in the acquisition, resulting in negative free cash flow for the period.

Adjusted free cash flow, which excludes certain merger related nonrecurring unusual and certain other expenses, was 11 million for the 12-month period ending December 30th. It was unfavorably impacted by the timing of advance payments and the collection of receivables, which are expected to correct themselves over the remaining quarters of fiscal 2012. We continue to expect to generate annual adjusted free cash flow in excess of 17 million for fiscal year 2012.

In summary, our profitability was impacted by increases in costs that resulted from last year's acquisition and refinancing and an unfavorable Canadian dollar to U.S. dollar exchange rate while our cash flow results were impacted by acquisition related expenses and the timing of customer payments.

Despite these negative factors, we believe that CPI remains in a good financial position and we are fully confident in our ability to achieve our financial goals this year and going forward. And now, I'll turn the call back over to Joe.

Joe Caldarelli: Thanks, Joel. As Joel just mentioned, we are reconfirming our previously issued guidance for the year. We expect to generate sales of 380 to 395 million, adjusted EBITDA of 63 to 65 million and adjusted free cash flow of more than 17 million. We expect this fiscal year to be a solid, stable year for the company with growth in a number of our key long-term programs.

That concludes our prepared remarks. We appreciate your time and attention this morning. Karen, let's begin the question-and-answer session.

Operator: Thank you, sir. Ladies and gentlemen, if you do have a question at this time, please press star followed by the number one key on your touch tone telephone. If your question has been answered or if you would like to remove yourself from the queue, you may press the pound key. Once again, if you do have a question, please press star and then one at this time. And we'll pause one moment for any questions.

And we do have a question from the line of Dan Colonna of UBS.

Julie Pearson: Yes. This is Julie Pearson in for Dan. The first question we have is can you give us an update on your balance sheet and your thoughts regarding leverage specifically where would you be comfortable taking leverage for the right strategic acquisition?

Joe Caldarelli: Well, I don't think we have a particular target per se. We have been historically and we'll continue to be fairly cautious in business like about acquisitions. We clearly have some capacity to do some more if the right thing came along – but we also recognize that we have a meaningful amount of leverage already to start with. But we don't have any specifics there; you know, we're certainly not going to go nine but we believe we had some room for reasonable size acquisitions should they come along at the right price and the right return.

Julie Pearson: OK, great. And then, just one more question, can you provide us any update on pricing of defense contracts given the budgetary concerns and have you seen any visibility on the volumes are affected on the platforms that you currently are on?

Joe Caldarelli: Now, actually we're fortunate that's so far so good. I would say the pricing pressures are probably no different today than they had been for some time. There's always price pressures, of course, and they're continuing, I would say, largely unchanged so far. The tone of our Q1 call is that we've done better in Q1 in defense related activities than we frankly expected to do so.

A list of the things we're doing for the time being? We have been relatively unaffected and things are going along probably better than we would have predicted they would have at this time.

Julie Pearson: OK, great. That's it for me.

Operator: Thank you. And once again, if you do have a question, please press star followed by the number one key on your touch-tone telephone and we'll pause to see if there are any further questions. And I see – no, wait. We do have another question now from the line of Tim Secontine of Northern Trust.

Tim Secontine: Hi guys. Hey, just a housekeeping question and I'm looking for it right now. I saw yesterday, there is a – I think like a $9.9 million debt maturity, that's current debt – can you give some color?

Joel Littman: This is Joel. Our credit agreement has something that it's very typical called an excess cash flow sweep.

Tim Secontine: OK.

Joel Littman: What that is is a system estimate of excess cash flow sweep, plus required amortization of 1.5 million per year.

Tim Secontine: Perfect. Thanks, Joel. That's it for me. Nice quarter.

Operator: Thank you, sir. And I see no additional questions at this time.

I'd like to turn the conference back over to Joel Littman, if you have any further comment, sir.

Joe Caldarelli: I'll take it here, it's Joe Caldarelli. Well, thank you all very much for joining us this morning. If there are any further questions you think of later, don't hesitate to give Amanda a call and we can arrange for follow-on dialogue. Thank you again for joining us this morning. Have a good day.

Operator: Thank you. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program and you may now disconnect. Everyone, have a good day.

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