CPI INTERNATIONAL HOLDING CORP.

SECOND QUARTER 2015 FINANCIAL RESULTS CONFERENCE CALL
May 13, 2015
11:00 a.m. ET

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

My name is Latoya and I will be the conference coordinator for today's call. At this time all participants are in a listen-only mode. We will be facilitating the question and answer session at the end of today's call.

If you should require assistance to anytime 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 will now like to take the conference over to Amanda Mogin, Director of Investor Relations for CPI International, please proceed.

Amanda Mogin: Thank you, Latoya. Good morning and welcome to CPI International's conference call for the second quarter of fiscal 2015.

Here is our agenda for today's call. First our Chief Executive Officer, Joe Caldarelli will discuss CPI sales and orders results as well as business conditions in our three largest market. Second, our Chief Financial Officer, Joel Littman will discuss our key financial metrics for the quarter. Third, Joe will discuss our financial predictions for fiscal 2015. 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 call.

Before we proceed, there are 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 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 risk and uncertainties related to our business are included in the safe harbor statement in yesterday's press release and 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 Second Quarter 2015 Financial Results.

I would now like to turn the call over to Joe Caldarelli.

Joe Caldarelli: Thank you. Good morning, and welcome to CPI's second quarter call. The first half of fiscal 2015 has progressed roughly as we anticipated. After an incredibly strong fiscal 2014, in which we outperformed CPI's previous record high results, we are seeing a somewhat natural pull back in our sales rates and profits this year, as expected.

As a result, we generated sales and profits in the first half of the year that are solid and healthy, representing growth from fiscal 2013, but which are not as strong as our record-setting fiscal 2014.

On the orders front, we are encountering some of the same headwinds as others in our industry. In particular orders for certain government programs are slow to emerge and the timing of these programs is slipping to the right.

Note that, in certain cases, we believe that the larger than normal demand levels we saw on 2013 and 2014 may have been due to an acceleration of order timing for certain programs to catch up on depleted stock levels.

In other words, certain replenishment in orders were pulled in to earlier periods and subsequent orders are being pushed out to later periods. This is causing minor but manageable challenges in certain areas of our defense business. Our customers tell us that our products remain vital for their systems and that their underlying fundamental need for our product is as strong as ever, but the government agencies have been slowed to place their orders for certain defense and communication programs nonetheless.

We are confident that these orders will be placed, but the timing of these programs is challenging to pinpoint accurately. Although this ongoing situation is worth mentioning on this call, it's also worth noting that this is not a new or altogether unusual situation for CPI or our industry and, we will continue to manage through it as always.

In the first six month of fiscal 2015, we booked 227 million in orders, a slight decrease from the 229 million booked in the same period last year. In terms of our three largest markets, orders decreased in defense, but increased in the communications and medical markets.

In Q2, we generated 108 million in total sales, as compared to the record 121 million reported in the same quarter a year ago. Our Q2 sales in our two biggest markets, defense and communications, were higher than the same quarter sales for every year except 2014, while sales in our medical market were effectively unchanged from last year.

As of the end of Q2, our backlog was respectable at 317 million and our year-to-date book to bill ratio was a positive 1.04.

Let's now take a deeper look at recent activity in our major end markets, starting with defense. Within this market, we participate in over 100 programs, a significant percentage of which are active at any one time. It is the largest and generally the most stable of our markets, and it is made up of a combination of consistently recurring and intermittently recurring programs.

Nevertheless, our sales and orders result in this market can be impacted in any one period by the timing of orders for large radar or electronic warfare programs. In the first six months of fiscal 2015 our defense orders totaled 92 million, decreasing 3%

from last year's period. Orders decreased for electronic warfare applications, particularly a small number of airborne EW programs, and for certain radar programs, including Aegis radar systems, due to the timing of the placement of orders for those programs.

It should be noted however that we enjoyed extraordinary orders in 2013 and 2014 for our Aegis products and we are still shipping from backlog against certain of those earlier orders. The order timing delays impacting some defense programs do not appear to be unusual nor universal. In fact, the decreases in certain programs were partially outset by an increase in orders for several other domestic and foreign radar programs.

Our defense market sales in the second quarter were also impacted to a degree by timing related issues. Q2 sales decreased 8% to 43 million. This decrease was due primarily to lower sales from a recurring radar program that regularly experience these fluctuations and demand levels and for two defense programs for which we have completed substantially completed our participation in their current iterations.

Partially offsetting these decreases, we had higher sales of radomes for an airborne electronic warfare program and higher sales for Aegis radar systems.

Overall, our defense business is healthy and generally stable despite some short term disruptions caused by the timing of the placement of certain orders in this market.

In our second largest market, our communications market, orders increased 6% to 76.4 million in the first six months of fiscal 2015.

Orders from military communications applications were higher, particularly orders for advanced Tactical Common Data Link, or TCDL, antenna products. Within the commercial communication segment of this market, orders from fixed satellite services applications were notably higher as well. Partially offsetting this increases, orders for radomes for naval milcom applications decreased from the year ago period.

Sales in the communications market decreased 15% to 38.4 million in Q2. As you may recall, our communications sales set a Q2 record in the year ago quarter. The primary reason for the decrease from last year's record quarter was lower sales from milcom applications, including lower sales in advanced Tactical Common Data Link antenna products and certain radomes.

The decrease in advanced TCDL antenna products was due to the recent completion of shipments for a large order received in fiscal 2013 for a UAV program. We have since received smaller follow on orders for this program for which we continue to make shipment. The decrease in radome sales is purely due to the timing of shipments for an ongoing program.

Within commercial communications, sales for fixed satellite services applications were higher. In general, our communications business is healthy. However in the near term, we are experiencing lower sales in this market - particularly from military communications applications - largely due to the timing of large milcom programs in previous years that have not repeated and are not expected to repeat at the same sales levels in fiscal 2015.

However, demand for communications products overall remain solid and we continue to see opportunities for growth within this market.

In the medical market, year to date orders increased 10% to 45.4 million; this increase was due primarily to higher orders for MRI applications. Although MRI programs make up only a small portion of our medical business, we periodically receive notable orders fees programs as was the case in the first six months of this year.

Orders for x-ray imaging programs also increased slightly.

Our Q2 medical sales were essentially flat at 17.4 million.

CPI's medical business has performed reasonably well as global conditions have stabilized for this market. While demand for certain of our imaging products used in radiation therapy systems has gone down, fundamental underlying demand for medical imaging programs remains solid, with new opportunities opening up as we introduce new products, and there is continued growth in Asia.

In summary, although last year's record sales have resulted in unfavorable comparisons to this year's sales levels, CPI's underlying business remains healthy. Business conditions are generally stable and fundamental demand for our products continuous to be sound.

We are managing the challenges presented by inconsistent timing and program delays in our government business and are pleased to see generally more favorable conditions within our commercial business.

At this time I like to turn the call over to Joel to discuss CPI's financial performance in Q2.

Joel Littman: Thanks, Joe. Good morning. I will focus this morning's comments on our profitability and liquidity metrics in the most recent quarter versus the year ago quarter. The definitions and reconciliations of the non-GAAP metrics that are mentioned in my prepared remarks are available on the financial tables of the press release to the CPI issued yesterday afternoon.

I'll start this morning's discussion with CPI's net income results. In the second quarter of fiscal 2015, we recorded a net loss of 0.9 million as compared to net income of 5.9 million in the same quarter of fiscal 2014. The primary reasons for this decrease were related to our sales. We sold a less profitable mix of products and had lower shipment volume in the second quarter of fiscal 2015 than in the year ago quarter.

In addition, the debt restructuring transaction that we completed in April 2014 which included an increase in our borrowings, resulted in a 2.3 million increase in our interest expense in the most recent quarter, negatively impacting our net income results. Personally offsetting these negative factors, our income tax expense was lower in the most recent quarter.

CPI's second quarter adjusted EBITDA totaled 16.6 million, or 15.3% of sales. This is a decrease from the 23.3 million, or 19.3% of sales, that we recorded for adjusted EBITDA in the year ago quarter.

As with our net income, the decrease in adjusted EBITDA was primarily sales related. We sold a less profitable mix of products and had lower sales volume in the most recent quarter.

Despite this decrease, our bottom line remains healthy. CPI's adjusted EBITDA results in the first half of fiscal 2015 have outpaced our adjusted EBITDA results for the same period of every year prior to the exceptional 2014. We continue to manage our operations and expenses with a careful eye on maintaining our bottom line and generating profitable business.

Let's turn to our cash balances. As of the end of the second quarter CPI had cash and cash equivalents totaling 48.3 million, as compared to the 50.6 million with which we ended fiscal 2014. Please keep in mind that CPI has made debt interest payments totaling more than 16 million in the first six months of fiscal 2015.

We also made debt principle payments totaling approximately 1.6 million during that period. We remain confident and uncomfortable with our ability to continue to generate positive cash flows to service out debt and run our business effectively.

For the 12 month period that ended on April 3rd, CPI generated cash flow from operating activities that totaled 35.7 million and adjusted free cash flow that totaled 32.8 million.

In short, CPI remains financially fit. We continue to generate healthy adjusted EBITDA results and positive cash flow and we are maintaining the cash balances necessary to operate our business and meet our customers' needs.

With that, I'd like to turn the call back over to Joe to discuss our guidance for fiscal 2015.

Joe Caldarelli: Thanks, Joel. To recap our conversation this morning, fiscal 2015 is shaping up to be a decent year for CPI but with some timing challenges. Our financial results, although lower than last year, are healthy and in line with our expectations. Conditions in our end markets are reasonably stable, fundamental customer demand is solid, our backlog is sound and we have the opportunity and the resources to continue to expand our business and generate long-term growth.

The fiscal 2015 financial projections that we discussed with you in our December and February calls remain unchanged. We continue to expect to generate total sales of between 450 to 475 million, adjusted EBITDA of between 80 million and 84 million, and adjusted free cash flow totaling more than 21 million.

That brings us to the end of our prepared remarks. Thank you for your time today. Operator, let's open up the call for questions.

Operator: Thank you. Ladies and gentlemen, if you have a question at this time, please press the star then one key on your touchstone telephone.

If your question has been answered or you wish to remove yourself from the queue, you may press the pound key. And once again if you have a question, please press star then one.

And I show we have a question from Ryan Spitz of Stone Harbor Investments, your line is open.

Ryan Spitz: Hi. Good morning. Thanks for taking my question. I just want to follow up on the margins for the quarter, they came in all weaker than I would have expected even with the lower sales and can you talk about the specifically what drove the mix and margin differential there? I know some of it was volume but it looks like most of it was probably product mix?

Joe Caldarelli: Joel, do you want to do that?

Joel Littman: Sure. I mean, it's primarily mix. I mean, part of that is volume and there are fixed costs that have to be absorbed, and with lower sales that there isn't as much absorption, but it's just primarily mix. We had some fairly profitable programs last year that are ending or ended before we got to the current quarter. There's really nothing unusual in there, there's no loss reserved booked or anything like that. It's mix.

Ryan Spitz: OK. So should we expect, I mean you did reiterate your '15 guidance, so should we expect that to reverse I guess with going to the second half a little bit?

Joel Littman: Yes, we do expect a stronger second half.

Ryan Spitz: OK. And then I guess just the follow up on the working capital. It looks like you guys had a pretty solid bookings quarter, although down, I guess, on the first half but in the second quarter for strong. So was that working capital increase, you know, particularly the use of cash, more directed towards, you know, orders that you expect to basically hit the income statement in the second half then?

Joel Littman: Yes. Our inventory did increase in the quarter and that inventory should be used up in the second half of the year, so which would decrease the working capital.

Ryan Spitz: Great. Thank you.

Operator: Thank you. And once again if you have a question, please press star then one on your touchstone telephone.

And at this time I'm showing no further questions in the queue. I would like to turn the call back over to Joe Caldarelli, closing remarks.

Joe Caldarelli: Thank you all again for your interest and for participating this morning and look forward to talking to you again in August. Thank you.

Operator: Thank you. Ladies and gentlemen, this concludes today's conference you may now disconnect. Good day.

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