CPI INTERNATIONAL HOLDING CORP.

SECOND QUARTER 2016 FINANCIAL RESULTS CONFERENCE CALL
May 11, 2016
11:00 a.m. ET

Operator: Good day, everyone, and welcome to the CPI Second Quarter 2016 Financial Results conference call. My name is Latoya, and I will be your conference coordinator for today's call. At this time all participants are on 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 the star followed by zero 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. Good morning and welcome to CPI International's conference call for the second quarter of fiscal 2016. Our agenda on today's call will be the following:

First, Joe Caldarelli, our Chief Executive Officer, will discuss orders, sales and business conditions in our three largest end markets. Then, Joel Littman, CPI's Chief Financial Officer, will discuss our key financial metrics for the second quarter. Next, Joe will discuss our expectations for the second half of the year, and lastly we will open the call up for your questions. Bob Fickett, our President and Chief Operating Officer, will join us for the question and answer session.

Before we proceed 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 market 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 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 Second Quarter 2016 Financial Results."

Now, I will turn the call over to Joe Caldarelli to discuss CPI's performance in the second quarter.

Joe Caldarelli: Thank you. Good morning. On last quarter's call, we told you that fiscal 2016 had gotten off to a slow start due to delays in orders for government-funded programs and softening global economic conditions that impacted commercial programs. I'm pleased to report that although the first four months of this year were challenging, the situation has improved and business conditions appear to be normalizing in most of our end markets.

Our Q2 orders and sales level were stronger than our Q1 levels, and several previously delayed orders have either been booked or are expected to be booked soon. Although we do not expect to make up the ground lost to order delays in the first four months of the year, February and March brought more normal activity levels and we are currently on track for a much improved second half of the year in comparison to the first half of the year.

Our Q2 performance represents an improvement over both the previous quarter and the same quarter of last year. In comparison to last year's period, some of the top line improvement was due to the inclusion of ASC Signal's orders and sales in this year's results. As you may recall, we acquired our – this business in September 2015. CPI ASC Signal Division contributed approximately $28 million to our year end – to our year-to-date orders and $18 million to our year-to-date sales this year.

Overall, CPI booked orders totaling 249 million in the first six months of fiscal '16. This was a 9 percent increase from the 227 million booked in the same period last year. Excluding ASC Signal, total orders were down slightly from last year. Although the situation has improved from earlier in the year, we are still experiencing delays in the placement of certain orders that are impacting year-to-date activity levels.

Looking at the orders within each end market, the clear standout was communications. Communications orders increased substantially due to the addition of ASC Signal to CPI, as well as the overall strength of CPI's traditional, i.e. pre-existing, communications business.

Orders in the defense and medical markets decreased.

CPI's Q2 sales totaled 120 million, increasing 11 percent from 108 million in the same quarter last year. Excluding ASC Signal from the most recent quarter, still – sales still increased 5 percent from the year ago quarter.

Sales increased significantly in the defense and communications markets, but decreased in the medical market.

As of the end of Q2, we have approximately 338 million of backlog. This is CPI's highest backlog level in two years.

Our LTM booked to bill ratio was 1.0. As previously delayed orders continued to come in, we expect this metric to improve.

Let's take a detailed look at CPI's largest end markets, starting with defense. The defense market consists of radar and electronic warfare programs, and in Q2 it included an insignificant contribution from the ASC Signal Division.

As we've discussed on previous calls, the placement of defense orders has been subject to lengthy delays in recent periods. Conversations with customers have identified no meaningful changes to their underlying need for CPI's products since a significant portion of our defense business is for spare and repair products for programs that we already support.

But these conversations continue to reveal ongoing funding challenges and, frankly, bureaucratic obstacles. Every step of the defense order placement process has simply taken longer. We could tell you multiple stories in which customers have asked us to expedite shipments for defense programs but the orders for those programs have either not yet been placed or have just been booked after lengthy delays.

In the first six months of fiscal '16, CPI booked defense orders totaling 75.9 million, an 18 percent decrease from last year's period. Although orders for CPI's largest defense program, the Aegis radar systems, have remained strong, lower orders for other naval programs and an airborne radome program drove this decrease.

In fact, one recurring naval radar program was responsible for nearly 80 percent of the decrease in defense orders and aptly demonstrates the timing challenge we are having in this market.

In last year's period, we booked our highest orders ever for this program. However, fiscal '15's orders included some orders that had been delayed from fiscal '14, magnifying the size of fiscal '15's orders for this program to a record level. This year we had expected to book sizable orders for this program in the first six months of the year, but the order booking was again delayed. We now expect to record the order in Q3. This is a long-term recurring radar program that consistently provides healthy business to CPI and the fundamentals of this program – and of the defense market – remain stable and unchanged, yet the ongoing push and pull of orders into and out of various periods is resulting in lumpy, unpredictable demand.

Turning now to sales, CPI generated 47.8 million in sales – in defense sales in Q2, an increase of 11 percent from prior years. Sales increased for a number of radar programs, including weather and naval radars and an airborne radome program. In the most recent quarter, sales for the Aegis radar system where the highest in CPI's history.

In the communications market, CPI's orders increased 53 percent from the same period last year to a total of 117 million in the first six months of this year. Approximately 60 percent of this increase was due to the inclusion of ASC Signal in this year's period, but CPI's traditional, pre-existing, communications business has enjoyed stronger organic growth this year as well. Traditional, commercial communications were strong due to higher orders for high-throughput satellite programs, and traditional milcom orders rose due to higher orders to support and maintain various long-term milcom programs.

The increased milcom activity included orders for advanced tactical common data link, or TCDL, antenna products for UAV applications, which, as you may recall, has been a very good, long-term program for our Malibu Division, but one with very lumpy timing. The latest round of orders for this program had been expected several months before it was finally placed.

On our last call I mentioned that a substantial order for radomes to support a milcom application had been delayed. That order is still delayed but it's now expected to be placed in Q3.

Turning to sales, Q2 communications sales increased 27 percent from last year's quarter to 40.6 million. Contributions from the new ASC Signal Division were responsible for approximately 60 percent of this increase, but we also enjoyed higher sales of amplifiers and radomes to support CPI's traditional milcom programs.

The communications business is healthy, and market conditions are currently favorable. Demand for Ka-band products to support high-throughput satellite applications is driving growth in CPI's traditional communications business. The ongoing support and maintenance needs for long-term programs are providing opportunities in the milcom business. And the addition of ASC Signal advanced antennas to CPI has extended the size and scope of our product portfolio, making communications our largest end-market. We expect to enjoy continued strength in this market throughout the remainder of the year.

The last market that I will discuss today is CPI's medical market. There are two main parts to our medical business, supporting medical imaging applications and supporting radiation therapy applications. The medical imaging business primarily serves foreign customers and requires quick turnaround times. As a result, CPI's medical market is more susceptible to changes in global economies than the defense-oriented markets.

Medical orders and sales in the most recent period were negatively impacted by challenging international economic conditions, particularly in Asia and, to lesser extent, Europe. In Asia, primarily in China and South Korea, softening economies have led to significantly lower activity within the medical imaging segment of CPI's medical business. Additionally, the unfavorable U.S. dollar exchange rate has made products that are priced in U.S. dollars less affordable to foreign customers. We continue to work with customers to overcome these economic challenges but do not expect a dramatic change in the near term.

In the first six months of fiscal '16, CPI's medical orders totaled 43.8 million, decreasing 4 percent from the same period last year. Orders for radiation therapy products, which primarily support U.S. customers, were strong and increased from last year's period. Orders from medical imaging products, chiefly for x-ray imaging, decreased due to lower orders from foreign customers, largely resulting from the economic challenges I mentioned a moment ago.

Q2 sales on the medical market totaled 13.7 million, decreasing 21 percent. Similarly, sales of CPI's radiation therapy products remain healthy but sales of x-ray imaging products decreased.

In summary, although the first four months of fiscal '16 were difficult due to the continuing delays in government-funded orders and challenging and uncertain global economic circumstances, conditions have improved and we are seeing more normal activity levels in most of our end-markets. Although the medical market is continuing to feel the effects of global economic challenges, the defense market is starting to see the placement of some previously delayed orders and the communications market continues to be strong. We anticipate that the second part of the year will continue with these recent trends.

At this time, I'd like to turn the call over to Joel, to discuss our recent financial performance.

Joel Littman: Thanks, Joe. Before I start my remarks, please note that the definition and reconciliations of the non-GAAP metrics that I will discuss today are available in the financial tables of the press release that CPI issued yesterday afternoon.

The first metric that I would like to discuss this morning relates to CPI's profitability in the second quarter of fiscal 2016. In comparison to the year ago quarter, net income and adjusted EBITDA increased primarily due to higher sales volume and the beneficial impact of changes in the Canadian dollar to U.S. dollar exchange rate.

As you may recall, we have manufacturing facilities in Canada that generate significant expenses, but we mostly sell our products in U.S. dollars. As a result, the strengthening of the U.S. dollar relative to the Canadian dollar in the past year has had a noteworthy positive effect on our profitability in the most recent quarter.

In the second quarter of fiscal 2016, CPI generated net income of approximately 500,000 which was an increase from the approximately 900,000 net loss that we recorded in the same quarter last year. This increase was primarily due to the higher profits related to higher sales volume, the more favorable U.S. to [Canadian] dollar exchange rate and a discrete income tax expense in the second quarter of fiscal 2015 that did not repeat in the most recent quarter.

Partially offsetting these favorable impacts, we recorded higher expenses for amortization of acquisition-related intangibles and increased interest expense from additional borrowings, most of which were related to the acquisition of ASC Signal last September.

Our adjusted EBITDA in the second quarter totaled 18.4 million, increasing from 16.6 million in the year ago quarter. The increase in adjusted EBITDA was primarily due to the higher sales volume and the more favorable U.S. to Canadian dollar exchange rate.

In both quarters, our adjusted EBITDA equated to 15.3 percent of sales, in keeping with our expectations for adjusted EBITDA margins in the mid-to high teens. We expect our adjusted EBITDA margins to increase in the second half of the year as we return to more normal business levels.

In the second quarter, we continued to generate healthy cash flows. As of the end of the quarter, our cash and cash equivalents totaled 34.4 million as compared to 37.5 million at the end of fiscal 2015. Please keep in mind that we paid the previous owners of our Radant Technologies Division a 10 million earnout in the first quarter of fiscal 2016 because they exceeded the financial goals we had set for them when we acquired that business two years ago.

We remain comfortable with the cash that we have on hand and our cash generation capability. We are confident that we have the financial resources necessary to continue to run the company successfully.

For the 12 month period that ended on April 1, 2016, our cash flow from operating activities totaled 24.3 million and our free cash flow was 17.7 million.

At 26.2 million, our adjusted free cash flow for the last 12 months exceeded our annual guidance. We expect our adjusted free cash flow to remain strong for the remainder of the year.

CPI's financial results in the second quarter reflect a financially healthy company that continues to be able to meet its debt obligations while growing the business.

I will now return the call to Joe to discuss our financial projections for the remainder of the year.

Joe Caldarellli: Thanks, Joel. As I mentioned earlier, the first several months of fiscal '16 saw continuing order delays and other challenges that resulted in a disappointing first-quarter. The situation improved in Q2, and we are currently operating at a more normal business levels. We expect Q3 and Q4 to be at these more normal levels as well and to be notably stronger than Q1 and Q2.

Unfortunately, although the worst is behind us, the lengthy delays in the placement of some quarters in the first several months of the year pushed some of the corresponding sales out of fiscal ‘16. We do not expect the sales and profit associated with them to be caught up this year. As a result we are adjusting our guidance for the year to reflect the effect of the fiscal first quarter and the improved remainder of the year.

At this time, we expect fiscal 2016 results to include total sales of between 500 million and 520 million, adjusted EBITDA of between 85 million and 90 million, and adjusted free cash flow totaling more than 20 million. Our adjusted free cash flow guidance has not changed.

Before we move on to the Q&A portion of today’s call, I want to touch on our capital structure, as we are aware that many of you have questions about our plans to address it.

As you know, CPI’s revolver matures in August 2017 and the term loan matures in November 2017, unless we repay or refinance at least 65 percent of our 215 million Senior Notes before then. If we do so, the maturity date on the revolver will extend out to April 2019 and the maturity date on the term loans will move out to April 2021.

At this time, we expect to refinance our debt before the revolver matures in August 2017. We will continue to carefully monitor conditions in the credit markets to determine the best possible time for us to refinance.

I cannot provide a date for this process other than to say that we expect to complete it before August 2017 at the very latest.

That brings us to the end of our prepared remarks today. Thank you for your time and attention this morning.

Operator, please 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 touch tone telephone. If your question has been answered or you wish to remove yourself from the queue, you may press the pound key. Once again, if you do have a question, please press star then one. One moment for questions.

You have a question from Ryan Spitz of Stone Harbor Investments. Your line is open.

Ryan Spitz: Hi, thanks for taking my question. Just wanted to follow up on ASC performance during the quarter. If I've done the math right, it looks like the ASC acquisition did about 7 million of sales in the quarter versus 11 million in the last quarter. Is that math right? And could you maybe comment a little bit on what the difference was sequentially and what may be a good run rate as you think about that business? Thanks.

Joe Caldarelli: Your calculation's approximately correct. ASC, like every other business, has seen the same effect of push outs in deliverable orders and has been somewhat starved with shipping backlog in the first six months. So that is correct. Their expectation in the second half of the year is actually ramped up significantly in revenue for the next six months and perform much better than they have in the first six months, and in Q2 particularly.

Ryan Spitz: OK, great. And then just a quick follow-up on that, so I know you talked about the second half improvement and it looks like your bookings and orders, you know, to date would be consistent with that. You know, how should we be thinking about the free cash flow profile? Not the adjusted numbers so much, but the actual free cash flow profile as you kind of – as you deliver more of it also, you know, it sounds like the order environment is improving so maybe there is an inventory build. How should we sort of be measuring the puts and takes on that?

Joe Caldarellli: Joel, do you want to do that? Joel? For some reason, Joel is not connecting. So, you're absolutely right. There will be some ups and downs as we build up the manufacturing rate, the inventory will build and certainly if we have a big push for shipment at the end of the year, again with the quarter the receivables will build. But in aggregate we do expect to finish, as I've mentioned, with total free cash flow in excess of 20 million which is consistent with what we've done in the last 12 months. So, you know, we'll maintain our aggregate free cash flow. There may be a lift here and there at any period-end specifically reflecting the increase in inventory and/or receivables.

Ryan Spitz: OK and then – and I guess in terms of the use of that cash would – how would you be thinking about the use priorities? Is it debt pay down, is it, you know, re-investing the business? How do you think about that?

Joe Caldarelli: Well, no I think we're going to hang on to it. So, you know, given the current circumstances and given that our maturities are coming due soon, we're likely just going to keep the cash in cash and, you know, focus on refinancing when the proper time to do that comes along.

Ryan Spitz: Great. Thank you.

Operator: Thank you and as a reminder, if you do have a question, please press the star then one key on your touch tone telephone. There are no further questions in the queue at this time. I'll turn the call back over to Joe Caldarelli for closing remarks.

Joe Caldarelli: Again, well thank you very much. We appreciate you listening to us again this quarter and we look forward to talking to you again in three months. Have a good day.

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

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