CPI INTERNATIONAL HOLDING CORP.

THIRD QUARTER 2013 FINANCIAL RESULTS CONFERENCE CALL
August 8, 2013
11:00 a.m. ET

Operator: Good day, everyone and welcome to the CPI International third quarter fiscal 2013 financial results conference call. My name is Katherine 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 the 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 the 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, Katherine. Good morning and welcome to CPI International's conference call for the third quarter of fiscal 2013. Our speakers and topics for this morning's call will be as follows. First, Joe Caldarelli, CPI's Chief Executive Officer, will discuss our recent sales and order results in our major end markets and our expectations for those markets going forward, as well as our recent acquisition of MCL.

Second Joel Littman, our Chief Financial Officer, will review CPI's third quarter performance for several of our key financial metrics. Next, Joe will discuss our expectations and guidance for the remainder of the fiscal year and, lastly, Bob Fickett, our President and Chief Operating Officer, will join us for the question-and-answer section of today's call.

Before this morning's call gets underway, however, there are some administrative details which I'd 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 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 rule 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 website. Interested parties can access the press release by going to www.cpii.com and opening the press release entitled CPI International announces Third Quarter 2013 Financial Results.

Now I'd like to turn the call over to Joe Caldarelli.

Joe Caldarelli: Thank you. Good morning and welcome to our call. We are very pleased with CPI's Q3 results and the continuation of the positive trends and followed operational performance that has characterized the first half of our year. In fact, our results this year have exceeded our internal expectations. In comparison to last year, we grew all of our top and bottom-line results including orders and sales in all of our major end markets.

We also set several new company records, including our highest quarterly sales rate, our highest sales and orders rates for the first nine months of the fiscal year and our highest quarter end backlog level.

Before we go into more details of our quarterly performance, I'd like to take a few moments to discuss the acquisition that we made at the end of Q3. Given the timing of the acquisition, it did not have a significant impact on our sales and order results in Q3, but we think this is an important addition to CPI.

During the last week of June, using cash on hand, CPI acquired certain assets of MCL, an Illinois-based manufacturer of power amplifier products and systems for the

Satcom market. MCL's products are generally similar in form, fit and function to the products offered by CPI's Satcom Division, and we are in the midst of integrating the business into our Satcom Division. In order to continue to serve the needs of former MCL customers, several MCL employees will transition into rules at CPI supporting fielded products and we intend to retain MCL's extensive global network of service providers.

We think this is an excellent acquisition that will strengthen our satellite communications business going forward. We expect that it to be accretive in fiscal 2014 excluding the impact of purchase accounting and non-recurring integration expenses.

Let's now turn to our sales and orders discussion. Our sales for the quarter totaled $110 million, increasing 13 percent from last year's quarter. Our total Q3 sales represent the highest quarterly sales level in CPI's history and are a clear indication of our solid product and market position.

In particular, our sales in the defense and communications markets exceeded our sales for the same quarter last year by double digit percentages for the second quarter in a row.

Our order results in the most recent period were similarly strong. As you may recall, we report orders on a year-to-date basis. For the first nine months of fiscal '13, we booked $386 million in orders, an increase of 37 percent from the same period last year. This is the highest orders level that we have ever booked in the first nine months of any fiscal year.

Orders in our defense, medical and communications markets all increased by double digit percentages over the first nine months of last year.

As of the end of Q3 our backlog equaled $324 million, another company record.

We continue to be encouraged by the strength of our defense markets. We have seen no measurable impact to our radar and electronic warfare businesses from sequestration. Prior to the start of sequestration we, like many others, had some concerns about its potential impact on our defense funding.

To date, however, although we have seen minor, very manageable delays and timing of finished product inspections and other government activities related to our defense business, we have not experienced any significant change to the funding of our defense programs. Interestingly, where we have seen government funding decreases has been in the smallest and most cyclical of our markets, the scientific market. In that market, we have seen cuts to and delays in programs funded by the Department of Energy and other government agencies.

Demand for our products to support a number of established defense programs remains high. In fact, due to the timing of new ship builds and the restocking of depleted spare-and-repair inventory levels, fiscal '13 will be our strongest year ever for the Aegis radar system.

In the first nine months of fiscal '13, orders for our defense markets increased 28 percent to $153 million. This increase was due to higher orders for U.S. and foreign military radar systems and U.S. electronic warfare systems.

Order to support the Aegis radar system have increased more than 80 percent from last year's period. Shipment against certain of these multi-year orders are expected to continue through fiscal 2015.

Our defense sales in Q3 increased 14 percent from the year-ago quarter to $41.5 million. This increase was driven by higher sales to support a number of U.S. and foreign radar systems, the largest of which was the Aegis radar system.

In the medical market, we continue to see signs of modest improvement across several geographic regions, including North America and Europe. Conversely, we have not yet seen orders this year to support the large periodic medical imaging programs in Russia. Indications from our customers are that these programs are still expected this calendar year, although their exact timing remains uncertain. Increases in our other medical programs, due in part to the slight market recovery we are seeing in other regions have offset the current absence of large programs in Russia this year.

In the first nine months of fiscal '13, CPI's medical orders increased 14 percent to $55.9 million. This increase was the result of higher demand for products to support radiation therapy, x-ray imaging and MRI applications. Those of you who have followed this for a while know that our MRI business is largely dependent on one customers and is highly variable. Thus, the increase in MRI orders is driven by the timing of a particular order.

In Q3, our medical sales increased 1 percent to $18.4 million. This increase was due to higher sales to support x-ray imaging applications as market conditions continue to modestly improve.

Our communications business has been one of our biggest successes this year. There are several reasons for the increases in our communications business, including a very large order for a milcom antenna program, our acquisition of the Codan Satcom business last summer and the general overall health of both of our military and commercial communications businesses.

Our recent MCL acquisition did not have a significant impact on our communications system in Q3 since we acquired the company during the last week of the quarter.

In the first nine months of the year, communications orders increased 72 percent to $151 million. One of the notable reasons for this increase was more than $20 million multi-year order as we receive earlier this year for our tactical common data link or TCDL antenna products.

Our TCDL products will support intelligence, surveillance and reconnaissance, or ISR, capabilities, on unmanned aerial systems. Shipments for this milcom program are beginning in Q4 and will continue to fiscal year 2015. In addition to this program, in the recent period, we enjoyed higher demand from other milcom and commercial communication programs, including broadband data applications. The inclusion of the Codan Satcom business that we acquired in July 2012 also contributed to the increase in communication orders.

Our Q3 communication sales increased 16 percent to $38.4 million. This increase was primarily due to the inclusion of sales of Codan products in the recent quarter. Codan Satcom products are primarily used in maritime commercial communications applications. We also had higher sales of products for milcom programs, including tactical common data link applications, and for commercial communications programs, including direct-to-home broadcast applications.

As you can see from our orders and sales result this quarter and so far this year, demand for CPI's products continues to be healthy. In particular, our defense and communications markets are strong and our medical market is stable and improving. Our book-to-bill ratio for the last 12 months is the positive 1.18. Our backlog is at its highest level of $324 million and we have several large multi-year orders that we booked earlier this year, including the aforementioned orders for the Aegis radar system and for ISR capabilities for UAVs, that we intend to convert into sales in Q4 and beyond.

Now here is Joel to discuss CPI's recent financial performance.

Joel Littman: Thank you Joe. Good morning. My comments this morning will focus on CPI's key profitability and liquidity metrics including our net income, adjusted EBITDA, cash, free cash flow and adjusted free cash flow results. The definitions and reconciliations of the non-GAAP financial metrics that I will discuss are available in the financial tables of yesterday afternoon's press release.

CPI continues to be a financially stable and prosperous company.

In comparison to the third quarter of fiscal 2012, all the CPI's key profitability and liquidity metrics rose in the most recent quarter.

CPI's net income in the third quarter totaled $6.2 million, an increase from the $2.9 million in the same quarter of fiscal 2012. This improvement in our net income results was primarily the result of our higher sales volume and sales of products with higher margins in the most recent quarter. In addition, the quarter benefited from a $717,000 decrease in amortization of acquisition-related intangibles related to the acquisition of CPI by Veritas Capital in 2011.

Adjusted EBITDA in the third quarter of fiscal 2013 was $22 million, or 20.1 percent of sales, an increase from the $19 million, or 19.5 percent of sales, that we achieved in the same quarter of last year. As with our net income results, the main reason for the increase in adjusted EBITDA was the higher sales volume and sales of products with higher margins in the most recent quarter.

CPI's cash and liquidity levels remain very strong and afford us the financial flexibility necessary to run our business, including having enabled us to acquire to the assets of MCL in June using only cash on hand.

As of the end of the third quarter CPI's cash and cash equivalence totaled $61.3 million, an increase of $18.3 million from the end of fiscal year 2012.

As you can see we continue to generate strong positive cash flows. For the 12-month period that ended on June 28, 2013, CPI's cash flow from operating activities was $41.2 million.

For that same period, adjusted free cash flow totaled $35.3 million, which remains well ahead of our previous guidance for adjusted free cash flow in excess of $17 million annually.

We are currently exceeding our annual adjusted free cash flow guidance due to higher profitability and more favorable timing for certain cash payments and receipts than had been expected. Although we anticipate remaining ahead of our previous guidance for this metric when the fiscal year ends, we do not expect the favorable timing for payments and receipts to repeat to the same degree during the fourth quarter.

CPI's financial health is excellent. In every quarter this year, we have achieved favorable results in all of our most significant profitability and liquidity metrics. Our net income and adjusted EBITDA have increased, our already solid cash flow position has improved and we have generated positive cash flow. We continue to have the necessary resources and flexibility to operate our business and meet our commitments while continuing to remain opportunistic regarding potential acquisition targets.

That brings me to the end of my prepared remarks. I will turn the call back over to Joe now to discuss our updated financial projections for fiscal 2013.

Joe Caldarelli: Thank you, Joel. As Joel and I have indicated throughout our discussion this morning, CPI's financial and operational performance in the first nine months of fiscal '13 has been strong. Market conditions are generally stable to positive. Demand for our products has remained very good and we have excellent backlog. As a result, fiscal '13 is turning out to be another successful year for CPI. Our organic results combined with our recent acquisitions continue to bode well for CPI. Therefore we are raising the lower end of -- lower end of our revenue guidance and are raising our adjusted EBITDA and adjusted free cash flow guidance for fiscal '13.

We now expect to generate total sales of $420 million to $425 million, adjusted EBITDA of more than $70 million, and adjusted free cash flow of more than $20 million.

As you can see we're having a strong year. We will discuss our expectations for fiscal 2014 on our next quarterly call in December.

Thank you for your time and attention this morning. Let's begin the question-and-answer portion of today's call.

Operator: Thank you. Ladies and gentlemen, if you have a question at this time please press star then the one key on your touchtone phone. If your question has been answered or you wish to remove yourself from the queue please press the pound. One moment for questions.

Our first question comes from Donovan Chaney, Wells Fargo Security. Your line is open.

Donovan Chaney: Good morning. Thanks for taking my question. My first question is really more about acquisitions. I know you guys have made one recently and one a little farther back. Could you just talk a little bit more about the acquisition environment, kind of what the pipeline looks like and kind of what makes sense for you guys? It looks like you're doing pretty well this year. Cash is up versus original guidance. EBITDA is up. Does that -- does that sort of change how you look at leverage or, you know, how you would use cash flow?

Joe Caldarelli: It doesn't really. I think our strategy continues to be the same, which is that if opportunities arise which we believe are desirable for the long-term benefit of CPI then, you know, clearly today we are in a very good position to capitalize on those opportunities and, as I think you know, acquisitions are done when the opportunity arise, you can't necessarily do them when you want to do them. So certainly today we're in a good position to continue to look at things that are available to us, and we'll continue to do that, but I think we'll use the same discipline as we have in the past: that it needs to fit into our portfolio and it needs to be something that we have, we'd bring something to that equation and make it overall worthwhile.

So I think there's really no change, and in the absence of doing that then, of course, we will continue to pay down our debt.

Donovan Chaney: That's great. Thank you.

Operator: Again, if you have a question please press star then the one key on your touchtone phone.

Our next question comes from Marc Bushallow from Manning & Napier. Your line is open.

Marc Bushallow: Hi, guys. I was just wondering, given that you've delivered business nicely since the deal, what is the sponsor thinking as far as exit or potentially getting some cash out of the business? Thanks.

Joe Caldarelli: I don't know that, you know, I can't very well speak for the sponsor, but, no, we're solid. So you know, overall we have flexibility but we haven't been tied to the sponsor all that long. So I don't think we should expect anything to happen in, you know, in a hurry.

Marc Bushallow: OK. Thank you.

Operator: I am showing no further questions. I would now like to turn the call back to Mr. Joe Caldarelli for further remarks.

Joe Caldarelli: We thank you all for participating. We look forward to talking to all of you after our year end in our December call. Thank you.

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

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