CPI INTERNATIONAL HOLDING CORP.

THIRD QUARTER 2015 FINANCIAL RESULTS CONFERENCE CALL
August 12, 2015
11:00 a.m. ET

Operator: Good day everyone, and welcome to the CPI International third quarter 2015 financial results conference call. My name is Amanda, 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 a question and answer session at the end of today's call.

If you require assistant 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 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 conference call for the third quarter of 2015. Today's agenda will be the following: first, our Chief Executive Officer, Joe Caldarelli, will discuss CPI's sales and order results in our three largest markets as well as business conditions within those markets.

Second, our Chief Financial Officer, Joel Littman, will discuss some of our key financial metrics for the third quarter. Then, Joe will discuss our current expectations for CPI's fiscal 2015 financial results, and, lastly, our President and Chief Operating Officer, Bob Fickett will join us for the question and answer session at the end of today's call.

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 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 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.

Our 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 Announces Third Quarter 2015 Financial Results. I would now like to turn the call over to Joe Caldarelli to discuss CPI's third quarter performance.

Joe Caldarelli: Good morning and welcome to our call. As we enter the last quarter of fiscal '15, CPI's business remains sound, operations are running efficiently and we continue to execute on growth opportunities. Having achieved record high results last year, we did anticipate and are experiencing naturally lower sales and profit levels this year.

We believe this year's activity levels are indicative of a more normal run rate, although there are some areas where we are running into headwinds. We are managing our business and working with our customers to address these issues, and while they are causing some near-term challenges, we remain confident that they will not have a material long-term impact on CPI.

We have talked about some of these headwinds on previous calls. For example, certain of CPI's defense programs, which are often cyclical long-running programs, are experiencing lower activity levels in fiscal '15 than in '13 and '14. This situation is primarily due to timing issues. It is not uncommon and we have extensive experience in managing through these issues successfully.

Some of these challenges we are encountering have developed more recently for us. For example, we believe that market conditions for medical imaging applications in

Asia may have softened. It is still a bit early to know the exact magnitude of the slow down but we anticipate that this will turn out to be a near-term timing issue.

Additionally, some of our medical and commercial customers in Europe are struggling with the effects of euro currency declines, which are resulting in higher costs to them for U.S. dollar denominated products. We are working with them to address situation on a case by case basis. We are confident that CPI's nimble and experienced enough to continue to effectively manage these situations as they arise. However, they are impacting our fiscal '15 results to a degree. Let's now turn to those results in more detail.

In the first nine months of fiscal '15, we booked orders totaling $336 million, a slight increase from the $334 million recorded in the year ago period. In CPI's largest end markets, communications orders increased, medical orders were unchanged and defense orders decreased slightly.

In Q3, we generated sales totaling $110 million, a decrease of 8 percent from the $119 million generated in the year ago quarter. As you may recall, last year's quarter included the highest Q3 sales level in CPI's history due to record defense and communication sales.

In comparison to last year's quarter, defense sales were basically unchanged while medical and communication sales decreased in the most recent quarter. We ended Q3 with $317 million in backlog, an increase of 3 percent from $308 million at the end of fiscal 2014. Our year-to-date book-to-bill ratio is a favorable 1.02, which we expect will support near-term sales.

Let's start today's detailed discussion with defense, CPI's largest market. As we've mentioned in previous calls this market is made up of more than 100 radar and electronic warfare programs, most of which are cyclical, long running programs that recur either on a consistent or intimate in basis. For instance, we recently announced that CPI's Radant Technologies Division had received $7.6 million in radome orders for airborne electronic warfare systems for the U.S. Navy. These were following orders for program that Radant has supported for several years.

Due to the breadth and longevity of the programs and systems we serve, CPI's defense business is generally very stable over the long term, although the ordered timing for certain defense programs can affect our orders and sales results in any one period.

For example, we have supported the Aegis radar system for several decades, providing products for new ship builds as well as spare and repair products for existing ships.

In recent years as new ships have been built, our installed base has grown and we have enjoyed a step up in overall demand for Aegis products, a trend which we expect to continue for the foreseeable future. Due to the healthy overall demand for this program, our Aegis sales are generally increasing at a steady, fairly linear rate.

However, the size and timing of Aegis orders can jump around quite a bit and the period of performance of individual orders can vary from several months to several years. Overall, Aegis orders and sales are strong and growing, but taking a snapshot of our Aegis orders as part of a particular – at a particular moment of time can lead to misleading comparison between periods due to the variations in size and timing between individual orders.

As a result of the new ship builds and consequential growing installed base of ships, which may have led to understocking of certain government depots, CPI's orders for Aegis radar systems in fiscal '13 and '14 were much higher than they had ever been before.

In fiscal '15, our Aegis orders are still very strong and remain well in excess of where they were prior to 2013, and we are also anticipating healthy levels of additional orders in the near future. Nevertheless, the timing of the placement of recent orders has resulted in unfavorable comparisons between last year's order levels than this year's order levels.

By the same token, certain other large defense programs have similarly unfavorable year-to-year comparisons due to the timing of placement orders. In some cases, as CPI's government customers try to juggle the funding available with optimum stocking levels, orders for these programs were pulled in to previous periods to cover inventory short falls. And in other cases, orders have been pushed out to later periods due to funding and administrative hold-ups. We still expect orders for these programs, but certain orders have slowed down and some have been pushed out of fiscal '15.

Overall, CPI's defense business remains healthy and stable, notwithstanding some short term perturbations caused by the timing of the placement of certain orders.

In the first nine months of 2015, our defense orders totaled $135 million, a decrease of 2 percent from last year's period.

Orders decreased for certain shipboard radar programs, including Aegis radar systems and for an airborne electronic countermeasures program for a foreign customer. The decrease in Aegis orders was due the varying timing and size of individual orders, as I explained a moment ago. Offsetting these decreases, orders increased for radomes to support an airborne electronic warfare program, as did orders to support foreign naval radar systems.

CPI's defense sales in the third quarter were basically flat at $45.6 million. Sales increased for certain radar programs, particularly several cloud-profiling radar programs and Aegis radar systems. In contrast, sales decreased for one of our recurring radar programs that has a vacillating annual demand level. Sales also decreased for the current iteration of an electronic warfare program in which we have completed our participation.

Let's now move on to our second largest market, communications, which remains healthy. CPI's communications orders increased 18 percent to $124 million in the first nine months of fiscal '15. Orders from military communications applications increased significantly, particularly orders for advanced tactical common data link, or TCDL. antennas, as well as orders from satcom amplifier products for a variety of new and existing milcom programs. As we have mentioned previously, the universe of military communications programs has evolved in recent years from a select number of big programs to a larger number of smaller programs.

In Q3, communications sales decreased 8 percent to $44.8 million. The main reason for the decrease from last year's record quarter was lower milcom sales, particularly for the advanced TCDL products and certain radomes. The decrease in radar sales was due to the timing of shipments for an ongoing naval communications program, and we expect shipments for this program to pick up in the near future.

The decrease in advanced TCDL antenna sales was expected because it resulted from the completion of shipments from an uncommonly large order received in fiscal '13 for a UAV program. We continue to make shipments for this UAV program, but they are against smaller recurring follow-on orders versus the outsized original order.

Notwithstanding the recent sales decrease, we've remained an active participant in the milcom sector of the communications market, and it continues to present us with opportunities for growth.

The commercial communications market remains healthy and stable. While the presence of large direct-to-home commercial communications infrastructure programs can vary from year-to-year depending on the readiness of customers to invest in new infrastructure expansion projects, this has proven to be largely a program timing issue, and we continue to work with our customers to support their demand.

The third and last market I would discuss today is the medical market. Medical orders were unchanged at $56.7 million in the first nine months of this year. An increase in orders for MRI products offset a decrease in orders for x-ray imaging products, including those used in radiation therapy applications.

In Q3, medical sales decreased 14 percent to $15.5 million. Lower sales of x-ray imaging products were partially offset by higher sales of MRI products. Although MRI programs comprise only a small part of our overall medical business, they played a sizeable role in the period-over-period comparisons of recent medical orders and sales. We receive notable orders for MRI programs on an irregular basis, and we received such orders and made corresponding sales in the most recent period.

X-ray imaging is more – is a more significant portion of our medical business. We sell CPI's x-ray imaging products to customers around the world, and it is not uncommon for various geographic regions to trade prominence in our medical business over time as different countries or regions make improving their medical imaging infrastructure a national priority for a period of time.

As you may recall, several years ago, we spoke extensively about our medical imaging business in Russia because, at the time, the Russian government was funding a number of x-ray imaging tender programs. Those national tender programs have died down, and the importance of Russia to CPI's medical imaging business in any one period has lessened as a result.

More recently, although we have been operating in Asia for decades, customers in the region have been playing an increasingly significant role in our medical business as there has been increased investment in medical imaging infrastructure, particularly in China and South Korea. As a result, we have reported higher orders and sales of these products to customers in that region over the last few years.

In recent months, however, some of these customers have report slowdowns in their business, and their demand has softened, in part driven by over-stocking. This has resulted in lower orders of sales of x-ray imaging products in Asia in the most recent period. We are optimistic that this will be a temporary situation.

Additionally, as I mentioned earlier, some of our Europe – of our European medical customers are reporting challenges due to the weakening of the Euro’s buying power for products denominated in U.S dollars. We are working with them to address these challenges, but in the meantime it is having a modestly negative impact on our medical business in the near-term.

As you can see, the medical business is dynamic and market conditions are in flux in various geographic regions. We will continue to carefully monitor this situation in order to react quickly and effectively as conditions change.

This concludes my remarks on CPI's defense, communications and medical markets. In summary our business remains healthy, but we do have some challenges to overcome in certain areas of our business. I'll discuss how these challenges are impacting our outlook for the rest of the year a little later on this morning's call.

Now I'll turn the call over to Joel to take us through CPI's financial performance in Q3.

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

I'll begin with net income. In the third quarter fiscal 2015 CPI generated net income of $1.2 million; in comparison we recorded net income of $3.5 million in the same quarter last year. The primary reason for this decrease was a lower sales volume and less profitable mix in the most recent quarter.

Our income tax expense has also increased $4 million, mainly due to the release of reserves for certain tax positions as statutes of limitations expired in last year's quarter. The situation did not repeat in the most recent quarter.

The decrease on our net income was partially offset by the lack of expenses in the most recent quarter related to the debt restructuring transaction we completed in April of 2014. In comparison in last year's quarter we recorded a $7.2 million loss on debt restructuring related to that transaction.

Last year's restructuring related expenses included the non-cash write off of previously capitalized debt issuance cost and the original issue discount from the previous credit agreement that we repaid as part of the restructuring transaction, as well as costs incurred for the consent solicitation on our senior notes. We had no such expenses in the third quarter of fiscal 2015.

Our adjusted EBITDA in Q3 fiscal 2015 was $18.1 million, or 16.5 percent of sales.

In the same quarter of fiscal 2014, adjusted EBITDA totaled $22.9 million, or 19.2 percent of sales. This decrease in adjusted EBITDA was primarily related to sales. We generated lower sales volume and sold a less profitable mix of products in the most recent quarter. In addition, in the most recent quarter, we booked an allowance for doubtful accounts of $600,000 for a European customer who is seeking protection under local bankruptcy laws.

Adjusted EBITDA is a key indicator of the health of CPI's business, and we carefully monitor our progress on it in order to manage our business accordingly. Despite the market challenges that Joe mentioned in his remarks, we have decreased our operating expenses this year and successfully maintained adjusted EBITDA margins in the mid to high teens, with adjusted EBITDA totaling 17 percent of sales year-to-date. We expect CPI's business to remain equally profitable going forward.

Turning to our cash position, as of the end of the third quarter of fiscal 2015, CPI's cash and cash equivalents totaled $61.3 million, as compared to the $50.6 million with which we ended fiscal year 2014. We have increased our cash position in the first nine months of the year while making debt interest payments totaling $19.5 million and debt principle payments totaling $2.3 million during that period, illustrating our ability to continue to generate sufficient cash flows to provide for both our debt and our business needs.

For the 12 month period that ended on July third of this year, CPI generated cash-flow from operating activities totaling $31.7 million. After payments for capital expenditures and excluding a handful of unusual or other items, our adjusted free cash flow totaled $26.2 million for that same period.

Overall, CPI remains profitable, and our underlying financial health remains sound. We continue to maintain favorable adjusted EBITDA margins and to generate positive cash-flow. These factors enable us the flexibility and strength to continue to manage our business effectively. That concludes my prepared remarks this morning. I will turn the call back over to Joe to discuss our financial projections for the year.

Joe Caldarelli: Thanks Joel. On the heels of an undeniably strong 2014, fiscal 2015 is turning out to be a decent but somewhat challenging year for CPI. The vast majority of our business remains stable and at normal run rates, and customer demand remains healthy, but the business pull-ins to 2014, delays in the timing of certain defense orders, a softer medical imaging market in Asia, and the negative impact of a strong U.S. dollar have affected our results in the back half of this year.

As a result of these recent challenging – challenges, we are revising our financial projections for the year. For fiscal 2015, we now expect to generate total sales of between $440 million and $460 million, adjusted EBITDA of between $77 million and $80 million, and unchanged adjusted free cash flow totaling more than $21 million.

And with that, I'd like to thank you for your time today. Operator, please open up the call for questions.

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

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

Donovan Chaney: Hey, good morning, gentlemen, and thanks for taking a couple of questions. Just two quick ones for you. One, it sounds like we're in for another continuing resolution. From what I'm hearing, it sounds like that's what people are expecting.

To what extent to do you guys have any really short cycle business or, kind of, near term orders or maybe new programs ramping up or anything like that you – do you think might be, kind of, end of December or maybe March quarter if we get a really long CR? Is that something that people should be worried about or not really?

Joe Caldarelli: No more than in the past. As you know, we've been dealing with those kinds of issues now for a number of years and so, you know, we tend to characterize that we're - when – we're deep in middle of those circumstances – and I don't know that the current one is going to be any different in past ones – as I have mentioned in my remarks, we are dealing with a number of programs where the orders have been delayed in the placement, and one might argue that they could be delayed further as a result of this, but they were delayed on multiple occasions in the past, and it may drag out a bit more.

But what tends to happen with us is, since a fair number of the orders with the agencies are for spares and repairs, at some point they are low enough that they actually end up having to make an emergency buy, which is what happened in some case in 2014. Hence, the run up in 2014. And then we end up with a somewhat larger, more expedited order than we otherwise would have gotten.

So, all in all, I would say probably not, but, you know, it wouldn't surprise me if the current drag out drags out a little bit longer as they probably would have anyways in respect with the budget situation.

Donovan Chaney: That's great. That's really helpful. Second question, another solid cash flow quarter for you guys and I hope you continue to build cash in Q4, even despite lowering some EBITDA expectations a little bit, you know, cash at the end of the year could be close to $70 million, which is a big number. What are your priorities for that cash as we sort of think about the next couple of years?

Joe Caldarelli: We actually have some meaningful interest payments in August so that's going to take a bit of a bite out of it, unfortunately. But our priorities haven't changed. They continue to be that, you know, we continue to look for ways to grow our business, and if we find accretive, proper acquisitions, then we will certainly look at them. And then in the absence of that, if we do end up with what we consider to be surplus cash, then we would selectively pay down portions of our debt.

Donovan Chaney: OK, That's great. Thank you very much.

Joe Caldarelli: Thank you.

Operator: Thank you. Again, ladies and gentlemen if you would like to ask a question please press star then one on your touch tone telephone. If your question has been answered or you wish to remove yourself from the queue please press the pound key. One moment for questions.

And I'm showing no further questions. I would like to turn the call back to Joe Caldarelli for closing remarks.

Joe Caldarelli: Well, thank you very much again for giving us your time and your attention today. We look forward to speaking with all of you again in December at the end of our fiscal year. Thank you. Have a good day.

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

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