CPI INTERNATIONAL HOLDING CORP.

THIRD QUARTER 2016 FINANCIAL RESULTS CONFERENCE CALL
August 10, 2016
11:00 a.m. ET

Operator: Good day, everyone, and welcome to the CPI International Third Quarter 2016 Financial Results Conference Call. My name is Sonia and I'll 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 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 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, Sonia. Good morning and welcome to CPI International's conference call for the third quarter of fiscal 2016. The agenda for today's call will be the following -- first, Joe Caldarelli, our Chief Executive Officer, will start us off with a discussion of CPI's recent orders, sales and business conditions in our three largest end markets. Next, Joel Littman, our Chief Financial Officer, will discuss our key financial metrics in the third quarter. Then, Joe will discuss our expectations for the remainder of the fiscal 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, however, 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 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. A presentation of the most directly comparable GAAP measures and a reconciliation 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 2016 Financial Result."

And with that, I will turn the call over to Joe Caldarelli to discuss CPI's performance in the most recent quarter.

Joe Caldarelli: Thank you. Good morning. CPI's third quarter performance was in line with our expectations, reflecting more stable business conditions and improved activity levels across much of our business. Although we continue to see some delays in orders for certain government-funded programs, a number of previously delayed orders were released to us, and together with our existing backlog, provided volume levels that enabled us to operate quite profitably during the quarter.

Our top line results in Q3 were stronger than in the same quarter last year and the first two quarters of this year. As a result, fiscal '16 remains on track to be a solid year for CPI.

As you may recall, this year's results are supported by contributions from ASC Signal, which we acquired in September 2015. Our new CPI ASC Signal Division contributed more than $30 million to CPI's orders and sales year-to-date. The majority of ASC Signal's orders and sales are in the communications market; the rest are in the defense market.

In the first nine months of fiscal '16, CPI booked orders totaling $349 million. Orders increased 4 percent from $336 million in the year ago period, with the most significant increase in the communications market. Communications orders for this nine-month period were the highest in our history, in part due to ASC Signal, as well as continued strong demand for our satcom amplifiers and advanced tactical common data link antenna products.

Excluding contributions from ASC Signal, total orders decreased 6 percent from last year's period. This decrease resulted from delays in the release of orders for certain government-funded programs. The situation has improved as the year has progressed. In fact, we received approximately $15 million in previously delayed orders for radomes and advanced antennas at the end of July. That will be recorded in our fourth quarter. Nevertheless, the push out of certain government-funded programs represents a challenge for CPI that we have been addressing on a program-by-program basis.

As I mentioned a moment ago, CPI's communications orders increased significantly during the first nine months of the year. Orders in the defense and medical markets, which largely rely on government-funded programs, decreased.

Turning now to sales, CPI generated $130 million in Q3 sales, an increase of 18 percent from the $110 million we generated the same quarter 2015. The most significant increase was in communications sales, resulting in the highest quarterly sales in this market in CPI's history, partly due to the contribution from ASC Signal, as well as higher sales of satcom amplifier products. Sales also increased in the defense market but decreased modestly in the medical market.

Excluding ASC Signal's contribution, CPI's total sales for the quarter still increased 6 percent from last year's Q3. As anticipated, CPI's quarterly sales have increased as the year has progressed. Sales in Q3 were 8 percent higher than in Q2 and 17 percent higher than in Q1. Q4 sales are expected to be the highest of the year.

As of the end of the most recent quarter, backlog totaled $308 million. Our year-to-date book-to-bill ratio was 0.97, reflecting the challenges that we have experienced this year with delays in the placement of orders for certain government-funded programs. We expect the book-to-bill ratio to improve as previously delayed orders are eventually placed.

Let's look more closely at our results by end market, beginning with communications. CPI's communication market includes commercial communications and military communications, or milcom programs. Our milcom business has grown significantly over the past several years, and year-to-date, it represents roughly half of our total communications business.

In the first nine months of fiscal ’16, communications orders totaled $160 million, a 29 percent increase from the year ago period. Orders for the ASC Signal Division accounted for approximately 80 percent of this increase. In addition, on the commercial communications side, we booked higher orders for fixed satellite service applications, and on the milcom side, we booked higher orders for advanced tactical common data link, or TCDL, antenna products for UAV programs.

I’m pleased to report that the long-delayed order for radomes to support a milcom application that we discussed on previous calls has finally been booked. We received a sizable order at the end of July, so it will be included in CPI’s Q4 results.

In Q3, our communication sales totaled $57.6 million, a 41 percent increase from last year’s quarter and the highest quarterly sales level ever in the communications market. Sales of ASC Signal’s products contributed approximately 70 percent of this increase. Additionally, we enjoyed higher sales of communication amplifiers including both vacuum-based and solid-state amplifiers for a variety of milcom applications.

CPI’s communications business continues to be stable and healthy, and market conditions have remained favorable. Our growing portfolio of communication products is broad and deep, enabling us to provide a diverse product selection that supports a vast array of communication applications for a wide range of customers around the world. From power sources to amplifiers, to advanced antennas and radomes, CPI’s critical components and subsystems play a vital role in all stages of satellite communications. As a result, communications has become our largest market, and we expect it to remain strong for the foreseeable future.

Let’s turn now to defense. CPI’s defense market includes radar and electronic warfare applications; most of which are for long-term, stable programs lasting many years, if not decades. The majority of our defense business is for spare and repair products for programs that we already support, providing a healthy and steady base business for which we have generally good visibility.

For the past several quarters, we have seen delays in the placement of orders for certain defense programs. These programs are still supported by their respective governments, still require our products, and they're expected to continue to require our products for the foreseeable future. Although the delays have impacted our business over the near term, we are confident that these programs will require the support of CPI products for years to come. As we have mentioned in previous calls, recently, every step of the order placement process for defense orders has simply taken longer.

In the first nine months of fiscal '16, we booked $116 million in defense orders, a 14 percent decrease from the same period last year. Orders for our largest defense program, the Aegis radar systems, remain stable and very strong. But orders for certain other naval programs and an airborne radome program were lower. Some of these orders were delayed from previous quarters and are still expected to be booked in Q4.

In fact, the largest of these delayed programs is responsible for more than 70 percent of the decrease in defense orders.

As we mentioned on last quarter's call, last year's results included record orders for the naval radar program because some orders that had been expected in 2014 were delayed into fiscal 2015, resulting in an unusually large order covering the longer than normal period. We had expected to book sizable orders for this program in the first half of this year but it has slipped to the right. The program remains stable, yet its timing has become somewhat less predictable. We expect to receive orders for this program any day now.

In Q3, CPI generated defense sales totaling $48.8 million, a 7 percent increase from last year. This increase was due to higher sales for a variety of radar programs, including foreign and domestic programs, and naval, weather, and other radars. Sales of radar products from the ASC Signal Division also contributed to the increase.

Sales in support of Aegis naval radar systems remained very strong in Q3. In fact, year-to-date sales for this enduring program are the highest level in CPI's history.

The third and last market that I want to discuss today is the medical market, which consists of medical imaging applications and radiation therapy applications. The radiation therapy business serves domestic customers and is generally very stable. However, the medical imaging business primarily serves foreign customers and relies in large part on government investments to expand their medical imaging infrastructure. Medical imaging is also a very quick turnaround business. Therefore, CPI's medical market feels changes in global economies more quickly than the communications and defense markets.

This year, CPI's medical orders and sales have been negatively affected by challenging global economic conditions particularly in Asia as well as in Europe and South America. Softer economies have resulted in less government investment in medical imaging infrastructure, leading to fewer available programs for our customers this year than in previous years. The strong U.S. dollar has resulted in unfavorable exchange rates and has exacerbated the situation. Ongoing discussions with our medical imaging customers reveal that they remain loyal to CPI and intend to purchase more CPI products when their own business improves. As a result, we do not expect the medical business to change significantly in the near future.

In the first nine months of this year, CPI's medical orders totaled $53.3 million, a 6 percent decrease from last year's period. Orders for products to support radiation therapy programs, which are largely domestic, were very strong and increased notably from last year's period. However, this strength was more than offset by lower orders for medical imaging products. And particularly – in particular, orders for X-ray imaging products to support foreign customers decreased significantly as a result of the economic challenges I discussed a moment ago.

In Q3, medical sales totaled $14.7 million, a 5 percent decrease from the same quarter of 2015. Sales of radiation therapy products increased but sales of medical imaging products decreased. The decrease was primarily due to lower sales of X-ray imaging products to support foreign customers as a result of the previously discussed challenging international economic conditions.

To recap, business conditions have continued to stabilize and, in many cases, improved across most of our end markets. We've continued to experience some timing challenges related to delays in the placement of orders for certain government-funded programs and some economic challenges related to foreign medical imaging programs. Nonetheless, we are beginning to see previously delayed orders released to us, overall activity levels have improved, and our communication market has remained strong. As a result, we are in track for solid fiscal '16.

Now, I'll turn the call over to Joel to discuss our recent financial performance.

Joel Littman: Thanks, Joe. Good morning. Before I begin my comments this morning, please note that the definitions and reconciliations of the non-GAAP financial metrics that I will discuss are available in the financial tables of the press release that CPI issued yesterday afternoon. You can find the press release on our website.

Let's now turn to CPI's profitability metrics for the third quarter of fiscal 2016. CPI's net income and adjusted EBITDA results increased in the third quarter in comparison with both the year-ago quarter and the first and second quarters of this year. The increases in net income and adjusted EBITDA from the year-ago quarter were driven by several positive factors, including higher sales, a favorable mix of products sold, contributions from the new CPI ASC Signal Division and favorable changes in the Canadian dollar to U.S. dollar exchange rate. The strengthening of the U.S. dollar in comparison to the Canadian dollar has had a positive impact on our profitability recently because we sell our products primarily in U.S. dollars but generate significant expenses in Canadian dollars due to the fact that three of our divisions manufacture products in Canada.

In the third quarter of fiscal 2016, CPI's net income totaled $4.5 million, increasing from the $1.2 million we reported in the same quarter in the prior year. The positive factors that I mentioned a moment ago were partially offset by a $4.1 million increase in income tax expense, which was primarily due to a $7.4 million increase in CPI's income before taxes.

Our net income margins also improved, increasing from 1.1 percent in the year ago quarter to 3.5 percent in the most recent quarter.

CPI's adjusted EBITDA totaled $26.3 million in the most recent quarter, an increase of 46 percent from the $18.1 million generated in the same quarter of fiscal 2015. Our adjusted EBITDA margin was 20.3 percent in the third quarter, an increase from the 16.5 percent from the same quarter last year. Our recent margins outperformed our guidance of mid to high teens and represent an improvement from earlier in the year due to stronger business levels.

CPI continued to generate healthy levels of cash during the third quarter. As of the end of the quarter, our cash and cash equivalents totaled $39.2 million, increasing from the $37.5 million we had on hand at the end of fiscal 2015. As you recall, earlier this fiscal year, we did use our cash on hand to pay the previous owners of our Radant Technologies Division an earnout totaling $10 million because they had outperformed the financial goals set following the acquisition of that business two years ago.

We remain comfortable at our current levels of cash and confident in our ability to continue to generate healthy levels of cash. For the 12-month period that ended on July 1, 2016, CPI's cash flows from operating activities totaled $16.5 million, our free cash flow totaled $9.8 million, and our adjusted free cash flow totaled $18.5 million.

Our adjusted free cash flow is slightly below our annual guidance of more than $20 million, primarily due to timing issues. We expect to end the year with strong adjusted free cash flow that meets or exceeds our existing guidance. CPI remains a solidly profitable company with significant financial resources and capable of generating significant levels of cash. We remain confident that we have the financial means necessary to continue to service our customers, grow the business and simultaneously satisfy our debt obligation.

We recognize that many of you may have questions about the status of our plans to refinance our existing debt. As you know, our revolver matures in August 2017 and our term loans mature November 2017, unless we repay or refinance at least 65 percent of our senior notes before that time.

As we discussed on last quarter's call, we continue to expect to refinance our debt before the revolver matures in August of next year. We are reviewing a variety of options with our owners and our bankers, and we're monitoring the credits markets to ensure that any move that we do make is well-timed. At this time, CPI cannot provide any additional details about the status or expected outcome of this process. We will continue to keep you updated as our plans progress. And we do expect to complete the debt refinancing before August 2017 at the latest.

That concludes our financial discussion. I will now turn the call back over to Joe to discuss the expectations for the remainder of fiscal 2017 – 2016.

Joe Caldarelli: Thank you, Joel. To date, fiscal ’16 has been a somewhat challenging, but productive, year for CPI affected by timing issues related to government-funded programs and economic issues related to foreign medical spending. The third quarter represented a significant improvement from the first half of the year, with more stable business conditions and improving activity levels resulting in stronger sales and profits.

Our operations teams have managed through the challenges well, working closely with customers to ensure that we are ready to fulfill their requirements quickly and efficiently once orders are placed. As a result, as the year has progressed and previously delayed orders have been released to us, our factories have been able to react nimbly and profitably, quickly shipping state-of-the-art products that meet our customers’ stringent requirements.

With the majority of the fiscal year behind us, we are narrowing our existing guidance ranges for fiscal ’16. We currently expect to generate sales of between $500 million and $510 million, and adjusted EBITDA from between $85 million and $87 million. Our adjusted free cash flow guidance remains at $20 million or above. We continue to expect the fourth quarter to be a strong quarter and hope to maintain this momentum into fiscal ’17. We will provide a more detailed look at fiscal ’17 on the year-end call in December.

That concludes the scripted remarks. Thank you for your time and attention. 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 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 our first question comes from Ryan Spitz from Stone Harbor. Your line is now open.

Ryan Spitz: All right, thanks for taking my question. Just a couple, I guess, follow-ups. Can you quantify the amount of your cost of goods sold which is denominated in Canadian dollars, please?

Joe Caldarelli: Yes, there's about CAD60 million to CAD70 million a year that's Canadian dollar denominated, now that we've added a portion of the ASC operation up here as well.

Ryan Spitz: OK.

Joel Littman: I mean – it's approximately CAD60 million going through cost of sales.

Ryan Spitz: Terrific. Thank you. And then I guess just a follow-up on your comments on the timing of orders. It sounds like, you know, you've got that $15 million order that you picked up at the end of July. Can you, maybe, you know, talk a little bit more about what gives you the confidence to see that sequential improvement, maybe whether it'd be through orders or discussions with customers, please?

Joe Caldarelli: You know, the visibility continues to be mediocre. The fact that we had a handful of orders that had been delayed and we were expecting – that one was the biggest and that's now been placed, so that's comforting. The other substantial order that I mentioned is, you know, we frankly expected it to be able to indicate that we had booked it this morning. But it's really, really close. So, really, the confidence comes in part from the fact that a number of the ones that had been previously delayed, that were substantial in size, have now been placed. Will they be replaced by other orders that will slip to the right? Undoubtedly. But, hopefully, now that we got into backlog some of the more substantial ones, so things will be able to better balance.

And, as you saw from our performance, we did have a decent order input in the second quarter which allowed us to have pretty strong shipments in the third quarter. Our backlog is in reasonable shape right now. So, if we have reasonable orders in the fourth quarter, that should kind of fill in any gaps and allow us to continue on into the early part of next year.

Ryan Spitz: Great. Thank you.

Operator: And our next question comes from Jamie Burns from American Capital. Your line is now open.

Jamie Burns: Hey, thank you for taking the question. I – just a follow-up on the orders point. I guess, as I look at Q3 specifically, not the nine-month period but just the quarter, versus the prior year period, you certainly kind of down and that's even including ASC, and backlog's a little bit lower as well. And that's including in this period, at least, ASC. Can you talk a little bit more – you know, beyond timing, can you talk a little bit more around specific market factors? Or has that, you know, impacted this particular quarter? It seems like perhaps, you know, the government spending environment hasn't changed dramatically over the last couple of fiscal quarters. But you had – we didn't see the same drop-off in your fiscal Q1 and Q2. So, I'm just trying to understand to kind of bridge to how we got to a much softer Q3 specifically.

Joe Caldarelli: Yes, it really is a continuation on what I mentioned. Part of it is that some of the government orders come in in fairly significant lumps, and, in some cases, actually cover more than 12-month periods. For example, last year, in the first nine months, we had an order for certain of our radomes that are used on military aircraft that gave us backlog to fiscal '17 for one model and fiscal '19 for another model. So, obviously, we're not going to have replacement orders for that sort of thing.

The Aegis system, which as you know is our largest single program area, had two extremely strong years for orders in the '13, '14, really part of '15 time frame, which gives backlog that goes out quite a long way. And so, if you look at the translation of some of those earlier orders into sales -- so, again, picking Aegis as an example -- Aegis sales are continuing to be at strong and record levels, feeding on orders that were placed in, some cases, 18 months ago.

So, you know, the placement of orders and the timing continues to be a concern to us, but it is fairly complex. And quite often the explanation is that we placed – that we got an unusually large order covering a longer than annual period at some prior period, then we're continuing to ship against it. In some cases, that is truly a delay in the placement, which will cause a bit of a gap on our shipments. So, it's a combination of all those items.

But to reinforce, I think, if you look at our sales performance in Q3 and our expected sales in Q4, currently, we have sufficient backlog to be able to keep the factories pretty well occupied even though the replacement orders are somewhat behind in Q3.

Jamie Burns: Sure. And just as the trends you've seen since July 1st, you – has that – and I know that you've mentioned a couple of larger or lumpier orders you received or expect to receive in the very near term. In more generic sense, have you seen the environment improve a bit and specifically over, kind of, the radar segment and then the medical segment?

Joe Caldarelli: No, I wouldn't say the environment has improved. But to be fair, I wouldn't say the radar – the environment had gotten worse in the prior quarters either. I think the environment is – continues to be in this situation where the government itself continuously is stretching out the placement of orders to our customers which often are the primes. And they in turn, of course, start delaying the placement of orders to us, in some cases by nine months or a year. Even though everyone you talk to acknowledges that the product is needed, the system is funded, it's simply just taking a long, long time. And then, you know, that's clearly hurting our primes or hurting us in certain circumstances. So, I wouldn't think there's anything unusual about Q3 versus the prior couple of quarters.

Conversely, I don't really think that situation is going to change dramatically going forward. I don't see any big drivers to cause the government order placement cycle to dramatically improve. And so, I think it will be a new norm for this level of unpredictability to continue, you know, into the future. So, it's not an absence of demand, particularly since a lot of our stuff in the government side goes for spares and repairs. It's really largely a timing of approval cycles and so on by the time it filters down to us.

On the commercial side, the underlying demand in all the areas, certainly in communications, particularly the amplifiers, continued to be quite strong even though there we've also seen the odd order that's been delayed a bit. But, you know, it's been placed and we've got very good backlog. We've seen some delays in placement of antenna order, but conversely, we're expecting quite large orders for that this quarter, for example, so it somehow will catch up.

On the medical side, there has been a reduction overall. As I indicated because some of the medical infrastructure programs in other parts of the world outside North America are seeing a bit of a slowdown, and that may continue for a little while, I don't know whether if we're talking months or a year. And it's quite often that medical programs are driven by substantial tenders where some country will put in a large number of X-ray products and will do that in a big block. So, last year, we had a couple of those; this year, we haven't had – we and our customers haven't had any although we're waiting for a couple to free up in the next little while. Those have been delayed.

So, I'd say in medical there has been a slight slowdown in the underlying demand. In the communication side, no slowdown in the underlying demand; actually, it's going quite strong. And on the defense side, the underlying demand, I think, continues to be consistent but it's really largely driven by the timing of the placement of the orders, or the fact that we placed a really big order a year, a year and a half ago, and then we're still shipping against that for that product.

Jamie Burns: Sure, sure. OK, thank you. And then I just – as I look at Q3 specifically in terms of total orders, I kind of – I get toward kind of $100 million number. And it sounds like if we adjust for a couple of the orders that you had expected to take prior to July 1 but have trickled in afterwards, and we where kind of more about $120 or $125-ish number if we try to adjust that a bit. Is that …

Joe Caldarelli: That's correct.

Jamie Burns: OK.

Jamie Burns: And would you expect – yes. And just as far as I look, you know, into '17, I mean, does it – did a soft order quarter like Q3 of '16, kind of what is the tail on that? Is it going to – you know, I guess the guidance is certainly strong and helpful for Q4. I mean should we kind of expect that to have more impact in the first half of '17 then, or perhaps not at all as we've received fewer orders after July 1 specifically?

Joe Caldarelli: You know, honestly the visibility into the quarterly performances of '17 is still a bit murky. And there could very well – I mean most years, we have been seeing these up and down quarters. So, I wouldn't be surprised if '17 also sees some up and down quarters. In aggregate, '17 should be stronger than '16, will be stronger than '16; that's fairly clear. Whether or not we might see a soft quarter early or midyear, I honestly can't say at this point here because …

Jamie Burns: Right.

Joe Cardarelli: … for example, you know, we just received these two substantial orders I mentioned, we're expecting another very substantial order in August/September in the communications arena, which has been delayed by six to nine months. So, you know, the time it'll take us for us to actually generate sales from that could very well cause a bit of a gap in that production cycle while we're waiting for the replacement order. So, I wouldn't be surprised to see some up and down quarters. But, you know, the point here is we're used to that now and we're learning to manage it. And, you know, we can perform reasonably well. Even in down quarters, they've have performed very well on the up quarters.

Jamie Burns: Sure. All right, no, thank you very much for the color. Appreciate it.

Joe Cardarelli: OK.

Operator: Thank you. And, again, ladies and gentlemen, if you will like to ask a question at this time, please press star then one.

And our next question comes from Rob Davis from Alcentra. Your line is now open.

Rob Davis: Thanks, guys. Just a follow-on to the prior question. I understand you don't have perfect visibility on specific timing of orders. But your full-year guidance for revenue in EBITDA implies both will be up on a year-over-year basis in Q4 standalone. Do you have the same visibility to be able to say that orders will be up in Q4 as well year-over-year?

Joe Cardarelli: I don't – I haven't actually checked Q4 last year orders. They'll certainly be up sequentially. Amanda or Joel, do you have that visibility down there?

Joel Littman: Yes. Fourth quarter should be substantially higher than last year's fourth quarter in terms of orders.

Rob Davis: Great, thanks. And is that inclusive of ASC? Or what would it -- it would be up year-over-year without ASC or either way?

Joel Littman: Either way.

Rob Davis: Great. Thank you very much.

Joel Littman: Thank you.

Operator: Thank you. And this does conclude our question-and-answer session. I would now like to turn the call back over to Joe Caldarelli for any further remarks.

Joe Caldarelli: Well, we thank you for listening to us again. Our next call is going to be in December, our year-end report, and we look forward to talking at that time. 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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