CPI INTERNATIONAL HOLDING CORP.

THIRD QUARTER 2012 FINANCIAL RESULTS CONFERENCE CALL
August 9, 2012
11:00 a.m. ET

Operator: Good day, everyone, and welcome to the CPI International Third Quarter Fiscal 2012 Final Results Conference Call. My name is Kevin, and I will be your coordinator for today's call.

At this time, all participates are on a listen-only mode. We will be facilitating a question-and-answer session at the end of today's conference. If you require assistance at any time during the call, please press star followed by zero and the conference 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, Kevin. Good morning, and welcome to CPI International conference call for the third quarter of fiscal year 2012. Our speakers and topics for today's call will be the following.

First, Joe Caldarelli, CPI's chief executive officer, will discuss our topline performance in our largest end markets and our ongoing expectations for those markets. He will also discuss our recent acquisition of the Codan Satcom business. Second, Joel Littman, our chief financial officer, will discuss some of our key financial metrics for the third quarter. Next, Joe will discuss our financial projections for the remainder of the fiscal year. And lastly, Joe and Joel will be joined by Bob Fickett, our president and chief operating officer, for the question-and-answer portion of today's call.

Before this morning's call gets underway, however, there are some administrative details to 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. We've interpreted 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 our filings with the Securities and Exchange Commission. Today's presentation under Securities and Exchange Commission rules also include non-GAAP financial measures related to EBITDA and cash flow as well as measures that combine results before and after the February 11, 2011 acquisition of the company by Veritas Capital.

The presentation of the most directly comparable GAAP measures and the reconciliation of each of these non-GAAP financial measures to the most directly comparable GAAP measures are available in yesterday's press release, which had 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 Third Quarter 2012 Financial Results.

And now, here is Joe Caldarelli.

Joe Caldarelli: Good morning, and welcome to our Q3 Call.

As I mentioned in our press release yesterday, the solid operational performance that had characterized the first half of the year continued in CPI's third quarter. Driven by strong performance from recurring core programs in our largest end markets, our operational and financial performance this year has continued to meet our expectations.

While we are mindful of the potential threat to our markets from challenging economic conditions in Europe and elsewhere as well as the ongoing political discussions about the U.S. defense budget, these have not had a significant impact to date on demand for our commercial and defense products. In fact, demand for CPI's products has remained stable in our defense, medical and communications markets. As of the end of June, our backlog remains healthy at 244 million and our year-to-date book-to-bill ratio is a respectable 0.98.

Before we delve into the details of our Q3 performance, I'd like to take a few moments to talk about CPI's recent acquisition of the Codan Satcom business, a leading designer and manufacturer of solid-state RF subsystems for satellite services for both commercial and government customers around the globe. The acquisition reinforces CPI's position as one of the leading providers of ground-based satellite communication amplifiers in the world.

We acquired the Codan Satcom business from Codan Limited, a manufacturer of a diverse range of electronic products in Australia. Given the large U.S.-centric nature of the satellite services industry, Codan Limited wanted a buyer with a broader position in the U.S. and in the industry in general. They were looking for a company that could devote the necessary focus and resources to grow the Codan Satcom business to its full potential. They found that company in CPI.

The Codan business consists of two main parts. First, there are operations based in South Australia that design and manufacture C-Band and Ku-Band subsystems and block up converters, or BUCs. Going forward, we will maintain a small engineering operation in South Australia but we plan to move the rest of the Australian operations to our existing facilities in North America over the next several quarters.

The second part of the Codan Satcom business is a former standalone company in Pennsylvania called Locus Microwave. Locus Microwave designs and manufactures X-Band and Ku-Band subsystems and BUCs, and it has an excellent reputation in X-Band communications applications, a key growth area in the expanding milcom market. We plan to continue to run this Pennsylvania-based operations on their current location under the name CPI Locus Microwave.

We believe that the Codan Satcom business is an excellent fit for CPI. It immediately and significantly expands our portfolio of solid-state products for Satcom applications. Because we have traditionally focused primarily on vacuum electron device products, the breadth of our previous solid-state product offerings has been fairly limited.

The addition of Codan's products to the CPI portfolio enables us to offer customers the most complete line of Satcom amplifiers in the industry, operating at all satellite uplink frequencies and power levels. With this acquisition, CPI can offer customers their choice of technology solutions from an extensive portfolio of vacuum electron device-based amplifier products and solid-state-based amplifier products depending on the customer's required power levels, linearity and frequency.

We acquired Codan Satcom for an initial payment of approximately $9 million, which we funded entirely from cash on hand. If the business meets certain financial and operational objectives over the next two years, we will make additional earn-out payments of about $4.5 million. Because the acquisition closed on June 30, which was the first day of our Q4, our Q3 results did not include any contribution from Codan Satcom. We do not expect the acquisition to have a material impact on our results for Q4 or fiscal year ’12. On a go-forward basis, we expect Codan Satcom to generate approximately $20 million in annual sales as part of CPI.

Let’s now turn our discussion to CPI’s topline performance in the most recent quarter. Our sales in Q3 totaled 97.2 million. As you may recall in fiscal ’11, we participated in a large onetime counter-improvised explosive device or counter-IED program, which as anticipated has not repeated in fiscal ’12. In Q3 of last year, we had 13.9 million in sales for this program. This year, as expected, we have none.

As a result, our total sales of 97.2 million in Q3 represent a decrease of approximately 7 percent from last year’s Q3. However, if we exclude the non-recurring counter-IED program from last year’s Q3, our total sales increased to approximately 8 percent in the most recent quarter as compared to a year ago and sales increased in each of our largest end markets.

In the first nine months of fiscal ’12, we booked total orders of 282 million. Excluding the 18.1 million orders that we booked in the same period last year for the onetime counter-IED program, our orders level was essentially unchanged from the year-ago period. As I mentioned at the top of the call, our year-to-date book-to-bill ratio stands at 0.98 and our backlog remains robust at 244 million. Let’s take a deeper look at each of largest end markets.

Fiscal ’12 has been a strong year for core recurring programs within CPI’s defense market, which consists of our business in radar and electronic warfare applications. In particular, a number of large radar programs, including the Aegis weapons systems and certain missile system radars, have had vigorous activity and strong demand this year. As I mentioned on previous calls, the factors driving this demand are unique to each particular program and are not necessarily indicative of the state of the global defense market.

Nevertheless, given the health of our long-running core defense programs and our relatively safe position as a components provider for new products as well as for spares and repairs, we do not expect that the ongoing discussions in Washington about potential cuts of the U.S. defense budget and possible sequestration measures will have a dramatic negative impact on our near-term defense business. For the first nine months of fiscal ’12, orders in our defense market decreased 7 percent to 119.5 million. This decrease can be entirely attributed to the inclusion of the aforementioned nonrecurring counter-IED program in last year’s period and the absence of this program in this year’s period.

When we exclude the 18 million in counter-IED orders that we booked in the first nine months of fiscal ’11, CPI’s core defense orders increased in the most recent nine-month period. This increase was due to the higher demand for products that support certain foreign radar systems, certain missile system radars and the Aegis weapons systems.

Our Q3 defense sales decreased 23 percent to 36.5 million. Again, this decrease was due to the inclusion of the counter-IED program in the year-ago quarter. If we exclude the 13.9 million in sales for this program that we recorded a year ago, our defense sales actually increased 10 percent in Q3. The increase was due to higher sales for some of our core radar programs including certain missiles radar – missile system radars and the Aegis weapon systems.

Let’s proceed now to our medical business. Conditions in the medical market continue to improve slowly. As we have mentioned on previous calls, this market has been more vulnerable to global economic conditions than the other large markets that we serve. Our end customers in the medical market are the hospitals and clinics that purchase imaging systems or radiation therapy systems containing our products.

These customers have been negatively impacted in recent years by economic downturns and tight credit markets, and so the demand for our medical products remained somewhat soft, particularly in parts of Europe. Demand for our X-ray imaging products in Russia, Asia and North America appeared to have stabilized and is improving somewhat. Demand for our radiation therapy products has remained stable. Demand for our MRI products continues to fluctuate depending on the needs of one large customer.

In the first nine months of fiscal ’12, medical orders were essentially the same as last year at 49 million. Orders for X-ray imaging products increased particularly from customers participating in X-ray imaging programs in Russia. Orders for radiation therapy products also increased. Offsetting these increases, the irregular timing and size of orders for large MRI customer resulted in a decrease in orders for MRI applications.

Our Q3 sales in the medical market increased 10 percent from the year -ago quarter to 18.3 million. Similarly to orders, sales for radiation therapy products and for X-ray imaging products increased particularly for customers participating in X-ray imaging programs in Russia and China. Partially offsetting these increases, sales for MRI products decreased in the most recent quarter.

The last of our major markets that I will be discussing this morning is our communications market, which we break into commercial communications and military communications, or milcom, applications. In the first nine months of fiscal ’12, communications orders decreased 10 percent to 87.9 million. The decrease was the result of lower orders in commercial and military communications.

In commercial communications, the decrease was due to the timing of programs for fixed satellite services, which are generally used for commercial broadcast applications. However, the overall market conditions for commercial communications applications continued to be healthy and overall demand remained stable. Our milcom orders were lower due to two specific programs, our telemetry development program and the Warfighter Information Network – Tactical or WIN-T program.

In the year-ago quarter, we participated in a complex foreign telemetry development program for which we incurred losses. The customer has since cancelled a portion of the contract and we de-booked the order this year. The second factor in our lower milcom orders was the WIN-T programs. We have talked about this program on numerous conference calls in the past few years, so I’ll simply remind you that we have now effectively completed our involvement in Increment 1 of the WIN-T program.

As you know, WIN-T has been a sizeable program for CPI, contributing approximately $55 million in sales over the past several years. Notwithstanding the conclusion of Increment 1 of the WIN-T program, our other milcom business continues to perform well. In Q3, partially offsetting the WIN-T and telemetry program decreases, orders for other milcom programs actually increased. We expect our non-WIN-T milcom business to continue to grow.

In Q3, sales from the communications markets increased 2 percent to 33 million. This increase was a result of higher sales for commercial communications applications particularly for fixed satellite service applications. Partially offsetting this increase, sales for the WIN-T milcom program decreased due to our having essentially completing Increment 1 of the program.

In summary, core programs in CPI's largest markets continue to show healthy demand and to provide us with stable, recurring business. Conditions within our defense markets remained sound and steady. Our medical market continues to improve, albeit slowly, and our communication market outlook remains solid.

The addition of Codan Satcom enables us to expand our solid-state product line and offer a broader portfolio of satcom amplifier products operating at a wider range of power levels and frequencies. We expect our communications business to grow as a result of this acquisition.

Now I'd like to turn the call over to Joel for a discussion of our Q3 financial performance.

Joel Littman: Thanks, Joe. I will focus my remarks this morning on CPI's profitability and liquidity performance in the third quarter of fiscal 2012. Specifically, I will cover our recent net income, adjusted EBITDA, cash, free cash flow and adjusted free cash flow results.

Some of these metrics are non-GAAP. For definitions and reconciliations of the non-GAAP metrics, please consult the financial tables at the back of the press release that we issued yesterday afternoon. Please remember that we completed the Codan Satcom acquisition in the beginning of CPI's fourth quarter. As a result, although we recorded approximately $700,000 in cost for professional services related to the acquisition in the third quarter, the cost of the acquisition itself is not included in our third quarter results.

Let's now turn to our third quarter profitability. Our net income in the most recent quarter totaled 2.9 million, a significant improvement over the 1.8 million net loss we reported in the same quarter of fiscal 2011. There were a handful of items that played a role in the year-over-year change.

First, let me talk about two items favorably impacting the most recent quarter's profitability as compared to the year-ago quarter.

The first and primary reason for this improvement lies in the timing of amortization expenses related to our being acquired by Veritas Capital in February 2011. In connection with that acquisition, we re-evaluated our inventory and intangible assets last year, resulting in an increase in the cost basis of our inventory and an increase in the intangible amortization. Over time, these noncash expenses have decreased. As a result, our net income results in the most recent quarter benefited from a 6.1 million reduction in the amortization expenses related to the intangible assets and re-evaluation of inventory.

Second, our net income results in the third quarter were positively impacted by improved operating performance for our telemetry antenna products. As Joe mentioned in his communications market discussion a few moments ago, we had been working on a foreign telemetry antenna development program for several years. We took a loss reserve provision on the program in fiscal 2011. A portion of the program has since been cancelled by the customer, and we did not have losses associated with this telemetry antenna development program in the most recent quarter. In comparison, the year-ago quarter included significant expenses related to the program.

Partially offsetting the impact of these favorable items on our net income were two items that unfavorably affected the most recent quarter's profitability as compared to the year-ago quarter.

The first of these items was, as Joe mentioned, that our sales in the third quarter of fiscal 2011 included approximately 14 million for a onetime counter-IED program that was not expected to and did not repeat in the current fiscal year. The resulting decrease in our sales is partially offset by approximately 7 million of higher sales for the programs in our defense and commercial markets. However, the net decrease in total sales in the most recent quarter unfavorably impacted our third quarter earnings as compared to the same quarter last year.

The second item contributing to lower earnings in the most recent quarter were 722,000 of legal and other professional service cost incurred to close the recent Codan Satcom acquisition. Last year's quarter did not have similar cost.

Let's now turn to our other profitability metric, adjusted EBITDA. CPI's adjusted EBITDA in the most recent quarter was 19 million, or 20 percent of sales. In comparison, our adjusted EBITDA in the third quarter of fiscal 2011 was 19.5 million, or 19 percent of sales.

The absence of expenses for the telemetry program we discussed earlier had a beneficial impact on our adjusted EBITDA results in the third quarter of fiscal 2012, mostly offsetting the negative impact of the third quarter's lower sales volume and related decrease in operating efficiencies in comparison to the same quarter of last year. On an ongoing basis, we continue to expect CPI's adjusted EBITDA margins to be in the mid-to-high teens.

Let's move on to CPI's liquidity metrics. As of the end of the third quarter, our cash and cash equivalents totaled 41.5 million. This is a high number for CPI, and it represents an increase from our cash balances over the last several quarters. Keep in mind, however, that we've spent approximately 9 million in cash on the Codan Satcom acquisition the day after our third quarter ended.

For the 12 months ended June 29, 2012, we generated 20.7 million in cash flow from operating activities and 11.8 million in free cash flow. Adjusted free cash flow for the period totaled 11.1 million, which is lower than our previous annual guidance of more than 17 million in adjusted free cash flow. There is no single contributing factor to this. Rather, several items aggregate to the less-than-expected adjusted free cash flow results.

These items include higher receivables and inventory due to the timing of certain orders in sales, an increase in longer-term programs which contributes to higher inventory levels, and higher capital expenditures as we increase our investment in plant and equipment to update our factories and facilitate revenue growth.

Overall, CPI remains in a comfortable and secure financial position. Our net income increased. Our adjusted EBITDA margins are in line with expectations. We are generating positive cash flow and continuing to paydown our outstanding debt. We have the financial resources to continue to serve our customers over the long term.

Now, I'd like to turn this morning's call back over to Joe for a discussion of our financial projections for fiscal 2012.

Joe Caldarelli: Thank you, Joel. Now that we are three quarters of the way through the fiscal year, we are tightening and adjusting some of our existing guidance ranges.

On the whole, we are comfortable with our performance in fiscal '12 to date and believe that we are on track for a successful year. Market conditions are stable to favorable in our major markets. Our operations continue to run smoothly. And customers continue to seek us out for leading-edge development projects as well as for our deep portfolio of reliable products and industry-leading technology. We do not expect any of these attributes to change significantly in the foreseeable future. Therefore, at this time, we are tightening our existing guidance range for our sales in fiscal '12 and reconfirming our adjusted EBITDA guidance. We currently expect to generate sales of 385 million to 395 million and adjusted EBITDA of 63 million to 65 million for the year.

One area where we have not been as successful as we would have liked this year is in managing our inventory levels throughout the company. Due to the timing of certain orders and sales this year, our inventory is higher than we had expected previously. This is an issue that we will continue to address going forward.

Nonetheless, as Joel discussed, higher inventory levels had contributed to lower adjusted free cash flow than we had expected in fiscal '12 to date, and so, we are amending our guidance for adjusted free cash flow for the year. We currently expect to generate adjust free cash flow for fiscal '12 of approximately 13 million to 17 million.

We continue to expect to generate adjusted free cash flow of more than 17 million on an annual basis in future years.

Our sales, adjusted EBITDA and adjusted free cash flow guidance assumes a nominal contribution from the newly acquired Codan Satcom business in the fourth quarter.

This concludes my prepared remarks for today. Thank you for your time and attention. Operator, let's begin the question-and-answer session.

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

Again, if you have a question or a comment at this time, please press the star then the one key on your touchtone telephone.

Our first question comes from Donovan Chaney from Wells Fargo.

Donovan Chaney: Hey. Good morning. Thanks for taking the question.

Joe Caldarelli: Hey.

Donovan Chaney: I just want to ask you a little bit about the solid-state market. If you could talk a little bit about kind of how that market compares in size to what you do now and who are some of the competitors are that Codan might have, and what Codan's size is kind of relative to them.

Joe Caldarelli: Yes. The term solid state is used rather broadly. And so, it's important to realize that when we talk about solid state, we're really talking about amplifiers that use solid-state devices that are at a reasonable power level, which would be sort of maybe 10 watts and up.

For example, there are – there are obviously solid-state amplifiers in cell phones. We're not in that business. So that market is enormous but we don't consider that part of our market. So if we confine ourselves to the applications that are along the lines that we serve, then probably the solid-state market is smaller than our vacuum electron device-based amplifier market. But in the ballpark of perhaps comparable size, we should be a couple hundred million dollars, maybe $250 million. I mean it's tough to put an exact number on it.

Codan was a leader in the field. With their revenue being in the $20-odd million range, that would put them at comparable scope to some of the other key players in that market. And the other key players are units of Teledyne that used to be independent with Paradise. There's the unit of General Dynamics. There is an independent company called Wavestream. Well, they're not – they're not independent anymore; Wavestream is part of another company as well. So all these other companies have revenues that are in the tens of millions dollars per year range. So I think with our combined existing solid-state business that we already had plus the Codan acquisition puts us right in the midst of the current market leaders.

Donovan Chaney: OK. So I mean, would you characterize that market then as relatively fragmented?

Joe Caldarelli: Yes. I don't think there is a single dominant player in the market today. I think it's available to whoever has the best product at a competitive price.

Donovan Chaney: All right. That's very helpful. Thank you.

Joe Caldarelli: OK.

Operator: Our next question comes from Dan Colonna with UBS.

Daniel Colonna: Hi. Thanks for taking my question. A couple of things. Joe, earlier in the call, you mentioned that you don't think sequestration would have a dramatic impact on your business going forward. But can you help us then put some level of parameters around the potential impact if that were to occur?

Joe Caldarelli: You know, it's really difficult to do that. As you well know, nobody has a real handle on, first of all, will it happen or not and how will it be implemented, how will it slow down. So frankly, it's really difficult to put anything rational on it.

What I can tell you is that, for the last two, three years and including year-to-date, we found that there had been slowdown and push outs in the business area. But I think right now, I'll describe the current situation as largely stable in the sense that the number of things that are getting pushed out is balanced with the number of things that are getting pulled in.

In fact, interestingly, within the CPI portfolio today, I would guess there is as many items that we supply where we're being expedited because the government is out of stock as there are items that are getting pushed out because they may be in an overstock situation. So it's kind of an interesting situation. I think I would call that to be equilibrium.

So, sorry, I can't really give you a useful answer. My sense is that things we support will continue to need support. And unless sequestration results in really dramatic steps like taking 50 ships out of inventory and grounding 1,000 planes, then obviously that would have an impact on us. Otherwise, if it's down in a sort of rational organized manner and equipment continues to be maintained, then it should have a fairly modest impact on us.

Daniel Colonna: That's very helpful. Can you help with the current EBITDA margin at Codan and the potential cost of moving from the ops back to the U.S.?

Joe Caldarelli: Yes. Codan was integrated within a larger organization – Codan Satcom was integrated within larger organizations. So it's tough to extract an exact EBITDA margin. But they were modest. We hoped that once we put it into our organizations that are bit more focused, we can get reasonable EBITDA margins from that incremental business. And I would define, in that business, reasonable EBITDA margins to be in the low-to-mid double digits sort of thing, 10, 15 percent margins.

The cost of moving the operation will be worked in to our 2013 budget, and they're kind of equivalent to the first year's EBITDA dollar sort of thing. So I don't think we're publicly stating the projected cost. But it's – I would think that in year one, the contribution from the incremental sales and the cost of moving them will be in the same ballpark.

So I would think in year one, it's probably going to be close to a wash. In subsequent years, we would expect it to be a fairly solid contributor going forward.

Daniel Colonna: That's very helpful. And is the – one more for me. I think based on your current guidance, you'll probably end the year with net leverage of around 5 times. Are you comfortable there? Or do you foresee trying to take that down further over the next 12 to 24 months? And if there's – I know you historically have had a leverage target, but any sort of help on where you feel comfortable operating this business on a go-forward basis?

Joe Caldarelli: Yes. I think we're consistent with what we've said in the past. We're fine at the current levels. Lower would obviously be better. And as we have done in the past, we'll continue to evaluate the opportunities that are presented to us. And if we find something like Codan, which we think is a worthwhile addition, then we think we are in a position to be able to handle that.

On the other hand, in the absence of that, then our primary objective will be to pay down debt. So I think we'll just continue to look at it as we go along, and that we have not established and will not likely establish particular targets because we don't want to tie our hands and miss out on certain opportunities. But we'll continue to be very prudent.

Daniel Colonna: Very helpful. Thank you, and nice quarter.

Joe Caldarelli: Thank you.

Operator: Again, ladies and gentlemen, if you have question or a comment at this time, please press star then the one key on your touchtone telephone.

Our next question comes from Tim Secontine with Northern Trust.

Tim Secontine: Hey, good morning. Echo the comments, also another good quarter. Thank you. One question left. You mentioned in the medical business on the MRI side, there is one kind of larger customer. Any chance that you could copy in a context of how large that customer or how much of the medical segment does it account for?

Joe Caldarelli: In certain years in the past when they were really doing a lot of stuff, they had been up to $5 million or $6 million a year. When they're not drawing much stuff, they're kind of $1 million to $2 million a year. So that's the range of where they fit in.

Tim Secontine: OK. Thanks.

Joe Caldarelli: OK.

Operator: I'm not showing any further questions at this time. I'd like to turn the conference back over to Joe Caldarelli for closing comments.

Joe Caldarelli: Right. Well, thank you very much for listening into us, and we look forward to talking to you again after yearend in September. Thank you very much.

Operator: Well, ladies and gentlemen, that concludes today's presentation. You may now disconnect, and have a wonderful day.

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