

CPI INTERNATIONAL HOLDING CORP.

FISCAL YEAR 2011 FINANCIAL RESULTS CONFERENCE CALL
December 09, 2011
10:00 am CT

Operator: Good day everyone and welcome to today's CPI International Fiscal Year 2011 Financial Results conference. My name is Sarah and I will be your coordinator today.

At this time, all participants are in a listen-only mode. We will be facilitating a question and answer session towards the end of today's conference.

If at any time during the call you require assistance, please press the star key 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 presentation over to Amanda Mogin, Director of Investor Relations for CPI International. Please go ahead, ma'am.

Amanda Mogin: Thank you, Sarah. Good morning and welcome to CPI International's conference call for fiscal year 2011.

The speakers and topics for today's call are as follows: Joe Caldarelli, CPI's Chief Executive Officer, will discuss some of the operational highlights of the just completed year and

expectations for our fiscal 2012. Joel Littman, our Chief Financial Officer, will discuss some of our key financial metrics for fiscal 2011 and give a brief overview of our current debt structure and covenants.

At the end of their prepared remarks, Joe and Joel will be joined by Bob Fickett, our President and Chief Operating Officer, for the question and answer session.

Before this call gets under way, 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. 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, as well as measures that combine results before and after the February 11, 2011 acquisition of the company by Veritas Capital.

The presentation's 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 on our website.

Interested parties can access the press release by going to www.cpii.com and opening the press release entitled CPI International Announces Fiscal Year 2011 Financial Results.

And now, here's Joe Caldarelli.

Joe Caldarelli: Thank you. Good morning. Due to the strategic initiatives that we undertook in 2010 and '11, it has been awhile since we last spoke with you on a conference call. I think you'll agree that we have accomplished quite a lot during this period.

Rather than focus on the details of all that has happened since we last spoke, I believe our time today is best spent talking about some of the bigger trends and programs that have impacted our business during that period.

We'd be happy to answer questions on all the particulars either at the end of our prepared remarks this morning or in follow-up conversations.

Fiscal '11 was a great year for CPI operationally. We ended the year with the highest sales orders and year-end backlog in our history. We booked higher volumes than we shipped, which bodes well for our business volumes in fiscal '12.

Our sales for the year totaled \$389 million, a healthy 8% increase over last year, while orders grew by 5% to \$393 million.

We continue to see solid demand in all of our significant end-markets for our reliable and trusted products as well as a growing interest for new and development products, particularly in our scientific market.

We maintain our diverse revenue streams and continue to expand our large base of blue chip customers and sockets during the past year as evidenced by a number of key metrics.

Our '11 sales were split evenly between sales to support government and military end-users and sales to support commercial end-users. Two-thirds of our total sales were for new sockets, while one-third were for spares and repair programs.

We maintained our significant global presence with approximately two-thirds of our sales being for U.S. customers and approximately one-third for foreign customers.

In addition, we were the sole provider for approximately 60% of our sales, meaning that CPI was effectively the only supplier considered and employed by our customers for the majority of our 2011 sales.

These metrics have remained relatively consistent over the past several years, underscoring the stability of our business.

Where we have seen changes, they have been due to the addition of significant new programs such as the Counter IED program we mentioned in yesterday's press release and 10-K. I'd like to talk about this program for a few minutes.

We cannot give many specifics about the program due to its sensitive nature, but it played a major role in our business this past year because of its large size and expedited timing.

Working with a major defense prime, we supplied the U.S. military with counter IED products for a new approach to countering improvised explosive devices in the field.

Drawing from our extensive base of pre-existing technology, we were able to quickly adapt our product in order to support this program at our Microwave Products Division in Palo Alto, California and our Satcom Division in Georgetown, Ontario.

We originally began working on this program in mid-2010, providing development prototypes, preproduction and qualification units.

In early '11 there was an extremely quick and coordinated ramp-up to full production by both divisions. All told, during 2011 we booked \$18 million in orders and shipped \$18 million in sales for this program.

It was a major success for CPI and our customers, and we are very proud of our team's performance and the positive contribution we were able to make to the safety of our troops.

In addition, we were pleased to read in an industry trade publication that the program was chosen by a panel of U.S. Army combat veterans as one of the best military innovations of the year.

It is important to note, however, that the entirety of our production orders and shipments for this program took place in fiscal '11. At this time we have no concrete expectations of future business.

The second significant program that I'd like to discuss this morning is the Warfighter Information Network-Tactical, or WIN-T, military communications program.

As you may recall, we were awarded the initial orders for Increment 1 of the WIN-T program in fall of 2007. We were not well known as a milcom vendor at the time, and winning the WIN-T contract significantly grew our reputation, experience and market share in this sector.

At the time, we estimated the potential value of the WIN-T contract at approximately \$50 million over four years.

It is now four years later and, as expected, Increment 1 of WIN-T is concluding. In its heyday we received approximately \$28 million in orders in '09. In '11 that number dropped to approximately \$4 million.

Our sales rates have been more even with approximately \$13 million in sales in fiscal '09 and approximately \$15 million in '11.

In total we have shipped approximately \$55 million over the past four years for WIN-T Increment 1 and its related and predecessor programs.

With the programs substantially complete, we expect sales of less than \$1.5 million in fiscal '12.

We are not currently participating in a test phase for the next increment of WIN-T program, but there may be opportunities on the next increment and the following increments in the future.

Building on the foundation laid by the WIN-T program, we have significantly grown our milcom capabilities, reputation and business volumes in the last four years, and as a result we have a solid base of core milcom business consisting of a number of more typically sized programs.

Our milcom sales have exceeded 10% of our total sales in the past two years, and notwithstanding the conclusion of Increment 1 of the WIN-T program, we expect our core milcom business to continue to perform well going forward.

Overall, however, our milcom business is expected to be at more modest levels in the next couple of years due to the conclusion of the atypically large WIN-T program.

I'll talk more about our expectation for 2012 in a few minutes. Now I'd like to turn the call over to Joel to discuss the 2011 financial results and our new credit agreement.

Joel Littman: Thanks, Joe. I am pleased to report that CPI remains a financially stable and secure company with excellent free cash flow generation capabilities. Our underlying financial performance was strong in fiscal 2011, as evidenced by our adjusted EBITDA and adjusted free cash flow results.

But a number of expenses related to the February acquisition of the company and the related refinancing obscure the strength of that finance performance on our GAAP financial statement.

I'd like to focus my comments today on those unusual items and their impact on our financial results. We believe that excluding those unusual items presents a clearer picture of our underlying financial results in fiscal 2011, which is why we closely watch our adjusted EBITDA and adjusted free cash flow metrics.

I will be confining my remarks to fiscal year 2011. For information on the fourth quarter, please consult the press release and tables we issued yesterday afternoon. I'll start with our key profitability metrics, mainly net income, EBITDA and adjusted EBITDA.

The unusual non-cash or non-recurring items that impacted our profitability in fiscal 2011 were as follows: First, and most significantly, our net income results were negatively impacted by the recording of the \$22.7 million in intangible depreciation and amortization expenses in fiscal 2011.

This is a sizable increase in our typical depreciation and amortization expenses. In fact, it was more than double last year's \$11.1 million. This increase is due to the re-valuation of our assets following the acquisition in February.

Second, our net income and EBITDA results for fiscal 2011 contained a charge of \$7.7 million for the amortization of the increase in the fair value of our inventory as of the date of the acquisition.

This non-cash expense is due to the application of purchase accounting in fiscal 2011, and is not expected to recur in future periods.

Third, our net income results for the most recent fiscal year were unfavorably impacted by interest expenses that, at \$23.5 million, were 54% higher than in fiscal 2010 due to the refinancing related to the acquisition.

Going forward, we expect our annual interest expenses under the new capital structure to be approximately \$12 billion higher than they were under the previous structure. I'll discuss the new capital structure in more detail in a few minutes.

Additionally, our 2011 net income and EBITDA results included strategic alternative transaction expenses of \$14.2 million. These expenses were comprised of non-recurring costs including fees for investment bankers, attorneys and others, as well as cash payments for the unvested portion of the restricted stock awards for which vesting was accelerated in conjunction with our transaction with Veritas Capital.

Note that our financial results for the previous year also included \$19.9 million in strategic alternative transaction expenses including a \$15 million fee paid in conjunction with the September 2010 termination of our merger agreement with Comtech.

Including these unusual non-cash or non-recurring items, our net loss for fiscal 2011 totaled \$11.2 million, as compared to net income of \$6.7 million in the previous year.

Our 2011 EBITDA, which, by definition, excludes the depreciation and amortization and interest expenses I just mentioned but includes a number of merger-related expenses, was \$33.9 in fiscal 2011.

This is a decrease from the \$38.6 million in EBITDA in the prior year primarily due to the utilization of the net increase in the fair value of our inventory as of the date of the acquisition and higher stock compensation expenses due to the transaction.

We consider our adjusted EBITDA to be the best indicator of our underlying financial performance and profitability, as it excludes certain non-recurring, non-cash or other unusual items. These items were largely merger-related expenses in the past two fiscal years.

In fiscal 2011 CPI generated adjusted EBITDA of \$62.4 million, or 16% of sales. Our adjusted EBITDA increased in comparison to fiscal 2010 \$61.6 million, or 17% of sales.

It is worth noting that fiscal 2011's adjusted EBITDA, as compared to fiscal 2010, was unfavorably impacted by approximately \$5.7 million, or 1.5% of fiscal 2011 sales due to the impact of the strong Canadian dollar versus the U.S. dollar.

We expect to continue to generate adjusted EBITDA margins in the mid to high teens going forward.

Before I move on to our cash flow discussion I'd like to mention that our fiscal 2011 tax rate was a benefit of 9%, whereas a more normalized rate would have been a tax benefit of approximately 37% to 38%.

The primary reason for the lower tax benefit were higher U.S. taxable income from CPI Canada in the form of actual and deemed dividends, as well as the non-deductability of certain merger expenses.

Moving on from our profitability measurements, I also want to discuss our cash flow metrics for fiscal 2011. Once again, these metrics were impacted by acquisition and refinancing related items.

Our adjusted free cash flow results exclude these items, making adjusted free cash flow a key indicator of the strength of our cash-generating capabilities.

Let me begin by discussing capital expenditures. In fiscal 2011 our capital expenditures were \$7.4 million, which is higher than our typical guidance of \$4 million to \$6 million in annual capital expenditures.

The main reason for the higher number was the customer-funded investment of \$2 million in our facilities and capital equipment necessary for the large counter IED program that Joe discussed earlier.

Our net cash provided by operating activities totaled \$17.8 million in fiscal 2011, which included \$13 million in cash paid for merger expenses. These after-tax costs included fees and expenses related to our acquisition by Veritas Capital and payments for the accelerated vesting of restricted stock awards that were cashed out in the acquisition.

Excluding these merger-related expenses and certain other non-recurring or unusual items, our adjusted free cash flow totaled \$25.3 million in fiscal 2011. This is in line with our standard guidance of annual adjusted free cash flow in excess of \$20 million.

Our robust adjusted free cash flow results demonstrate our continued good health and ability to maintain high levels of financial strength and flexibility.

I would next like to briefly discuss our new debt structure and covenant compliance. In fiscal 2011, in conjunction with the transaction with Veritas, we refinanced the company, repaying all of our previously outstanding debts.

We issued \$215 million in 8% notes, which are due in 2018, and entered into a new credit facility which includes a six-year term loan of \$150 million and a five-year revolving credit facility of \$30 million. The revolver is currently undrawn other than for outstanding letters of credit totaling \$4.1 million.

In total we have \$364 million in total debt as of September 30. Interest on our term loan is calculated based on LIBOR plus 4% with a 1% LIBOR floor.

As of September 30 the interest rate on the term loan was 5%. The interest rate on our notes is 8% per year and is paid semi-annually in February and August. In total our annual interest expense for fiscal 2012 is expected to be approximately \$27 million.

The most significant debt covenant requirements of our new credit agreement are, first, we must maintain a maximum leverage ratio of 7.0:1. Our leverage ratio as of the end of fiscal 2011 was well below this maximum at 5.5:1.

Second, we must maintain a minimum cash interest ratio of 1.65:1. As of the end of fiscal 2011 our cash interest ratio was well above this minimum at 2.5:1.

Third, our annual capital expenditures must not exceed \$8 million. In fiscal 2011 our capital expenditures, excluding the \$2 million that were paid by our customer and which are excluded

from this covenant calculation, totaled \$5.3 million, safely below the \$8 million cap. We fully expect to remain compliant with the covenant requirements of our credit agreement.

That brings us to the end of my prepared remarks this morning.

In summary, although the expenses and purchase accounting related to the acquisition of CPI earlier this calendar year somewhat cloud our GAAP financial results, we remain a financially strong and stable company.

In fiscal 2011 we achieved record sales and orders and generated adjusted EBITDA and adjusted free cash flow results in keeping with our typical expectations for a normal year.

We believe our current debt, although at higher levels than in previous years, is well within our ability to manage and allows the flexibility necessary for us to grow our business.

With that, I'll turn the call back over to Joe to discuss our expectations for fiscal 2012.

Joe Caldarelli: Thank you, Joel. Before I get into the financial projections for the year, I'd like to address the current business climate. As you are all aware, there has been much discussion and concern regarding budget cuts in the U.S., particularly as they relate to the defense budget, and therefore we are mindful of the potential impact this may have on CPI.

We do not currently have details on what specific platforms or programs would have their funding reduced or eliminated, nevertheless if we look at previous reductions to the defense budget the programs that we tend to support, which are often long-lived, proven legacy programs, have not been greatly impacted in the past.

We support more than 100 defense programs in the United States and only a handful of them are of a significant enough size to us to really impact our financial results in any one period. As a result, our exposure to cuts in any one program is fairly low.

In addition, we are typically somewhat insulated from feeling a dramatic impact resulting from changes in the defense budget because we are a few levels down in the supply chain, first because we are a component manufacturer and not a prime contractor, and second because approximately 50% of the parts that we sell into the defense markets are used for spares and repairs meaning that they support systems that are currently in mainstream use in the field.

While budget cuts may mean that order rates slow down or orders are delayed causing a modest dip in our short-term defense orders and sales numbers, if systems continue to be in active duty sooner or later spares and repair parts need to be ordered to keep those systems running.

One last reminder about our defense markets: Our fiscal 2011 results included \$18 million in orders and sales related to the one-time counter IED program I discussed on the top of this call.

The absence of that program in 2012 is expected to be noticeable, although we expect to partially offset it with increased participation in other core programs. For example, we have significant levels of business supporting the Aegis weapons system for which new ships are expected to continue over the next few years as well as several other stable and recurring legacy programs.

Let's now turn to our major commercial markets, specifically our medical and communication markets.

In the medical market, which was slow to recover from the economic downturn, conditions have greatly improved and stabilized. Demand for our radiation therapy products for the treatment of cancer continue to be stable and solid.

Further, we are seeing solid demand right now for our x-ray imaging products, particularly from foreign customers. There are sizable x-ray imaging tenders underway in China and Russia, and several of our customers are participating in these programs, increasing the current demand for our products as a result.

Our MRI business, which we've always considered to be somewhat of an extra contributor to our medical business, has been quite volatile in the last few years due to the unpredictable and irregular buying practices of one of our significant MRI customers. We don't anticipate this volatility going away any time soon, and we're only budgeting for nominal levels of MRI business in fiscal '12 and beyond.

In the commercial communications market demand is stable and steady and the long-term outlook is strong. There has been increasing activity in programs such as high through-put satellite systems that deliver broadband internet services to consumers, and we expect this market, although somewhat lumpy and cyclical, to perform strongly for us in the next few years.

You will recall that our communications market includes both commercial and military communications applications. Our milcom business is likely to contract a bit in the short-term due to the conclusion of WIN-T Increment 1, as I mentioned earlier. Overall, though, our core recurring milcom business is expected to remain healthy and grow in the long-term.

In aggregate, we seem to have weathered the worldwide economic storm quite well so far. We continue to carefully monitor our defense markets for more definitive funding details in the weeks and months to come.

In addition, we will continue to watch the worldwide economic situation for developments that might impact both our defense and commercial end-markets.

Our financial projections for 2012, therefore, are as follows: We expect total sales of \$380 million to \$395 million, adjusted EBITDA of \$63 million to \$65 million, and adjusted free cash flow of more than \$17 million.

We anticipate that Q1 of 2012 will follow historical patterns. It will likely be the softest quarter of the year due to the typical spending patterns of the U.S. government, which is generally slow to ramp up funding at the beginning of the year.

In addition, Q1 contains the Thanksgiving and Christmas holidays when several of our customers and our manufacturing facilities shut down, and so it is the quarter with the fewest working days. We expect our financial results to increase as the year progresses.

In conclusion, 2011 was a strong year for CPI. Operationally we saw solid demand for our products and executed well on a number of new initiatives. We posted respectable adjusted EBITDA and adjusted cash flow results. In addition we gained an excellent strategic partner in Veritas Capital.

For fiscal '12 our visibility of the defense market spending is clouded, but we think our exposure to major changes is fairly low.

We expect our core business to grow to some extent, partially offsetting the conclusion of two significant programs. Hence, we are forecasting another stable, profitable year.

Thanks for your time this morning. Let's begin the question and answer portion of today's call.

Operator: Thank you. To the audience, if you have a question or comment today, please press star the one on your touch-tone phone. For those of you joining us today via a speakerphone, please

make sure your mute button is turned off to allow your signal to reach our equipment. Once again, to the audience, please press start then one if you have a question or a comment.

We'll go first today to Dan Colonna of UBS.

Dan Colonna: Hi, everyone. Thank you for hosting the conference call. Couple of questions. First, in the current quarter you highlighted contract loss provisions and cost overruns. Can you just give us a little bit more detail behind that please?

Joe Caldarelli: Yeah, we have a contract with a French customer that hasn't gone all that well, and they have decided to terminate a portion of the contract, and, so, we have taken provisions which we believe are appropriate to finish off the remaining portion and there are things that we have to do to sort of wrap up those things that we are no longer going to be performing against. We think that's largely behind us.

Dan Colonna: Can you quantify that?

Joe Caldarelli: I'm sorry?

Dan Colonna: Can you quantify how big that was? The provision?

Joel Littman: You know, the charge that we took in the fourth quarter was \$1.5 million for that contract.

Dan Colonna: Thank you. I then just wanted to focus on the guidance for next year. It seems like another strong EBITDA guidance. The free cash flow guidance is a tad bit lower than fiscal '11. Can you just help us walk from fiscal '11 to fiscal '12 and what some of the drivers may be behind that.

Joel Littman: The significant item is interest expense. Our pre-tax interest expense is up \$11 million, so, after tax that's \$7 million to \$8 million and if you just subtract that from the mid-twenties, where we had been in the old days before we came up with the new capital structure, you get to the new guidance.

Dan Colonna: Okay. That's quite clear. Then, just, the last question for me, can you just discuss the seasonality of your backlog? You know, obviously it's a record fourth quarter backlog, an up-year year, down a little bit sequentially. I think that's typical but can you just help me understand that a little bit better?

Joe Caldarelli: If you're talking about the backlog changes during fiscal '11, it was primarily as we booked and then shipped that counter IED program that I talked about in Q2 and Q3, and as we ate into preexisting backlog into the WIN-T program, those were the major sort of significant ones.

Other than that, the remaining backlog is fairly typical products with fairly typical shipping requirements, and that means that the backlog that's for the defense products tends to go out to six or 12 months, and the commercial products tend to go out from a few weeks to several weeks/a few months, which is fairly typical for us.

So I think the closing backlog at the end of the year was fairly typical. We still had a little bit left over from a couple of those programs for WIN-T, but otherwise it's fairly typical.

Dan Colonna: Okay. Great. Thank you very much.

Operator: And as a final reminder to our audience today, it is star then one if you have a question or comment. We'll pause for just a moment. And we'll pause for just a final moment.

And next from Standish, we'll go to Clark Orsky.

Clark Orsky: Yeah, hi, just wondering on seeing any impact from the financial situation in Europe when I think about a third of your business is international.

Joe Caldarelli: Yeah, so far nothing dramatic. In fact, Europe, as a result of some of the tenders that I mentioned for the x-ray imaging is currently fairly strong, but we recognize that, of course, during the performance of these tenders so after that it will go back to normal.

But we haven't seen any dramatic impact as we haven't anywhere else in the world. But, we're surely cognizant and cautious in our approach where we wouldn't be surprised to see some order delays and so on, but truly to date we've been surprisingly unaffected.

Clark Orsky: Okay, thanks. And, I guess, also, just on the liquidity, I mean, you're sitting on a pretty big cash balance. Any thoughts about what you use that for?

Joe Caldarelli: Well, as in the past we'll look at the choice available to us between acquisitions and debt repayment and we'll make judgments accordingly on the situation at the particular time.

You know, we're not uncomfortable with the amount we have now. You'll notice in the past we've kept approximately that level on hand, and so we may eat into that a little bit at various points.

Remember, we have some interest payments coming up in February and August so a certain amount of that will get eaten up by the interest payments in February.

Clark Orsky: Okay. Is there any area of acquisitions that you think you need to do in order to fill in the business or...

Joe Caldarelli: Well, there's none that we feel we need to do. With Veritas as a partner we certainly see a lot more opportunities than we did when we were on our own. And, the Veritas folks are brilliant at evaluating and pointing out to us areas of interest, so we're certainly looking at more things than we have in the past.

But our mode of operation, our general standards for doing acquisitions, haven't really changed. We will continue to be careful. We will continue to make sure that we use our money wisely, and so, I don't see any change overall from before except that we're seeing a lot more opportunities and we're evaluating more opportunities.

Clark Orsky: Okay. I guess, lastly, I think in your comments you said you weren't participating in the next phase of WIN-T. Could you just talk about that a little bit?

Joe Caldarelli: Yeah, the Phase 2 WIN-T is sort of at its infancy. There's been some contracts let out for sort of early products for evaluation, and we're not in those early contracts. But we think there's still opportunity to participate both in the second phase as well as any subsequent phases so we're very much sort of standing by, if you like, and continuing to work various avenues to participate. But we're currently not written into any Phase 2 contracts.

Clark Orsky: Okay. Is that a potential upside to 2012 or is that sort of beyond that?

Joe Caldarelli: Probably beyond that. I think a lot of the work being done in 2012 is a preparatory nature, and so any upside in terms of revenue would be moderate for us and, I think, others as well.

Clark Orsky: Okay, great. Thank you.

Operator: And it appears we have no further questions at this time. I would like to turn the call back over to Joe Caldarelli for any closing remarks.

Joe Caldarelli: Well, thank you all very much for joining us in our first call in some time, and we look forward to working with all of you going forward. If you do have any more questions don't hesitate to call and we wish you all a Merry Christmas and happy holiday season. Thank you.

Operator: Thank you. And again, that does conclude today's conference. We thank you all for joining us.

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