

CPI INTERNATIONAL HOLDING CORP.
FIRST QUARTER 2013 FINANCIAL RESULTS
CONFERENCE CALL
February 6, 2013
10:00 a.m. ET

Operator: Good day ladies and gentlemen and thank you for standing by. Welcome to the CPI International First Quarter 2013 Financial Results Conference Call. My name is Karen and I'll be your conference coordinator for this call.

At this time all participants are in listen only mode. We'll 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 the coordinator will be happy to assist you. As a reminder this teleconference is being recorded for replay purposes.

I would like to turn the conference over to Amanda Mogin, director of investor relations for CPI International. Please proceed.

Amanda Mogin: Thank you, Karen. Good morning and welcome to CPI International's conference call for the first quarter of fiscal 2013. Our speakers and topics for this morning's call will be the following. First Joe Caldarelli, CPI's chief executive officer, will start the call with a discussion of our performance in our major end markets in the first quarter and our expectations for those markets this year.

Second, Joel Littman, our chief financial officer, will discuss some of our key financial metrics for the quarter. Next, Joe will talk about our financial projections for fiscal year 2013. 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. Please interpret these statements in that light. Additional information regarding risk and uncertainties related to our business are included on 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 include non-GAAP financial measures related to EBITDA and cash flow. A presentation of the more directly comparable GAAP measures and a reconciliation at least of the non-GAAP financial measures to the more directly comparable GAAP measures are available in yesterday's press release which has 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 First Quarter 2013 Financial Results. And with that I'd like to turn the call over to Joe Caldarelli.

Joe Caldarelli: Thank you. Good morning and welcome to our call. Fiscal 13 is off to a good start for CPI. During Q1 we enjoyed growth and sales and orders in all of our key markets. And we increased our revenue and profitability in comparison to the year ago quarter. The relocation and integration of our recently acquired Australian Codan Satcom business into our facilities in the U.S and Canada is progressing according to plan.

Our business with government and defense customers remains healthy, and our business in the medical and commercial communications markets continues to do well. In comparison to Q1 of last year, our total sales grew five percent to \$97.6 million. This is the highest first quarter sales level CPI has ever recorded. Sales increased in our defense, medical and communications markets in comparison to the year-ago quarter.

Following a strong Q4 and a very productive fiscal 12, our solid Q1 sales speak to the continuing underlying strength of our markets and business.

Our order results for Q1 of fiscal 13 were also very strong, increasing 41 percent from last year's first quarter to \$138 million. This is the highest quarterly orders levels in CPI history and has resulted in our highest ever backlog. At the end of Q1, our backlog totaled 283 million. The sizeable increase in our orders and backlog were

partly results of one very large communications order that we received in the most recent quarter. I will talk about that order in a moment.

Within our defense markets we have continued to enjoy solid levels of activity driven by enduring demand for spare and repair products to support established radar and electronic warfare programs.

To date the ongoing talk of sequestration and cuts to defense budgets has had little discernible impact on us. While we have seen fairly typical delays and push outs in certain defense programs, these have been more than offset by pull ins and increased demand in other programs. In aggregate, we expect our defense business to hold steady over the short to medium term with minor time perturbations.

In Q1 orders for our defense markets increased 11 percent to \$55.3 million. This increase was primarily due to higher demand for products to support certain radar and U.S. electronic warfare systems. A decrease in orders to support the Aegis weapons system partly offset these increases, but that decrease was entirely attributable to the timing of orders for that program. In fact, we expect to book a very healthy level of Aegis business this year.

Sales in the defense market have increased by one percent to \$34.8 million in the most recent quarter. This increase was due to higher sales to support electronic warfare systems for the U.S. military and certain domestic and international radar systems.

In our medical market, conditions have generally been improving. We are seeing increased demand for our products from our customers in North America and emerging markets.

Our North American medical customers include a number of OEMs who distribute our products to their customers around the world. As a result we do not have a direct view into the ultimate destination of some of our products, but we do know that demand for our medical products, particularly our X-ray imaging products, has been quite strong in countries such as Russia and China. And that our North American customers are indicating more optimism about their market conditions than they have been in the last several years.

Our Q1 orders in the medical market increased 17 percent to \$14.9 million in comparison to the year-ago quarter. This increase was due to the higher demand for products to support X-ray imaging applications, including higher demand for products to support imaging programs in Russia. The radiation therapy segment of our medical business remains stable.

Medical sales increased by 13 percent to \$21.8 million in Q1. The primary driver of this increase was higher sales for radiation therapy programs, but sales of products to support X-ray imaging and MRI applications were also higher in the most recent quarter.

Our communications market was the clear standout in Q1. Orders in this market increased by 134 percent from a year ago quarter to \$59.1 million. While overall market conditions continue to be positive and demand continues to be solid for CPI's commercial and military communication products, the primary driver behind the sizeable increase was one very large multi-year order of more than \$20 million for military communications applications.

Specifically the order is for tactical common data link or TCDL antenna products to support unmanned aerial vehicles which provide intelligence, surveillance and reconnaissance, or ISR, capabilities. This is the largest single order ever placed on CPI and it speaks to the confidence our defense customers have in our Milcom capabilities and advanced antenna products. We will start shipment against this order in late fiscal 13 and shipments will continue into fiscal years 14 and 15.

In addition to this large Milcom program, our Q1 communications orders also including approximately 5 million in orders for Codan Satcom products. These orders were primarily for commercial communication products used in maritime applications.

Our communications sales also rose in Q1, increasing one percent to \$32.6 million due to the inclusion of approximately \$4 million in sales of Codan Satcom products in the quarter.

The integration of the Codan Satcom business into CPI is progressing well and has been favorably received by our customers. We are currently relocating some of Codan Satcom product lines from the business's previous facility in Australia to our existing facilities in North America and that effort is proceeding according to plan.

The increase in our Q1 communications sales resulting from sales of Codan products was partially offset by our decrease in sales of other commercial communications products.

This decrease was due to the timing of a number of smaller orders from various commercial communication applications. Fundamentally, however, our commercial communication business continues to be quite healthy.

As demonstrated by our orders and sales results in our defense, medical and communications markets, CPI had a solid first quarter, and our market conditions remain favorable. We have record high backlog of 283 million and a very health book to bill ratio of 1.07, pointing to continued strong sales levels in coming quarters. I'll talk about our expectations for fiscal 13 and seasonality a little later in this morning's call. Now here is Joel to discuss our Q1 financial performance.

Joel Littman:

Thank you, Joe. I will focus my remarks this morning on CPI's profitability as measured by our net income and adjusted EBITDA results and on CPI's liquidity as measured by our cash, free cash flow and adjusted free cash flow results. As CPI's first fiscal quarter of 2013 was a straightforward quarter financially, my remarks today will be relatively brief. The definitions and reconciliations of the non- GAAP metrics I will discuss are available in the financial tables of the press release we issued yesterday afternoon.

All of our key profitability and liquidity metrics increased in the most recent period, demonstrating the continuing financial health our business.

CPI's net income in the first quarter of fiscal 2013 totaled 1.5 million. In comparison, we recorded net loss of 1.6 million in the same quarter last year. The reason for the improvement in our net income results were a higher sales volume and a more favorable mix of products with higher margins sold in the first quarter of fiscal 2013 than in the year ago quarter. In addition, also contributing positively to our net income results in the most recent quarter, we recorded a 2.1 million decrease in amortization of acquisition-related intangibles in connection with the February 2011 acquisition of CPI in comparison to the same quarter of fiscal 2012.

Our adjusted EBITDA for the first quarter equaled 16.9 million, or 17.3 percent of sales. That is an increase from the 12.7 million, or 13.7 percent of sales, that we generated in adjusted EBITDA in a year ago quarter. As with our net income results, the primary reason for the increase in adjusted EBITDA was the higher sales and the more favorable mix of products with higher margins sold in the first quarter of fiscal 2013 in comparison to the year-ago quarter.

Let's now discuss CPI's liquidity measures. As of the end of the first quarter, our cash and cash equivalent totaled 50.5 million, an increase of 7.5 million from our balance as of the end of fiscal 2012. For the 12-month period that ended December 28th, 2012, our cash flows from operating activities equaled 31.3 million. During that period our adjusted free cash flow totaled 23.1 million, significantly exceeding our standing guidance of annual adjusted free cash flow of more than 17 million.

In conclusion, the first quarter of 2013 was a strong quarter financially for the company. All of CPI's key profitability and liquidity measures were favorable in the most recent quarter and 12-month period. Our net income and adjusted EBITDA results have improved. We have healthy cash balances, we continue to generate positive cash flow and we maintain the financial stability and flexibility necessary to run our business optimally.

With that, I'd like to turn the call back over to Joe to discuss our financial projections for the remainder of fiscal 2013.

Joe Caldarelli: Thanks, Joel. As you have heard in our remarks this morning, fiscal 13 has started off strong for CPI and we have good momentum to carry us through the rest of the year. Conditions in our largest markets are positive and demand for our products remain healthy. Going forward, we will continue to be mindful of the potential impacts of the ongoing budget and sequestration discussions and we remain vigilant and prepared to act accordingly. We do not expect that these discussions would result in any significant near-term impact to CPI's financial results.

At this time we are reconfirming the financial projections for 2013 that we first announced in December. We continue to expect total sales of \$410 million to \$425 million, adjusted EBITDA of 66 to 68 million, and adjusted free cash flow of more than 17 million.

In terms of seasonality, we expect our sales to increase in each quarter in fiscal 13. However, our Q1 profitability exceeded our internal expectations, hence we expect our net income and adjusted EBITDA results to be slightly lower in Q2 than they were in the just-completed quarter. This is due in part to a less favorable mix of products planned for shipment in Q2 than in Q1. Although lower than our Q1 results, our net income and adjusted EBITDA results in Q2 are expected to be an improvement over last year's second quarter.

Following our typical pattern we also expect our net income and adjusted EBITDA results to be stronger in the second half of fiscal 13 than in the first half of the year.

That wraps up our prepared remarks for today. Thank you for your time and attention this morning. Let's begin the question and answer portion of our call.

Operator: Thank you. Ladies and gentlemen, if you have a question at this time please press star followed by the number one key on your touchtone telephone. If your question has been answered or if you would like to remove yourself from the queue you may press the pound key. Our first question comes from the line of Donovan Chaney from Wells Fargo.

Donovan Chaney: Hello good morning. Thank you for taking the question.

Joe Caldarelli: Good morning.

Donovan Chaney: My priority question is on the cash balance sheet. You guys have been able to grow that nicely. Can you just talk about your priorities for cash and, you know, what kinds of M&A opportunities you might be interested in if that's that highest priority for the use of cash? Are they still small bolt-ons or would you think about doing something larger? Maybe something that involved more debt? I know that the loan market's quite cheap right now.

Joe Caldarelli: Yes, we haven't changed our thoughts on that subject. I think we continue to regard debt reduction as the most obvious opportunity when, you know, when we have no better use for the cash. As you know, we did a modest size acquisition last year. We have had the opportunity to look at some other moderately sized acquisitions and we have done that - looked at it that is. So I think we'll continue to keep our eyes open. If things come along that are, you know, either strategically important or accretive to

us, then we'll look at them. Otherwise we'll pay down our debts. So we haven't really fundamentally changed our approach that we've had for many years.

Donovan Chaney: All right, that's helpful. One other question. I know you guys talked a little bit about this earlier but if you could just sort of reiterate it or elaborate. I've read a little bit about the DOD agency flexing down maintenance over the last, kind of, 60 days to sort of prepare for the impact of, the possible impact of sequestration. Have you guys seen any change in order patterns since the beginning of the year? Can you talk about that?

Joe Caldarelli: Yes, I think, certainly, in the last 60 days we have not seen a change in pattern. What we have seen, and we have reported on for some time, is there is certain orders in certain agencies where there is a significant drag out in order placements often driven by the availability of manpower at the agencies - perhaps even more so than the availability of funds. So we certainly are seeing delays in the placement of a number of our orders, really across all the spectrum. On the other hand, since we have seen that now for, you know, several years, frankly, we've also correspondingly, more recently, in the last several months, seen rush orders for things where the agencies have gotten dangerously low in stock.

And as you are getting orders more quickly and of a higher value than we might have otherwise expected, especially given the current climate. So as I mentioned in my remarks, today, if anything, we're slightly positive, but best case, balanced, in terms of positive things that are coming in early and larger offsetting the ones that are delayed and perhaps slowed down. So all in all, so far, you know, keep our fingers crossed. We've done relatively well and unless something dramatic happens like tomorrow, there are a fair number of orders that are in the pipeline that should be bookable in the defense market in the next, you know, couple of months.

Donovan Chaney: Thanks a lot.

Operator: Thank you. And our next question comes from the line of Dan Colonna from UBS.

Dan Colonna: All right, thanks for taking the question. Just, you said a few times on the call today that you shipped a higher mix of products and that should maybe reverse in Q2 - could you describe where the higher mix is being driven from - which divisions, which products and a little color on that would be helpful. Thanks.

Joe Caldarelli: Yes, the first quarter, it was really kind of a decent quarter all around. Most of the divisions did fairly well. The medical business had pretty strong demand. Let me step back a little bit. As you've heard us talk in the past, we have business from Russia that comes in periodically from the medical business, and that tends to come in in lumps. In fact Q1 had significant, Q4 of last year versus Q1 of this year, had a significant amount of Russia business in it. So that certainly was positive. It was medical and it was needed at that time.

Q2 is a little bit softer simply because most of that requirement was satisfied in Q1 to satisfy their need to get shipment before the calendar year end. So we have, to some extent, the absence of that incremental Russia business in Q2 compared to Q1.

We also had, compared to the prior year, we had less customer-funded R&D programs, which quite often have relatively lower margins. And so, you know, Q1 of this year was more related to production-type programs in proportion and, you know, proportionally less. In fact,, if you look at our report, you'll see customer-funded R&D was a bit lower this quarter and that, generally speaking, is good for margins because that's generally lower-margin business.

Q2 is really a pretty decent quarter but it, to some extent, reflects a fact that we overshadowed a bit of Q1 since our customers needed some of the products to shipped by calendar year-end and so we had just a tiny bit of a gap in a couple of areas.

Dan Colonna: That's helpful. And then just to circle back on the guidance, on the EBITDA guidance even, I think your comment was down sequentially in Q2 but up year over year. And if we assume a small improvement year over year and essentially the flat back half of the year, you're still looking at, you know, guidance still is somewhat conservative. You know, are you expecting the second half of the year to be down and then, if not, at what point would you revisit the guidance?

Joe Caldarelli: No, we're not expecting the second half to be down. I haven't done our one to one comparison of each quarter compared to last year but certainly while Q2 EBITDA will be slightly lower than the Q1 EBITDA, but we're expecting Q3 and Q4 EBITDA to be higher than both Q1 and Q2, adding up to the range that we mentioned of 66 to 68

million. So, you know, right now, we would expect Q3 to be fairly strong and Q4, as has often been the case, to be probably our strongest quarter.

Dan Colonna: And if that tends the trend, I would think you might have to revisit. So is that something that you'll look at after Q2 or at what point would you, you know?

Joe Caldarelli: Yes, well, we'll keep our eyes opened. I mean, right now, the forecast right now look reasonable. We haven't done a very detailed forecast for the year, but we took a snapshot just recently, it looks, you know, it looks reasonable and able to reconfirm our guidance. You know, as we talked earlier, there is still a lot of uncertainty in the defense market and, well, I indicated that, so far, so good for us. And we're mindful that that could change fairly quickly, and so we don't want to get ahead of ourselves and assume there would be zero impact on us. You know, just as you know the implementation of the cuts is very much up in the air and it's very unclear how they will be implemented - whether they will, for example, cancel existing backlogs, delay existing backlogs and so on.

Dan Colonna: Very helpful. And then just a couple more, if you don't mind. Can you talk about the new order? We should we assume that that large TCDL antenna program has a similar margin profile of the corporate average margins?

Joe Caldarelli: Yes, that one's a, should be a good solid contributor to us in the mid term. We don't start doing significant shipments on that until late this fiscal year, but, yes, that could be a good solid contributor.

Dan Colonna: Are there any other large programs that you are currently bidding on that could be announced within the next few quarters?

Joe Caldarelli: Not of that magnitude. I think, you know, as you know, our programs tend to be hundreds of thousands to a few million dollars. It's relatively rare to get something more than five, 10 million, with the exception of a couple of recurring medical orders that we book in Q2 and Q4 that I think you know about those from the past. Those tend to be true every year. And those we are expecting, we expect in late Q2 or early Q3 we would book our radiation therapy medical order, which is usually sizeable, and then in Q4, we would book the X-ray generator portion of that same application. Other than that I don't think there is any unusual orders. A lot of the orders we're getting from the government for example are coming in pieces, so they may

aggregate. In the case of Aegis, for example, barring something traumatic happening tomorrow, for example, we're expecting this to be perhaps one of the best years ever in orders, but it comes in little pieces so it's not something that's going to happen as a \$15 million chunk, for example.

Dan Colonna: Great and last one from me. Joel, data from the working capital and cap ex assumptions for fiscal 13?

Joel Littman: Sure, I mean, for cap ex I think we said seven to eight million. Probably closer to seven than the eight, which is consistent with what it has been in the prior years. In terms of working capital, you know, it's all over the board. Inventory is kind of high right now, and receivables are at a very good level for us at 40 days. I would hope that we could lower inventory a little bit for the, you know, the remainder of the fiscal year. And that we could maintain the receivables, you know, in terms of day sales outstanding in the low 40s. But no real unusual items are expected in terms of working capital.

Dan Colonna: Great. Thank you very much.

Joe Caldarelli: You're welcome.

Operator: Thank you and our next question comes from the line of Clark Orsky from Alcentra.

Clark Orsky: Yes hi you talked about the Aegis system, just wondering, you know, you seem quite positive about that program, just wondering how your visibility on that is?

Joe Caldarelli: So, it's confused, we don't have a direct visibility to end use consumption or to which ship, whose ship our products are going on to. But we get, you know, decent correlation. So what I can tell you is that the current consumption, the current stocking levels of our products is such that there is an overall acceleration in requirements. And we provide a whole variety of product ranges and almost every one of them is in an expedited state.

Clark Orsky: Thank you. Is that just because they are low on stocks or is that?

Joe Caldarelli: Accomplishing two things, there are some new shipments built and certain of the products will be destined for these new ships that are currently under construction, already approved and under construction. And yes, the other part is because, as we

reported in the past, there was certainly a draw down, a concerted draw down, in stock in the depots in the prior two three years since we pulled out of Iraq.

Clark Orsky: Thank you.

Operator: Thank you and I show no further questions at this time. I'd like to turn the conference back to Joe Caldarelli for any concluding remarks.

Joe Caldarelli: Well, thank you all very much for your interest this morning. We look forward to talking to you again in May. Thank you, have a good day.

Operator: Ladies and gentlemen thank you for your participation in today's conference. This does conclude the program and you may now disconnect. Everyone have a good day.

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