CPI INTERNATIONAL HOLDING CORP.

FOURTH QUARTER AND FISCAL YEAR 2012 FINANCIAL RESULTS CONFERENCE CALL
December 7, 2012
11:00 a.m. ET

Operator: Good day, everyone, and welcome the CPI International Fiscal 2012 Financial Result Conference Call. My name is Ben and I will be your conference coordinator for today's call. At this time, all participants are in a listen only mode. We will be facilitating a question and answer session at the end of today's call. If you require 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 conference is being recorded for replay purpose.

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, Ben. Good morning and welcome to CPI International's conference call for fiscal 2012. Our discussion this morning will focus primarily on CPI's results for the entire fiscal year, but you can also find our fourth quarter results in the table of the press release we issued yesterday afternoon.

Our speakers and topics for today's call will be as follows – first, Joe Caldarelli, CPI's Chief Executive Officer, will discuss several operational metrics, our performance in our largest end markets and our expectations for those markets going forward. Second, Joel Littman, our Chief Financial Officer, will discuss some of our key financial metrics during fiscal 2012. Third, Joe will discuss 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 statement within the meaning of the Securities Exchange Act of 1934. These statements are based on our best view of our markets and our business as we see them today 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 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. A presentation of the most directly comparable GAAP measures and a reconciliation of each of those non-GAAP financial measures and the most directly comparable GAAP measures are available in the 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 Fiscal Year 2012 Financial Results. And now here is, Joe Caldarelli.

Joe Caldarelli: Good morning and welcome to our year end call. For CPI fiscal '12 was a stable and successful year. Our largest markets and principal programs continued to perform well and our results were in line with our guidance. Importantly, we grew our top line and bottom line in fiscal '12 despite little to no contribution from two large programs that together provided more than $30 million in sale during the prior year. A number of key revenue metrics demonstrate that we have maintained the diversity of our revenue streams, our position as an industry leader and our global presence during fiscal '12.

Let start our discussion with metrics illustrating the diversity of our revenue streams during the year. First, our sales were split approximately evenly between sales for government and military end users and sales for commercial end users. This ratio has held steady for the past several years.

Second, slightly less than two-thirds of our total sales were for new sockets, while slightly more than one-third of our products were sold for spare and repair programs. This ratio can shift a bit depending on the particular programs we‘re working on in any given year, but in its held consistently at approximately two-thirds new to one-thirds spares and repairs for the past three years.

And lastly, a growing portion of our business in recent years has come from areas in which we have not traditionally been a significant player. Namely, the military communications, or milcom, applications and the solid state portions of our business. Our recent investments in these areas have paid off and they're playing a greater role in our overall business. Milcom sales made up more than 10 percent of our overall sales in fiscal '12 despite the completion of our involvement in WIN-T Increment One, while solid state sales were in the middle single-digit percentages.

The last sales metric I would like to discuss highlights the continued global reach of CPI's business. Approximately 36 percent of our sales in fiscal '12 were to foreign customers, which represents an increase of a few percentage points from last year but it is in keeping with our typical annual results. In order to better serve our international customers, for quite some time now we have positioned sales professions and service centers around the world.

With our recent acquisition of the Codan Satcom business, we've now added three more service centers and we serve customers on all major continents.

Most of the sales metrics that I just mentioned remained essentially unchanged from the previous year's results. The consistency of these metrics over the years underscores the fundamental stability and soundness of CPI's business model.

The diversity of our revenue streams, our industry position and our global customer base also serve to reduce the fluctuations from exposure to changes in conditions and funding in anyone industry, customer or program.

Let's turn now to our top line performance in fiscal '12. Our overall fiscal '12 sales totaled $391 million, a slight increase from our $389 million in total sales last year.

As you know, we participated in a large one-time counter-Improvised Explosive Device, or counter-IED, program last year that contributed $18 million in both sales and orders in fiscal ’11. That program was not expected to and do not repeat in fiscal ’12.

Excluding the counter-IED program, our total sales increased 5 percent from last year. On the orders front, we booked total orders of $383 million for the just completed fiscal year, representing a decrease from $393 million in total orders a year ago. Again excluding last year’s $18 million counter-IED program, our total orders actually rose 2 percent from last year. Our year-end backlog remained healthy at $242 million.

For our defense markets, fiscal ’12 was a strong year characterized by a great deal of activity for several of our significant long-term traditional defense programs, particularly for radar applications. In fiscal ’12 orders for defense markets decreased 4 percent to $149 million. Once again, the counter-IED program that contributed $18 million in order in fiscal ’11 that did not recur in ’12 was the most important in the factor in the decrease.

If we exclude this program, our defense orders actually increased by 8 percent. This increase was due to higher demand for products to support radar applications, particularly for the Aegis weapons systems and certain another foreign and domestic radar systems.

Sales in the defense market decreased 3 percent to $147 million in fiscal ’12. Again the large counter-IED program in fiscal ’11 was the principal factor behind this decrease. When we exclude last year’s $18 million in sales for this program, our core defense sales actually increased by 10 percent in the most recent year. This increase was due to higher sales for radar applications including radars on certain missile systems, the Aegis weapon system and the Automatic Carrier Landing System.

Our defense market provides with us a large diverse and relatively stable revenue stream. We have no expectations that this situation will change dramatically in the foreseeable future. We have been monitoring and we will continue to monitor, the ongoing discussion of our U.S. defense budget. Whatever the outcome of these discussion however, we believe that there is a only a relatively modest risk of a significant impact on CPI’s near-term business from potential sequestration or other budget cuts.

This belief stems from a number of mitigating factors including: first, the long delivery schedules required for our defense and government customers, which means the near-term programs are funded and most orders to fulfill these customers present requirements are already in our backlog.

Second, the long-term legacy nature of a substantial number of our core defense programs, which makes them less vulnerable to cuts than newer or untried programs.

And third, the significant portion of our business that consists of spare and repairs. In fact, 56 percent of our defense sales in fiscal ’12 were for spares and repairs, which means our product are required to keep already deployed radar and electronic warfare systems running.

As a result, we have not felt and do not expect to feel a significant impact in the near-term from the ongoing discussion concerning the U.S. Defense budget cuts. As always, programs could be delayed or orders could to be pushed out to the right, if funding grows tight, but this is a constant risk in our defense business in one that we believe we can manage.

The second of our major markets that I’d like to discuss today is our medical business. Conditions in this market over the past year have been consistent with our expectations but have not been overly robust. While overall demand within the medical market has improved and is more stable than it was a couple of years ago, the ongoing challenging government funding conditions in the U.S. and Europe, plus the austerity measures in Europe have resulted in somewhat softer demand from medical products from customers in those region. Nevertheless, our x-ray imaging business is up as the result of strong demand in Russia and the Far East, and our radiation therapy business remains steady.

Our MRI business continues to follow the needs of one large customer making it vulnerable to large swings from period-to-period.

In fiscal ‘12, CPI’s medical orders increased by 1 percent to $72.6 million as a result of increased demand for x-ray imaging and radiation therapy products. In particular, we saw higher orders for customers participating in x-ray imaging programs in Russia.

Over the last several years, Russian x-ray imaging programs, although periodic in nature, have become an important part of our medical business. In 2006 and 2007, we saw large centralized annual programs, as the Russian Federal Government made a concerted effort to modernize the country's medical imaging infrastructure using proceeds from its energy exploits.

A number of our European customers participated heavily in the annual government programs resulting in spikes in our medical imaging business when the programs occurred. More recently, the centralized federal programs have been replaced by regional programs in Russia that are less regular and less unified but still significant. Our traditional European customers still participate in these programs and their requirements make substantial contribution to CPI's medical imaging business.

In addition, however, we have now established direct links to several Russian medical imaging OEM's and we supply product directly to them as well.

As before, the timing, the size of these imaging programs can vary from year-to-year. For example, we received orders from Russian x-ray imaging programs towards the end of fiscal '11, which converted to sales in the first part of fiscal '12.

We also received orders for these programs earlier in the year fiscal '12, allowing us to ship some of the products for the latest round of Russian orders during the late part of fiscal '12. As a result of the later timing of the fiscal '11 orders, on top of the later timing of the fiscal '12 orders, we enjoyed fiscal '12 sales for the Russian x-ray imaging business that were significantly stronger than in the prior year.

Overall, our medical sales for fiscal '12 increased 11 percent from the previous year to $75.7 million. As discussed this increase was primarily due to significantly higher fiscal '12 shipments of x-ray imaging products for Russia.

The third and last of our major markets that I'd like to address is CPI's communication's market. We break this business down into two categories, namely commercial communications and military communications. Overall, our communications business was steady in fiscal '12.

Demand for commercial communications applications were strong and reflected the continued excellent commercial market for satellite systems for broadcast, direct to home and internet related communications services around the world.

Demand for military communications applications was also good in fiscal ’12 but the positive trends in this segment of our business were somewhat obscured by an approximately $13 million decrease in sales for the Warfighter Information Network-Tactical, or WIN-T, program in the most recent fiscal year.

We have completed our participation in Increment One of the WIN-T program, which was a multi-year program that netted CPI sales of more than $55 million over the past several years. Due to the decrease in WIN-T sales in fiscal ’12, our milcom sales fell 16 percent from the prior year excluding this program, however our milcom sales actually grew 13 percent in fiscal ’12.

Despite the notable decrease in shipments for the WIN-T program, our milcom business nevertheless provided more than 10 percent of our overall sales and more than 30 percent of our communication sales in the most recent fiscal year.

Overall communication orders, increased by 3 percent to $129 million in fiscal ’12. This increase was primarily due to higher demand for milcom applications.

Although no single milcom program in which we are currently participating matches the size of the WIN-T program, we are actively involved in number of smaller but important milcom programs that together provide sizeable business for CPI. These include the Navy Multiband Terminal program, U.S. military satcom on the move programs and the Navy commercial broadband satellite program.

CPI’s total communication sales decreased by 3 percent to $130 million in fiscal ’12. Again this decrease was attributable to expected absence of approximately $13 million sales for the WIN-T milcom program in which we completed our involvement. Offsetting this decrease, sales to support our other milcom applications increased, as I mentioned a moment ago.

Sales to support certain commercial communications applications including direct to home and other satellite broadcast applications also increased during the most recent fiscal year.

This concludes my discussion of CPI’s top line results in fiscal ’12. In summary, although not characterized by large extraordinary new programs, this past year was another solid successful year for the company. Our traditional and long-term programs dominated the year and provided opportunities for growth. Business conditions remained sound. We were able to execute well within our major markets.

Additionally in Q4, we acquired the Codan Satcom business. That acquisition has been well received by our customers and, excluding a one-time cost of relocating certain operations in Australia, we expect the Codan Satcom business to contribute to our fiscal ’13 financial results. And with that, I’d like to turn the call over to Joel, for discussion of CPI’s financial performance in fiscal ‘l2.

Joel Littman: Thank you, Joe. As Amanda mentioned at the start of this call, today’s discussion of CPI’s recent financial performance will focus on our fiscal year 2012 results. Our fourth quarter results were included in the tables of yesterday afternoon’s press release.

Specifically, our remarks, this morning will focus on CPI’s profitability and liquidity performance in fiscal 2012 including net income, adjusted EBITDA, cash, free cash flow and adjusted free cash flow. Some of these are non-GAAP financial metrics. For definitions of these metrics and reconciliations of them to GAAP metrics, please review the financial tables at the back of yesterday’s press release.

Fiscal 2012 was a sound year for CPI financially. We achieved our projections for the year and remained a financially secure company with the continued ability to generate strong free cash flow.

The unusual items that impacted our previous year results, namely expenses related to the February 2011 acquisition of CPI by Veritas Capital and the refinancing of the company, were largely absent from our fiscal 2012 results, allowing for a clearer picture of our financial performance in the most recent fiscal year.

I’m pleased to report that fiscal 2012 was a profitable year for CPI. Our net income for the year totaled $3.7 million, a significant improvement from last year’s $11.2 million net loss. The main reason for this improvement were considerable expenses incurred in fiscal 2011 in conjunction with the Veritas acquisition and refinancing that either did not recur or were significantly lower in fiscal 2012. Specifically these expenses were as follows.

First, in fiscal 2011 we recorded $14.2 million in strategic, alternative transaction expenses. These expenses included non-recurring transaction cost related to the acquisition of CPI by Veritas Capital, including fees for investment bankers, attorneys and other advisors. We did not have any such expenses in fiscal 2012.

Second, in fiscal 2011 we incurred a $7.7 million non-cash charge for the increase in the fair value of our inventory as of the date of the acquisition in connection with the application of purchase accounting.

Finally, in fiscal 2011 we had $4.9 million in stock compensation expenses, the overwhelming majority of which were related to our prior stock compensation plans that were cancelled with the acquisition. In fiscal 2012 in comparison, our stock compensation expenses totaled $1 million. a significant reduction from the previous year.

Partially offsetting the impact of these positive factors on our net income results, our interest expense increased $3.7 million in fiscal 2012 to $27.2 million. This increase was primarily the result of the refinancing of the company in conjunction with the acquisition in February 2011. That refinancing increased our debt obligations by $170 million.

Now that we've addressed CPI's net income results for the year, let's look at our other measure of the company's profitability: our adjusted EBITDA results, which exclude among other items, the non-recurring expenses related to the Veritas acquisition that impacted our GAAP results.

For fiscal 2012, CPI's adjusted EBITDA totaled $64.4 million, or 16.5 percent of sales. This was an improvement from the $62.4 million, or 16 percent of sales, that we recorded in the prior year and met our standing guidance for adjusted EBITDA margins in the mid to high teens. The year-over-year increase in adjusted EBITDA was due to a number of factors, including our higher total sales results in the most recent fiscal year and the related improvements in operating efficiencies that accompany higher sales volume.

In addition, we achieved higher profit margins on the advanced antenna products designed and manufactured by our Malibu division as more of its products move from development into production during the year. You may recall that, when we acquired the Malibu business in 2007, one of our stated goals was to help it evolve from a specialty research and development house into more of a production shop. We have made great strides toward this goal – which contributed positively to our profitability in fiscal 2012.

Let's turn now from profitability to liquidity. As of the end of fiscal 2012, CPI's cash and cash equivalence totaled $43 million. This represents an increase from our cash balances at the end of the previous fiscal year despite spending $7.5 million in cash to purchase the Codan Satcom business this summer.

For the year, we generated $25.1 million in cash flow from operating activities and $17.5 million in free cash flow. Our adjusted free cash flow for the year totaled $17.3 million, which was in line with our ongoing guidance of more than $17 million in annual adjusted free cash flow. In fiscal 2012, we acquired the Codan Satcom business and Freeland Products using our available cash balances while simultaneously paying $25.4 million in cash interest on an outstanding debt.

As we enter fiscal 2013, CPI remains financially strong and secure. In the just completed fiscal year, our profitability increased, our margins were in line with our expectations, we generated positive cash flow, we paid down our outstanding debt and we used our cash to fund two small acquisitions that we believe will contribute effectively to our business.

At this time, I would like to turn the call back over to Joe for discussion of our fiscal 2013 financial guidance.

Joe Caldarelli: Thanks, Joel. As Joel and I have indicated throughout our remarks this morning, we feel good about CPI's market and financial positions. After the excitement of fiscal '11, which saw the acquisition CPI by Veritas, the associated refinancing and the large one-time counter-IED program, fiscal '12 was a much less eventful year during which we successfully focused on our traditional programs and our operations.

Fiscal '13 is shaping up to be a similar year. Conditions in our major markets are largely stable and our operations continue to run smoothly. In our defense market, there are still federal budget and sequestration decisions to be made that may destabilize the defense market to some degree. We do not believe that potential cuts to the U.S. defense budget will have a significant near-term impact on our financial results, but it is a situation that we will continue to watch carefully. We will remain vigilant and flexible in order to react quickly and appropriately.

In our commercial markets, our medical market business is stable with continued solid demand for radiation therapy products and improving market conditions for our imaging products. In addition, demand remains strong for communication products and services.

In fiscal ’13, we expect the Codan Satcom business to broaden our product portfolio and hence drive higher sales.

Our financial projections for fiscal ’13 are as follows. We expect total sales of $410 million to $425 million, adjusted EBITDA of $66 million to $68 million resulting in margins in mid to high teens, and adjusted free cash flow of more than $17 million. Please keep in mind, that our projections now include the Codan Satcom business for the full year, since we completed the acquisition of this business in Q4 of fiscal ’12.

In terms of seasonality, we anticipate that, as usual, Q1 will be the softest quarter of the year, due to the typical slow ramp up of government funding at the beginning of the year and the impact of the Christmas holidays. Our quarterly financial results are expected to improve as the year continues.

That wraps up for prepared remarks for today. Thank you for your time this morning.

Operator, let’s begin the question and answer portion of the call, please.

Operator: Ladies and gentlemen, if you would like to ask a question at this time, please press star and then one on your touch-tone telephone. If your question has been answered or you would like to remove yourself from the queue for any reasons, you may press the pound key. Again to ask a question, please press star and then one now.

Our first question today comes from the line of Donovan Chaney from Wells Fargo. Your line is open, please go ahead.

Donovan Chaney: Good morning, thanks for taking the question.

Joe Caldarelli: Good morning.

Donovan Chaney: First I was hoping maybe you could just remind me again, where if at all you have any significant program concentration on the military side. Is anything, is any one program any larger than 2 or 3 percent of your overall revenue? I think it's not, but I just hope maybe you could refresh that.

Joe Caldarelli: The Aegis system, and I used the word system because we have a multitude of products on a variety of sub-systems on a ship. So if you think a ship as a whole, then on the Aegis ships, we do operate to $15 to $20 million a year worth of the business on the aggregate of several systems on one of those ships so that would be the only one that's of significance. The other ones would all be in the 1, 2 percent range.

Donovan Chaney: OK, that's and that's of total revenue not when you say 1, 2 percent, not of military revenue?

Joe Caldarelli: That's correct, that will be a total revenue.

Donovan Chaney: OK, great. And I just have one follow-up question. You've given some helpful guidance on free cash flow but I was wondering if you could give us your expectations for CapEx and cash taxes for next year, do you think CapEx will be materially different than it was this year and should be expect that you'll pay material amount of cash taxes next year? I think this year, it was essentially immaterial.

Joe Caldarelli: Joel?

Joel Littman: Sure, I mean in terms of CapEx, yes, the expectation going forward would be very similar to the prior year, $7 to $8 million of CapEx spending.

In terms of cash taxes, if you take the 42 percent we have provided as our guidance for our tax rate on our pre-tax earnings and assume that, the cash taxes are very similar to that.

Donovan Chaney: OK, that's great. I will get back in the queue. Thank you.

Operator: Thank you. And once again, ladies and gentlemen, if you would like to ask a question, please press star and then one now.

Our next question comes from the line of Dan Colonna from UBS. Your line is open, please go ahead.

Dan Colonna: Hi, thanks for taking my questions. Just a little bit on the guidance. I was hoping, maybe you could break it out, the drivers for fiscal 2013 revenue increase? Maybe some commentary on volume and pricing as well as what you're assuming for the Codan business?

Joe Caldarelli: Well, the Codan business once it's fully transferred and settled, we expect that could run in the neighborhood of $20 million a year. We don't expect quite that contribution in fiscal '13 because we are still in the transition period. But it will be approaching that certain level. So that's clearly a primary driver to the change in '12 to '13.

But in addition to that, if we exclude the one-time programs that we talked about before, some of the key things, I talked about I think will be good drivers in '13. We continue to see surprisingly strong demand for some of the military programs that we are on and in fact, we note that you've heard us talking prior year, about the fact that they've have been pushed out to the right. We did notice, but in '12 in other locations, we had the equivalent of emergency buys on certain spares because, in fact, certain things got drained excessively and pushed out to the right and they had to make emergency buys.

We have backlog for some of those now that will continue to drive in '13. So we are currently going into '13 with really pretty robust backlog on our traditional support, of our traditional military programs, and I think that's a major driver. The communications front is sort of business is usual, we don't see any significant ups or down in '13. It will be another good solid year.

And on the medical side, we continue the momentum from '12. We are still shipping against the orders we booked in '12. We are shipping some of the medical business to Russia in the first quarter of '13. So that's certainly a contributor. So it's really pretty strong all around. There isn't any one single area, but Codan obviously is a meaningful contributor.

Dan Colonna: That's helpful. And any commentary on pricing? Is it steady as it goes?

Joe Caldarelli: No dramatic change in pricing. I think we have seen certainly as economic conditions get tougher, pricing invariably gets a little bit more challenging, and that has continued. But I wouldn't say there has been any extraordinary change in the last year nor that we project any extraordinary change in the coming year. I think we will continue with all the competitors working pretty hard to win the business, and so that tends to result in somewhat more aggressive pricing.

Dan Colonna: OK and that is kind of follows up to my next questions. I guess, if we take the mid-point the guidance, it does imply very slight margin compression, not sure if it's rounding but is there anything that's driving that margin compression? I think it was about 40 or 50 basis points.

Joe Caldarelli: Yes, it's rounding. I think, we are not envisioning a discrete compression from this year.

Dan Colonna: OK and then you mentioned that there will be a one-time cost for moving some of the Codan business, have you quantified that cost?

Joe Caldarelli: Yes, we expect it will be about $3 million to take care of the whole transition – consisting of a modest amount of capital expenditure and a meaningful amount of just training and travel and relocations and so on.

Dan Colonna: And is that excluded from the free cash flow guidance of more than $17 million?

Joel Littman: Yes, it is.

Dan Colonna: OK and then just lastly for me. If you can just discuss your cash priority for 2013, it will be helpful. Thank you very much.

Joe Caldarelli: No change to the cash priorities. I think as we have said before, we will continue to monitor things that are available to us from an accretion perspective and, as we did in '12, if we see something a digestible size that we can get our, we can put volume on that, then we can even look at it, failing that, then we will figure out, I guess, so you know really no change. We've had this posture for a number of years and we will continue going forward the same way.

Dan Colonna: Thank you very much.

Joe Caldarelli: Thank you.

Operator: Thank you. And once again, ladies and gentlemen, to ask a question, please press star then one.

And I'm showing no additional questions in queue. I would like to turn the conference back over to Mr. Joe Caldarelli for any closing remarks.

Joe Caldarelli: Well, thank you all very much for joining us this morning and listening to our fiscal year end results. We look forward to talking to all of you again in February. Thanks very much.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program and you may all disconnect. Have a great rest of the day.

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