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ESIO - Q2 2015 Electro Scientific Industries Inc Earnings Call

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CORPORATE PARTICIPANTS

Brian Smith *Electro Scientific Industries, Inc. - IR Director*

Ed Grady *Electro Scientific Industries, Inc. - President, CEO*

Paul Oldham *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

CONFERENCE CALL PARTICIPANTS

David Duley *Steelhead Partners - Analyst*

Tom Diffely *D.A. Davidson & Co. - Analyst*

Jim Ricchiuti *Needham & Co. - Analyst*

Mark Miller *Noble Financial Group - Analyst*

PRESENTATION

Operator

Good day ladies and gentlemen, and welcome to the ESI fiscal 2015 Q2 earnings call earnings call conference call. My name is Andrea and I will be your operator for today. (Operator Instructions). As a reminder, this call is being recorded for replay purposes. I would now like to turn the call over to Mr. Brian Smith. Please proceed, sir.

Brian Smith *- Electro Scientific Industries, Inc. - IR Director*

Thank you, Andrea, and good afternoon everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Ed Grady, our CEO; and Paul Oldham, the Chief Financial Officer. This call will cover our fiscal second-quarter 2015 results.

Before we go into the details of the call, I would like to remind you that some of what we say on this call will include forward-looking statements concerning customer orders, shipments, revenue, gross margin, expenses, and earnings. These statements are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements include a number of risks and uncertainties that are discussed in more detail in today's press release and our filings with the SEC. Actual results may differ materially from the forward-looking statements. This call also contains time sensitive information that we believe to be accurate as of today, October 30, 2014, and which could change in the future. This call is the property of ESI.

Now I will turn the call over to Ed.

Ed Grady *- Electro Scientific Industries, Inc. - President, CEO*

Thanks Brian. Good afternoon and welcome to our second quarter conference call.

Overall, this was a solid quarter for ESI as we executed on our milestones to revitalize the Company and delivered financial results at the high end of our expectations. In addition, we continued to further refine and communicate our strategy and really appreciate the attendance at our analyst day in New York earlier this month. Although we still have work to do over the next several quarters, we believe we are on the way to putting in place the building blocks to return to profitable growth.

Although orders were seasonally lower, revenue improved to $43 million this quarter. The entire organization worked hard to keep costs under control as adjusted expenses came in below last quarter and last year. The result was an adjusted net loss per share of $0.16, which is favorable to our guided range.

Our gross margin was lower than our expectation. Although we are focused on operating margins as a company, gross margin is an important and financial metric for ESI and we are working on ways to get back on track and improve it going forward. Paul will cover the rest of the financial results later in the call.

Looking at some of our key markets, flex via drilling was a solid. Bookings were down seasonally from last quarter as expected. Our flex portfolio, with the new model 5335, continues to prove its value in the market. We penetrated two new customers in the PCB space and recently began shipping products to the largest flex circuit manufacturer in the world.

As our customer successes grow, we see good growth opportunities in the flex circuit market. We also see compelling opportunities to leverage our capabilities into attractive adjacent PCB markets outside of flex circuits. The entire PCB market for laser applications is many times larger than the segment we address today, and we are pursuing growth in these adjacent segments.

Our bookings in semiconductor business declined following a strong quarter for wafer and circuit trim products last quarter. However, we've seen ongoing interest in our next generation scribing technology and recently received a qualification order from a major semiconductor manufacturer.

Component test and test bookings improved modestly as we are seeing early indications of increased demand in this market. Our bookings in consumer product micro-machining business were down from last quarter when we won a new application. Looking forward, we are pursuing this market aggressively and have changed our approach in several ways in order to capture the many opportunities at both OEMs and contracting manufacturers in Asia.

On the product side, we launched our new midrange platform, the first in our series of micro-flex tools under the new trade name Lumen ESI that will expand our addressable market. It is a highly flexible and configurable tool and it accommodates a wide variety of laser characteristics to optimize the processing of a broad spectrum of devices and materials. This platform epitomizes our new emphasis on cutting-edge design that delivers high-end performance at midrange price. The initial customer response has been positive as we shipped our first multi-unit order in the quarter. In addition, this application features the first use of an internally developed laser based on our ELI technology. We believe this technology will provide us a platform for differentiation and lower costs across many of our systems in the future.

One of the keys to maximizing market potential is extending our reach through an indirect sales channel that will take our existing and new products into new customers. During our second quarter, we signed definitive rep agreements with three industry-leading firms who have customer relationships within the PCB and Chinese consumer electronics and contract manufacturing markets that we are targeting. These firms are excited to sell ESI products within their customer network.

Turning to our outlook for the future, our management team has been working for over six months now to revitalize ESI and put it on a solid path to growth. I'm exceptionally pleased with the reaction across the Company and from the broader customer base to these changes and initiatives. Our market focused drive into new adjacent market segments combined with our technology leveraged cost-focused product design and expanded channel for broader customer reach should allow us to commercialize our technologies into more market segments and grow our revenues. Topline growth combined with disciplined expense management is the key to sustained earnings growth.

With that, I'll turn the call over to Paul for an overview of our financial results.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Thank you, Ed, and good afternoon everyone. The following information includes results from our second quarter of fiscal 2015 which ended September 27. To improve comparability, we are also providing earnings per share and related income statement results on a non-GAAP or adjusted basis, excluding the impact of purchase accounting, equity compensation, and other items.

Bookings were $43 million compared to $47.3 million last quarter and $46.2 million a year ago. Bookings in our interconnect and microfabrication business were down seasonally following solid orders last quarter. However, follow-through on our flex via drilling business was stronger than we expected, particularly in China and Taiwan, driven by strong smartphone demand and good acceptance of our 5335 platform. In addition, we saw growth in demand for service and support of our installed base for both multiyear contracts and on-demand service as manufacturers began bringing idle capacity online.

Orders in our semiconductor business were down slightly from Q1 as demand for circuit trim products fell from record levels last quarter. Orders for component test increased modestly with strong demand for tooling and a few new capacity orders. We continue to expect small capacity orders in this area as tool utilization improves. Over the next several quarters, meaningful improvement in demand could be driven by new technology as we expand into additional chip types and the potential for broader capacity expansion.

Our book-to-bill ratio was 0.92. Shipments were $47 million. Backlog decreased by $4 million to $33 but deferred revenue was up $4 million on shipments of new products.

Revenue for the quarter was $42.9 million, up 22% from last quarter. Revenues came in slightly higher than our guidance due to solid flex bookings and higher on-demand service and support revenues.

GAAP gross margin was 37% and included about $380,000 of purchase accounting and equity compensation in cost of sales. On an adjusted basis, gross margin was 38% compared to 39.5% last quarter. The lower gross margin was primarily due to timing of laser repair activity and higher other cost of sales partially offset by increased production volume.

Looking forward to next quarter, we expect adjusted gross margin to improve modestly. Over time, we continue to expect margins above our breakeven point to be in the low to mid 40% range. As volumes increase, we introduce new lower-cost platforms and we focus on lean processes and productivity in manufacturing.

GAAP operating expenses were $21.3 million, including $971,000 of equity compensation and purchase accounting. On an adjusted basis, operating expenses in Q2 were $20.4 million, down from $21 million last quarter. The lower expenses were a result of good expense management, lower discretionary spending, and timing of project spending. We expect adjusted expenses next quarter to bounce back to roughly the level of Q1, primarily on higher project spending as new products approach introduction.

On a GAAP basis, operating loss was $5.6 million. Adjusted operating loss was $4.2 million compared to a loss of $7.1 million in the prior quarter, reflecting the higher sales and gross profit combined with lower expenses.

On an adjusted basis, income tax expense was $400,000, reflecting foreign taxes. For fiscal 2015, we continue to expect to pay roughly $1 million to $1.5 million.

GAAP net loss was $6.2 million, or $0.20 per share, compared to a loss of $0.27 per share last quarter. Adjusted net loss was $4.9 million, or $0.16 per share, compared to a loss of $7.4 million, or $0.24 per share, last quarter.

Turning now to our balance sheet, cash and investments were $98 million at quarter end. We used $3.8 million of operating cash during the quarter largely due to increased receivables on the higher shipments. Also, we paid $2.4 million as a quarterly dividend. Although cash was down this quarter, it was consistent with our expectations, and we continue to believe that we have sufficient runway to execute our revitalization plan.

For the quarter, inventories decreased by $4.6 million. Inventory turns improved to approximately 1.9 times. Inventory continues to be an area of focus for us.

Accounts Receivable increased by $6.4 million to $39.4 million on higher shipments. DSO improved slightly to 84 days. Capital expenditures were $1.2 million, and depreciation and amortization, excluding purchase accounting, was $2 million.

In summary, this was a solid quarter for our financial execution with results at the high end of our expectation. In addition, our initiatives are on track and laying the foundation in product, marketing, and channel that will enable us to return to profitable growth.

As we look forward to next quarter, we expect to deliver financial and operating results in line with the plans we communicated recently to revitalize the Company and increase shareholder value over time. As a result, we expect Q3 revenues to be in the $40 million range. Adjusted loss per share is expected to be between $0.16 and $0.21.

Now I'll turn the call back to Ed for a brief summary.

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

Thanks Paul. Our plan for revitalizing ESI is in place. We are focused on execution, and we are meeting the milestones we set for it. By the end of the fiscal year, we expect to begin seeing results from this plan and as Paul said, next year, we expect revenues to grow and to be EBITDA positive. We are confident that our strategy will drive topline growth and bottom-line profitability.

This concludes our prepared remarks. At this time, we would be pleased to take your questions. So, Andrea, could you open the line?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). David Duley, Steelhead.

David Duley - *Steelhead Partners - Analyst*

Thanks for taking my questions. The first question is you talked about I think a repeat order for the new midrange laser. What was the -- have you talked about what the application is around that order, or maybe you could give us a little bit more color there.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Yes, we didn't talk about a repeat order. I think we were referencing the same order we discussed at our analyst day a couple of weeks ago. Certainly, that platform will lend itself to potentially repeat overtimes as well as to other applications and we haven't discussed what that application is as it's confidential under an NDA.

David Duley - *Steelhead Partners - Analyst*

Okay. And then along the same lines, does the midrange platform that you've introduced -- I'm sorry if you've already covered this. I missed the first part of the call. Does that platform cover the expanded opportunities in the printed circuit board and chip packaging markets, or do we have to wait for the lower-cost platform to get into that marketplace?

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

David, it covers some of the opportunities in the printed circuit board. There are multiple needs in the printed circuit board HDI/ICP space and this platform will address some of those but not all. As we said in the objectives we set out for the second half of this year, there is an additional platform that we have in the queue and that's one of the reasons the project expenses have a slight increase next quarter supporting getting that ready to get to market.

David Duley - *Steelhead Partners - Analyst*

And that new platform comes out did you say by the end of the fiscal year? So the end of the March quarter?

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

Yes.

David Duley - *Steelhead Partners - Analyst*

Okay. And then the -- what is exactly -- I think I understand from the cost perspective. It seems like you have pretty good cost controls and everything like that. What do you see that's necessary to get to EBITDA positive for next fiscal year? Is it simply a matter of growing the revenue and how much revenue growth do you think you need?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Yes. We think it's largely a matter of growing the top line. And we think our gross margin, as we discussed a couple of weeks ago -- I'm sorry, our revenues to get to that is in the roughly $50 million range. That would get us gross margins in the low 40s% and operating expenses roughly consistent with the levels that we have today. That's on a quarterly basis, David.

David Duley - *Steelhead Partners - Analyst*

Right, got you. Thank you.

Operator

Tom Diffely, D.A. Davidson.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

So, I guess looking at the mall right now, you talked about some margin weakness in the quarter. I'm hoping you can explain a little bit more about was that just mix related or customer specific or volume orders? What drove the softness?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Yes, it was really more timing of some of our laser repair activity where the mix of that can shift quarter to quarter depending on the type of lasers and whether they are under warranty or not, and so we saw a little higher expenses this quarter. We also saw a little bit higher in other cost of sales for a couple of discrete items. Largely, we think those will improve. They are more timing-related as we look forward. Therefore, we'd expect to see slightly better margins next quarter of course on slightly lower volumes.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. So, in a sense, you were ramping up the service costs before getting the service revenue.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

It's a little more like the cost from our laser vendors on lasers that need to be repaired and the mix of those lasers.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay, okay. That makes sense. All right. And then when you look at your plan or your continuing plans to develop more internally developed lasers, is cost the main driver? Are there capabilities or applications that you can do that you can't currently get from the outside vendors?

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

This is Ed Grady. The answer is it's both because, in some cases, the technology that's in the lasers allows us to do more advanced things with the laser capability, whether it's beam shaping or power at the work surface, at a lower cost than we can get from the commercial market. So, let me make it very clear. Our objective is to have product differentiation where the commercial market cannot meet our cost or technology requirements. If the commercial market can meet our cost and technology requirements, we are happy to do business with third-party laser suppliers. It's in those cases where we can create differentiation, either technologically or on a cost basis, that we'll deploy our lasers. And as we segmented the markets, we think that's somewhere around 50% of our total product mix over the next three years.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay, all right. And then I guess obviously you are now focused on kind of expanding the micro-machining market, especially in the midrange. Is there any activity at all in some of those other adjacent markets that you once served and have tools for that I guess were a bit dormant lately?

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

Yes, I'd say there's two markets. One is we talked in the remarks about the semiconductor market. We've had some investments there and we think -- not we think -- we've got an order for the first tool from a large semiconductor manufacturer as a qualification order, so that should work to our advantage.

I think the other space in terms of adjacent markets, we've talked consistently in New York and hear about the adjacencies from the flex printed circuit market into more of the rigid ICP/HDI markets. And in that case, we have some new and unique technology that we are deploying that will drive cost of ownership on a per-hole drilled or on a per-cut made that we think will give us a great position in those new markets. So, I consider that an adjacent market in both cases.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. And then I guess finally, Paul, when you look at the operating expense structure right now, if you were to ramp from here, say, over the next year or so, how much variable addition do you need to make to your operating expenses as revenue grows, or can you keep it relatively flat?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Well, on the fixed side, we're going to keep it flat. Really, if there is any growth, it's going to be in support of variable activity. Primarily, I would say, on the sales side as well as other variable costs, that would be natural with revenues. So, the variable increases ought to be quite small. You know, as a percentage of sales growth, I would say they would be quite, quite low, maybe less than 30% of sales growth -- sales growth rate.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. And is that impacted by moving to more of a distributor model for some of the Asian markets?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

That would be one of the primary drivers. As we expand our channel, we'll be getting business that we are not otherwise getting today. And there will be some cost to that. We think that's the right approach for a couple of reasons. One is it gives us sort of instant access to those markets where we get a fairly large salesforce that we pay for on a variable basis and there is established relationships already there. So, as we grow in those areas, we can certainly assess how much of that we want to bring in-house over time, but we think, as we enter the market, we will get a lot more leverage off of using a variable model either through a manufacturer's rep type model or a distributor model.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. And it sounded like from your comments that that distributor is now in place, and so you could potentially get revenue in the next couple of quarters.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Yes. We are fortunate. We actually have multiple distributors in place across a couple -- really three different markets, as Ed mentioned, in the PCB market as well as in the ODM market and the contract manufacturer market. These are all industry-leading firms. We've already assigned the contracts. We recently conducted the initial training of those distributors. So, clearly there's some lead time as people become familiar with the products and get out and sell them, but we would expect certainly over the next quarter or two to begin to see some benefit from those relationships.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Right. Okay, thank you.

Operator

Jim Ricchiuti, Needham and Company.

Jim Ricchiuti - *Needham & Co. - Analyst*

Ed, I wonder if you would comment, or Paul, on how we might think about the seasonality of bookings in the current quarter? Don't know if you would expect -- it looked like you had a nice pickup in the flex via drilling area. Would you expect some seasonality to enter into that area of the business?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Typically, in the flex business, our strongest quarters are the March quarter and the June quarter, March really driven by Korea and June driven by the rest of the world, effectively Taiwan and China. Korea this year, as you recall, we saw really nothing because the whole Korean supply chain has been and I'd say continues to be in overcapacity and quite weak. And you can read externally for reasons around that.

I'd say that the China and Taiwan channels have been quite good and even a little better than we expected, and so we saw strong June orders and the follow-through was stronger in this current quarter, the September quarter, than we expected. So that market seems to be fairly robust and we would expect to continue to see some pretty good activity there. But, seasonally, certainly on the orders perspective, our December quarter and March quarter tend to be a little lighter.

Jim Ricchiuti - *Needham & Co. - Analyst*

Okay. And a little bit of a step-down in R&D and you are expecting that I think to pick up a bit in the current quarter. How should we think about R&D? Is this a function of something more immediate in terms of product launching, or should we just think of R&D kind of moving up in Q4 and then potentially the quarter after that? I'm just wondering. It's been bumping around a bit.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

You know, as we've tried to make R&D a little bit more variable, we will see that the R&D amount bounce around a little bit quarter to quarter and particularly based on timing of product launches and what I'll call project materials, and so this quarter we saw that a little bit lower. We'd expect that to bounce up closer to where it was in Q1. And the primary driver is, again, timing of how these kind of products are coming out. And as Ed mentioned in his comments, we see that picking up a little bit in the next couple of quarters as we are getting a couple of these products we discussed earlier out to market.

But overall, we would expect to see expenses in this range for the next several quarters, plus or minus, you know, $0.5 million. We are down about that much this quarter. We expect the quarter to maybe back up to the same level we were in Q1. But in this range is where we expect to be with some increases, as Tom was referencing, as we see revenues grow just from the variable costs related to those.

Jim Ricchiuti - *Needham & Co. - Analyst*

Got it. And then, Ed, I think you called out -- referenced a win for the 5335 with one of the larger flex circuit manufacturers in the world. Can you talk a little bit more about that? Is this more for a unit that's under evaluation? Is it their potential follow-on business in the near-term associated with that? How much of -- how significant is it?

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

Well, to us, it's very significant in that this customer has historically been more of a mechanical-based drilling company. And as they are moving forward, they are moving -- obviously via size are getting smaller, so the move to laser-based is a big deal. And we are very, very pleased to have orders and significant orders with this customer as they are moving and changing their product mix to these smaller features. So, it's a real big win for us.

Jim Ricchiuti - *Needham & Co. - Analyst*

Okay. So this was, from a dollar standpoint, this was not insignificant?

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

Well, it's probably insignificant from this quarter that we just reported, but going forward, this is -- it's a booking. It's not a shipment yet.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

I'd say it's a meaningful opportunity for market expansion in the laser portion of this market as this is a significant player in the flex industry but largely using mechanical tools today but will shift over time, and so it's a very significant strategic win. Small dollars but we clearly have been qualified in their process.

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

It's nice to be the incumbent in the plan of record.

Jim Ricchiuti - *Needham & Co. - Analyst*

Okay, that's helpful. One final question, if I may. You know, the investor day that you held recently, I think you gave some good color on the initiatives in China. Is there anything to report since then that just you might be able to talk a little bit about where you are in the last couple of months in terms of what additional progress you might have made?

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

I think we talked about the reps that we brought on. All three of those reps are highly focused in China. I think, at the time of the New York, we had just finalize kind of the last set of terms on the third one but they are all signed up now. They are in training. I believe we had somewhere between 35 and 50 sales feet on the ground, people in training this past two weeks. So, that part is moving forward.

The interaction with low-cost manufacturing has continued to move forward. It's in a prototyping phase so it's not ready for prime time, but we are beginning to see some opportunities there. And, you know, the biggest issue for us in China has been the right sized platform from a cost perspective and the relationships that you have to have to get into the contract manufacturers and the ODMs. And in both cases those are moving forward.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

Yes, I would just add to that, Jim, we also talked about increasing our application and engineering investment locally. And if you look at our results, you'll see that we added a little bit of headcount this quarter. The vast majority of that was putting in place the initial applications engineering and additional sales people in China. So, where we are putting investment in headcount, that's where we are putting it consistent with those initiatives.

Jim Ricchiuti - *Needham & Co. - Analyst*

Okay, great. Thanks very much.

Operator

Mark Miller, Noble Financial Capital Markets.

Mark Miller - *Noble Financial Group - Analyst*

Good afternoon. I'm just wondering if your competitors, if you've seen any response yet to your competitors in some of your new initiatives?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP Administration, Corporate Secretary*

I think it's probably a little too early to tell, Mark. You know, we've been out talking to customers. I think we are seeing good reception for the direction we're going. Obviously, as you know, penetrating these markets is a -- it's a process, not an event. And we feel like we are on that track and have a compelling -- will have a compelling value proposition. It's probably a little too early to tell on the competitive response.

Mark Miller - *Noble Financial Group - Analyst*

Okay, thank you.

Operator

Due to no further questions, I will now turn the call back over to Mr. Ed Grady. Please proceed, sir.

Ed Grady - *Electro Scientific Industries, Inc. - President, CEO*

Thank you, everyone, for joining us on the call. You are welcome to call Paul, Brian, or me if you have any further questions, and thank you for attending our call today.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect and have a great day.
