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ESIO - Q3 2016 Electro Scientific Industries Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the ESI fiscal 2016 third quarter earnings call. My name is Stephanie, and I will be your operator for today. At this time all participants are in listen-only mode. We will conduct a question and answer session towards the end of this conference. (Operator Instructions). As a reminder, this call is being recorded for replay purposes. I would now like to turn the conference over to your host for today, Mr. Brian Smith. You may proceed.

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

Thank you Stephanie, 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, our Chief Financial Officer. This call will cover our third quarter 2016 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 margins, 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 those forward-looking statements.

This call also contains time-sensitive information that we believe to be accurate as of today, February 2nd, 2016. And which could change in the future. This call is the property of ESI. Now I would like to turn the call over to Ed.

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

Thank you Brian. Good afternoon, and welcome to our third quarter conference call. This was a good quarter for ESI, as we took more steps advancing our corporate turnaround. We grew our orders, increased gross margins, lowered our expense base, generated cash from operations, and delivered positive earnings on an adjusted basis. We also introduced new products and earned key customer wins that will drive growth as we move forward. Paul will go into the financial details in a few minutes. Looking at Q3 and our near term outlook, in the component processing space, GemStone continues to win in the flex via drilling market, and its momentum is building. It is winning on both industry-leading performance and cost of ownership, driven by our internally developed laser. Looking forward, smaller vias, higher via densities, and more complex flexible circuit designs should continue to grow demand for GemStone.

While the overall growth in smartphones may be slowing, the use of flexible circuits is expanding to broader applications and becoming more complex, so we believe we are well-positioned in this market to capitalize on this growth. We're leveraging our capability in flex circuits to expand into adjacent markets. We achieved a key milestone in our strategy this quarter, with the order received for our CornerStone IC Series 2 via drilling system. The selection of this tool by a large semiconductor manufacturer following an extensive evaluation period, demonstrates this system's industry-leading capability in speed and accuracy for current and next generation packaging application. It's a tribute to the ESI team that we won this business with our first offering in the IC package market, and I believe it positions us well to win additional business in this customer supply chain, and alternative substrate packaging designs.

Another exciting event in the third quarter was our entry into the HDI or high density interconnect market, with the introduction of our nViant CO2-based via drilling platform. HDI printed circuit boards are becoming more prevalent, and represent the largest segment in the printed circuit board laser drilling market. We believe we can leverage our capability, industry knowledge, and service footprint to grow our share in this large mainstream via drilling segment, and expect multiple nViant product placements over the next few months. With our broader footprint in GemStone and introduction of CornerStone and nViant, we have in the past year more than tripled our addressable market in the PCB space.

Moving into our Micromachining group, we continue to see good activity on our Lumen platform, and received a nice follow-on order from a previous design win. In addition we're building out our application set for our Jade platform, and are working hard to be positioned to win new business in the next year with this product. In addition to Jade, we expect to announce another platform this quarter to address larger format applications in this mid-range value segment. As we build out these lower cost platforms and continue to invest in our local channel and applications capability, we see significant opportunity to grow our business in the large China market for Micromachining tools.

Finally in the quarter we completed the consolidation of our Chelmsford facility, and continued to see benefits of our ongoing Lean programs to reduce waste, improve efficiency, and lower cost. In summary, our market expansion strategy is working. The market segments we've entered with our new products over the past 18 months, represent a significant market opportunity for share and revenue growth. The initial products we introduced, Lumen and GemStone, are driving solid revenue growth. As are more recent introductions, CornerStone, Jade, [Altiris], and nViant complete evaluation, and begin to see traction in the market over the next few quarters, we expect to see growth continue to expand. Our efforts to improve our gross margin and cost structure will translate this growth to improve profitability.

While economic uncertainty is slowing growth in consumer electronics, and in China may impact the pace of capacity buys, and the adoption rate of our new products, we believe we are investing in the right markets, and are seeing the benefit in our results. With that, I'll turn the call over to Paul for an overview of our financial results.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Thank you Ed. Good afternoon everyone. The following information includes results from our third quarter of fiscal 2016 which ended January 2nd, and represented a 14-week quarter, as compared to 13 weeks last quarter and last year. 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, inventory write-downs, restructuring and other items. For the quarter, bookings were $52.6 million, up 2% from last quarter, and 30% from last year. This represented our highest third quarter bookings in five years, in what is normally a seasonally softer quarter. Bookings in our component processing segment grew 6% over the previous quarter.

Within this segment, demand for Interconnect's products grew almost 10% sequentially, with sequential growth in GemStone and strength in service. Bookings for our semiconductor products group were strong again, on higher demand for wafer trim, plus the receipt of a follow-on order for our legacy memory repair products. Orders for component test products increased from last quarter on higher system demand. Based on recent customer activity, we expect to see some improvement in this business over the next several quarters. Orders in our Micromachining segment were solid, but down slightly from last quarter. We received a follow-on order for our Lumen Series but not as large as in Q2.

Adoption of our new Jade platform and the Topwin line of products were both slow. However, we are building out the applications for these platforms, as Ed mentioned, in order to demonstrate to a broader set of Chinese contract manufacturers the advantage of the ESI solution. Shipments were $38.8 million. Backlog increased to $12.9 million to $52.3 million, and our book-to-bill ratio was 1.4. Deferred revenue decreased by nearly $5 million, as we received acceptance on several new products. Revenue for the quarter was $43.3 million, and was impacted by the timing of customer site readiness, resulting in delayed shipments of several tools. We expect these to largely ship in the next two quarters.

Even with this delay, we saw sequential growth in the component processing segment more than offset by a decline in Micromachining. Micromachining was down due to the timing of shipments. The Lumen Series order received in Q2 shipped in the same quarter, while the order in Q3 will not ship until Q4. Systems revenue was $31.3 million, down 12% from last quarter. Service revenue increased sequentially to $12.1 million. GAAP gross margin was 40.9%, and included about $370,000 of purchase accounting and equity compensation and cost of sales. Also in cost of sales was a $1.4 million charge to reserve inventory associated with the discontinuation of our large format glass-cutting products.

On a non-GAAP basis gross margin was 44.9% compared to 40.6% last quarter. The higher gross margin was due to very favorable product mix, including legacy memory repair tools, new products, and service contract timing. In addition we are seeing benefit from lower material costs and more efficient manufacturing operations, following closure of our Chelmsford facility. Looking forward we expect continued favorable product mix for the next couple of quarters, with margins down slightly from current levels. Over time, however, we would expect a more normalized mix with margins in the low 40% range, but on higher volumes.

GAAP operating expenses were $22.2 million, about $750,000 higher than last quarter, and included $1.3 million of purchase accounting and stock compensation. In addition, we recognized $1.9 million of costs associated with previously announced restructuring activities. Most of these were related to the closure of our Chelmsford facility. On a non-GAAP basis operating expenses in Q3 were just under $19 million, down more than $600,000 from last quarter. These lower expenses reflect our ongoing efforts to optimize our cost structure including the Chelmsford closure. Expenses came in lower, despite the fact that Q3 contained a 14th week. For Q4 we expect operating expenses to increase slightly, but remain in the low $19 million range, driven by significant new product launch and placement activities.

On a GAAP basis, operating loss was $4.5 million. Non-GAAP operating income was approximately $0.5 million, compared to a loss of $0.8 million in the prior quarter. On a non-GAAP basis, income tax expense was $160,000, reflecting foreign taxes. We expect Q4 tax expense to remain in this range. Our GAAP net loss was $4.6 million, or $0.15 per share. That included approximately $3.3 million of one-time charges associated with inventory and the site closure I mentioned previously. This compares to a loss of $0.10 per share last quarter. On an adjusted basis, net earnings were $0.4 million, or $0.01 per diluted share, compared to a loss of $1 million, or $0.03 per share last quarter.

Turning now to our balance sheet, cash and investments increased $2.6 million to $62.8 million. We generated $3.5 million of operating cash during the quarter, primarily on positive EBITDA and good cash collection. Total Accounts Receivable decreased by $12.6 million to $37.3 million. DSO improved to 79 days, on timing of shipments in the quarter and improved terms. Inventories increased by about $2.8 million primarily as a result of the delayed shipments I mentioned earlier, and investment to support new product placements and revenue. Inventory turns were approximately 1.7 times. Accounts Payable decreased by $3 million on the timing of inventory receipts and payments.

Capital expenditures were $555,000, down from $840,000 last quarter on reduced purchases of test equipment. Depreciation and amortization excluding purchase accounting was $1.9 million. Looking forward, we expect to see cash down in the fourth quarter, but about flat from the beginning of the year, as improved EBITDA will be offset by investments in working capital for inventory and Accounts Receivable. In summary, while there is more work to do, we believe that we are generally on track with our turnaround plan, and are beginning to see this in our financial results. Year-to-date we have grown orders 12%, increased revenue 9%, achieved positive EBITDA, and generated positive cash flow each quarter. This quarter we were non-GAAP operating income positive for the first time in over two years.

As we look forward, we continue to see some headwinds related to macroeconomic factors, slowing growth in China, and timing in the spending of capital budgets. However, we believe that we are investing in the right markets, and that the technology trends around smaller vias, higher complexity, and increased use of flex material and advanced packaging are moving in our direction. Although we saw some impact from timing of shipments in our third quarter, we believe that on balance our business is strengthening in the near term, and that we are well-positioned as we move into next fiscal year.

As a result we expect fourth quarter revenues to be between $47 million and $53 million, and non-GAAP earnings per share between $0.03 and $0.08. While we are not providing specific guidance for next fiscal year, we are generally comfortable with current Street expectations. Now I will turn the call back to Ed.

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

Thanks Paul. During Q3, we grew our bookings, increased our cash balance, generated positive cash from operations, lowered our expenses and delivered positive adjusted earnings. We are very pleased with these results and the progress we made to our goals of introducing new products, entering new market segments, growing our served addressable market. Our global team is highly motivated, enthusiastic and energized, as we continue the success and drive sustainable long-term revenue and earnings growth. My personal thanks to all of the ESI team for your contribution to our success. This concludes our prepared remarks. At this time we would be pleased to take your questions. Stephanie.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Questions will be taken in the order received. Your first question comes from the line of Jim Ricchiuti. You may proceed.

Jim Ricchiuti - *Needham & Company - Analyst*

Thank you. Good afternoon. I wonder, Ed, if you could talk a little bit about the new products. I know you can't be specific about expectations, but you have had a fairly active roll-out of new products, and how people should think about the acceptance, potentially the contribution of some of these over the next two to three quarters. Clearly you're making some headway in the IC area. But maybe if you could just talk about CornerStone, and maybe expectations for some of the other products?

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

Sure, Jim. I guess what I would say is the first thing is CornerStone being selected as a POR is a big deal, because it's not just a POR for the single customer but it has leverage to a broader supply chain. So that's a big deal in terms of that supply chain and that application. We have multiple applications with multiple people right now in the packaging space. In the flex space, GemStone has continued to perform in Q3, and we see it very strong going forward. I would say the Lumen Series is in place, and we're doing fine with that. It has targeted a specific market segment, and we think that market segment is much more cost sensitive, so the introduction of Jade and our new product that we'll introduce this quarter, will actually broaden the portfolio. nViant that was just introduced in December, the impact of that on revenues is clearly going to be out a couple of quarters, because it will take time to get the qualifications in place. But we do expect nViant and CornerStone to be the drivers of incremental gross throughout FY 2017.

Jim Ricchiuti - *Needham & Company - Analyst*

And with respect to CornerStone, can you say how many qualification orders are out there? I may have missed it in your overview.

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

We have several

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

evaluations in process. One qualification, where we have been selected and received the order.

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

Right.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. And just with respect to the flex via drilling market, it just seems like we're still hearing some mixed reports, but it sounds like your characterization of demand is fairly healthy? In other words, you're not seeing much of an impact from the macro headwinds?

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

No, as a matter of fact it's interesting, the key driver there is as I said, the smaller vias, the higher density, and the more complex boards. More complex stacks within the flex. Actually we have found our product is preferred, because it actually gets better yields and higher throughputs, and has lower costs. So we're extremely well-positioned in that market right now with GemStone, with the 5335, with the 35 XI. And so with the broad product portfolio we have in the space, we can kind of do anything anybody wants at the right cost point. And obviously the benefit at any company is that having the ESI tool set, means that their service costs and support costs are less because we can service their tools onsite across the board at a very low cost.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. Thanks very much. Congratulations on the quarter.

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

Thanks, Jim. Appreciate it very much.

Operator

Your next question comes from the line of Tom Diffely. Please proceed.

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

Good afternoon. Maybe another question, then, on the Lumen. It sounds like you think it might not be the right product for the market right now, and the market is more set up for a Jade-type product?

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

I would say Lumen has its application. It's a higher end, more, I guess more capable tool. The Jade and the other tool in the space, the Topwin tools as well, they just have a different cost point. So if you're in the China market, which a lot of these tools go into the China market, that's where these other tools, Jade and our other tools are more fitted to that market. What we're seeing is continued demand for Lumen at the, I'll call it the higher end applications. And that, as I said earlier in the remarks, Tom, is where we won orders over the last several quarters at a customer that requires much more stringent application.

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

Okay. That makes sense. And you mentioned, Paul, that there was a kind of one-off memory repair order as well. What is the driver behind that? Is that capacity requirements? Or is it something unique that requires a new tool?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

There's a little bit of capacity. I wouldn't call it broad. But there are some designs that still require the laser fuse process. And so we're seeing just a small incremental demand there. This is in the very few units. So it's nothing we would expect over a long period of time, but it's good business in the meantime when we can get it. And we would expect to see a couple of units here and there probably for a little while still.

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

I think, Tom, we went through kind of a dry spell because when some of the newer applications went away from laser fuse, there was a lot of used equipment on the market for several years. That used equipment has pretty much dried up now. So the underlying demand that was masked for a while is still there. It's never going to be a big growing business for it, but it is nice business, and we have a great customer base that we serve with that product.

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

Okay. Is it a certain type of DRAM chip then?

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

Yes, it's specific DRAM applications.

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

All right. Paul, you mentioned that there were a few delays during the quarter. Maybe just a little more on that. Was it a facility that wasn't ready, or just new demand pushouts by the end customer?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, we mentioned in our call last quarter that we could see some impact from timing. And in fact we did have two customers whose sites weren't quite ready, and we saw those push out. In the case of one, they took a portion of the tools, but didn't have the balance of the facility ready. In the case of the other they did push the tools out because the site just was not quite ready to go yet. It's shipments that we would still expect to see over the next several weeks here. But it did impact our top line. And we thought that could happen, and we did see that come in this quarter.

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

Okay. So your range of revenue in the fourth calendar fiscal quarter kind of represents, if it gets pushed out again?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

I would say not specifically. I think that's just more broadly that there's a lot of moving pieces, and the timing of when shipments actually go out the door. There's a little bit of risk around that. But as we mentioned, I think we feel generally that our business is strengthening, and that's reflected in the guidance. But there could be some impact in timing just quarter to quarter.

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

Okay. And then I couldn't quite make out what you were saying on the OpEx side. It came down this quarter when you did the consolidation. What is your expectation going forward?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, we would expect to see OpEx generally $19 million to $20 million range, depending on our volume and variable costs. But in this coming quarter it will be in the very low end of that $19 million range. It's up a little from this quarter, particularly when you consider the extra week, because we have a lot of activity in the market with getting our new products placed. And the cost of being out there with the various installations and other activities. So it's up a little bit even on one less week. But it should be in the very low $19 million range. And that's generally where we would expect it outside of variable costs that are driven by volume.

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

Okay. And then as revenues ramp over the next couple of years, how much overhead absorption impact is there? Is there a certain incremental gross margin we could look at?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Well, the way we think about it, Tom, a little more broadly is around our model that we would expect to see about $0.35 to $0.40 of what we call leverage or drop-through to the operating income line. That contemplates both absorption in manufacturing, but also the fact that we don't need to add fixed costs in the expense line. There will be some variable costs around selling and other volume-related things. But for the most part we'll be able to keep our expenses fairly flat. So that's really the way to think of it, is around this 35% to 40% of leverage.

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

You said to the operating?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

The operating income line, yes.

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

Perfect. Okay. Great. Thank you.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

You're welcome.

Operator

(Operator Instructions). We have no questions in queue. And I would now like to turn the conference over to Ed Grady for final remarks.

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

Great. Thank you very much for joining us. You are welcome to call Paul, Brian, or me if you have any further questions. Thanks for attending. This concludes our call for today.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.