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ESIO - Q1 2018 Electro Scientific Industries Inc Earnings Call

EVENT DATE/TIME: AUGUST 02, 2017 / 9:00PM GMT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESI FY '18 Q1's Earnings Call, hosted by Brian Smith. My name is Steven. I'm your event manager. (Operator Instructions).

Now I'd like to hand over to Brian.

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

Thank you, Steve, and good afternoon, everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Michael Burger, our CEO; and Paul Oldham, our Chief Financial Officer. This call will cover the results of our fiscal first quarter of 2018. Before we go into the details of the call, I would like to remind you that some of what we say in this call will include forward-looking statements. These statements are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are subject to 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 these forward-looking statements. This call also contains time sensitive information, which we believe to be accurate as of today, August 2, 2017, and which could change in the future. This call is the property of ESI.

Now I will turn the call over to Michael.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Thank you, Brian. Good afternoon and welcome to our call. Our first quarter was a strong one with revenues growing about 50%, both sequentially and year-over-year. Revenues and earnings exceeded our expectation and guidance for the quarter. Orders were very strong at $76.6 million, up dramatically from last year, as the ramp in activity we saw in Q4 continued into Q1. While this performance was primarily driven by our flex drilling business, we once again saw year-over-year growth in all of our businesses. The strong business levels translated into excellent earnings and cash flow. Paul will discuss the financials in more detail in a minute.

In the flexible drilling space, the market strength we saw on the March quarter continued into Q1. Smart mobile devices continue to drive this capacity expansion with a combination of projected growth -- unit growth volume and devices, more flexible circuit boards per device, new materials and technology. This is proving to be an exceptional year for flex drilling as we continue to hold our dominant share in a healthy market environment. However, we are entering the build season for our customer base. So we do not expect our current business levels to continue into the second half as consistent with previous years. Although we see seasonal adjustments, we do believe the market drivers are longer term in nature and should continue to drive overall growth in the flex drilling market for the next several years.

Q1 was also a productive quarter for new products. We first -- we received a multi-unit order from a new customer for our nViant HDI drilling platform. This order was delivered through the customer and accepted into production during the quarter. We also received an additional multi-unit order for our Ultrus wafer scribing tool. While this progress is encouraging, it is early days in the adoption cycle and the run way to full market acceptance for these products will take some time.

As you will recall, we announced in February, our intentions to restructure the company into a functional management structure, bringing a new executive team, while lowering the overall expense base. We've been working on this process for about 6 months, and I'm very pleased to report that virtually all the cost reduction actions have been completed. The new management team is onboard, and our new organizational structure is in place, all of which should allow us to be more nimble and productive in executing our growth strategy. In summary, we are executing on our strategy to expand on our core competencies and to develop new products that will allow us to maintain and grow our share in our current markets as well as to win in new markets. All of which are leveraging a leaner expense base. In the near term, we are encouraged by the strength of the market environment, the demand for our product offering as well as our ability to respond to our customers demand.

As we look forward, we expect that our business will continue to be subjective to seasonal buying partners. However, we are well prepared to weather these changes in demand, with our lower fixed cost structure that will be fully realized by the end of this quarter. In addition, as new products gain traction over time, we believe we'll be able to leverage this model to drive higher and more consistent earnings on a quarterly basis.

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

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Thank you, Michael, and good afternoon, everyone. The following information includes results from our first quarter of fiscal 2018, which ended July 1, 2017. 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, restructuring, asset and inventory impairments and other items.

Bookings were $76.6 million, just below last quarter, and up more than double from a year ago. The order levels reflected a healthy environment, strong technology and market drivers and seasonal strength in several of our markets. Bookings were particularly strong in flex for the second quarter in a row. Flex order levels were up dramatically year-over-year, reflecting not only the strong current market environment, but also underscoring the unusually weak environment we saw last summer. And then for our semiconductor products was also above last year and about flat with last quarter, reflecting a healthy capital spending environment.

Orders for our new Ultrus wafer scribing tool, offset lower orders for legacy products. Component test product demand was flat with last year, but decreased sequentially after a very strong past 2 quarters. The demand level still reflects a healthy capacity spend on the part of MLCC manufacturers. Demand for what we now call our industrial machining products grew year-over-year, but was down slightly sequentially with continued orders for our guarded system. Backlog grew by over $2 million to $71.7 million and is at its highest level in 5 years. It is worth noting that current backlog includes a relatively higher proportion that will revenue over several quarters.

Our book-to-bill ratio was 1.05:1. Revenue for the quarter was $72.7 million, up 52% from a year ago and 46% sequentially. The stronger revenue levels were due in part to strength in flex and the timing of customer acceptance for our most recent nViant installation, which occurred earlier than expected.

Both systems revenue and service revenue grew sequentially and year-over-year. GAAP gross margin was 36.3% and included $7.2 million of charges, primarily related to asset and inventory impairments associated with our restructuring program. Also included in cost of sales was approximately $300,000 of purchase accounting and equity compensation. On a non-GAAP basis, gross margin was 46.7%, about flat with last quarter and last year, with the benefit of higher volume, offset by less favorable mix. Looking forward to next quarter, we expect adjusted gross margin to be down slightly on mix and lower volume.

GAAP operating expenses were $23 million and included $1.4 million of equity compensation and purchase accounting. It also included $1.2 million of restructuring charges, largely related to headcount reductions, which occurred late in the quarter. Overall, headcount was down 76 people from Q4 and 109 from the end of Q3.

On a non-GAAP basis, operating expenses were $20.3 million, slightly above last quarter on higher variable cost associated with higher revenues. And above a year ago, both due to higher valuable cost and the Visicon acquisition. Looking forward, we expect adjusted operating expenses to be down slightly with lower fixed cost, offset by higher variable cost and engineering project expenses.

We believe, we're on track to achieve our stated goal of realizing most of the cost reductions in our second quarter and to be fully at our new operating model in Q3. On a GAAP basis, operating income was $3.5 million. This included a total of $8.4 million in costs associated with our restructuring activities, of which, $1.9 million is cash related. Non-GAAP operating income was $13.6 million, or 18.7% of sales compared to income of $3.3 million in the year-ago quarter.

Operating leverage was well over 40%, demonstrating the strength of our financial model. Adjusted EBITDA was $15.3 million or 21% of sales. GAAP and non-GAAP tax provisions were about $400,000. We expect Q2 tax expense to be about flat. GAAP net income was $2.9 million or $0.08 per diluted share. This compares to breakeven net income last year. Adjusted net income was $13 million or $0.38 per diluted share compared to income of $300 million or $0.09 per diluted share a year ago. This reflects our highest level of adjusted quarterly earnings in over 40 quarters.

Turning now to our balance sheet. Total cash, restricted cash and investments were $69.7 million at quarter-end, up from $63.5 million last quarter. We generated $7.4 million of operating cash during the quarter. Accounts receivable increased by $8.2 million to $49.2 million. DSO improved by 13 days to 62 days on a strong mix of turns and collections. Inventories increased by $3.3 million to $62.3 million on higher shipments. Inventory turns increased to approximately 3.1x, primarily on higher volume.

Accounts payable and accrued liabilities increased by $6.2 million related to the timing of inventory purchases. EPO was 61 days. Capital expenditures were approximately $500,000, well below our target model of 2% to 3% of sales. Depreciation and amortization, excluding purchase accounting was $1.8 million. In summary, we are pleased with our near-term results, and believe that the current ramp demonstrates the flexibility in our business and our ability to leverage growth into profitability. As our new cost structure becomes fully in place, we will have a better ability to whether the downside and consistently deliver positive earnings.

Looking forward, we expect a strong second quarter, but do not expect these business levels to continue in the second half based on seasonality. However, this should still result in growth and profitability for the full year. Based on current schedule backlog levels for Q2, we expect revenues to be between $63 million and $70 million, and non-GAAP earnings per diluted share to be between $25 million and $0.30.

This concludes our prepared remarks. At this time, we would be pleased to take your questions. Steve?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question is from the line of Jaeson Schmidt from Lake Street Capital.

Jaeson Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

I just wondered if you could (inaudible) first quarter outlook. I'm just wondering some of the puts and takes related to that guidance, obviously, PCB was extremely strong in June, and I would get some of that momentum continues. But any additional color you could provide the by that segment would be helpful?

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Yes, I think in general, Jaeson, the big driver is PCB. Although there is a portion of that, that is scheduled to ship out over several quarters, not just in this quarter. We also saw good demand across all of our other product areas and that will also contribute to the guidance. Where we had new products, of course, we expect there will be a little bit of lead time in order for those products to be installed and accepted by the customers. So -- for example, our Ultrus tools, we wouldn't expect necessarily to revenue in the next quarter, but over a quarter or 2 -- a couple of quarters. That's generally the dynamics we're seeing, pretty healthy overall, but relatively higher proportion in backlog that will actually revenue not next quarter or in our Q3 but out a couple of quarters beyond that.

Jaeson Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. That's helpful. And then just -- if you could talk little bit about what you're seeing from a linearity side on the bookings and orders this past quarter?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Yes, I think as Paul said. Jaeson, this is Michael. We have seen, I would think, unceasingly strong bookings through recent times, and so hence the guidance for Q2. Our visibility in the consumer electronics space really hasn't increased much, in fact, our visibility doesn't go beyond the beginning of Q3. So there's not a great deal of linearity in our world. We do believe that, as Paul said, and I think I said in my script, the second half shouldn't reflect what we've seen in Q1 and what -- and Q2 in terms of bookings. We expect to see kind of the seasonal downturn as our customers and their customers enter into full scale manufacturing for device side.

Jaeson Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. That makes sense. And the last one for me and I'll jump back in the queue. Could you just talk about what you're seeing from an opportunity standpoint within the non-consumer end markets and the industrial machining? I know that was one of the longer-term opportunities for you guys, just curious if there's been any rate attraction there?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

No traction that we're talking about. The activity level continues to be extremely strong and really encouraging. We have a new platform that is really aimed at this space. We haven't talked about it yet. But stay tuned, the feedback to date from primarily the aerospace world has been very encouraging. And we hope to have something to announce, up merit here in the next quarter or 2.

Operator

Our next question is from the line of Jim Ricchiuti from Needham & Company.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

So if we think about the guidance that you gave going into the quarter, and where you came in. Is the vast majority of that's flex?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Yes. Flex was a big driver, but I think, Jim, we also mentioned that, frankly, all of our other businesses were also -- but flex being our largest business as it moves the needle the largest and the fastest.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

And, Michael, is that across the strength that you saw in the flex. I assume that's just across multiple customers.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Yes.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

Was that something that -- trying to get a better senses to, how quickly this has the potential to fall off? And it doesn't sound like it is yet, but you're certainly anticipating the seasonal decline in. But it's fair to say, you're not seeing it yet.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

No, we haven't seen it yet. And hence our guidance for Q2, we do believe -- and frankly, we're paranoid by virtually the fact that we don't have a great deal of visibility beyond current backlog. Paul mentioned that we do have a significant amount of the backlog the $71 million that we talked about in our script, is scheduled beyond Q2. So we're -- that's -- there is some flex in that. But the bulk of the flex business is really kind of under tight demand schedules, primarily through Q2 and maybe the very, very first part of Q3. So again, visibility isn't improved. We do believe that flex is driven primarily by the consumer electronics space. And so our history shows that we've been through a cycle that typically into the summer, into the fall demand for capacity continue -- tends to vane, and the focus of our customers is really on trying flexible circuits out to their end customers, which are the mobile phone providers. And I -- we don't have an indication that, that cycle is changing.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

Got it. Now that make sense. From where you sit today with respect to the newer products, how are you more optimistic that we're nearing this key points where we might be seeing larger scale acceptance, broader acceptance to nViant?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Yes, we are. nViant and Ultrus, we've got some very encouraging feedback on both. I think as I mentioned, we're probably a couple of quarters away from calling victory. But we've gotten really no negative indications that our products are not competitive. So we're -- again, it's adoption not necessarily in market at large, but by customer and we have to kind of slog it out by customer, which we're -- we've been in now for the last 9 months or so. And I would -- Ultrus has actually been even longer than 9 months. So the adoption cycle for Ultrus, because it's a primarily semiconductor tools taken even longer than what we're seeing on the printed circuit board space. So -- but it is happening and so yes, we're very encouraged.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

Are you willing to maybe give us a sense as to what your expectations are for these systems, these products in the next 1 to 2 quarters? Not necessarily putting a dollar number to it. That's not I'm looking for. But I'm just trying to get a sense as to -- it appears that there's just going to be some lumpiness in the adoption. But I'm wondering if we might be also seeing the potential for some steadier progress?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

No. I don't think we're comfortable doing that yet, Jim, I think perhaps in a couple of quarters. We will give you status every quarter as relates to how the adoption cycle is executing. I think, as I said, I think it's early days to call it success. And so I think gives us a couple of quarters before that. I think we have been on record saying that in a 2 to 3-year period, success for us for the HDI space is about a 10% market share. And so I think in a longer-term model that's kind of what we both should be looking at. Shorter than that, we'll just -- we'll give you status and as we get larger scale adoption, we'll begin to talk more about it. But we're not there yet.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

Okay. Final question for me is just, with respect to the way you have been characterizing the target gross margins. Clearly, the strength you're seeing in the business last quarter, this quarter. Is there any change in the way you're thinking about gross margins in this initial phase of the restructuring and the repositioning?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

No. I think the important thing to point out is, while we -- Q1, we had a relatively very healthy gross margin. And we think that, you said in the script that we think it'll be -- may be a little down, but not a great deal down from Q1 and Q2. Because the visibility in Q3 and Q4 is so scattered. Our success model is really aimed at an annual view, and so our success model of 44% gross margin for the year. We think it's doable, certainly, with the strength in Q1 and Q2 should help a great deal. But again, not really understanding what Q3 and Q4 looks like, we're -- it's early for us to call success.

Operator

Our next question is from the line of Jason Ursaner from Bumbershoot Holdings.

Jason Ursaner

First looking at the flex business. How should we kind of think about recovery from last year's numbers versus just overall market growth in terms of the numbers you're putting up now?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Well, I'll take a shot at it, and then Paul can add some color to it. But he's got a lot more history than I do. But I think the way to think about the flex market is when you think about it in terms of consumption, all the analysts that were reading are saying that the consumption of flexible circuits, which is really the output of our customer base, is really geared it around 11% per annum on a compounded annual growth rate. That's a very healthy growth rate in terms of consumption of flex circuits.

Then you overlay the fact that the complexity of the devices that flex circuits are used in is continuing to expand. And what we've seen in this most recent round of device types that are being -- that are targeted by customer base, the number of flexible circuits per device are continuing to grow. Paul mentioned, and I mentioned, both in our script that technology is also shifting. I think all of these factors bode very, very well for us. That being said, we've got a very, very high market share. We estimate anywhere from 75% to 80% market share. So we kind of float with the boat if you will. And so I think very good news about the future we think, a lot of demand, but I wouldn't say that it's so much of a recovery as it is basically, the buying cycle at large. And frankly, as we said a couple of quarters ago, we've felt that the flex market was somewhat in a pause, primarily due to the end device demand, not so much had anything to do with our share or our technology or any of those things. And I think that's the case today. We're benefiting from an increase in demand in smartphones, and an increase in forecasted usage of -- or adoption of the smartphones. That coupled with the trends, I mentioned earlier, more complexity, more flex circuits. And I think it bodes very, very well for flex business here for next 2 to 3 years minimum.

Jason Ursaner

Okay. Appreciate all the details. And I guess when you think about this cycle of tooling that's getting installed, can you see any the dean driven at all by OLED in terms of the connectors? I know that there's been a lot written about flexible connectors that are kind of needed with some of the OLED displays that are potentially going to be coming out?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Again, our customers are really not at liberty to tell who they're working with. But our intelligence -- we read the same stuff you're reading. And yes, we believe that OLED display and some of the issues that have been surfaced about that has led to increased capacity needs and increase of demand, both of which I think we're benefiting from.

Jason Ursaner

Okay. And then -- just any general update on the HDI strategy. I know you called out the nViant machine in the script, but I didn't catch the details. Just kind of how that overall (inaudible)?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

We -- well -- what we announced is that we've, again, got another customer who has placed a multi-unit order, which again is a successful outcome of our effort of trying to drive adoption. We're very excited by the HDI market, we think that it offers a great deal of upside for us. It's a bigger market frankly than flex is today. It's growing kind of mid-single digits, anywhere from 5% to 7%, depending on who you believe. We have effectively 0 share in that space. We save what we've announced. We won a couple of customer orders, but they're not actually what we would consider mass adoption yet. In a flex factory, we make it in order from anywhere from 15 to 25 systems, as guys managed their capacity. We're in the mid-single-digit, high double-digit or high single-digit numbers, where guys are actually taking the next step. They're actually exercising our product on their production floor, which is very positive but part of the process.

Jason Ursaner

Okay. Great. And then just lastly, I wanted to follow-up on Jim's question. In terms of the -- may be an update to the overall success model, is there any way to think, I guess of that incremental margin? Or -- obviously, it's going to be revenue dependent, since you have some pretty big fixed cost leverage. And I don't want to get ahead of the revenue side since that can kind of take a step back in the second half. But how do you think about incremental margin when you think about the success model that you've put out there?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Well, we've got several moving pieces, probably the biggest long term is new products. And as we develop new products and as they become adopted, we believe that, that will have an accretive effect on gross margins. Volume certainly plays a big part at this and as demonstrated here in the last quarter and our guidance going forward. I think, the new cost structure that we've talked about, some of those changes will affect COGS and have a gross margin impact. But frankly, I think as a -- in a longer term, 2 years from now, 3 years from now, when we're talking about how we're going to go from what was our success model that we talked about 44% gross margins on annual basis to high 40s. How do we get there? Arguably the most sustainable way of doing that is new product adoption.

Operator

And our next question from the line of David Duley from Steelhead.

David Duley

I apologize, I missed part of your prepared remarks. I saw that you talked about getting another follow-up on the during the quarter. Could you talk about a couple of things. How much of revenue have you recognized? Or do you have, can you mention what's your installed basis? And have when-- how often have you recognized revenue if you don't want to give me the numbers, on a couple of orders now? I'm just trying to kind of figure out what's your installed base, frankly?

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Yes. We've announced that we've had 2 multi-unit orders. Those are kind of the key ones. As Michael said, they are sort of in the mid-single-digit, high single-digit range. So we're not talking about large orders at this point. But there more than one try it out kind of unit. They are going into production and being used. And we have one of those sites that's, that's actually gone through the full acceptance process, and we've recognized revenue on and that was in this quarter, which we talked about.

David Duley

Okay. And so you recognized some revenue this quarter, and then shipments that are being shipped in this upcoming quarter or were they shipped in the current quarter? And when will you recognize revenue on that second multisystem order I guess?

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Yes, I think it's sort of -- I think we would anticipate over the next quarter or 2 at the most. It is a matter of going through a pretty rigorous acceptance progress even though the tools are in production there. They have to be subjected to all the various recipes and pretty well exercised by the customers release for the first cell of tools. So I would say in the next 1 quarter or 2 quarters at the most we would see our next batch of (inaudible) revenue.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Yes. And because we haven't shipped a large number of these, our accounting practices are we need to actually get acceptance signed off by the customer, unlike a lot of our flex tools, which, because we have a long shipping history, we can ship it and claim revenue. That's not the case with nViant. So it takes a little bit longer to get to the revenue.

David Duley

How much longer will you be under that criteria where it's a multi-quarter acceptance period?

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

There's no bright line, but we want to make sure we have multiple customers and demonstrated track record that tool works. And I'd say, probably maybe one more major customer would probably get us over that hurdle.

David Duley

Okay. And then, I know the IC package drilling product came before the nViant, I don't think you guys talked very much about that. Could you give us an update there? And what you see going on?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Yes. You're referring to CornerStone. We are still very much committed to the IC package drilling space. I think as we mentioned, some time ago, the market is really not as mature or as developed as we'd hoped. And so through this process of restructuring and really looking at where we are from a product support perspective, we've made a decision that we're going to rev the product one more time. And we'll probably end up doing that in concert with our next HDI product as well. So we think there's a convergence potential, and we're working on that as we speak. So we've got several CornerStone machines out in the marketplace today. But we don't anticipate actually shipping any further until the next rev.

Operator

Your next question is from the line of Tom Diffely from D.A. Davidson.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

First question is for Paul. So Paul, did you state that earnings hit the highest level in 10 years?

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

I did. On an adjusted basis. Yes.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Wow. So I guess the follow-up question is, are you surprised to take 3 long quarters for Michael to turn things around?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Seriously, that's not right. That's not right at all. And no, no, no. I have nothing to do with this.

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

I pass on to that question. Obviously, I think we're very happy to see this kind of results. And I think the 2 things it points us to is: One, our ability to respond to this ramp in our manufacturing and supply chain has been tremendous. And so I think we're very fortunate that we've been able to get that ability in the company and to be able to respond to it. I think the second thing is it demonstrates, as we see revenue growth, there's a lot of profitability potential. And I think as we've now taken our restructuring actions, as we see seasonality, and or not in our business, we're better prepared to weather those lower times as well because it's a lower fixed cost base now, and while we'll have variable costs that will scale with revenue, that the base levels will be lower. So we're also very happy that we've had the right products at the right time for this ramp. And I think that's a positive thing. But I guess we're not declaring victory, if you will because we still need more irons in the fire that are reliable and will drive sustainable growth over time. And our models look beyond 1 quarter. It's great to have a great quarter. And we've obviously guided to a very next quarter, I think, in Q2. But ultimately the success for us over the next 2 or 3 years will be to see if we can on a more sustainable basis. So that's what we're really shooting for.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

So on that front, I want to kind of dig into the flex market a little bit more. If you look at the kind of a 2-year period of the softness last year combined with the strength this year, does it feels like something has changed, where the market is bigger now or it feels like you're making out for the weakness a year ago with some strength today? And maybe next year goes back to a normal market size.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Yes, I'll take a shot. And I think, Tom, Paul should give some color on the history. But in talking to our customer base, it seems that the supply chain, of which they are a part of, there's a great deal of disarray right now, in terms of just what the actual demand is. There seems to be some pent up demand and a real bullishness around what is going to become to market and apparently, the consumer demand for it. I think Paul has said in the past, that the hurdles that were -- the headwinds that the company and frankly the market we're looking at a year ago, don't really seem to be there today. And that's evidenced by the fact that, although flex is up, we're also seeing semiconductor and component package. We're seeing literally every part of our business kind of rise, and I think that is a general statement that the overall economy in general is hotter than any of us expected. I think that has had an acceleration effect on the consumer electronics space.

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Yes, I'd agree. I mean, clearly last year, we were seeing headwinds, unit growth had flattened out, people are pulling back, and there was really no new features set --

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Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Cellphone growth was flat.

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Cellphone growth was flat. This year, projected growth was only in the low single digits, but it's like 650 million units, that's a lot of units. And I also think that you are seeing more new technologies come to market that are at the early stage of their adoption. So I think in that technology side, you are getting sort of the double benefit of overall higher capacity and more and different technologies that are driving complexity in that. So I think in that case, it is a very different environment than it was a year ago.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

I think the just -- it is amazing to me relatively new here. But the seeds that sown by this company from a technology perspective are actually now bearing fruit through this latest ramp. You've read a lot about the supply -- the fruit company supply chain and the concern around yields and those type of things. And I think our product, which arguably has been out now for a couple of years, is able to really kind of solve the problem that was probably not even foreseen a year ago. And I think that bodes very well for the near-term future. Our job is to ensure that we keep investing in it such that we're leading that next tranche of technologies that are coming. But it seems that with unit growth growing in cellphones, the number of flex circuits per cellphone growing and the complexity of each of these circuits growing, it really has pushed the market right in our sweet spot. And you overlay the fact that our manufacturing organization was able to really address this demand that arguably is perishable, it was a perfect nice storm for us.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Okay. Great. It seems like you have maintained a pretty high market share for the last several years. Have you not seen a more aggressive try by the competitors to get into this particular market? Or what are you seeing on kind of a competitive product point of view?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

We are seeing competitors actually throwing their body at it. Again, I applaud our technology and our technologists in that we've got some technologies that one, are very well IP protected, our customer base knows that. Second -- secondly, our technology is very scalable. And we've demonstrated this now through probably 2 or 3 different revs of, or iterations if you will, of flex circuit evolution. So certainly, we need to continue to innovate, and we need to be ready for the next coming, which is right around the corner. So we're not resting on our laurels but, yes, we are seeing competitors. We have not been dragged into a pricing battle because again, we think we have differentiation from a technology and service perspective.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Okay. And then it sounds like a vast majority of business is driven ultimately by the handset. Are you starting to see some small form factors kind of lower end IoT devices starting to drive flex circuit as well?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

We believe so, particularly in some of our component testing business. We do testing of multilayer ceramic products, which are capacitors that are used largely in radio design. In that business, frankly, in the last quarter, we reported was up substantially from the previous year. And I think that that's driven and not just by handset, but by design IoT ferber. So it's exciting, actually. I think than you overlay the fact Ultrus, which is our wafer scribing tool, is catching on, again it's a overnight 2-year sensation. But we're beginning to see adoption on multiple customer fronts and these customers frankly are household names. So we're very excited about that. We've got -- but we need another, frankly, another $100 million business for us to call success and be able to kind of counter weight what we've got in flex and we're working diligently on that. We believe right now HDI is that space.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

And then Paul, when you look at the operating expenses. I think you said they would be down slightly in this second fiscal quarter? And then, you said it will normalize in the third fiscal quarter. I mean, was that mean it goes down a little bit more and then that's kind of ...

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Yes. So the full impact of the reductions will be in place at the beginning of the third quarter. It's mostly in place today, but the benefit of that's being masked by higher variable cost that go at the higher volumes and profitability. There is, the obvious things like commissions and higher costs that scale directly with volume. But every employee in the company is also on a form of a variable pay plan. So that allows our costs to add some variability in them. So if you looked out, for example, if you look at the second half of the year, and you looked at comparable revenue levels that we had a year ago, our expenses would essentially be running about 15% below last year's levels, in the second half. That's kind of how to think about it. So it doesn't look like it's changing much right now, but underneath that, the structure of the fixed and variable has changed dramatically. And as the volume changes, the variable is going to come down and the fixed is at a much lower level.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

So very good place to be right now.

Thomas Robert Diffely - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Yes. So over the next couple of quarters, the smaller changes, mainly to the SGA line or the R&D line?

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

Primarily to SG&A. In fact, our R&D is going to look flat or maybe even up a little bit as we looked how we have allocated our resources and where we want work done and we've actually taken some kind of market -- what would be maybe considered marketing applications and moved it into R&D. So most of the savings are coming out of the SG&A.

Operator

The next question comes from the line of David Nierenberg from Nierenberg Investment Company.

David P. Nierenberg - *Nierenberg Investment Management Company, Inc. - President*

Very nice quarter guys. And very nice guidance as well.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Thank you, David.

David P. Nierenberg - *Nierenberg Investment Management Company, Inc. - President*

I wanted to ask if you could comment on several things that you haven't talked about yet, please. The first is, can you give us an update on the vertical integration of our lasers into our products as well as an update on the quality, reliability, warranty costs of the lasers and where you're headed there? And second, can you tell us, please what the latest about the Visicon acquisition made last year?

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Sure. Laser integration continues to do very, very well. We talked about Ultrus a little bit our wafer scribing tool, that utilizes our laser, which we called Chinook, designed in Bordeaux and manufactured in Singapore. So again, we are looking for new opportunities to use and differentiate laser technology in our products. And so I would see -- I would forecast David, that the percentage, which is running maybe in mid-to low 30s, depending on the mix of systems ship using our own lasers should continue to grow. From a reliability perspective, we have gone through some bumps, and as a result, it ends up being reflected in warranty costs. We believe that a lot of those moving pieces are intact or in place today. We put a long-term reliability position under Steve Harris, tasked with doing live test on all major components, our own lasers being one of those. We -- so I think over time we will continue to see our long-term reliability on our lasers to continue to improve. So I am -- I feel good about that. And your third question was Visicon. You want to ...

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

I mean, Visicon, the acquisition there has gone very well. We really believe that, that was a very complementary core competence to the company, aligned around the concepts of precision and accuracy. Obviously, the operation is fully integrated into our businesses today. We continue to pursue standalone opportunities with that business, and we have incorporated those groups directly into our other groups to get broad leverage across the company as a differentiator. So it's -- generally, it's on track.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

The real opportunity for Visicon for us long term is really to integrate some of those capabilities, particularly around metrology and inspection into some of our larger running industrial-based systems, and our engineering team and our marketing team are looking ways to do that. And I think that is actually -- that will be the long-term success of that acquisition will be. Can we integrate it in our kind of core products, I'm excited by that opportunity.

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

And there's a little bit of incremental revenue in things like medical and some of those very differentiated places.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Exactly.

Paul R. Oldham - *Electro Scientific Industries, Inc. - Senior VP of Administration, CFO & Corporate secretary*

So I think we're getting out of it what we hoped.

David P. Nierenberg - *Nierenberg Investment Management Company, Inc. - President*

Let me conclude by asking you somewhat longer-term question because as you both know very, very well, the street is myopic. It tends to took out maybe a quarter, and it strikes me that the situation that you're in because of the seasonal cyclicality of the largest business being flex. You've said that things continue to look good through the visibility period you have, which is the end of the quarter that we're in, right now. But for at least historical seasonal reasons, people could expect that there could be sequential declines for a couple of quarters in the flex business. You are trying to grow HDI, trying to grow Ultrus, trying to grow your new industrial applications. Your component test business is doing better than its done in years. But there is always, to use the word, the possibility of sort of a temporal disconnect in that one business could be declining before the others have grown large enough, fast enough, to make it a smoothly linear growth pattern.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

Right.

David P. Nierenberg - *Nierenberg Investment Management Company, Inc. - President*

I just want to invite you to think about the kind of guidance that you want to give to the financial community about that, so that the people don't get trapped into myopic euphoria only to lapse into frustration later in the calendar year, even though that's not deserved.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

I appreciate that. And I think that's an insightful question. Our attempt maybe not as overt as your question, so let me try to be direct. We believe that by talking about our success model in the context of an annual number gives The Street some major financial components revenue, not being one of those. But gross margin and EBITDA percentage as an -- on an annualized basis should be a pretty big building block for trying to understand what our performance on an annualized basis will be, fill in the revenue blank and certainly, revenue looks very positive for the first quarter and the second quarter. But you're absolutely right, the visibility beyond 6 weeks or 8 weeks from now is foggy at best. So I think if The Street could take away our success model, knowing that, that is not an endgame, but simply a milestone, that once we are able to achieve a 44% gross margin, 8% EBITDA on an annualized basis, we will immediately increase those numbers. What I think is positive, and I think what you're getting to is that certainly, if we were able to run these volumes on a quarter-to-quarter basis, we now know what the leverage of the model looks like. And I think we talked about greater than 45% leverage, which is excellent. And I think there's a little bit of improvement by virtue the fact that a lot of other changes that we made albeit done, not completely vetted through the P&L in yet. So we believe that by Q3, that fall through will be in the 45-ish range, which is very exciting. So you follow that revenue. And so our strategy as a company is, taking these competencies and trying to drive them, and we call them horses. We have a very large horse in flex, and we need a couple of more horses. We've got a couple of good bets, and we think industrial machining is one. We think HDI is definitely one. And then this IC packaging, as it matures, could be potentially be others. And we're looking, we're investing in a marketing organization to continue to kind of scan the horizon. So assuming that we can fill another $100 million stall, I think the machine that we're adding that revenue on, the fall through is there demonstrated by this quarter. So you're right, if we can get another business that is not as seasonal or cyclic as the consumer electronics business, we should be in good position. That being said, in the interim, as flex falls off, as we've talked about, we should be able to still continue to generate cash, certainly not burn cash and depending upon the revenue level and actually continue to earn. So that's kind of -- that's a big change. But that's an interim position, until we're actually in a position to actually find that additional $100 million business.

David P. Nierenberg - *Nierenberg Investment Management Company, Inc. - President*

Thank you. And it strikes me strategically, Mike, that the industrial machining opportunity being diverse across so many industries and geographies, could present something of an anti-cyclical antidote to flex and possibly to HDI. And if you could get the dogs to eat the dog food there, that would be an additional benefit, not just a $100 million plus market space, but one that marches to a different drummer.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

We agree with that actually, David. Thank you for your questions, that's a good one.

Operator

I would now like to hand the call back over to Michael Burger.

Michael D. Burger - *Electro Scientific Industries, Inc. - CEO, President & Director*

We appreciate, everyone, listening today. We are obviously, pleased with the quarter. We're looking forward to Q2. We'll talk to you in 3 months. And thank you for your interest.

Operator

Thank you. Ladies and gentlemen, that concludes the conference call for today. And you may now disconnect. Thank you for joining, and have a very good day.
