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ESIO - Q1 2017 Electro Scientific Industries Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESI Fiscal 2017 Q1 Earnings Call. My name is Whitley, and I'll be your operator for today.

(Operator Instructions)

I would now like to introduce your host for today, Mr. Brian Smith. Please proceed.

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

Thank you, Whitley 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 fiscal first quarter 2017 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, August 2, 2016, and which could change in the future. This call is the property of ESI.

Now I'd 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 first quarter conference call. Before we jump into the quarterly results, let me give some context in terms of the three year plan to revive and reposition ESI in growth markets leveraging our core competencies and expanding into adjacent larger markets.

In our first year of the plan we invested heavily in new product platform developments in both core and adjacent markets. In year two, last fiscal year, we leveraged several of these new products and got back on a path to growth and profitability. In Q3 and Q4 of last fiscal year we exceeded our expectations primarily driven by the success of the new jump stone Flex via drilling system; a major win with our Lumen high-end micro-machining platform. Amid this success we continue to see weakening or negative growth in the large volume end market for PCs, tablets and smartphones.

As we stated in our May call, we expected there could be headwinds in our core business, but we couldn't predict the timing or the magnitude of many of our customers remained bullish in their forecast. With this context in mind, Q1 was a mix quarter for ESI as we delivered solid year-on-year revenue growth, operating profit at the high-end of our range on improved margins and lower expenses and excellent operating cash flow. In addition, we made good progress on our new product strategy with several initial placements and orders in our key markets.

However, the Flex via drilling market hit a reality check as the impact of slowing growth rates for consumer electronics and smartphones rippled through our customer-base, causing a pause in new system orders that dramatically affected our bookings this quarter. In addition, our micro-machining business was flat to Q4 as we did not win any large volume business as we had expected. These were significant disappoints to all of us. It is increasingly clear that our strategy to diversify into adjacent market segments with differing capacity expansion cycles is the right one, and the sooner we can get into the volume purchase cycles with our new products the better. Paul will go into the financials in detail.

Looking at Q1 and beyond, as I mentioned, our Flex via drilling business had a very soft quarter following a record year last year. This slowing was expected directionally but was more severe from a timing perspective than we had expected. Although the timing of this pause is unfortunate relative to our turnaround plans, the underlying market for Flex circuits will continue to grow, driven by miniaturization, increased Flex content in devices, new applications and overall device growth. We are the clear leader in this market and we expect the demand to begin to increase over the next two to three quarters as the industry digests installed capacity.

At the same time we continue to strengthen and broaden our product portfolio to provide a broad range of solutions to the Flex laser processing market. Last year we introduced the GemStone product, which included our internally developed laser and saw the fastest product ramp and customer acceptance for a product in recent ESI history. Yesterday we announced two new versions of the Flex tools; the LodeStone is a high-end drilling and processing tool for medical and other markets, which require low carbonization and the minimization heat affected zones. It also features an internally developed laser.

Second, we're expanding our offering on the low end of this market with our new Redstone product for standard through-hole drilling and routing as the cost of ownership entry point. We believe that this product will further expand our addressable share to a broader set of customers who would not typically purchase our standard industrial leading tools. We've received initial orders for both of these products.

In the IC package segment of the PCB market our cornerstone series two product continues the qualification process with excellent results. The recently cornerstone series two won a technical selection at a very large Korean manufacture with a purchase order received last week. In addition we've completed process development and have unique technical solution on Cornerstone leveraging our own internally developed high energy laser for the next largest material set and supply chain in the IC package market. As we expose this capability to a new set of customers we expect additional placements and orders over the next two quarters.

Overall, we will believe we're on track in this segment with multiple single orders and placements this year and volume opportunities beginning later this fiscal year and early next year.

We've also seen good customers reactions to the evaluations of our nViant Series 1 system for via drilling on high density interconnect boards with several placements in the past two quarters. We received our first order during the quarter which should ship end revenue in Q2. We recently placed our first system in China and we're getting good traction of customers in Europe and the US.

The nViant Series 1 at our demo center in Korea is fully subscribed by potential customers processing their sample. It is clear that adding a CO2 based platform to our portfolio has opened the door for us to engage with many more customers than in the past. We still expect a number of customer evaluations to grow and we anticipate nViant Series 1 will contribute incremental revenues starting this quarter and in the second half of the fiscal year.

Moving into our micro-machining group, we continue to build out our application set on our portfolio of lower cost micro-machining platforms. Our portfolio systems including, Jade, Garnet, Lumen and the Topwin mine provides a new level of price performance in the China micro-machining market. As I mentioned we did not see any significant design wins in our first quarter which was a major disappointment because we had delivered the performance and quality at a competitive price for a key customer program but we were the last to be qualified.

Also unfortunately placement of demo system evaluations for verification testing was constrained this quarter by floods in Central China which impacted the deployment of the Garnet, Jade and Topwin tools.

On a positive note we received our first orders and revenue on a garnet product this quarter. We have several active engagements with customers and expect to see additional order activity over the course of the year. Our investments in new micro-machining platforms, local applications and development and local manufacturing are coming together to create traction in this market.

On another positive note today we announced the acquisition of Visicon Technologies, Visicon has industry leading technology in measurement and defect detection with the highest throughput and accuracy for the medical device and consumer electronics market. It brings an established customer base in medical applications and a strong brand.

For ESI this acquisition strengthens our underlying differentiation beyond precision and accuracy to verification and expands our presence and channel into the medical market. Visicon is very complementary to our laser micro machining business, its customers are increasingly requesting process verification in combination with laser micro-machining. In addition ESIs larger scale and footprint in manufacturing and support in China will provide Visicon with an increased ability to capture some of the growing market for defect detection for both consumer electronics and medical applications.

In summary, while the timing of the near term softness in our core Flex and micro-machining markets is frustrating we believe our longer term growth strategy remains on track. Our core markets have good business drivers. We have leading position and we see business levels as -- and we will see business levels return as capacity utilization improves and we win new programs in micro-machining over the next two to three quarters.

We're in the early stages of our qualification and validation for several of our new products and we believe they will drive significant growth in market diversification overtime. In the meantime we're taking actions to manage our cost structure and focus our investments on driving the adoption of our new products and penetrating new markets to position us to participate in the next volume order cycle in each of the target market segments.

As we do this we will continue to transform ESI into the company that it can be with the right technology and products, localized design engineering, applications engineering, field service and in growth markets. While we're facing some challenging market dynamics our differentiated capabilities set us apart from competitors and the ESI team is excited and energized to drive revenue and profit 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*

Thank you, Ed and good afternoon everyone. The following information includes results from our first quarter of fiscal 2017 which ended July 2nd, 2016. 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 impairments, restructuring and other items.

For the quarter, orders were $30.4 million. Orders in our component processing segment were down primarily the result of overcapacity in the Flex via drilling market after several quarters of strong technology and capacity buys at a record year last year. Orders for semiconductor products were higher in Q1 as our WaferTrim business was strong both in systems and service.

Orders for component test products were about flat from last quarter with another quarter of modest capacity additions in this market. We did receive our first orders for our new [Allegro] product which offers faster throughput and better handling.

Demand in our micro-machining segment were slow again in Q1 with several small orders that no significant design wins or capacity additions. This year's capacity additions for consumer electronics were smaller than in the past with limited feature changes being introduced so technology buys were also limited. In addition as Ed mentioned we were qualified but not selected for a new design opportunity.

While this was disappointing we are encouraged that the new Jade and Garnet platforms put us in a more competitive position in new applications. As we focus on differentiated capability and broader customer relationships, we expect to see multiple opportunities over the next several quarters. Shipments were $50 million, backlog decreased by $18.1 million to $37.1 million. Our book to bill ratio was 0.6. Revenue for the quarter was $47.7 million down 7% from last quarter but up 11% from last year.

Revenues were impacted by modest push out of deliveries as some customers began to reassess capacity during the quarter. Systems revenue is $38.2 million down 13% from last quarter. Service revenue increased sequentially to 9.5 million. GAAP gross margin was 43.7% and included about $350,000 of purchase accounting and equity compensation in cost of sales. Also in cost of sales was a $1.1 million charge to write off inventory and equipment that was damaged in our Wuhan facility as a result of massive flooding in Central China.

While the impact locally was significant, the team in Wuhan is working hard and we expect full recovery this quarter. In addition the facility was insured and we expect to recover the majority of the cost.

On a non-GAAP basis gross margin was 46.7% compared to 42.7% last quarter. The higher gross margin was due to favorable mix and a higher proportion of service revenue. Looking forward we expect gross margins to be lower in Q2 on lower revenues. GAAP operating expenses were $20.5 million, up $450,000 higher than last quarter and included $1.4 million of purchase accounting and stock compensation. Most of the increase is due to higher stock compensation on a higher stock price for this year's grants and forfeitures in Q4 that did not repeat.

On a non-GAAP basis operating expenses in Q1 were just under $19 million up slightly from last quarter but down nearly 1 million from last year. These lower expenses reflect our on-going efforts to optimize our cost structure. Looking forward we expect non-GAAP expenses in Q2 to remain in this range with base expenses lower on actions we are taking to reduce cost, offset by the addition of Visicon. On a GAAP basis operating income was $0.3 million. Non-GAAP operating income was $3.3 million the same as in prior quarter on lower sales.

On a non-GAAP basis income tax expense was $282,000 reflecting foreign taxes. We expect Q2 tax expense to be in the same range. GAAP net loss was $0.1 million or roughly breakeven on a per share basis. This compares to earnings of $0.06 per diluted share last quarter and a loss of $0.20 last year. On an adjusted basis net earnings were $3 million or $0.09 per diluted share compared to $3.4 million or $0.11 per diluted share last quarter and a loss of 4.5 million or $0.14 last year.

Turning now to our balance sheet, cash and investments increased $9.5 million to $69.8 million, we generated $11.4 million in operating cash during the quarter primarily our positive EBITDA and good cash collection. Accounts receivable decreased by $8.5 million to $34.4 million. DSO improved to 66 days on timing of shipments in the quarter and improved terms. Inventories decreased by about point $0.9 million to $59.5 million. Inventory turns were approximately 1.8 times.

Accounts payable increased by $3 million on the timing of inventory receipts and payments. Capital expenditures were $1.5 million up from $950,000 last quarter on increased purchases of test equipment and facilities improvement. Depreciation and amortization excluding purchase accounting was $1.7 million.

A couple of other items, first this quarter we renegotiated our line of credit with Silicon Valley Bank. The new terms provide additional flexibility to utilize the line while not increasing costs.

Second, we negotiated to Topwin for $900,000 recovery of purchase consideration. This will be reflected in approximately $450,000 adjustment to equity and compensation cost and in the receipt of about $450,000 in cash.

Finally as Ed mentioned today we announced the acquisition of the Visicon Technologies. We believe this business provides complimentary technology, expands our presence into the medical device market and is highly leveraged into our consumer electronics customer base. Visicon is based in Napa Valley but will be highly synergistic with our China infrastructure and footprint. As part of the acquisition we expect to add about 40 people after synergies.

We expect the business will add $10 million to $20 million in revenue annually with good growth prospects. The business will be diluted by $0.02 to $0.03 in Q2 but should be accretive by the end of the fiscal year. We expect to pay approximately $2.1 million in cash and up to $5 million in equity based on final working capital and other adjustments.

In summary we had a solid financial quarter with strong gross margins, good expense management and earnings at the high end of our range. Excellent cash flow puts us at the strongest cash flow within six quarters. However we have clearly hit an air pocket within the Flex PCB market and did not see significant micro-machining orders which negatively impacted our bookings in Q1 and will impact our revenues in Q2. While we do not know how long these conditions will last we consider this a short term issue and expect that we will see improving results over the next two to three quarters based on improved capacity utilization, initial design wins in micro-machining and tractions on our new product.

In the near term we are aggressively reducing discretionary spending, increasing hiring and focusing our investments to drive growth. Based on the level of Q1 orders and backlog we expect second quarter revenues to be between $30 million and $35 million and non-GAAP loss per share between $0.20 and $0.25.

Now I will turn the call back to Ed.

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

Thanks, Paul. This concludes our prepared remarks. At this time we'll be pleased to take your questions. Whitley?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Tom Diffely with DA Davidson.

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

Ed, I wanted to dig into a little bit of the capacity utilizations that you referred to, not being quite at the level where we need them to be to get orders going. From some of the comments it sounded like business may have gotten a little softer through the quarter and change the customers view of what they need during the course. I'm curious what are your view of the capacity utilization rates today and how they compare to last quarter when do you think you will get to a point where more capacity is necessary?

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

So Tom, the capacity utilization I'm going to talk specific about the flex market. Into the cycle through with kind of a couple of things, the back to school cycle, the Christmas cycle and the product introductions of new products in those sectors and what we typically see is in the Q1 this timeframe that we're in today we typically see a cycle down in terms of tool utilization that's out of the field.

And what we typically see then is that cycles back up again as we go back through the quarter. So as we look at the volume additions in the marketplace we typically see this in kind of a Q like Q2, Q3, Q4 timeframe fiscal that's when the tool purchases happen and then the tools are installed.

Now, I think what's unique about this year is for the first time we've seen smartphone growth in the global market in the single digit level, we're seeing forecast now down to 0% growth rate for smartphones and you know you see negative growth in PC's and in tablets. So I'd say the net-net from a market demand or in the flex market has really not continued to grow from the end user market perspective. That's what we're seeing right now.

I think the second part of it is what we're hearing in the marketplace we don't have any data specifically but what we're hearing is that some of the new phones that are being brought to market this year have minimal changes from their prior configuration. So a lot of the existing installed capacity can be utilized on the new generation of phones that is supposed to come up that kind of the September timeframe.

So if you add all of these things together what we see this broader decline short term in in the Flex market demand. I think the positive side is that we're seeing more applications for Flex circuits being broader coming outside of just the smartphone tablet and consumer electronics markets but we're starting to see flex circuits go into other markets like automotive and aerospace and other places, that's growth.

The second thing is that all the flex circuits are seeing more miniaturization, smaller via holes, higher density circuits to get more content into the phones. And if you look out into our Q3, Q4 timeframe when tools will be what we believe tools sales will come back driven primarily by the next generation of devices that will come up the following year.

So I hope that gives some context of why we think this is short term cycle and you know it's a little deeper than what we thought it might be when we were talking last May.

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

Okay. So when you look at the install capacity right now for flex drilling just across the Board, how does it segregate itself between kind of old technology and new technology and if the hole gets smaller the bends get tighter and stuff like that, how much of that old capacity needs to be replaced?

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

In the case of what you just said which is smaller holes higher density circuits, it's none of the existing tools can do it. That's why we were so successful with GemStone last year. GemStone filled the need in that next kind of next set of circuits that were coming out but without a double digit growth rate in the overall market that the amount of tools required was less than what we had expected would follow through to this year.

And that's the difference that we're seeing coming the following year is that there's predicted to be in the next generation some fairly substantial redesign and content increases that will drive a larger proportion of the tools to the newer technologies.

I'd say it's really important that the many of the flex tools we have in the market today, the 53, 35 base tools those tools will work and last generations several generations of circuits. So you're always looking to add capacity on kind of the front end and the higher technology stuff and that's where we see the growth in continued.

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

Okay. But you haven't seen competitive offerings out of --

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

No, not by any stretch. As a matter of fact the LodeStone is a higher end tool that attacks some new applications in the flex circuit space and the Redstone if there's anything where we had some potential competition from a couple of the Asian suppliers was on that kind of low end through hole only type drilling and the Redstone now takes us to be competitive in that market. So I'd say in every single market segment we now have a tool that's priced right with the right cost of ownership to defend that complete market.

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

And maybe quick question on the acquisition. It's a measurement in defect detection type tool, is this something that you ultimate want to integrate into your tools, or is this a standalone tool that you could just utilize your existing infrastructure to grow over time?

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

So, both. Actually, the acquisition is quite synergistic and complementary in the form of we do intend to have inspection capability what we call verification integrated into the tool in many cases, but we will also sell the current standalone tools as there is continued demand for that in a standalone basis.

One of the big markets is medical; Visicon is known for its strength is probably the largest supplier of inspection for stents, multiple kinds of stents in medical applications. So we believe that we can continue to sell into that market but also leverage our laser processing tools into that medical market through their channel. So that's kind of a win in both ways.

But secondarily, as you point out, integrating the verification into the tool is something we've been requested to do over the past couple of years and we've actually lost programs when we didn't have the capability. So if you look at the broader markets and some of the recent announcements, you'll see that this whole concept of verification metrology in the consumer electronics space is growing. It's at an infancy stage and Visicon has some very unique and differentiated technology in this space.

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

Okay, thanks. And Paul, when you look at the cost structure going forward, it sounds like OpEx is moving pretty flat because you have the increase coming from the acquisition and then you're cutting some cost in the base business. Just curious, are you cutting any programs or products from the base business?

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

Yes. What we try to do, Tom, is to look at reducing discretionary cost. Looking at anywhere where there is opportunity in infrastructure and support cost and then within the areas that will drive growth we're trying to focus on - I will say prioritizing rather than reducing the investments.

Fundamentally, we think the strategy is sound. Certainly as we get these new products in the market and get more traction on them, that's what's going to drive growth. So certainly we are going to curtail some spending here, but we also believe of the future the new products and our investing for growth on those.

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

Okay. And then finally, Ed, you said that you're qualified but not selected, I think it was the Jade product line. Just curious what the compared offering look like on kind of head to head basis?

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

Well it's an it's a difficult question to answer because of our NDAs, but let me put it this way; the technology and capability we supply was superior to the competitors, the customer decided to reduce the specification requirements because they already had an install-base from our competitor and they chose to stick with that installed base and then add to that install-base from the current that set of supplier.

Essentially what they said is they couldn't have two different capabilities in different parts of their line and they were unwilling to replace the whole volume of tools that they had in their tool set today. So they made an economic decision to just stick with what they had even though we had done exactly what they had asked for in terms of expanded capability and cost of ownership.

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

I think, Tom, in our view in this case obviously it's disappointing for us but in many ways it also created a little bit of a new a new entry point for us and demonstrated some capability at a cost point which is, frankly a little bit new for us in the market. And so we think it's - while we didn't get this particular order we think it's a good point to build from.

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

Okay. Well, thanks for your time today.

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

Thank you, Tom, and we appreciate you're sticking with us here through this difficult time.

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

That's what semiconductor is all about.

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

Okay, take care.

Operator

(Operator Instructions) There are no questions in queue. I will now turn the call over to Mr. Ed Grady for closing remarks.

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

Okay. Thank you very much for joining us. You're welcome to call Paul, Brian or me if you have any further questions. Thank you for attending our call today.

Operator

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