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ESIO - Q2 2016 Electro Scientific Industries Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESi fiscal 2016 Q2 earnings call. My name is Santita and I'll be your operator for today. At this time, all participants are in listen only mode. We will conduct a question and answer session at the end of this conference. (Operator Instructions) As a reminder, this call is being recorded for replay purposes.

I will now turn the call over to your host for today, Mr. Brian Smith. Please proceed.

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

Thank you, Santita 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 second quarter of 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, October 28, 2015 and which could change in the future.

This call is the property of ESi. Now, I'll turn the call over to Ed.

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

Thank you, Brian. Good afternoon and welcome to our second quarter conference call. This was a good quarter for ESi as we took another step forward in our corporate turnaround. We grew our orders and revenue, increased gross margins, reduced expenses, improved earnings, and generated operating cash flow and EBITDA on an adjusted basis.

The core business performed very well, allowing ESi to deliver its highest quarterly bookings and revenue in two years. Strong revenues and margins, combined with consistent efforts to manage our cost structure delivered non-GAAP earnings per share that handily beat our expectations and guidance. Paul will go into the financials in detail.

Looking at some of our key markets, Flex Via Drilling remains strong with bookings at their highest levels in more than three years. Despite being the number one player in Flex, we believe we are continuing to gain share, as our high performance product portfolio addressing UV Flex Via Drilling is unmatched in the industry.

The new Gemstone product continues to gain traction with quarterly bookings up from a strong start in the previous quarter. In addition, we're very pleased with the performance of our proprietary laser and our success at ramping this laser in production volumes. We do, however, anticipate some seasonal flattening of demand for capacity additions in the flex manufacturing, as our customers react to a more uncertain demand environment.

Looking forward, we continue to expect solid growth from this market driven by miniaturization of interconnect requirements from consumer electronics and wearable applications. In June, we shipped our first Cornerstone platform, which is a high performance Via drilling system for IC packages. Evaluations are in process with multiple customers and the response continues to be very promising. We are still targeting qualification of tools at at least one customer in December quarter and initial orders in revenue in this fiscal year.

That said, the adoption rate in the IC package equipment market is being impacted by near term capital budget reductions and timing of product release in the semiconductor and related packaging markets. However, we believe we have a differentiated and exciting product offering that delivers world-class throughput and accuracy, and we see multiple opportunities for technology and potentially capacity purchases over the next several quarters.

On the semiconductor side, we continue to see good evaluation results for our ultra-advanced wafer-scribing product, which we introduced last quarter. This quarter, we received formal qualification of a large semiconductor manufacturer and received a follow on order. This application replaces classical techniques that are running out of gas and where ESi's unique capability allows continued design rule strengths at higher yield and it represents upside for ESi when customers ramp production. In the quarter, demand increased for our wafer trim and marking systems and we also received a small order for our legacy memory repair tools.

Demand in micro machining segment was the highest in two years, driven by another application win for our Lumen series platform. Since introducing this platform, we have had multiple application wins, but this is the largest order to date and contributed to strong revenues in greater China. In addition, we continue to see build out -- we continue to build out the applications on our low cost Jade platform. We believe these platforms, combined with the expanded local footprint and technology collaboration from our Topwin acquisition will drive multiple opportunities as we move into the next fiscal year.

Last, while our primary focus has been on growing topline revenue, introducing new products, we've continued to drive our lean programs across the Company and optimize our cost structure. Without a lot of fanfare, we've taken a number of actions to increase productivity, shift resources to Asia, and consolidate facilities. These actions are all having positive impact on our cost structure.

In summary, this quarter was one of progress and improvement in virtually all financial aspects, and also in terms of our strategy and execution. I'm extremely pleased with the success of the Lumen and Gemstone products and our other new products are ready to contribute to growth. Initial customer response has been excellent and we're working diligently with customers to qualify these new products so they can begin to contribute as soon as possible.

As I'm sure you're aware, all -- our customer base is being impacted by changing demand environment, which could impact capacity buys and the adoption rate of our new products. As a result, we expect some bumpiness in our results over the next couple of quarters. We have known that this turnaround would not be linear, but we are as confident as ever that we are on the right track, and that our market and our product strategies will yield growth and profitability as we look forward.

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 second quarter of fiscal 2016, which ended September 26. To improve comparability, we are also providing earnings per share and related income statement results on a GAAP -- on a non-GAAP or adjusted basis, excluding the impact of purchase accounting, equity compensation, restructuring, and other items.

Also, please keep in mind as we discuss our next quarter guidance that our third quarter will consist of 14 weeks compared to the normal 13 weeks. Our fiscal year ends on the Saturday nearest to March 31, which means that about once every five years, our fiscal year needs to include 53 weeks rather than 52. This is one of those years and the extra week falls into the third quarter.

Now, moving onto our results. For the second quarter, bookings were $51.5 million, up 23% from last quarter and 20% from last year. Bookings in our component-processing segment grew nearly 20% over the previous quarter. Within the segment, a demand for interconnect products grew sequentially with Flex Systems up more than 20%, including strong demand for our new Gemstone system.

Bookings for our semiconductor products were also strong on higher demand and circuit trim and wafer marking, plus the receipt of an order for our legacy memory repair products. As Ed mentioned, we also received a follow on order for our new Ultrus Advanced Wafer Processing tool.

Orders for component test products decreased from last quarter. Demand for new systems and consumables were down from Q1 with orders related to capacity moving out a quarter or two. Orders in our micro machining segment grew to their highest quarterly level in two years with several system orders, upgrades, and a new application win for our Lumen series performance micromachining system. Demand for our new Jade platform and the Topwin line of products were both slow, as we are building out the applications for these platforms.

We are working with our channel partners to penetrate new Chinese contract manufacturers with these products, and we are excited about their potential to drive incremental revenue. Shipments were $44 million. Backlog increased by $7.1 million to $39.4 million and our book to bill ratio was 1.17. Deferred revenue decreased to $12.7 million as we received acceptance upon several new products. The combination of backlog and deferred revenue increased nearly $5 million.

Revenue for the quarter was $46.5 million with sequential growth in the micromachining segment more than offsetting a decline in the component-processing segment, which was impacted by the timing of shipments in semiconductor products. Product revenue was up 11% from last quarter at $35.6 million. Service revenue was about flat at $10.9 million. GAAP gross margin was 39.6% and included about $440,000 of purchase accounting and equity compensation and cost of sales.

On a non-GAAP basis, gross margin was 40.6% compared to 36.6% last quarter. The higher gross margin was due to increased volume, improved mix, and lower material costs. Looking forward to next quarter, we expect adjusted gross margin to be slightly lower, driven by the extra week of production cost and higher material cost, partially offset by continued favorable mix and improvement in warranty expense.

GAAP operating expenses were $21.4 million, slightly below last quarter, and included $1.2 million of purchase accounting and stock compensation. In addition, we incurred approximately $600,000 of restructuring costs associated with lowering our headcount. On a non-GAAP basis, operating expenses in Q2 were $19.6 million, down from last quarter. These lower expenses reflect our ongoing efforts to optimize our cost structure. For Q3, we expect operating expenses to increase between $500,000 and $1 million, driven entirely by costs associated with the extra week. Excluding the impact of the extra week, expenses should be flattened to down.

In addition, we expect to incur approximately $1.5 million to $2 million of restructuring costs, primarily associated with the consolidation of facilities, which we announced last March. Looking forward, we would expect non-GAAP operating expenses to be between $19 million to $20 million per quarter depending on revenue levels and other variable expenses.

On a GAAP basis, operating loss was $3 million. Our non-GAAP operating loss narrowed to approximately $750,000 compared to a loss of $4.1 million in the prior quarter. As a result, EBITDA was positive on an adjusted basis, a key milestone for us in the turnaround.

On a non-GAAP basis, income tax expense was $292,000, reflecting foreign taxes. We expect Q3 tax expense to remain in this same range. GAAP net loss narrowed to $3.3 million or $0.10 per share, compared to a loss of $0.20 per share last quarter. Adjusted net loss improved to $1 million or $0.03 per share compared to a loss of $4.5 million or $0.14 per share last quarter.

Turning now to the balance sheet. Cash and investments increased $1.8 million to $60.2 million. We generated $2.2 million of operating cash during the quarter, primarily on positive EBITDA and improvements in working capital. Total accounts receivable decreased by $1.4 million to $49.9 million and DSO improved to 98 days.

Inventories increased by about $800,000. Inventory turns were approximately 1.9 times. Accounts payable increased $3 million on continued normalization of timing of inventory receipts and payments, and days payable represented about 54 days. Capital expenditures were $840,000, down from $1.3 million last quarter on reduced purchases to text equipment and machinery. Depreciation and amortization, excluding purchase accounting, was $1.9 million.

In summary, we are pleased with the progress we are making in improving our financial results. This quarter reflected the impact of good execution, in which a lot of things went right, but it is also an indication of the leverage we can see in the business as we continue to execute on our strategy. As we look forward, our business is being impacted by several factors.

First, as Ed mentioned, we are seeing some headwinds in our markets as a result of slowing growth and uncertainty in China, delays in the rollout of products in the semiconductor and related packaging markets, and reduced capital budgets. This is having some impact on capacity buying in our base business, and the rate of adoption of our new products.

In addition, we have several customers where we have one business whose fabs are expected to complete this quarter, which if delayed could affect timing of shipments. As a result, we expect to see some bumpiness in our results over the next couple of quarters. Considering all of these factors, we expect revenues in the third quarter to be similar to Q2 in the mid $40 million range.

Second, as I mentioned, the third quarter this year includes an extra or 14th week, which has the effect of increasing on a quarter basis payroll, depreciation, and other time based expenses. The impact on higher costs this quarter will be between $1.1 million and $1.5 million. As a result, we expect non-GAAP loss per share to be in the $0.05 to $0.10 range. Excluding the impact of the extra week of expenses, adjusted EPS results would be roughly comparable to our second quarter, consistent with the improvements we have made to the overall cost structure of the business.

Although there is some uncertainty around order and shipment timing over the next couple of quarters, we continue to believe we are on track to broadly meet our financial objectives. For the first three quarters of the fiscal year, we expect to be on or ahead of our revenue projections and our cumulative loss to be better than collective street expectations. In addition, we expect cash to be flat or up slightly from the beginning of the year, as we have delivered improvements in both EBITDA and cash flow. Although results in Q4 will be heavily dependent on macro positions and timing of adoption of new products, we see several promising opportunities in both the PCB and micro machining markets and believe we are well positioned as we move into next fiscal year.

Now, I'll turn the call back to Ed.

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

Thanks, Paul. I'm very pleased with our results so far this fiscal year and the progress we've made on executing our strategy. We're moving into existing adjacent markets with differentiated products, driven by our core capability of speed, accuracy, precision, and laser material interaction. We're enhancing our sales channel to broaden our customer reach, and we're investing in localization initiatives in China and Asia to deliver the best cost of ownership and time to market. I'm more confident than ever that we're on the path to deliver profitable growth for our shareholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Tom Diffely. Please proceed.

Tom Diffely - *DA Davidson & Co. - Analyst*

So quick question. You talked about the extra week obviously having an impact on the cost structure. Historically, do you get a revenue bump at all from that extra week? Or is it just kind of lost in the whole quarter?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

It's difficult to tell, Tom, and clearly there's five more days that we can sell product. But it does tend to fall over the holiday season and as you know, our revenues aren't linear like some of these expenses can be. So we try to project what we think the revenues would be during the quarter. But certainly, there could be some impact there.

Tom Diffely - *DA Davidson & Co. - Analyst*

Okay. And the fact that your bookings were 51.5 and your guidance is for mid-40s, does that get back just to your lumpiness comment where historically you'd have a nice little increase in the revenues if your bookings were at that level?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes, I think it has more to do with the timing of shipments to the customers as well as the bumpiness comments that we made earlier.

Tom Diffely - *DA Davidson & Co. - Analyst*

Okay. I just wanted, in (inaudible) of that, are there longer lead times with some of these newer tools?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

I don't know if that's such a factor right now. I think it's more the other factors.

Tom Diffely - *DA Davidson & Co. - Analyst*

Okay. And then when you look at the two new tools that are up there today, the Gemstone and Lumen, are you finding that those tools are enabling you to expand the market? Or are they just a better replacement tool that is further ahead of where the competition is?

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

Yes, Tom, it's actually gain in market share. While the market is growing for Flex, like in the Flex space, we're actually gaining share as the market is growing. Some of the most recent data from an independent source shows us gaining double-digit market share points in the Flex market.

Tom Diffely - *DA Davidson & Co. - Analyst*

And then obviously, we all know about the lumpiness in the semiconductor world today. What is the activity level like on the micro machine side in China for you right now? I know when you first came out with some of these new announcements, there was a lot of buzz. Curious, has the activity level kept up?

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

I would say the investment rates in China are largely driven by more industrial and government spending. So there's a little bit less of that. There seems to be more of a mixed shift, however, from what we could call the historic kind of marking business, which seems to be flat to down. I think we talked last quarter about how customers who have bought tools are repurposing tools in that space. So there's not a lot of big purchases. I'd say the big upside for us is newer applications in the market where the Chinese subcons are the primary actors. And we're seeing a lot of activity there. It just happens to be more of a seasonal approach where it tends to be more associated with when new products are going to be announced by the mobile device manufacturers in the back to school periods where they put the capacity in, and it's used, and then they go through a cycle. So I'd say that the market in China is much more seasonal because of those things and that's what we're seeing.

But I'm very encouraged by the incremental applications that we're seeing. It's quite encouraging right now for what we're seeing.

Tom Diffely - *DA Davidson & Co. - Analyst*

Okay, great. And then you talked about a kind of a bluebird or an old laser repair system for the semiconductor industry. Is that driven by just capacity needs or there's something special about that, where there's plenty of capacity out in the marketplace but for some reason they needed a new configure tool?

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

It's more of a replacement of install base. The install base, many of the tools that are out there that do this laser fuse blowing are -- have been in the field for many, many years. The laser that's in that tool or in some of those older tools are obsolete now. So the people who are making the devices that still require the laser fuse blowing are getting two benefits. One is they don't have to change their design. And secondly, they can -- the newer tools from us, the 9850 TPIR, is actually a better tool, higher productivity tool. So as they retire some of the older tools, they're getting a lower cost.

Tom Diffely - *DA Davidson & Co. - Analyst*

Okay. Do you think this might become a more active market over the next year?

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

I wouldn't put a lot of growth potential in it, but I think it's a nice little set of bumps that helps -- that adds good profitable business to us. I guess, Tom, the point is I'm not counting on that as a growth segment for us.

Tom Diffely - *DA Davidson & Co. - Analyst*

Okay. Nice margin when it comes.

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

You got it.

Paul Oldham - *Electro Scientific Industries Inc - CFO*

That's right.

Tom Diffely - *DA Davidson & Co. - Analyst*

so when you look at the -- I guess previously you had a goal of getting back to profitability by the end of the March quarter. It sounds like with the cost currents in the industry, you're saying that maybe, maybe not at this point. It really is at this point with the model is in good shape. It's just the top line that dictates that.

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes. In fact, we've made some improvements to the model, as you've seen in our results the last couple of quarters. But yes, with some flattening of the top line here, it will be difficult probably to get to that break even. But I think while we're not giving any guidance out beyond the third quarter, we think that the overall results could stay roughly in this range.

Tom Diffely - *DA Davidson & Co. - Analyst*

Okay. And it's just a minor pro forma loss and cash flow positive.

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes, probably I'd say cash around break even. I mean at these levels, we're running at flat to positive EBITDA and I think that's where -- we think that's, while not at a breakeven level quite yet, where we'd like to be, we think the improvements we made in the cost structure and other things will allow us to stay around that level.

Tom Diffely - *DA Davidson & Co. - Analyst*

Definitely shows nice year-over-year improvement in addition to the overall profitability sense. It's a very good sign. Okay. Well, thank you for your time today.

Operator

Your next question comes from the line of Jim Ricchiuti. Please proceed.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Thanks. Good afternoon. Question just with respect to the macro environment. Are you seeing it more in the Flex business? It is across your product lines? Is it affecting some of the newer products that you had anticipated.

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

Jim, it's across the board and it's across the board for different reasons. I'd say the micro machining side is clearly more kind of the macro effects of what's going on in China whereas some of the new products, are much more impacted by the semiconductor industry, packaging related part of the semiconductor industry where we've seen the big players in that space have had capital budget reductions, which is putting a squeeze on their capacity investments. And I think that's probably -- I would call that, that's the biggest issue in the ICP space.

On the other side of that, though, the technology, because the technology is so compelling, we're still seeing pull for at least the technology buys, which is really all we had forecasted for this year anyhow. So we're actually on track. It's just the rate at which the adoptions are getting processed in these factories. So actually, we're feeling pretty good about things but it's -- I think we're more concerned about more of the base business type of things when you saw a slight downslide in the -- or actually push out in the components test group.

Haven't lost any business there but clearly we see that as a more macro trend. We're seeing some of that in the trim space, some of that in laser ablation. So I'd say the areas where our new products are, the technology differentiation is really creating a huge pull. And then it's just going to be the rate at which people release capital budgets that allows us to get those larger volume purchases.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Ed, within some of these markets -- is that perhaps are a bit more competitive, are you seeing any price actions by competitors? Or is pricing fairly stable? It's just a question of demand being a little slower.

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

It's the latter. Demand is slower. We're actually seeing the technology differentiation in our products as being highly appreciated. As I mentioned in my remarks, some of the things like the Ultrus tool, the current technology is just running out of gas and it can't be done. It can't be done at reasonable yields. So what we're providing is a process technology where people can continue to do the scribing and dicing that they need to do at smaller dimensions. So that's a technology pull.

And the same thing is true on the ICP space where the newer technology has smaller diameter [vias]. It has more vias per unit area and those technology buys are things that what we're hearing from the customers as they're testing the tools is that we are really uniquely positioned, driven by this core technology that we developed in kind of the laser fuse blowing era of high accuracy, high precision, and speed is translating into a unique differentiator.

So we don't see the price pressure in that space right now, even though I assume if our customers were listening to this call, they'd not be happy with me. But it is a competitive environment. I don't want to take away from that. But where we're playing, it's pretty nice.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Okay, and a very strong quarter in micro machining. And I wonder if you could talk a little bit about that revenue might have spread out. Was it concentrated with a few customers? And was the bulk of what we're seeing the orders on Lumen?

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

It was pretty much all on Lumen and it was highly concentrated to a couple of specific applications. And it all booked and shipped in the quarter. This is part of our -- again, part of our change in our philosophy and our process here is be very, very short cycle time on that kind of business because that's what the competitive environment is in China.

Operator

(Operator Instructions) There are no more questions in the queue.

Ed Grady - *Electro Scientific Industries Inc - President and CEO*

Okay. 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 our call today.

Operator

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