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ESIO - Q4 2016 Electro Scientific Industries Inc Earnings Call

EVENT DATE/TIME: MAY 10, 2016 / 9:00PM GMT

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PRESENTATION

Operator

Good day, ladies and gentlemen. And welcome to the ESI fiscal 2016 Q4 earnings call. My name is Maja, and I will be your operator for today. (Operator Instructions.) Later we will conduct a question and answer session. I would now like to introduce your host for today, Mr. Brian Smith. Please proceed.

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

Thank you. 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 the fourth quarter fiscal 2016 results. Before I go into the details of this call I would like to remind you that some of what we say on this call will include forward-looking statements concerning customer orders, shipments, revenue, gross margin expenses and earnings. These statements are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements include a number of risks and uncertainties that are discussed in more detail in today's press release and our filings with the SEC. Actual results may differ materially from those forward-looking statements. This call also contains time-sensitive information that we believe to be accurate as of today, May 10, 2016 and which could change in the future. This call is the property of ESI. Now I would like to turn the call over to Ed.

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

Thank you, Brian. Good afternoon and welcome to our fourth quarter conference call. This was another good quarter for ESI as we took more steps forward in our corporate turnaround. Orders and revenue grew both sequentially as well as year-over-year and we delivered earnings per share that exceeded our guided range. We also introduced new products and made progress on our customer qualifications which we are confident will enable long-term growth, profitability and shareholder return as we drive our product line expansion into our target near adjacent markets. Paul will go into the financials in detail looking at Q4 and beyond our flex drilling business had a very strong quarter as we received our largest GemStone bookings to date.

GemStone has become one of our most successful new products in recent years. It is winning on both industry-leading performance and cost of ownership, enabled by our internally developed laser. With our current portfolio of products, we believe we are winning the majority of the flex drilling business. Given the strength of the flex bookings this quarter the industry may take a quarter or two to digest and install this last quarter's orders. However, the industry dynamics signal that flex will continue to grow and the demand for GemStone and our evolving family of flex drilling tools will remain strong. I mentioned last quarter that our CornerStone IC packaging via drilling system was selected by a large semiconductor manufacturer as the preferred solution for its next generation packaging applications. And this quarter we have expanded our engagements beyond this supply chain. We have multiple evaluations ongoing and expect to ship our first customer's tool this month.

These tools take time to work through the multi step qualification process and we expect additional selections over the next couple of quarters, with potential to contribute to revenue in our fiscal -- current fiscal year. Another positive event in the fourth quarter was the receipt of customer evaluation commitments for our new nViant CO2 drilling platform. We have already shipped two tools against these placements and expect additional shipments this quarter. Customer interest in nViant has exceeded our initial projections as we are leveraging our technology and capability to address this large market and at an attractive total cost of ownership. We expect the number of customer evaluations to grow and we anticipate nViant will contribute incremental revenues in the second half of the fiscal year.

Moving into our Micromachining group we continue to see good customer interest in the new lower cost Micromachining platforms. In Q4 we introduced the garnet platform which adds larger format devices to the list of applications we can address. Our low cost Topwin family of products and capability, Garnet in its smaller format sister, Jade, provide us new capability to address the large market for low cost but fully capable Micromachining tools. While this quarter did not produce any key wins or large orders in Micromachining we expect to be in a position to win new business opportunities as several customers in fiscal 2017. Looking back on fiscal 2016 I am pleased with all that we accomplished. We introduced five major new platforms; Jade, Garnet, Ultrus, CornerStone Series 2, and nViant on top of the 3, GemStone, CornerStone series 1, and Lumen that we introduced in 2015.

Overall we have expanded our market by nearly $1 billion and strengthened our position in our core markets. We've seen good traction on the new products that have been in the market the longest and believe we have great potential for long-term growth as our products continue to gain exposure and qualification. These new product platforms represent the initial releases or extensions of the product families that address our target growth markets, so there is more to come that leverages our unique laser and systems control technology that differentiate ESI. Additionally, our investment in integrating our unique internal lasers has provided new capability and adds new dimensions to our business model. Finally, we have begun to translate this success into improved financial performance as we grew revenue for the first time in four years, achieved our goal of reaching break-even during the year, and generated positive cash from operations.

While we are excited about the progress we have made, there is more work to do as we look forward to fiscal 2017, our focus is on driving the adoption of our new products and penetrating new markets and customers. This process will continue to be a challenge against tough competitors and rapidly changing market demand. Recent economic and industry trends signal near term volatility and economic challenges with headwinds and capacity purchases that may affect the adoption rate of some of our new products. And we're still assessing the impact of changing dynamics in the growth of smartphones and other consumer electronics. As we have stated before, our overall turnaround likely will not be linear growth quarter to quarter but is expected to improve annually. We believe we are targeted at broad new adjacent markets and put the right product and channel building blocks in place and are executing on our long-term strategy. 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 and fiscal year 2016 which ended April 2nd. To improve comparability we are also providing earnings per share and related income statement results on a non-GAAP or adjusted basis, excluding the impact of purchase accounting, equity compensation and other items. Bookings were $56 million, up 6% from last quarter and up 39% from a year ago. This represented our highest fourth quarter bookings in four years and was driven by strong demand in our component processing segment which grew 26% over the previous quarter and 54% year-over-year. Within this segment, interconnect products provided the strength as bookings grew over 70% sequentially and more than doubled year-over-year, fueled by our new GemStone flex drilling system.

Bookings for our semiconductor products group were lower as we did not see or receive any demand for our memory repair products which we had in the past two quarters. And seasonal weakness in our wafer trim product line following a trim quarter in Q3. Orders for component test products increased from last quarter on higher system demand as we are seeing some modest capacity additions in this market. Demand in our Micromachining segment was slow in Q4. This is a project-oriented market and we did not receive any major wins this quarter. In addition, recent softness in consumer electronics is impacting capacity additions and purchase decisions. However, we now have a full family of platforms and believe we are better positioned going forward as we invest in applications development and in expanding our customer base. Service demand was also slow, in part due to timing of contract demand but also lower capacity utilization in our T and M business.

Shipments were $50.8 million and backlog was $55.2 million, up significantly from last year, giving us a relatively stronger footing as we move into fiscal 2017. Our book-to-bill ratio was 1.1. Revenue for the quarter was $51.5 million with sequential growth in both component processing based on strength in our flex products, and Micromachining as we shipped the large Lumen order received in the third quarter. Systems revenue grew by nearly $13 million while service revenue declined by more than $4 million due to the lower capacity utilization and contract revenue. GAAP gross margin was 41.1% and included about $400,000 of purchase accounting and equity compensation in cost of sales. We also took a $435,000 charge to write down some intangible assets due to a reduction in forecasted sales for an acquired technology. Service gross margins were 32% in Q4, on timing and mix of contract revenues and the volume impact of lower T and M revenues.

On a non-GAAP basis, gross margin was 42.7% compared to 44.9% last quarter. The lower gross margin was primarily due to a higher proportion of Micromachining revenues and the impact of lower service contract revenues I mentioned previously. Looking forward to next quarter, we expect adjusted gross margin to be slightly higher on a stronger mix. GAAP operating expenses were $20.1 million, down almost 10% from last quarter. That included $1.1 million of equity compensation and purchase accounting. It also included $227,000 of restructuring charges, down from 1.9 million last quarter and mostly related to a change in the estimated lease cost of the Chelmsford site which we closed last fall.

On a non-GAAP basis, operating expenses were $18.7 million, down slightly from last quarter, and 9.5% below a year ago. We are pleased that we have been able to reduce operating expenses each quarter this fiscal year. Looking forward, we expect operating expenses to increase slightly on product placement and other variable costs. On a GAAP basis, operating income was $1.1 million. Non-GAAP operating income was $3.1 million or 6.4% of sales compared to income of $0.5 million in the prior quarter. For income tax on a GAAP basis we had a benefit of $697,000, largely reflecting reduced withholding taxes and final adjustment to prior year tax expense and losses at Topwin. On a non-GAAP basis, income tax expense was $33,000, reflecting lower withholding tax and the level of foreign income for the year. We expect Q1 tax expense to normalize back to around $300,000 to $400,000 and to increase slightly during the year on higher taxes on foreign income. GAAP net income was $2 million or $0.06 per diluted share and reflects our first GAAP profitable quarter in nearly three years.

This compares to a net loss of $0.15 per share last quarter. Adjusted net income was $3.4 million or $0.11 per diluted share compared to income of $0.4 million or $0.01 per diluted share last quarter. Turning now to the balance sheet, total cash and investments were $60 million at quarter end. We used $3.3 million of operating cash during the quarter but generated $4.7 million of cash from operations for the year. Operating cash flow in Q4 was impacted primarily by higher accounts receivable on higher sale partially offset by improved income levels. Accounts receivable increased by $5.7 million to $43 million. However, DSO improved to 76 days on good collections and a better mix of terms. Inventories decreased $0.4 million. Inventory turns were approximately two times. Capital expenditures were $950,000, up from last quarter but still below our model of 2% to 3% of sales. Depreciation and amortization excluding purchase accounting was $1.7 million.

Let me turn for a moment to summarize our fiscal 2016 results. Revenues grew for the first time in four years and were up 16%. Primarily on growth from our GemStone and Lumen products. Margins improved by nearly 500 basis points on mix of new products, material cost improvements, and lower manufacturing costs as we consolidated facilities and made lean improvements. Adjusted operating expenses fell by 3% on good cost control and lower head count. This led to EBITDA margins of 3.4% and an operating loss of just $1 million compared to $22 million last year. And we finished the year strong, with an adjusted operating margin of 6.4% in Q4. In summary, our fourth quarter was a great finish to a year in which we took a big step forward in our turnaround strategy. Our new product initiatives drove solid revenue growth and our leveraged business model turned the incremental revenues into significant bottom line improvement. We delivered 35% operating leverage for the quarter, off a solid Q3, and over 80% leverage for the year.

As we look forward we are starting fiscal 2017 with a strong backlog and exciting new products, and we believe our turnaround strategy is broadly on track. At the same time, recent announcements regarding slowing in consumer electronics growth, utilization rates and timing of new product adoption may affect our quarterly results over the course of the year. Despite potential unevenness quarter to quarter, however, we believe that we are focused on the right markets and technologies for long-term profitable growth. For Q1, we expect revenues to be between 48 and $53 million and non-GAAP earnings per diluted share between $0.04 and $0.09. Now I will turn the call back to Ed.

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

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

QUESTIONS AND ANSWERS

Operator

Ladies and gentlemen (Operator Instructions.) Your first question comes from the line of Jim Ricchiuti. Please proceed.

Jim Ricchiuti - *Needham & Company - Analyst*

Thank you. Good afternoon. I just wanted to go back to some of the comments in the -- with respect to the interconnect portion of the business. You clearly had some strong bookings, it seems like, if I heard you correctly, up 70% quarter on quarter?

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

Yes.

Jim Ricchiuti - *Needham & Company - Analyst*

And most of that is being driven by GemStone. Is that the major product now, in the product portfolio, the interconnect product portfolio?

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

Clearly GemStone has helped to drive the growth this year, Jim. But it is a portfolio of products. And overall I would say that GemStone for this year was approaching 50% of our flex systems that we sold. It's been a significant product. It's been a big part of expanding our growth in that area. But certainly our other products, the 5335 and XI continue to do very well also.

Jim Ricchiuti - *Needham & Company - Analyst*

And you're anticipating, I guess, some -- I'm not sure if this is seasonal slowing, or just a function of what you're hearing and reading just about the consumer electronics market. Is this -- I mean, how much of a pause do you anticipate in this area?

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

Well, I think quarter to quarter, it's a little hard to gauge. Certainly we have had strong orders and we've added a lot of capacity into the industry over the last couple of quarters. So we anticipate there will be some absorption of that capacity. It's hard to predict how much that will be. And I think, as Ed mentioned, we're still kind of digesting the recent comments around consumer electronics growth and you know, the impact that might have. But ultimately we believe this continues to be a growth market. There's more flex in all types of devices. And we believe we're well positioned with the portfolio of products that we have. But it's probably not going to continue at the same pace, at least for a quarter or two, as we saw this quarter.

Jim Ricchiuti - *Needham & Company - Analyst*

Sure.

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

Yes, Jim, let me add to that, Jim, just for a second. I think if we just stay focused on the flex market, that's the fallacy in the discussion because the key to the strategy and the turnaround has been to broaden our base outside of the flex market into the adjacent markets and printed circuit boards and integrated circuit package. And in those areas we just -- I think you have seen from other releases, some people are still quite strong in the printed circuit board space, and our new product entrant is just now being shipped for qualification. So what we don't know is what's going to happen in the sub-segment that's called -- or is the higher end, more smartphone driven part of the business. It appears there's some softness there. But if you look at other companies and other projections going forward, you know, in these other markets that we're just entering, packaging and HDI, there seems to be continued broad demand. And really, it's all about us gaining traction and getting these products that we've placed now with customers, to get them qualified with their customer and then get the volume orders, which we still expect to happen this fiscal year.

Jim Ricchiuti - *Needham & Company - Analyst*

That's what I was just going to ask, in terms of some of the newer products, how much of a wild card is nViant Is that something that you feel pretty good, about that there's clearly demand in HDI that's going to drive sales orders for that product?

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

No question. Absolutely no question in my mind. If I look at what we're getting feedback from the customers, it's not only get the tool in here and let's get it qualified but let's get it qualified fast. There's a cost of ownership advantage that we're providing to these customers. So if you look at what's pulling through the HDI demand, it's not just the high-end smartphones, it's every single phone. It's every single consumer electronics device. It's every automobile. It's every airplane. I mean, HDI is pervasive across every single market. It's not just so dynamically-centric on what -- I'll call it the high end smartphone market. Which is the whole strategy we've put forward is to diversify so they don't get these swings.

Jim Ricchiuti - *Needham & Company - Analyst*

Got it. I'll ask one other question and then I'll jump back into the queue. Just given the ASPs for CornerStone, how should we be thinking about the potential for that product to move the refuse needle this year?

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

You know, I think it's going to be -- I would say that the volume of those is going to be one tool initially going in. I suspect that some of those tools will be sold at a lower ASP because we will not have as much content. So we can sell that tool in configurations of basically a 1-head tool, a 2-head tool or a 4-head tool. And I suspect that the initial qualification, tools will be kind of 2-head tools, with the option to upgrade to a 4-head at a later date. And that's a real huge advantage for the people who buy into that. We're also seeing the number of applications in that space expanding beyond the initial technology that we used on the largest customer order that we got for that tool. So much broader applications and I would say I see that as a real upside potential in the packaging market.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. Thanks a lot.

Operator

The next question comes from the line of David Duley with Steelhead Securities. Please proceed.

David Duley - *Steelhead Securities LLP - Analyst*

Yeah, thanks for taking my question. On the nViant tool, I think you mentioned, could you just maybe take a step back and help us understand -- I think you're shipping a couple of tools out for evaluation, or you have. How long will those evaluations take and then when would you expect to see repeat orders and revenue for that CO2 laser driller tool?

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

Okay. So, David, I think yes, we have shipped two. We will ship more this current quarter. The demand that we're seeing -- we actually are having demand that's greater than we expected. So we're actually scrambling to get more tools available and resources to support those in the field. But I think your question is around how quickly do those then turn into orders and revenue. It seems that it's a shorter cycle than the CornerStone tool because of the technology. This is a very straightforward known technology. So the expectation is that these are going to be three to six months kind of qualifications. I would expect to see revenue from these tools sometime in the second half of this fiscal year.

David Duley - *Steelhead Securities LLP - Analyst*

Okay. And then just a clarification. I think in your prepared remarks you talked about winning a second customer or food chain with the CornerStone. Could you talk a little bit further about your successes there in the packaging market?

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

Yes, as it turns out the packaging market has multiple sub-segments. And in the multiple sub-segments there are designs that use a material set called ABF. There's a design that uses a material set called PPG. There are a couple of other applications within each one of those sub-segments. And as we've broadened the tool offering to each of those sub-segments, we're seeing more and more traction across not only the semiconductor companies but the packaging houses, the backend packaging houses that there seems to be a demand for this tool, the high accuracy tool.

David Duley - *Steelhead Securities LLP - Analyst*

Okay. So you've won a second customer or food chain with that particular tool. Has the first customer moved into higher volumes yet, or when will we expect that to happen? Just remind us of what's going on there.

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

Well, I think the higher volume on the first customer, it's obviously dependent on the traction of their new product offering, which we expect will be sometime this year. But the point -- I guess let me come back and clarify on your earlier comment. I did not say we have won a second customer. We have placed tools and we're in qualification. But we haven't actually got an order or won an additional customer. Just to make sure, David.

David Duley - *Steelhead Securities LLP - Analyst*

Okay. Yes. Thank you. Final thing from me, I think in your prepared remarks you talked about how there's some macro head winds. There's some digestion going on in the marketplace with some areas on the capacity front. And you mentioned how that could impact the adoption of some of your new products. Which new products would you think that would impact the adoption of?

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

The rate of adoption probably mostly in the CornerStone and some of the additional flex tools.

David Duley - *Steelhead Securities LLP - Analyst*

Okay. That's it from me.

Operator

Your next question comes from the line of Tom Diffely with D.A. Davidson. Please proceed.

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

Yes, good afternoon. So first I would like to follow up on the last question about CornerStone. So the first order last quarter went to a semiconductor OEM. I'm curious, are they using the tool or is it then sent to a packaging house to be used?

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

The answer is not as straightforward, Tom. The first tool will ship to them for internal use and we are in qualifications with some of their supply chain.

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

Okay.

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

Is that clear?

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

Yes. So going forward, with this follow-on for capacity, you would expect it from the packaging houses, then?

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

I would say yes.

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

Okay. And then getting back to your market comments about the volatility, I guess first of all what -- do you know what end markets drove the strength for the GemStone over the last quarter and a half or so? And have you seen any kind of seasonal change quarter-over-quarter or post Chinese new year this year?

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

You know, the GemStone is really focused at the higher end flex circuits, and best we can tell, it is driven largely by the mobile device market. So smartphones, tablets, things like that. I think that's what we believe.

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

And I think in terms of timing, we did see probably a little earlier ordering of those types of tools than we have in other years. So that's a little bit where timing quarter to quarter could change for us. As Ed said, we're going to have quarters that can be a little higher and a little lower. And I think we saw a little bit of that come into Q4.

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

Okay. So fair to say that a lot of the Chinese market was in a deep freeze kind of the second half of last year. There was pent-up demand. They ordered it and got it early last year and now they're going to digest it before the next round?

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

No, I don't think it was a China-centric deep freeze for us. We, quite honestly, haven't seen the impact of some of the more macro Chinese market. And I think it's largely because of the market segments that we're participating in.

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

So I think in this case it was more driven by technology and capability that drives cost of ownership that's really driving the adoption of these tools.

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

Okay. Good. And then, Paul, on the OP expense side, you said this was going to be up a bit. Was that for beta tools? I missed your comment on that?

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

Yes, there's a number of costs that we have that's related to getting these new tools placed in the market. Around putting people out with the tools, doing individual customer--centric applications, work as we meet the specific applications. There are some beta tools and other expenses associated with getting the tools adopted and placed in the market. So -- and then there's just the costs that go with the volumes as we sort of pick up the activity. So it's really, I would say, variable cost. We're not adding fixed cost. But it is related to more activity in getting tools placed and getting these evaluations. As Ed said, we have seen more activity than we anticipated so we're mobilizing to get more tools available and to deploy resources to move through the qualification processes quickly.

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

That's a good problem to have. Just two more questions on the model front. You talked about 35% operating leverage. Is that a good number going forward?

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

In general, our model is 30% to 40% of operating leverage. That's going to vary a little bit quarter to quarter, just based on mix and volumes and things like that. Obviously for the year it was much more because we have been able to sort of take out costs and improve margins as -- you know, gross margins as we've gone along. But from a target model over a course of a few quarters, that's exactly what we would expect.

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

Okay. And then finally, what was the percentage of turns business in the quarter? And do you expect the turns business to go down over time with new products coming out?

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

I would have to get back for you for sure on the amount of turns business. I would say it was pretty typical this quarter. It wasn't, you know, particularly high or low quarter. As we look forward, certainly we're starting the quarter with a fair amount of backlog. So I would expect that a lot of the shipments this quarter will be from backlog because those are committed ship dates and there's a lot of activity around people wanting to have those tools in place. Over the long run, we will have some fluctuation because new tools will take -- they will be out there for a little bit before the orders come in for them. But I guess I'm not expecting there would be a large swing in the amount of turns business we expect quarter to quarter over time.

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

If anything, it will go down just because of the long lead on some of the bigger tools. And the lesser dependence on the Micromachining as a percentage of the total shipments.

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

Yes, I think that's right. The Micromachining tools tend to be pretty short order, 4 week to 6 week kind of delivery times from orders. The other classic tools are more in the 8 week to 12 week time frame. So as our mix shifts over time, and as these other products, nViant, CornerStone and (inaudible) flex tools, to be a bigger proportion, then yes, we would probably have less turns business over time within a quarter.

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

Sounds good. Thanks for your information.

Operator

There are no further questions in the queue. I would now turn the call back to Ed Grady for closing remarks.

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

Okay. Thank you very much for joining us on the call today. You're welcome to call Paul, Brian or me if you have any further questions and we appreciate your time. And look forward to moving forward at ESI. Thank you for attending the call today.

Operator

Ladies and gentlemen, this concludes today's conference. You may disconnect and have a great day.