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ESIO - Q3 2015 Electro Scientific Industries Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESI fiscal 2015 third-quarter earnings call. My name is Jackie and I will be your coordinator for today. At this time all participants are in a listen-only mode, and towards the end of the presentation we will conduct a question-and-answer session. (Operator Instructions) I would now like to turn the conference over to Mr. Brian Smith. Please proceed.

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

Thank you, Jackie, and good afternoon, everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Ed Grady, the CEO; and Paul Oldham, our Chief Financial Officer. This call will cover our fiscal third-quarter of 2015 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. The 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 believed to be accurate as of today, January 28, 2015, and which could change in the future. This call is the property of ESI.

Now, I will turn the call over to Ed.

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

Thanks, Brian. Good afternoon and welcome to our third-quarter conference call. Overall, fiscal Q3 was a solid quarter for ESI as we made good progress on our initiatives to revitalize the Company by introducing new products, expanding into adjacent markets, and increasing our presence in China. We also capitalized on revenue opportunities to deliver financial results at the high end of our expectations.

Revenues were up slightly from last quarter and bookings were down a little. Gross margins came in slightly lower than expected. We continue to manage expenses carefully while investing in the marketing and engineering resources necessary to develop new product and channels to expand our addressable market. The result was an adjusted net loss per share of $0.15, which is better than our guided range. Paul will cover the details of our financial results later.

Looking at some of our key end markets, flex via drilling was solid with significant growth from last quarter and our highest order levels in several quarters. Last quarter we mentioned that we had penetrated and received an order from a new customer which is the largest manufacturer of flex circuits in the world. This quarter we received a follow-on order from this customer.

In addition, we won new business at another large flex manufacturer. However, the timing of their demand has been pushed out to next year. Combined with the normal seasonal pattern in Q4 and continued overcapacity in Korea, this push out will create a relatively soft period in Q4 for this business.

The microfabrication business was about flat. However, we won a Lumenesi qualification order with a new customer, consumer electronics customer, and we have several opportunities in the pipeline which can utilize this platform.

The demand was up sequentially in our semiconductor business. Early in the quarter we received a qualification order from a major semiconductor manufacturer for our new thin film scribing tool. As this market develops it could represent a nice upside to us, leveraging the technology investments we have previously made in this market.

Our components business was down for the quarter, but we are seeing increased signs of modest demand as we look to the next few quarters.

I am pleased with our financial execution in the quarter and with the progress we have made in delivering to our milestones and putting in place the foundation that will drive growth for ESI. Probably the most significant accomplishment is our acquisition of Topwin Optoelectronics, a manufacturer of laser systems located in Wuhan, China. This acquisition will accelerate our China strategy. First, it gives us a solid portfolio of performance systems addressing lower-cost applications. Second, it provides a springboard to address new applications within China. Third, it gives us access to very efficient and low-cost China-based supply chain. And fourth, its systems and platforms, when incremented with ESI technology, will open up many new applications and markets for both inside and outside of China.

In addition to the Topwin acquisition, we completed the buildout of our new Shanghai Center for Advanced Development and are in the process of increasing our local applications and engineering resources to complement the Topwin team.

Another of our growth initiatives involved entering adjacent segments of the PCB market. Earlier this month we introduced the CornerStone ICP platform, which is a high-performance via drilling system for integrated circuit packages. CornerStone ICP beats today's competing systems on total cost of ownership and is extendable into the next-generation performance requirements. The market for via drilling and IC packages is over $200 million today and is growing faster than the overall PCB market. The nature of this product is such that it takes approximately six months after installation to get it qualified in customers, and we have seen near-term customer interest and expect to ship the first qualification unit later this quarter.

Another key element of our revitalization effort is deploying our own internally developed lasers in our systems. During Q3 we qualified a second internal laser platform into one of our key systems. The new laser is unique in that it delivers more power to the material surface, which gives the system dramatically higher throughput. We will be announcing more about this new platform at the PCCA show in Shanghai in March.

Turning to our outlook for the future, the key to our revitalization effort is growing the top line by expanding our addressable market. We outlined our plan for doing that at last quarter's analyst day and we are tracking to milestones we set forth at that time. It's still too early to see the impact of these steps in our financial results, and our recovery will not necessarily be linear. However, we are already seeing early indications from customers that we are on the right track.

In addition, the credit financing that we are putting in place will provide us additional flexibility as we fund investments needed to revitalize the Company. Overall, I'm very pleased with our progress and am confident that we are, as a team, taking the right steps to turn ESI around and put it on a long-term growth path.

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

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

Thank you, Ed, and good afternoon, everyone. The following information includes results from our third quarter of fiscal 2015, which ended December 27. 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, acquisition costs, and other items.

Bookings for the quarter were $40.6 million, down from $43 million last quarter but up from $35.6 million a year ago. Bookings in our interconnect and microfabrication business were down slightly from last quarter. Flex via drilling was up sequentially and at its highest level since Q1 of fiscal year 2014. Advanced micro-machining orders were about flat, but service bookings were down following record contract and on-demand service levels last quarter.

Bookings in our semiconductor business were up primarily due to the first qualification order for the next-generation semi scribing system. Orders for component tests decreased seasonally after good systems demand last quarter.

Shipments were $34.9 million. We also received customer acceptance for the first Lumenesi systems, shipped primarily in our second-quarter and contributing to the reduction of about $8.5 million in deferred revenue. Backlog increased by $5.4 million to $38.1 million and our book to bill ratio was 1.16.

Revenue for the quarter was $43.7 million, up 2% from last quarter. Revenues came in higher than our guidance, primarily due to customer acceptance of new products, some of which we had projected to occur in Q4.

GAAP gross margin was 36.1% and included $317,000 of purchase accounting and equity compensation in cost of sales. On a non-GAAP basis, gross margin was 36.9% compared to 37.7% last quarter. The lower gross margin was primarily due to timing of warranty expenses associated with [newer] products and extended warranty and the impact of lower shipments. Looking forward to next quarter, we expect adjusted gross margin to be up modestly.

GAAP operating expenses were $21.8 million including $975,000 dollars of equity compensation and purchase accounting, plus about $300,000 of acquisition costs related to the Topwin deal. We expect to incur an additional $300,000 to $500,000 in acquisition and transition-related cost in the fourth quarter.

On a non-GAAP basis, operating expenses in Q3 were $20.5 million, just about flat with last quarter. We expect adjusted expenses next quarter in the $21 million range, primarily due to the added cost of Topwin and higher product launch costs associated with CornerStone and Lumenesi.

On a GAAP basis, operating loss was $6 million. Non-GAAP operating loss was $4.4 million compared to a loss of $4.2 million in the prior quarter. On a non-GAAP basis, income tax expense was [$343,000], reflecting foreign taxes. We expect Q4 tax expense in the same range.

GAAP net loss was $6.4 million or $0.21 per share compared to a loss of $0.20 per share last quarter. Adjusted net loss was $4.7 million or $0.15 per share, compared to a loss of $4.9 million or $0.16 per share last quarter.

Turning now to our balance sheet, cash and investments were $80 million at quarter end. We used $13.4 million in operating cash during the quarter, largely due to a combination of factors. Our operating loss adjusted for non-cash expenses was $2.9 million. Inventories for the quarter increased by $3.7 million. Inventory turns were approximately 1.9 times. Accounts receivable increased by $1.1 million to $41 million. DSO remained about flat at 85 days.

Lastly, current liabilities decreased by $8.7 million, impacted by reductions in deferred margin I mentioned earlier and the one-time retirement payout to a former executive. In addition, capital expenditures were $1.2 million. Depreciation and amortization including purchase accounting was $2 million. And we paid $2.4 million as a quarterly dividend.

We also announced today that earlier this month we signed a term sheet for a three-year revolving line of credit through Silicon Valley Bank of up to $30 million. We believe this facility and the relationship with SVB will give us more financial flexibility through this transition as we drive our growth initiatives.

In summary, we are putting in place the building blocks which will drive growth for ESI. At the same time, we are staying disciplined in our spending and have added a line of credit to give us additional balance sheet flexibility. We are confident in the steps we are taking, but we expect to see some continued volatility in our results until our new products are fully adopted in the market. We expect fourth quarter to be down seasonally, consistent with previous years, largely due to capacity absorption across most of our markets, the delayed ramp for our new flex customer, which is moving into fiscal year 2016, and continued softness in the Korean supply chain.

While we have several opportunities in the pipeline and potential upside related to some of the actions we've taken, we believe it is too early to count on these in our current projections. As a result, we expect fourth-quarter revenues to be between $32 million and $40 million. Adjusted loss per share is expected to be between $0.22 and $0.32.

Now, I will turn the call back to it for a brief summary.

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

Thanks, Paul. While we are not happy with our Q4 guidance and continued volatility, turnarounds of this magnitude take a couple of years. We have been consistent in this message.

On a positive note, in the past last nine months, we have successfully defended our core flex market and begun to penetrate two very large new customers in this market. We have introduced three new products, two in large existing adjacent markets. We have deployed new in-house-sourced lasers with more in the pipeline. We completed a key acquisition in the largest geographic market for laser systems, leveraging a stream of new products and removing barriers to entry.

We have built from scratch an effective global marketing organization. We have substantially expanded our sales channel on a variable cost basis. We have localized our customer applications and development capability in key regions. We continue to improve operational efficiencies and cost reduction through implementation of lean processes.

While we are impatient for the payback of these investments to show up on our top and bottom line results, we believe we are still on track to deliver our turnaround plans. We are focusing on the entire energy of the Company to commercialize our technology, expand our market, and grow our revenues and improve financial results.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) James Ricchiuti with Needham & Company.

James Ricchiuti - *Needham & Company - Analyst*

The question I have is just with respect to the guidance. It's clearly a wider range than we've seen in the past. I wonder if you might be able to talk about what areas of the business that you might be more cautious about relative to the low end.

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

Well, Jim, I think the key answer is that in the micro-machining space we have, as we've experienced over the past several quarters, those are big lumps of business. And it's just so hard to predict the timing of when those orders come in that it just puts us in this box of having to open the range up. That's probably the biggest issue we are facing.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

And I'd add, Jim, on the low end of that it's just a seasonally lower quarter for us typically. And that primarily affects our traditional markets in flex and MLCC. And particularly with Korea being continued in overcapacity, it's hard to gauge the timing as customers start to put in new orders and take systems for next year's ramps.

In fact, as we mentioned in the call, we already had one customer that we saw orders for that have moved some of their demand out of the fourth quarter and into next fiscal year. So I think that characterizes the downside of that range. And I think Ed described, to some degree, part of the upside of that range.

James Ricchiuti - *Needham & Company - Analyst*

Okay, that's helpful. Thanks, Paul. And just with respect to that last point about -- that both you and Ed have made about this additional large flex manufacturer -- so some of that business is slipping into fiscal 2016. Do you have a sense whether that's Q1, Q2?

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

As best we know now, it's spread throughout the year, Jim. There could be some part of it in Q1. I would expect the more dominant piece to be in Q2, though.

James Ricchiuti - *Needham & Company - Analyst*

And, Ed, you talked about large opportunities. And these two wins that you have what appear to be in that category of large opportunities. Is that fair to say? And are there other ones that you are close to, do you think?

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

First answer is, no question, the penetration of these customers, who are the two largest manufacturers of flex circuits in the world is a significant upside for the long haul with us. I guess the other side of it is, what are the big opportunities that we have? And our opportunities in the micro-machining marketplace have increased, I'd say, much more than they have in the past couple years. So I think that's the big lumps. And lastly, I would add that the upside that we see from the Topwin acquisition is really significant. Those are the three big legs of the stool.

James Ricchiuti - *Needham & Company - Analyst*

Okay, thanks. I'll jump back.

Operator

Mark Miller with Noble Financial Capital Markets.

Mark Miller - *Noble Financial Group - Analyst*

You've seen, since the fourth quarter of 2014, a significant reduction in cash. Cash fell again this quarter. And I'm just wondering what your outlook is for cash in the next couple quarters.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

Yes, we expect that we will continue to burn cash. I think, in the near-term as we look to next quarter, we will have probably less of a burn from operations, although on a larger loss. There will be less impact for working capital. And of course, we will have the cash from the Topwin acquisition. As we move into next year, we would expect the one-time items that hit us this last quarter and the Topwin acquisition -- those aren't going to be there. And so largely be boiling down to cash from operations as we continue to improve the results of the Company, which ought to narrow the cash burn as we go into next fiscal year.

Mark Miller - *Noble Financial Group - Analyst*

I think Apple made a decision to shift some of its -- a decision that was kind of up in the air about orders for Samsung. I'm just wondering if that has an implication for you.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

Not directly.

Mark Miller - *Noble Financial Group - Analyst*

Thank you.

Operator

Jairam Nathan with Sidoti.

Jairam Nathan - *Sidoti & Company - Analyst*

So I had a few. First, on the qualification order for thin film scribing, when do you think that will get into revenue?

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

I think that's a longer-term program that will evolve over the next couple years. I don't see that as a short term. There will be some impact in fiscal 2016 but the larger impact is beyond fiscal 2016.

Jairam Nathan - *Sidoti & Company - Analyst*

Okay. You mentioned the semi business saw some good growth sequentially. And you mentioned the trim business was strong. Can you provide us some more details? And how should we think about it going forward?

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

Well, there's two parts of the semi business, as you point out. The new win plan of record in describing business is actually a significant opportunity for us. And the trim business is cyclical, much like a couple of the other businesses. So we had a really good quarter last quarter. We would expect that kind of cyclicality to be preserved in the coming fiscal year as well.

Jairam Nathan - *Sidoti & Company - Analyst*

Okay. And lastly, on the credit facility I'm guessing that there will be some quarterly expense for the credit facility to be maintained. How significant is that? And then also wanted to understand the Topwin contribution in the fourth quarter.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

Yes. I think, if I got your question right, Jairam, you are asking about the expenses related to the credit facility. They are relatively de minimis on an undrawn basis. We haven't disclosed the terms of that yet because we are finalizing the loan documents. But they would be less than $0.01, certainly, on cost. And I think the drawn cost of those are going to vary based on various tiers of Company performance but would be commensurate with what you see in the market today for these types of facilities.

Jairam Nathan - *Sidoti & Company - Analyst*

Okay. And lastly, I also wanted -- does your revenue estimating -- I'm guessing it includes Topwin. And what is your in-built assumption for Topwin in the first quarter?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

Yes, the range does include Topwin. And we think if -- Topwin we acquired at the beginning of January, January 15 was the close date. And so we would expect it to be pretty small, in the $1 million-plus range for this first quarter.

Jairam Nathan - *Sidoti & Company - Analyst*

Okay, that's all I have. Thanks.

Operator

Tom Diffely.

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

First question here, when we look at the new products that you just announced, what kind of impact, if any, will that have on the model in terms of margins or kind of structure?

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

I'd say the margin structure -- difficult to answer, but the products are designed to have margins that support the structure that Paul has talked about, which is a breakeven at $200 million, $50 million a quarter, 40% gross margin. I think a lot of the leverage comes in volume. When you start

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increasing the volume I think there's some upside potential behind that as the volume increases. But generally, I think the way you should look at any of the new product developments is they tend to deliver gross margins in the 40%-plus range.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

And I'd add that we would expect that for both the -- I'll call it the higher-end tools as well as the lower-cost tools as well. I think that's the big thing that has changed is, particularly with Topwin and our new modular architectures we would expect to be able to compete more effectively in the mid-range of these markets and still preserve margins in that 35% to 45% range.

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

So, Tom, just one other quick comment on gross margin -- keep in mind what of the big issues that we are working to resolve now and fight is the absorption of overhead from a manufacturing perspective. So when you look at gross margin, running below the $200 million level has a significant impact on gross margins. Once we get to $200 million, which is where we are headed, I think you will see the margins see much, much more stability.

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

Okay. And would you expect to see any kind of a kicker happened when you start implementing or inserting more of your own internally developed lasers (multiple speakers)?

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

Paul?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

There will be some impact to that. We have talked about that in the past, that that could be, in the long term, up to 100 to 200 basis points. So that will definitely have an impact. It will be a little bit hard to segregate because a lot of what can happen, I think, is we will have more capability for the price. And that will give us a better ability to win on a cost of ownership basis. And it will clearly be supportive of better gross margins as well.

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

Okay. And then the new Lumenesi product -- would you expect to sell that through the Chinese channel, through Topwin? Or is that truly a lower end market where you have a very customer or a very specific tool to go through that organization?

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

Well, let me answer the question. The Topwin platforms that we will sell are Topwin-design platforms. They are very conservatively low-cost platforms that we intend to leverage throughout the whole mix of our product line. The Lumenesi product line is more targeted to midrange. And so, we do not intend to mix the Lumenesi back into the Topwin channel. That would get sold directly through our direct and represent channel, rep channel.

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

All right. And then in any one quarter, what is the potential for turns business with your current lineup?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

Well, we tend to have about 40% of our business on turns in any given quarter. I think as we move forward, because of the nature of these lower-cost and lower-end products, we will have the potential to have a greater proportion of turns because they will have shorter lead times.

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

Okay. But I guess, being nearly a month into the quarter, is it at the point now where we are past turns business that start tomorrow? Or can they be turned within the next two months?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO, VP of Adminstration, and Corporate Secretary*

No. We clearly have opportunity for turns business over the next couple of months.

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

Okay. And then finally, you mentioned some improving industry trends in the components business. I wonder if you could just elaborate on that a little bit.

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

Yes. I think what we are seeing there, Tom, is for the larger-sized chips we have seen a long time where there just has been not much activity and a lot of overcapacity. And that capacity is running in the 80%-plus range now. And so we are seeing some opportunities here and there where people are beginning to add in a few tools. And compared to a long dry spell, that's encouraging.

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

All right. Well, thank you.

Operator

Pete Enderlin, MAZ Partners.

Pete Enderlin - *MAZ Partners - Analyst*

On the Topwin acquisition, is the earn out based on sales, or earnings, or a combination of both?

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

Net profit after tax in China.

Pete Enderlin - *MAZ Partners - Analyst*

Okay. And what would you characterize their main strengths to be? Is it essentially product development, or some distribution capabilities, or connections that they have?

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

Pete, it's really a broad spectrum. So let me start with their design philosophy is very much commercial off-the-shelf parts, very fast build cycles and short-term delivery to customers, very responsive to customer requirements in China. So it's very typical in China to have a customer come in and want to have a operation tested on the machine, and they want machines like a week and a half later. So you have to be able to turn on a common platform, and that's one of their core strengths. They have a few common-platform, a lot of commercial off-the-shelf parts and a very quick turn time.

The second part, more leverage for us at ESI, is that their base platform we believe we can leverage and put some of the ESI intellectual property in optics and laser controls technology on that will leverage us into other higher-end parts of the market but with a lower-cost platform where we can compete again.

So it really is a multifaceted leverage on the growth of the Company. I would come back to one of the core reasons that we acquired Topwin is to get the capability of the company but also to take down what I call artificial barriers to entry, which is the compliance cost and some of the other issues we have to deal with when we send -- design products in Portland, build them in Singapore, and then ship them through customs. My contrasting comparison is a local Chinese company can build the product and ship it to their customer in a week. It takes us sometimes three weeks to get our through customs in China. So by reducing those barriers to entry we have a much better ability to compete in China. And so design in China, build in China to meet China requirements in the largest single geographic segment for laser systems is our strategy.

Pete Enderlin - *MAZ Partners - Analyst*

That obviously makes a lot of sense from your standpoint. Can you address the question about why they were willing to sell at this point in time?

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

They are a small company that wanted to grow. And I think the reputation that ESI has in China is exceptionally strong from a technology perspective. It's consistent with where they want to position themselves. And it came together as a mutual best interest in both parties.

Pete Enderlin - *MAZ Partners - Analyst*

Can you help us understand what happens to old equipment when it gets either traded in or shut down? I just don't quite know what the typical lifecycle and outcome of that is.

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

It varies. I would say some of the products have life cycles in the, let's say, 10-year timeframe. And typically at the end of that 10 years they get retired and thrown away. There are cases, some unique cases where we will have a new product in an area like flex drilling, where we will work with the customer and they want to completely upgrade their installed capability, and we will work out commercial terms that may include some trading capability. But that's not the normal practice for us. Most of the time the products are completely depreciated and just disposed of.

Pete Enderlin - *MAZ Partners - Analyst*

Okay. All right, thanks a lot.

Operator

Ladies and gentlemen, that concludes our question-and-answer session. With that, I would like to hand the call back over to Mr. Ed Grady for closing remarks.

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

Thank you very much for joining us on the call. You are welcome to call Paul, Brian, or me if you have any further questions. Thanks for attending today's call.

Operator

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