THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ESIO - Q2 2018 Electro Scientific Industries Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 01, 2017 / 9:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

David Duley

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

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESI FY '18 Q2 Earnings Call. My name is Natalie and I'll be your operator for today. (Operator Instructions).

I would now like to turn the conference over to your host for today, Mr. Brian Smith. Please proceed.

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

Thank you, Natalie, and good afternoon, everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Michael Burger, our CEO; and Paul Oldham, our Chief Financial Officer. This call will cover the results of our fiscal second quarter of 2018. Before we go into the details of the call, I would like to remind you that some of what we say in this call will include forward-looking statements. These statements are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are subject to a number of risks and uncertainties that are discussed in more detail in today's press release and our filings with the SEC.

Actual results may differ materially from these forward-looking statements. This call also contains time sensitive information that we believe to be accurate as of today, November 1 2017, and which could change in the future. This call is the property of ESI.

Now, I will turn the call over to Michael.

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

Thank you, Brian. Good afternoon and welcome to our call. We had a very strong second quarter with revenues more than doubling from a year ago, adjusted earnings per share above projections and operating cash flow at its highest level in several years. Bookings came in at $129 million for the quarter, up 68% sequentially, driven by a very robust manufacturing environment, which continues to rely upon our laser processing tools and expertise. While this exceptional order performance was influenced by our flex drilling results, we again saw broad strength across our business with year-over-year and sequential order growth in all of our major product categories.

Finally, we've executed on our restructuring plans, which we discussed in February and have completed the actions required to achieve our reduced fixed cost model going forward. Demand in the flexible circuit market has traditionally been slower this time of year. However, we saw extraordinary demand this quarter driven by capacity adds related to overall device growth along with the introduction of several new material, technology, and applications in the consumer market.

Within the smartphone market specifically, new display, sensing, and RF features and technologies drive the interconnect requirements within these devices, which means more flex circuits per device at higher complexity. Our industry leading 5335 family of products is ideally suited to meet the technical and throughput challenges of these new applications.

Our current product offering, application knowledge, and product roadmap have earned us the leadership market position we enjoy today. Simply put, we believe the TAM for these products has expanded and we have maintained or gained market share.

Looking forward, we are in an exceptional period for flex drilling systems demand, which we believe will continue for the next couple of quarters. We believe that the underlying technology drivers in the flex market are real and longer-term in nature. Transparency market research projects the flexible circuit market will grow at 11% CAGR through 2025. However, our flex business will continue to be subject to seasonal and capacity factors, and we would not except the current business levels to repeat next year.

Within the high density interconnect market, we continue to make progress with customers in evaluation and development of our nViant platform and expect to announce the next iteration of this tool in the near term. We had a very good quarter in semiconductor products highlighted by multiple orders for our new Ultrus wafer scribing tool. It is exciting to see initial high volume manufacturing ramp of these products that will ship over the next several quarters. In addition, we had a strong quarter in wafer mark and trim products. Overall, it was our strongest booking quarter for semiconductor products in over 10 years, reflecting the strength of the semiconductor manufacturing environment.

Demand for our component test products also grew in the quarter to its highest level in over 4 years. We appear to have finally overcome the overcapacity situation that has plagued this market over the last several years. We expect continued solid demand for our component test products driven by consumer electronics, automotive, and RF technologies. In addition, we have completed the restructuring activities needed to achieve our targeted cost model and are on track to realize a lower fixed cost structured we committed to in February. as evidenced by our sequential decrease in operating expense in Q2.

Our new management structure is in place and operating extremely well. I am particularly pleased with the execution of our operations team and our supply chain partners and their ability to respond to the ramp in demand without sacrificing quality or our on time delivery performance. In summary, we've achieved excellent results this quarter due to the strength in our current markets and are excited about opportunities in the near term. Our business visibility beyond the next couple of quarters is still very limited and still subject to seasonal and capacity factors.

However, we believe the long-term growth drivers for our business are healthy. Our investments in new products are progressing and will contribute meaningfully to growth over time. Finally, our new business (inaudible) enabled us to be financially resilient to changes in business levels and deliver improved profitability and consistency of earnings.

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

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

Thank you, Michael, and good afternoon, everyone. The following information includes results from our second quarter of fiscal 2018, which ended September 30, 2017. To improve comparability, we are also providing earnings per share and related income statement results on a non-GAAP or adjusted basis, excluding the impact of purchase accounting, equity compensation, restructuring, asset and inventory impairments and other items.

Bookings were $128.9 million, well above last quarter and more than 4 times the order level a year ago. The order levels reflected the robust market conditions and strong flex orders Michael discussed. It is worth noting that this reflects our highest quarterly orders since Y2K and our first half orders are well above all of last year.

In addition, although flex had a remarkable order quarter, non-flex bookings were at their highest level in over 5 years. Backlog grew by over $47 million to $118 million. Our book to bill ratio was 1.82 to 1. We expect to shift the majority of this increase in backlog over the next 2 quarters.

Revenue for the quarter was $71 million, up 139% from a year ago and down 2% sequentially. Revenue was slightly above the high end of our guidance due to several orders that were both booked and shipped in the quarter.

GAAP gross margin was 37.4% and included approximately $6.1 million of charges for inventory and other asset impairments associated with the final actions of our restructuring program and the related product portfolio review. Also included in cost of sales was $319,000 of purchase accounting and equity compensation. On a non-GAAP basis, gross margin was 46.4%, well above the 38.2% from last year and about flat with last quarter on similar volume. Looking forward to next quarter, we expect adjusted gross margin to also be about flat with less favorable mix offsetting the benefit of higher volume.

GAAP operating expenses were $22.1 million and included $1.4 million of equity compensation and purchase accounting. It also included $2.2 million of restructuring charges, largely related to final headcount reductions and facility closures.

On a non-GAAP basis, operating expenses were $18.6 million, slightly below last year with significantly lower fixed costs partially offset by higher variable costs associated with the higher revenues. Operating expenses declined sequentially reflecting the impact of our cost reduction actions. Looking forward, we expect adjusted operating expenses to rise slightly driven by higher variable costs and timing of engineering project expenses.

As Michael stated, we are happy to report that we are fully at our new fixed cost operating model in Q3. On a GAAP basis, operating income was $4.4 million compared to a loss of $9.9 million in the same quarter last year. GAAP operating income included $8.3 million in total restructuring costs and asset impairments. Of the $8.3 million, approximately $2.4 million was cash related. Non-GAAP operating income was $14.4 million, or 20% of sales compared to a loss of $7.6 million in the year-ago quarter. Adjusted operating income improved sequentially primarily on lower operating expenses.

Adjusted EBITDA was $16 million or 23% of sales. The GAAP tax provision was a small credit due to timing of income between quarters. Non-GAAP tax expense was around $400,000 and we expect non-GAAP Q3 tax expense to be in the same range.

GAAP net income was $4.3 million or $0.12 per diluted share compared to a loss of $0.30 per share last year. Adjusted net income was $13.7 million or $0.39 per diluted share, higher than last quarter's low, which represented a multiyear high compared to a loss of $7.7 million or $0.24 per share last year.

Turning now to our balance sheet, total cash, restricted cash, and current investments were $81.9 million at quarter-end, up from $69.7 million last quarter. We generated $18.3 million of operating cash during the quarter. We are particularly pleased with the efficiency of the balance sheet as we have increased revenue significantly over the last few quarters without growing working capital.

Accounts receivable decreased sequentially by $1.4 million to $47.8 million. DSO stayed flat at 61 days. Net inventories decreased from last quarter by about $800,000 to $61.4 million despite higher projected shipments, primarily as a result of the inventory impairments related to discontinued products. Inventory turns were approximately 2.9x.

Accounts payable and accrued liabilities increased by $6.8 million related to the receipt of customer deposits and the timing of payroll accruals. DPO was 50 days.

Capital expenditures were approximately $1 million below our target model of 2% to 3% of sales. Depreciation and amortization, excluding purchase accounting was $1.6 million.

Now, let me turn to the outlook going forward. For Q3, we expect revenues to be between $80 million and $90 million and non-GAAP earnings per diluted share to be between $0.48 and $0.60. Given order and backlog projections, we expect Q4 to be in a similar range. As Michael described, we are seeing extraordinary demand this year. As we look forward, our visibility into next fiscal year remains limited. Nonetheless, we believe that increased [CAM] and flex circuits, long-term growth drivers in our markets, and contribution of new products will help mitigate the impact of the extraordinary capacity additions this year and help drive long-term growth.

Finally, our new financial model gives us the ability to deliver profitability, cash flow, and consistency of earnings.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from line of Jaeson Schmidt with Lake Street Capital Markets.

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

I just want to start first on your comments, Michael, on you guys think you have maintained or grown your market share certainly with early strong results this year. Do you think that's more a function of just a rapidly expanding market or you guys really do feel like you gained significant share in each of your markets?

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

I think maybe a better way to say it is we are not aware of any orders that we have not participated in. We believe that we have seen literally every quote that's gone down and we know what we've won and what we lost. So I think it's ground up.

We actually believe that at a minimum, we've maintained and we haven't, frankly, the dust hasn't settled yet but I think it's probably more than likely that we gain share.

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

I know the inherent lumpiness of the industry is something you guys can never get around and it sounds like visibility longer-term remains somewhat cloudy. But could you comment on how lead times have currently been or expectations for lead?

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

We have been under a lot of pressure from our customer base to deliver actually within our stated lead times, which range from 6 to 8 weeks. As I said in the script, we're very pleased with our supply chain partners. They've been able to expedite product deliveries and we really -- we've been able to kind of stay within that lead-time. So I think we are under pressure to deliver more quicker but we don't believe that we have lost an order because of lead time or our inability to deliver to request.

Operator?

Operator

Jason's line is open.

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

Why don't we go to the next question then? If Jaeson gets back online, we'll circle back with him.

Operator

The next question comes from Tom Diffely.

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

Last quarter when you had us build in a little bit of seasonality in the fourth quarter, fourth calendar quarter, I didn't realize it was actually positive seasonality.

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

I guess neither did we.

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

It's been a very dynamic couple quarters for sure.

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

So I wanted to dig in just a little bit more on the increased demand you're seeing this year. Do you have a sense that some of it is from under investment the year before? Are these tools obsolete and old tools that just can't handle any more? Is it purely just the number of holes that you need to drill that goes up?

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

We actually think there may be a bit of catch up in terms of last year's demand. Again, it's hard to quantify because a machine is a machine. It's used for a number of different applications but our theory is going on the fact that yes, demand may have been a bit lax by virtue of the fact that the market has been kind of on its heels for last couple years. And so there may be some recovery there.

But we also believe what we've said, which is we believe the overall market is expanding at a pretty fast rate. You overlay some of the forecast for some of the multiple phone guys and their increases, that actually is also an accelerator and I think both of those things happening coincidentally roughly at the same time has really kind of driven this kind of extraordinary situation we're in.

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

Why do you think it's even stronger now than it was, say, 2 quarters ago when you would have been in front of a build cycle?

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

I think our understanding is that forecasts continue to grow for the end units, the cellphones themselves that they're being slated for and that has put our customer base under a lot of pressure to drill more flexible circuits. So I think that's really -- that's what's driving it.

There also have been a number of new applications that have been introduced recently as capacity would be normally added from a timeline perspective. On top of that, there were some extraordinary new materials, new technologies that were kind of happening coincident with that and

I think that also drove the incremental demand. And so we really -- it's kind of a confluence of 2 things happening at the same time and that's our best guess as to what's driving the overall demand.

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

I noticed on your prepared remarks too you put a little extra emphasis on meaningfully growing the non-flex business over time. Is there something that happened during the quarter that gives you more confidence in some of these new products you're working on?

Yes, I think that the more we talk to our potential HDI customer base, we're getting more and more confidence. That's very positive. We saw a really nice acceleration on our new Ultrus wafer scribing tool, which is also welcomed and arguably expected. The component test business, which is an older business for us, but actually extremely profitable, and frankly, we have a leadership position in that space. We've seen a lot of demand in that business and I think that particular end market is really interesting to us as that it is not necessarily just related to consumer electronics. It has its fingers into the automotive space, into the RF space in general, and of course, cellphones.

So I think the confluence of semiconductor, component test is really bullish. And as we said, we're hitting all-time highs in some of these businesses in terms of booking levels. So we're very excited about the fact that we've got 3 stools -- flex, which is obviously the biggest; semiconductor, which is quite strong; and component test, which is doing very, very well. And then the promise of the new products in nViant and Ultrus. The market seems to be very excited about all of this stuff right now.

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

Just one side note on the component test side. Is it due to the smaller components or is it just the units that were all going up?

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

Units are going up. Smaller components as a mix is growing and we are very interested in expanding our offering into new areas, for example, some of the larger chip and specialty chip. And we think our conversations around the fact that we are entering into these new spaces has generated a lot of demand for our existing product.

So yes, I think the drivers our real. RF is primarily the big driver and we've had a very strong position in this marketplace. But as I think I said in our remarks, we believe that there's been an over capacity in test systems for some time and it looks like we've kind of worked through that. And so now, we're seeing perhaps more of what we would expect as an ongoing run rate in that business and it should accelerate as we enter the large chip and specialty chip markets.

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

And then Paul, moving over to the model, how much would you estimate that -- I guess if you look at the operating expenses for what you just reported, is that pretty similar to the ongoing base level that you would assume? You said that obviously, they're going to go up next quarter because of the increase in R&D spending. But in general, does the reported results reflect the floor?

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

Yes, I think at these revenue levels it's pretty close. I think if revenue levels declined from the $70 million back down to $50 million or something, we would see those expense come down commensurately. And so our fixed cost base and actually come down more than the total expenses because of just cost related to higher revenues.

And so I think that's the beauty of the model here is that expenses in total are down. The underlying expenses are down more and then the variable piece will move around with our volumes.

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

Would you expect any recurring restructuring costs in the December quarter?

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

No, I think we're basically done. There's a few things that GAAP requires you to take a little bit over time, like some facility things like that but we're down into just noise levels. There's nothing significant left.

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

Then finally, when we look across the laser markets, especially on the industrial side, we're seeing a huge demand across the board. Has it been an issue for you to get any parts and pieces for your products?

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

We've had some issues but our supply base has been tremendous and we've been able to work through and work around some of the shortages. That being said, I think we've now been in this ramp for a couple quarters and I think we're now pretty -- I think we've got smooth sailing ahead as it relates to, one, we know what our backlog looks like. That backlog has been in place on our vendor set and they're dealing with it. So I think we're in pretty good shape right now, Tom.

Operator

(Operator Instructions) Your first question comes from David Duley with Steelhead.

David Duley

I was wondering if you could give a little bit more detail about the new applications and materials that you're addressing in the flex market?

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

No, unfortunately, David, we're under NDA for a lot of the material stuff. So unfortunately, no. I will say it's driven primarily in the cellphone business.

David Duley

Maybe just to expand on your prepared remarks, you had mentioned that you're seeing I think incremental applications in display and RF and one other thing. Could you just talk about those applications?

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

Yes, we have seen -- I think we talked about OLED in our last call. OLED seems to be one of the drivers for a specific set of customers. We're also seeing a lot of the RF module and RF applications that actually cut across perhaps cellphone guys and so we've seen that -- the structure of those modules changing and in fact, now, utilizing laser drill where in the past they haven't. So we feel good about that and I think that should be part of the ongoing TAM expansion.

And then if you look at any of the breakdowns on any of the new phones that have been introduced, just the sheer number of flex circuits per phone has gone up pretty dramatically and I think all of those things, that's kind of a confluence of 2, or 3, or 4 different things but it seems to be driving this 11% CAGR projection that we've mentioned in the script.

So I think RF modules, a lot of this new sensing capability, some of the new haptic physical feedback mechanisms, all of those are driving I think more complex flex circuits and more complexity -- actually, complexity is our friend. More complex it becomes, I think the more -- the better suited our solutions are for our customer base.

David Duley

You mentioned you had a really good quarter with this new scribe tool. I was wondering is there certain trends in the marketplace that are driving adoption of the tool, like perhaps some sort of wafer level packaging, or fan out, or something like that? Or what is it that have all of a sudden caught customer's attentions where they want to buy this tool?

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

Depending on which customer we're talking about, there's different needs. I think overall, though, I can say that the use of thinner wafers is really driving most of the applications that we're involved in. They're each using it specifically for a different application but it's all -- the common thread through all of it is thinner wafers.

David Duley

So some of these new advanced packaging trends are being picked up with the demand for this tool.

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

Well, we're really focused on the wafer itself and the back end wafer processing. But I think the new packaging technologies and the requirements for those are driving some of the demand for the Ultrus. But it's one step removed. Our applications are on the wafer themselves, not necessarily related to package directly.

David Duley

Paul, I think I heard something in your prepared remarks about March quarter being flat with the December quarter. If you could help me understand why you -- I guess you must have really good visibility into that quarter at this point to make that projection and what gives you the confidence to do that at this point?

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

I just think given the level of backlog that we've built and as we've mentioned, the majority of that increase is expected to ship over the next couple of quarters. Michael talked about there's a lot of pent up pressure in the supply chain to get these tools that this current environment that we're seeing in the supply chain gives us confidence that for this quarter and next, we should be in about the same range.

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

We've got backlog scheduled through the next 2 quarters, which is actually unusual for us. We typically -- well, it's not unusual but this level of coverage into the second quarter out is unusual and that's driven by this $128 million booking this quarter.

David Duley

You painted a picture about next calendar year where I think you said you would guess that your flex business would be down and your other businesses would be up. Care to take a stab? Does that equate to overall revenue growth or how are you thinking about that?

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

Well, we don't give annual guidance for this very reason because our visibility a couple quarters out is poor. I think that we're trying to signal is that FY '17 was a pretty poor quarter for flex demand overall, and obviously, this year -- or annually, I'm sorry, FY '17 annually was a pretty slow quarter or slow year for flex. This year, obviously, is shaping up to be extraordinary.

We haven't said anything forward guidance but we don't believe that the business -- because of this TAM expansion, will retract back to the FY '17 levels. We don't think that's the case. But we're hesitant to say that it's going to be staying at these current levels that we're going to finish FY '18 out.

So we do think for model's sake, we think it's prudent for you guys to think somewhere between where we are today and where we were in FY '17 for flex is prudent. The semiconductor business, the component test business, those businesses look like they've got some legs that are going to continue to grow into '19 but as you know, in terms of scale, those businesses are relatively -- are smaller than the flex business.

So the model has got a lot of moving pieces from a revenue perspective. Our visibility goes out 2 quarters for all of our businesses. Semiconductor and component test look pretty strong through FY '19. We just don't have a lot of visibility in flex beyond Q1.

Operator

At this time, there are no further questions in queue. This concludes the Q&A session of today's call. I'll now turn the call back over to Mr. Michael Burger.

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

Thank you very much for attending the call today. We are obviously very excited about the results for the quarter. We're very excited about Q3 and the future and can't wait to talk to you next quarter. Thank you very much. Bye.

Operator

Ladies and gentlemen, that concludes today's conference. You may now disconnect and have a wonderful day.
