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Electro Scientific Industries, Inc.	ESIO	Q2 2013 Earnings Call	Oct. 25, 2012
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PARTICIPANTS

Corporate Participants

Brian Smith – Director-Investor Relations
Nicholas Konidaris – President, Chief Executive Officer & Director
Paul Oldham – CFO, Secretary & Vice President-Administration

Other Participants

Mark S. Miller – Analyst, Noble Financial Capital Markets
Jim A. Ricchiuti – Analyst, Needham & Co. LLC
David Duley – Managing Principal, Steelhead Securities
Tom Diffely – Analyst, D. A. Davidson & Co.

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to your ESI Fiscal 2013 Q2 Earnings Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] And as a remainder, the conference is being recorded.

I'll now turn the call now over to Brian Smith. Please go ahead.

Brian Smith, Director-Investor Relations

Thank you, Chris, and good afternoon everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Nick Konidaris, our CEO; and Paul Oldham, our Chief Financial Officer. This conference call will cover our fiscal 2013 second quarter 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 25, 2012, and which could change in the future. This call is the property of ESI.

Now I will turn the call over to Nick.

Nicholas Konidaris, President, Chief Executive Officer & Director

Thank you, Brian. Good afternoon, and welcome to our second quarter conference call. In our second quarter, we drove strong sequential sales growth, delivered improved gross margins, and generated solid profitability. Our operations team executed well on a very aggressive shipment plan to meet customer commitments, and our Singapore factory shipped a record number of units during the quarter. Orders were lower, which reflects the variability of our advanced microfabrication business. Revenues for the quarter were $80 million. Non-GAAP earnings per share were $0.23. Orders were $55 million. Paul will go into more detail around the financials in a moment.

Now I will discuss each of our businesses. The Interconnect & Microfabrication Group had revenue of $69 million, up about 45% from last quarter. The great majority of this revenue was microfabrication, as we shipped most of the large orders received in the June quarter. Orders in this business fell in Q2 by about half sequentially due to design-in timing. In addition, customer activity for our flex interconnect products continues to be slow, as customers are still absorbing the significant capacity ordered in the March quarter. We expect our flex business to push upwards in the coming quarters, driven by smartphones and tablets.

Despite the decline in Q2, orders for advanced microfabrication in the first half of fiscal 2013 were up more than 25% over the first half of last year. We're investing new capabilities and applications in this business, and our low-cost platforms continue to open additional opportunities that we have not addressed in the past. Although in this business quarterly orders can vary dramatically, it is a growing business year-over-year, and we believe the potential for further expansion is very exciting.

Turning to our Semiconductor business, our $3 million of revenue, our DRAM and LED businesses continue at trough levels, as the market remains in overcapacity. Forecasts are for DRAM bit grow to slow further in 2013, causing us to remain cautious in our expectations for this business. LED manufacturers continue to invest in technologies to boost light output, and capacity utilization is rising for high brightness LEDs. But our solutions in a number of applications have not yet completed the design-in process. Both in LED as well as 3D packaging, we'll continue to invest in advanced dicing and scribing solutions, and are making progress on several customer opportunities.

Our Components Group generated $8 million of revenue, about flat with last quarter. Orders however were down after initial technology buys in Q1 for our new 3510 microchip tester. As with previous quarters, almost all the demand is being driven by the smallest-sized chips used in smartphones and tablets. The market for larger-size chips, which is normally the largest piece for the market, continues in overcapacity.

Turning now to the outlook for ESI, despite the tough demand environments last quarter, we executed well and met our customer commitments. And although our business may be lumpy, I have never been more excited about our opportunities for growth. Our capabilities, expertise, and our chances to capture ever larger segments of the microfabrication market continue to increase. As for the other markets, we are well positioned when meaningful capacity investment resumes. In the meantime, we will take actions to adjust our valuable cost structure in the near term, while investing in products to drive growth in the future.

Looking now to the third quarter, we expect revenues to be around $40 million. Non-GAAP EPS is expected to be breakeven to a loss of $0.05.

Now I will turn the call over to Paul for a detailed discussion of our results for the second quarter.

Paul Oldham, CFO, Secretary & Vice President-Administration

Thank you, Nick. Good afternoon, everyone. The following information includes results from our second quarter of fiscal 2013, which ended September 29. To improve comparability, we are also providing earnings per share and related income statement results on a non-GAAP basis, excluding the impact of purchase accounting, equity compensation, restructuring charges, and non-recurring items.

For the second quarter, we generated $35 million of orders compared to $74 million last quarter and $41 million a year ago. Interconnect & Microfabrication orders showed the largest sequential decline, but grew year-over-year for both the quarter and year-to-date, illustrating the variable nature of this business. Orders for our flex business were steady from last quarter, but down from last year as customers absorbed the large capacity orders placed in the spring. Activity for semiconductor, LED and broader MLCC remained weak given overcapacity and slowing economic growth.

Shipments were $79 million, and backlog decreased to $40 million.

Revenue for the first quarter was $80 million, up from $59 million last quarter. The sequential increase was primarily related to shipments of our advanced microfabrication products ordered in the June quarter.

Gross margin was 42%, including $762,000 in cost of goods sold for purchase accounting and equity compensation. The EOLITE acquisition added about $250,000 per quarter of purchase accounting expenses.

On a non-GAAP basis, gross margin was 43%, up 180 basis points sequentially, largely a result of excellent work by our operations team to drive down material cost. Looking forward to next quarter, we expect non-GAAP gross margins to be around 40% due to lower sales volume. Over time improvement in gross margins will be driven by recovering in our traditional business, the introduction of new products, and continued improvement in operational efficiency.

GAAP operating expenses were $25.6 million, up about $400,000 from last quarter. The increase was driven by variable expenses related to higher sales and the addition of EOLITE expenses into our run rate, partially offset by lower stock compensation expenses due to timing of expense recognition within the year. Purchase accounting amortization was $129,000, and we spent about $70,000 on the EOLITE integration.

Non-GAAP operating expenses in Q2 were $23.8 million, up $2.2 million sequentially. Looking forward, we expect non-GAAP expenses in Q3 to decrease significantly as we take aggressive temporary actions to lower variable expenses and overall spending in order to mitigate the impact of the lower revenues.

On a GAAP basis, operating income was $7.9 million compared to a $1.5-million loss last quarter. Non-GAAP operating income was $10.5 million compared to $2.7 million in the prior quarter, reflecting higher sales and gross profit. Income tax for the quarter was $2.8 million, an effective tax rate of approximately 35%, and the non-GAAP tax rate was 34%.

On a GAAP basis, second quarter net income was $5.2 million or $0.17 per diluted share compared to a loss of $0.03 per share last quarter. On a non-GAAP basis, net income was $7 million or $0.23 per diluted share compared to income of $0.06 per diluted share last quarter.

Turning now to our balance sheet, cash and investments including restricted cash were $205 million, a decrease of $15 million from last quarter. During the quarter, we used $11 million of operating cash, including paying off $1.8 million of debt assumed in the EOLITE acquisition. We also issued a dividend of $0.08 per share or approximately $2.3 million.

For the quarter, inventories increased by $9 million to support early Q3 shipments. Inventory turns improved to approximately 2.5 times. Accounts receivable increased by $30 million, directly related to the timing of shipments late in the quarter. DSO increased to 63 days. We expect the receivables balance to decrease considerably in Q3.

Capital expenditures were $1.5 million, and depreciation and amortization excluding purchase accounting was $2.3 million.

Looking forward, our Interconnect & Microfabrication business will continue to be the principal revenue driver for the near future. Although the pipeline of opportunities in this business remains full, the timing of design wins is difficult to predict. In our other markets, the timing of recovery remains uncertain and will depend on the pace of economic growth in the next year.

Based on recent order levels, we expect Q3 revenues to be about $40 million, and the non-GAAP loss is expected to be breakeven to a loss of $0.05 per share.

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

Nicholas Konidaris, President, Chief Executive Officer & Director

To summarize, we had a good quarter with record shipments and solid profits. The timing of design wins and market softness made for a tough demand environment. Our strategy to pursue and expand a number of microfabrication applications is yielding results, and we are well positioned with our new products to capture the revenue opportunities in semiconductor, LED, and components when those markets recover and thus solutions get designed in.

This concludes our prepared remarks. We are ready for your questions. Chris?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions]. And our first question is from Mark Miller with Noble Financial Capital Markets. Please go ahead.

<Q – Mark Miller – Noble Financial Capital Markets>: I'd just like to get your impression about the linearity of orders during the quarter. The reason I'm asking that – maybe you don't know, but Apple just provided results and actually guided down by 25% from consensus for earnings for the December quarter. The stock's taken – it's been up and down all – after hours. But were orders linear during the quarter, or did you see a fall-off as the quarter ended?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Yeah, Mark, our orders depends on us being designed in for – first of all, I want to make sure that I'm talking generally for the microfabrication. You mentioned a customer, and I'm not necessarily connecting [indiscernible] (13:10) customer. But in microfabrication, our orders depend on us being designed in. Once we're design in, we receive a big order. That happens in a day or two during the quarter, and then after that we are working very hard for the next three to four months to deliver the order. So during the quarter, the orders are not linear.

<Q – Mark Miller – Noble Financial Capital Markets>: They were not, okay. All right, thanks.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: But in any quarter this is not the nature of our business. This is fundamental to the tool business. But the thing that I want to emphasize here is that the microfabrication business, although it is extremely variable, extremely lumpy, on a year-over-year basis, it is a growing business.

<Q – Mark Miller – Noble Financial Capital Markets>: Okay, thank you.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Thank you.

Operator: Next, we'll go to the line of Jim Ricchiuti with Needham & Company. Please go ahead.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Thanks. Good afternoon. Paul, I'm struggling a little bit to see how you get to breakeven to a slight loss given the gross margin assumptions in the revenue numbers. Your R&D was up significantly in Q2. Does that drop down, is that projects being completed, and how should we think about your SG&A expense?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Well, the primary driver for the increase that we saw in expenses in our second quarter was variable expenses and the addition of EOLITE. So as we look forward in our next quarter, we should see all of those variable expenses essentially reset and more as revenue declines much lower than we were in Q1. So the biggest driver is certainly variable costs, and we worked hard to have a more variable cost structure.

But in addition, as we mentioned, we'll be taking aggressive temporary actions to manage our cost structure because of the downward drop in orders here in the short term. And that will include all of the traditional things that you can think about, including looking at contractors and temporaries, managing discretionary expenses very closely, really prioritize and managing our R&D project spending. We'll be taking a selective time, I think, like Christmas and other things that you would expect companies to do.

So we are being quite aggressive in the near term to manage costs down on a variable basis in order effectively to preserve the long-term investment that we're making in our business.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay, and just – I think you gave a number and I missed it regarding the acquisition-related expense from EOLITE in the quarter.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Yeah, it was quite small. The actual integration expense was less than $100,000. I think we said $70,000.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay, okay. Nick, a question for you...

<A – Paul Oldham – Electro Scientific Industries, Inc.>: That's not the expenses of the organization. That was kind of the integration costs.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. Got it. Nick, just a question on the Microfabrication business – we understand the variability of the business. And if you look at it on a year-over-year basis, it's certainly a growing business. But I think you still come back to what success are you having in terms of expanding the customer base there? Is that – how active is that, and is there any update you can provide on opportunities outside of your major customer there?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: I think we are very much involved in expanding the customer base and expanding the number of applications. I think that we have gone on record that we're looking for opportunities in microfabrication – as an example, doing glass processing. We're working on that. That eventually offers expansion opportunities.

But at the same time, I want to make sure that the whole smart consumer electronics segment is really a robust growing segment. And to the extent that we're addressing the growing parts of this segment, the customers that are winning in the segment, I think it goes without saying that we're going to be fully dedicating to serving those customers and expanding the applications within those customers.

<Q – Jim Ricchiuti – Needham & Co. LLC>: And within those customers that you're working with, is it safe to say you have good visibility into their development, their new product development as it relates to potential orders for you in this area, not necessarily next quarter but over the next couple of quarters? Is that fair to say – I mean, you had that kind of visibility, maybe not necessarily within a given quarter but in general over the next couple of quarters?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Absolutely. It's more than fair to say.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay, thank you.

Operator: Next we will go to the line of David Duley with Steelhead Securities. Please go ahead.

<Q – David Duley – Steelhead Securities>: Yes, I guess I had a couple questions. Could you talk about what you think the cash flow from operations or cash flow will be in this upcoming quarter given it seemed like you used some on the balance sheet last quarter?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Yeah, certainly with shipments and revenue up significantly this last quarter, the biggest driver of the use of cash was the growth in receivables. We clearly expect to collect those in the coming quarter and effectively see the reverse of both the growth in inventory and the growth in receivables in this quarter. That'll be partly mitigated by accounts payable, which will moderate as well. But in the end we would expect to have a very strong cash flow in our third quarter.

<Q – David Duley – Steelhead Securities>: Conceivably get the whole $40 million back?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Well, certainly we'll get – I think we'll get those back on those two lines. But we'll give something back in inventory – not in inventory, but accounts payable and a couple other line items. So I don't think we'll get $40 million in cash flow, but we'll get a significant number.

<Q – David Duley – Steelhead Securities>: Okay. Did you have any 10% customers during the quarter?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Yes, we did.

<Q – David Duley – Steelhead Securities>: And I can't remember – do you disclose that percentage on a quarterly or annual basis?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: We do not. We do that on an annual basis.

<Q – David Duley – Steelhead Securities>: Okay. So if it was just on an annual basis where you're just looking at your business and what you see going forward, do you see yourself becoming more concentrated or less concentrated towards that customer?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: I will not say – I will not conclude this way. What I would say that over time, the growth drivers for our business are continuing winning new design wins in advanced microfabrication, and in addition continuing winning design wins in new technologies that are emerging. And examples of those outside microfabrication are 3D packaging in semiconductor, high brightness LED, small MLCC chips, small [indiscernible] (20:41) in PCB. And ultimately another growth driver is the fact that our other markets other than consumer electronics at some point in time are going to recover. And at this point they have not recovered.

<Q – David Duley – Steelhead Securities>: Okay. And I'm assuming when you just look at the breakout of your – whatever breakout of your revenue guidance that you – your revenue guidance, how it breaks out amongst the pieces will be just like the orders just went up and down. So your biggest business will be the thing that was declining because these other businesses can't really go down very much.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Well, that's exactly right, yeah. On that part we agree.

<Q – David Duley – Steelhead Securities>: Okay. Hey, thank you.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Thank you.

Operator: Next we will go to the line of Tom Diffely with D.A. Davidson. Please go ahead.

<Q – Tom Diffely – D. A. Davidson & Co.>: Yeah, good afternoon. Nick, you talked a little bit about expanding the micro-machining into, I guess, more of a low-end market. So I'm just kind of curious how big do you see that market versus the high end you used to compete in or still compete in? And it seems like it has a lower margin profile too – maybe just a little bit color on that.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: I don't think I made a reference into expanding into the low-end market. I made reference that advanced micromachining is an expanding business, but lumpy or variable. But as we go into more niches in the markets and as our business is expanding, not all opportunities are of equal technological depth. But the majority of this market is based on us being able, with the latest technology that we have, winning design-ins.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. I guess I was under the impression that you went into some more competitive markets recently with some of the....

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: We have gone through – as we do this thing, we are finding out other niches that are – some of them happen to be competitive. The particular needs that we are finding out is cutting PCBs. That is the big market. It's competitive market. We do have the right product, and we have the right solution. But the cost is competitive. We're going to do whatever we have to do to really compete, and at least for – part of it would be to accept lower margins.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. So I guess the way to look at it is just incremental margin dollars as opposed to the overall impact on our margin percentage.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Correct. At the same time, sometimes it's very difficult to see the difference between incremental and non-incremental.

<Q – Tom Diffely – D. A. Davidson & Co.>: Yeah.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: But that's one way of viewing that, and that's a correct way. But at the end of the day if we have a product and we see that this is a big market and we can compete successfully, why we would not compete even at lower margins?

<Q – Tom Diffely – D. A. Davidson & Co.>: Yeah, okay. That makes sense. And then you talked about – you said the LED market is still very quiet for you. But we're hearing more on the advanced packaging side from some other companies. I'm wondering if things like your thin wafer dicing business is starting to pick up a bit from that?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Well, we are actively involved in evaluations in thin wafer dicing with major customers. We are actively involved in dicing of substrates that are related to the LED business. I mean, this is – we are extremely busy in those areas.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. All right, and then just waiting for volume production to commence again in a few quarters down the road?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: We are – this is the main driver that we're expecting.

<Q – Tom Diffely – D. A. Davidson & Co.>: Yeah, okay. And then, Paul, say a little bit more on the OpEx. It looks like you have to take out, I don't know, $4 million or so to get to your earnings guidance. Is that too much? Am I thinking about that the right way?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Well, I think you're thinking about the right way. But, yeah, that's right. And we think we can do that through our more variable cost structure and, like I said, some of the temporary actions which we're taking to drive down expenses in the near term.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. All right, thank you.

Operator: [Operator Instructions] And we have a follow-up from Jim Ricchiuti. Please go ahead.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Nick, just regarding acquisition opportunities, the last couple of acquisitions you've made – EOLITE and awhile back – have been laser companies. Can you talk a little bit about how you're viewing the opportunities out there in terms of acquisitions?

What – can you give us some sense first of all as to how active the pipeline is, and just generally, how are you thinking about it? Obviously you can't comment on specifics, but just as you look at putting some of that cash to work and developing some of these newer markets...

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Yeah. We are in consumer electronics, semiconductor, and LED. And everywhere we compete, we need to be winning new design-ins. In all of these markets, technology is changing. New materials are presented to us, and we need to be advancing the state-of-the-art of laser microfabrication. So strategically where we cannot find readily available laser solutions in the marketplace, we'll need to be looking for emerging new technologies that can provide to us an edge. And that has been the example of EOLITE and PyroPhotonics. We're using – we have used PyroPhotonics extensively internally, and we have a plan in terms of what we're going to do with EOLITE on a standalone basis, plus EOLITE and PyroPhotonics combined.

So clearly we're looking for strategic acquisitions that give us differentiation to be able to have a better chance for winning design-ins as the opportunities present themselves. But at the same time to the extent that we can find other tuck-in acquisitions that can give us in the synergistic [indiscernible] (27:39) market more buck, more revenue because this is important. But again in an accretive and synergistic way, we're looking at those things. It's not that the funnel is full of opportunities. These things take time. But we are always looking for those.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. Thank you.

Operator: We'll go again to the line of Mark Miller. Please go ahead.

<Q – Mark Miller – Noble Financial Capital Markets>: Maybe I missed it. What was your quarter ending backlog?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: $40 million.

<Q – Mark Miller – Noble Financial Capital Markets>: $40 million. Okay, and I just was wondering – we've heard from a couple firms with mixed results in the high brightness LED area. Avico continues to struggle, and orders went down. But Ultratech, which is marketing a lithography tool, indicated they had a significant pick-up in orders. I'm just wondering what you're seeing on your recently introduced products. I know you were expecting it more to be a 2013 event.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Yeah, we see that, as far as LED is concerned, the standard LED is really in overcapacity; the high brightness is having signs of coming back to a healthy mode. In our case, our situation is that this is (a) a slow recovery in terms of high brightness, and at the same time we have not completed the design-in work that we need to do to start seeing some orders.

<Q – Mark Miller – Noble Financial Capital Markets>: Okay. That was – I'm sorry that was $40 million for your end of quarter backlog, was that correct?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: That's correct. Mark.

<Q – Mark Miller – Noble Financial Capital Markets>: Thank you.

Operator: And, speakers, at this time there are no questions in queue. Please continue.

Nicholas Konidaris, President, Chief Executive Officer & Director

Thank you very much for joining us. You are welcome to call Paul, Brian, or me if you have further questions. This concludes our call. Thanks for your interest in ESI.

Operator: And ladies and gentlemen, that concludes your conference. Thank you for your participation and for using AT&T Executive Teleconference Service. You may now disconnect.