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COHU - Q3 2018 Cohu Inc Earnings Call

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## PRESENTATION

### Operator

Good afternoon, ladies and gentlemen, and welcome to the Cohu Inc.'s Third Quarter 2018 Financial Results Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Mr. Rich Yerganian, you may begin your conference

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### **Richard Yerganian** - *Cohu, Inc. - VP of IR*

Thank you, Kyle. Good afternoon, and welcome to our conference call to discuss Cohu's third quarter results, the acquisition of Xcerra and fourth quarter outlook. I'm joined today by our President and CEO, Luis Müller; and our Vice President of Finance and CFO, Jeff Jones.

I want to remind everyone that our Q3 financials reflect Cohu's stand-alone results, and Q4 guidance represents expectations of the combined company following the completion of the Xcerra acquisition on October 1. If you need a copy of our earnings release, you may access it from our website at [www.cohu.com](http://www.cohu.com) or by contacting Cohu Investor Relations. There is also a slide presentation in conjunction with today's call that can be accessed through the webcast link on Cohu's website and is also posted as a PDF in the Investor Relations section. Replays of this call will be available via the same page after the call concludes.

Between now and our next earnings call, we will be participating in the Mizuho Global Investor Conference in New York on December 3; the seventh annual NYC Investor Summit also in New York on December 11, and the Needham Growth Conference on January 15 and 16. We will also be on the road meeting with investors in the Midwest and Boston in the coming month. Please contact us if you would like to request a meeting with the company at one of these events or locations.

Now to the safe harbor. During the course of this conference call, we will make forward-looking statements reflecting management's current expectations concerning the company's future business. These statements are based on current information that we have assessed, by which -- which by its nature is subject to rapid and even abrupt changes. We encourage you to review the Forward-Looking Statements section of the slide presentation and the earnings release as well as Cohu's filings with the Securities and Exchange Commission, including the most recently filed Form 10-K, 10-Q and registration statement on Form S-4.

Our comments speak only as of today, November 5, 2018, and Cohu assumes no obligation to update these statements as a result of developments occurring after this call.



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Finally, during the call today, we will also discuss certain non-GAAP financial measures. Please refer to our earnings release and slide presentation for reconciliations to the most comparable GAAP measures.

Now I'd like to turn the call over to Luis Müller, Cohu's President and CEO. Luis?

### **Luis A. Müller** - Cohu, Inc. - President, CEO & Director

Good afternoon, and welcome to our conference call. First, I would like to provide some commentary on the third quarter and current business environment, and then I'll talk in greater detail about the combined business following the completion of the Xcerra acquisition on October 1.

Q3 sales of \$86 million came in lower than expected, primarily due to headwinds in the mobility market. We had originally modeled a reduction in thermal handler demand for testing application processors, but later in the quarter, turret handler sales were impacted, which are generally used for RF, power management and discrete device testing. Cohu still delivered a solid 14.8% adjusted EBITDA, demonstrating the resilience of our business model. We believe fundamentals for the semiconductor industry remain strong, even though the recent general tone in the market has caused some customers to take a more cautious approach to capacity additions in the short term. We're optimistic about developments in 5G applications, continued penetration in semiconductors in the automotive market that are particularly strong now with vehicle electrification and ADAS; growth in industrial and the prospects in the IoT market; and the ongoing retooling for testing TDDI and next-generation flat-panel display drivers.

Moving on to the acquisition of Xcerra. The integration of the 2 companies is off to a good start, and we have already implemented \$9.1 million in annual run-rate cost synergies. We expect to meet our initial cost synergy target of \$20 million within the first 2 years and later achieve our midterm goal of \$40 million run rate within 3 to 5 years. Jeff will provide more detail later on this call.

We've already had meetings with several customers to communicate product end-of-life and consolidation plans and started to identify cross-selling opportunities for our semiconductor products that will be part of our plan and focus for 2019. More recently, we announced that Cohu has terminated Xcerra's distribution agreement with Spirox and will be leveraging our well-established global sales and service organization and expanding test development centers in China and Taiwan to directly support customers in the region. Once these transitions complete in the next 12 months, we'll benefit from increased direct service revenue, improved gross margins and reduction in operating expenses that are included in our cost synergy model.

With the completion of the Xcerra acquisition, we have significantly strengthened the financial profile of the company and expanded our addressable market to \$5 billion across key product segments. In 2 of those segments, handlers and contactors, we are the leading supplier. In the largest new segment for Cohu, semiconductor testers or ATE, Xcerra has a strong position for testing RF power amplifiers in front-end modules, microcontrollers, power automotive ICs and a growing position in flat-panel display drivers. Across all our product lines, we have a premier customer base that is global in scope, with no one customer accounting for more than 10% of sales in the last 12 months.

Through our atg-Luther Maelzer brand, we provide equipment for printed circuit board test and an established leadership position in flying pro. Cohu is aligned with key end markets, automotive, industrial, consumer and mobility and IoT that are projected to outpace the semiconductor industry growth in the next 5 years. Our system sales in automotive and industrial markets represented 45% of combined trailing 12 months or about \$200 million. Requirements in the automotive market are a key driver for all of our major product lines: semiconductor testers, handlers and contactors as well as our PCB test business.

From the semiconductor perspective, the growth in safety, infotainment systems, communications, sensors, ADAS and vehicle electrification have provided a significant boost to a market segment that typically has a higher-task capital intensity due to stringent quality requirements and multiple insertions at various temperatures. We are, today, the leading supplier of handlers and contactors in the space with best-in-class thermal control, solutions for testing radar sensors up to 77 gigahertz and a wide portfolio of MEMS-staffed equipment.

In the third quarter, we secured a design win for our MATRiX handler for testing ADAS processors for a major automotive customer, further expanding the applicability of our T-Core thermal technology. Many don't appreciate the extent to which semiconductors are impacting the industrial market



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and how the proliferation of MEMS sensors, RF and power management ICs are creating a wave of new applications, including factory automation, security, environmental monitoring and medical devices. Particularly challenging is testing of MEMS sensors that require an actual physical stimulus for the device, and that is where Cohu, combined with Xcerra, has the broadest portfolio of capabilities in the industry.

Turning next to the mobility market. The growing complexity of integrating digital RF and an antenna onto a semiconductor package is opening a new spectrum of opportunities for millimeter-wave contactors in test instrumentation, with the plan to capture several design wins in 2019. We also target growing ATE sales in support of 5G infrastructure ramps starting next year and further deploy our unique over-the-air contacting technology. Our newly acquired ATE product portfolio is gaining traction in the flat-panel display driver market. This is being driven by the more complex test challenges of TDDI devices plus capturing new volume in large panel display drivers for television monitors. Unlike the traditional approach taken in this market, which is to offer specialized test systems, our display driver solution is available as part of our well-established general-purpose SoC test platform, the Diamondx, which offers subcontractors a more compelling value proposition. We plan to continue winning new sockets in this market and expand our resources to support test program development.

Additionally, MEMS sensors extend well beyond industrial applications to automotive, and of course, mobile devices. This has a compounding effect because the data generated by these devices need to be transferred, processed and eventually stored. With an endless range of applications, including facial recognition to unlock your phone, to being able to open the trunk of your car with a swing of your leg, we project continued demand for our handlers integrated with MEMS test modules, ATE and contactors. In the third quarter, we captured a design win with the Eclipse handler at a test subcontractor in Taiwan.

Cohu is now one of the largest providers of leading-edge solutions for back-end semiconductor equipment and services and printed circuit board tests. We're the only company offering a one-stop shop for handlers, testers and contactors, focused on increasing yield, reducing cost of test and accelerating time-to-market. Customer feedback on this has been very positive, along with our continued focus on being best-in-class in each of these areas.

I'd like to now turn the call over to Jeff to review our third quarter results and provide fourth quarter guidance.

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### **Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Thanks, Luis. Let me begin by reviewing Cohu's third quarter financial results, which demonstrate the strength of our business model, as we generated non-GAAP operating margin of 13.2% and adjusted EBITDA margins of 14.8% on sales of \$86.2 million. Cohu delivered \$23.3 million of cash from operations during the third quarter, and our cash balance increased \$20.3 million to approximately \$171.2 million at the end of the quarter.

Our contactor business represented 11.4% of sales for the quarter. For Q3, the GAAP to non-GAAP adjustments include approximately \$1.9 million of stock-based compensation expense, \$1 million of purchased intangible amortization expense, approximately \$400,000 in restructuring and manufacturing transition costs, \$1 million of acquisition costs related to Xcerra and a \$227,000 adjustment to the earnout valuation from the Kita acquisition.

My comments that follow, including the Q4 guidance, are all based on Cohu's non-GAAP results, which exclude the impact of these items. As I mentioned, sales for the quarter were \$86.2 million. One customer in the computing market represented 11% of third quarter sales, and no other customer exceeded 10% of sales in the quarter.

Q3 gross margin was 40.8% and consistent with our guidance. Operating expenses for the third quarter were \$23.8 million and better than our guidance of \$24.5 million due to lower sales and service costs associated with the lower revenue.

The non-GAAP effective tax rate was approximately 23% for Q3, higher than previously anticipated, primarily due to an increase in cash generated in Switzerland, which we expect will incur a 5% or approximately \$600,000 withholding tax upon the anticipated repatriation of these funds to the U.S. in connection with funding the Xcerra acquisition. For the combined company, we expect our effective tax rate for the fourth quarter to be approximately 24% and 19% for the full year 2018.



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Based on our Q3 results and year-to-date financials, we continue to execute against our strategies that are yielding measurable results. For the first 9 months of 2018, revenue grew 5% organically over the same period last year as a result of our continued traction in the automotive and industrial markets and expansion of contactor sales. Year-to-date gross margin is approximately 42% compared to 41% for full year 2017 and 36% in 2016.

Our EBITDA margin has improved to approximately 18% of revenue, and non-GAAP earnings per share continues to grow through the third quarter at \$1.29 for the 9-month period.

Revenue from our recurring business, which includes sales of our test contactors as well as equipment service and spares, represented 46% of total revenue for the first 9 months of 2018. As many of you know, this business provides a stable base that generates higher than company average gross margins. Growth in this business is being driven by our expanding installed base -- handler base and the contactor design wins.

With Xcerra, we expect the total recurring business to remain at approximately 45% of revenue, with significant opportunity for further growth. In fact, the contactor business alone is expected to be approximately \$120 million in annual sales with an opportunity to grow to \$300 million, serving our combined handler installed base.

Turning to Cohu's balance sheet as of September 29, 2018, and prior to the acquisition close, we had approximately \$171 million in total cash and investments. Accounts receivables decreased sequentially by approximately \$13 million, and DSO decreased by 1 day to 84. Inventory increased sequentially by approximately \$700,000, with inventory days increasing by 16 to 120. Accounts payable days increased by 7 to 75, and the overall conversion -- cash conversion cycle increased by 8 days to 129. And we achieved \$23 million in cash flow from operations.

Fixed asset additions in Q3 were approximately \$600,000, and depreciation was \$1.4 million. Deferred profit at the end of September was \$1.9 million, up \$185,000 from \$1.7 million at the end of the second quarter. The related deferred revenue at the end of Q3 was \$3.6 million, up \$200,000 sequentially.

When looking at the pro forma balance sheet of the combined company as of October 1, cash and investments were approximately \$148 million, net of approximately \$30 million in deal costs. Total outstanding debt is \$358 million, including the Xcerra acquisition-related \$350 million 7-year term loan with a rate of LIBOR plus 300 basis points.

Subsequent to the acquisition, our cash strategy continues to be maintaining approximately \$125 million of cash on the balance sheet to support operations, capital expenditures and the dividend. Cash generated in excess of \$125 million will be used to pay down the debt and delever the company.

Cohu's Board of Directors approved a quarterly cash dividend of \$0.06 per share payable on January 2, 2019, to shareholders of record on November 16, 2018.

Looking at the synergies from the integration of Xcerra. We achieved immediate annual run-rate cost savings of \$9.1 million, primarily from the elimination of redundant public company costs as well as executive management consolidation. We continue to expect to achieve our target of \$20 million in annual cost synergies within the first 2 years, reflecting approximately \$7 million from cost of goods sold and approximately \$13 million in operating expense savings. These synergies will be achieved through product rationalization, supply chain alignment and consolidation of the direct sales organization. Many of these initiatives have already started with the communication to customers of our product end-of-life and consolidation plans and the termination notice of Spirox distribution in China and Taiwan. Our midterm target within the next 3 to 5 years is to double these initial 2-year synergies by another \$20 million for a total of \$40 million through facility consolidation and manufacturing optimization.

And now moving to our guidance for the fourth quarter, which includes a full quarter of contribution from Xcerra. We're expecting Q4 sales to be in the range of \$168 million and \$183 million. Revenue distribution is expected to be 94% semiconductor test and inspection and 6% PCB test. Gross margin in Q4 is expected to be approximately 43%, reflecting benefits of a larger consumable test contactor business. Operating expenses are expected to be approximately \$59 million, which includes realizing initial cost synergies of approximately \$2.2 million in the quarter or approximately \$9.1 million on an annualized basis. The Xcerra acquisition is expected to be 34% EPS accretive in the quarter, and the diluted share count is expected to be approximately 41.7 million shares.



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Over the midterm, we're targeting gross margin of 48% and EBITDA of 22% on quarterly sales of approximately \$235 million. Profitability targets include the benefit of annual cost synergies totaling the \$40 million that I discussed previously.

So let me conclude our prepared remarks by summarizing our comments today and why we are excited about the future of Cohu. With the Xcerra acquisition, we've increased our total addressable market to \$5 billion. With a larger market comes additional opportunities to offer differentiated technologies and best-in-class systems and consumables to uniquely address customers' test and inspection challenges. We have a larger presence in the growth segments of the market. We have a clear path to realize significant cost synergies, driving increased margins, cash flow and earnings. And we have started the process to identify cross-selling opportunities by leveraging our expanded customer presence and global direct support organization.

That concludes our prepared remarks, and now we'll open the call to questions.

### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions) Your first question comes from the line of Patrick Ho.

**J. Ho - Stifel, Nicolaus & Company, Incorporated, Research Division - MD of Technology Sector**

Luis, if you could provide a little more color, given some of the mix commentary out there right now in the semiconductor market in market segments like automotive, industrial and even IoT. How do you see the market today in some of those key market segments for you? And what does it look like for the test environment as we start looking ahead to 2019?

**Luis A. Müller - Cohu, Inc. - President, CEO & Director**

So a lot of pieces to your question here, but if I start by talking about where we are today, we're seeing slow growth in smartphone units year-over-year. As I said in the remarks, on the other hand, auto and industrial semiconductor markets do remain healthy. And we are seeing a seasonal pattern in Q4 as we've seen in past years, with slower demand for microcontrollers, and this impacting both the testers as well as the handlers; small power management ICs, RF ICs; and also LEDs, which is essentially impacting, in this case, our handlers only. So overall weakness in semiconductors for smartphone applications, and I would say amplified by a pullback from Chinese customers being more cautious. Yet frankly, our direct exposure to Chinese domicile customers is limited today. As far as 2019, you're asking for next year, it's a little too early to be talking about this for the big picture view for next year. We're still rolling up input from customers into our plan. Traditionally, we'd expect things to pick up again post Chinese New Year or into early Q2. What I can tell you is we are targeting design wins for contactors, mainly auto customers, our automotive customers. We're planning to expand the penetration that we have, which is still small in flat-panel display driver test. This is particular to ATE. We have some targets for 5G applications next year, particularly to ATE and contactors. And we are -- I mean, initial indication is that we are expecting another solid year for PCB test equipment next year.

**J. Ho - Stifel, Nicolaus & Company, Incorporated, Research Division - MD of Technology Sector**

Great. That's really helpful for the color. And as my follow-up question, I know you're very early in the stages of the integration of the 2 companies. Obviously, with the \$9.1 million achieved to date, which I will say is quite remarkable. As you look at some of the easy costs and expenses that you can get out of the way in terms of duplicate costs, as you look at other line items like R&D, given that both Xcerra and Cohu participated in similar markets, are there already opportunities for you to cut some of those costs and potentially even bring higher cost synergies when all is said and done?



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**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Patrick, it's Jeff. We've looked at that, and we've taken that into consideration. As a matter of fact, as we mentioned on the call, we've talked to customers about end-of-life and product consolidation. And so as we go through that process, yes, we're looking at product rationalization. And the potential cost savings from those actions and the impact is built into the \$20 million in the first 2 years, \$40 million over the midterm.

**Luis A. Müller** - Cohu, Inc. - President, CEO & Director

Yes, Patrick. Let me just reinforce here what Jeff said here. We have already communicated these product plans, product end-of-life, to the affected customers. And those will be taking place by -- the end-of-life will be taking place by mid-2019 and through next year, will be combined in the capability of those products on the surviving products. And needless to say, there is no overlap, and therefore, no consolidation to be talked about for ATE or PCB test.

**Operator**

Your next question comes from the line of Tom Diffely.

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

I guess, following up on Patrick's questions there. Just want to get a little more information about how Xcerra did in the last 2 quarters, maybe just from a top-line basis, to see what the trends are heading into the fourth quarter.

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Tom, it's Jeff. We don't anticipate in the future to break out that level of detail. I mean, I will say that they're not immune from the seasonality. So I think from that perspective, they -- like I said, they're not immune to it, so they felt the seasonality as well.

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

Okay. At any point, are we going to get any kind of a historical pro forma the last 2 quarters for Xcerra?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

No, not at the moment. We just filed an 8-Ka, but it was for periods that were already filed with the SEC. So there's no new information there, Tom.

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

Okay. And then when you talked about the kind of normal seasonality in the fourth quarter, and I assume seasonal strength coming out of Chinese New Year, what is the, in your mind, the normal seasonal trends on, maybe on a percentage basis, third to fourth quarter, then fourth quarter to first quarter?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Yes, that's hard to say. I mean, in particular, sort of in these periods that we're working through at the moment, as Luis said, it's kind of magnified now with the slowdown in smartphones. But I would say looking back, it's at...





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**Luis A. Müller** - Cohu, Inc. - President, CEO & Director

It's about plus or minus 10, plus or minus, maybe low-teen percentage fluctuation from peak to trough on the seasonality. Just speaking out of memory here.

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

Okay, that's helpful. And then, I guess, just quickly on the tax rate. You talked about 19% for 2018. Is that what you expect as well going forward, kind of a long-term tax rate?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Yes. We're working through the next year's operating plan at the moment, but our preliminary view of that is 20%. So a little bit higher than where we'll be for 2018, but I think 20% is a good rate to use for modeling right now. We'll update that as we have better information.

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

Okay. And then just one final product question. When you look at the flat-panel display driver business on the Diamondx, is that going to be upgrade existing Diamondxes in the field? Or is that a new tool?

**Luis A. Müller** - Cohu, Inc. - President, CEO & Director

Tom, this is Luis. No, this is essentially new tool. We are still sort of a small #2 in the market. And as you pointed out, the Diamondx is the platform, which is a general-purpose SoC tester. And so new sales here are essentially new Diamondx with instrumentation that enables TDDI or large panel display driver test.

**Operator**

Your next question comes from the line of Craig Ellis.

**Craig Andrew Ellis** - B. Riley FBR, Inc., Research Division - Senior MD & Director of Research

Guys, I first wanted to try and better understand the mobility dynamics in the quarter. So Luis, clear it was some thermal and turret handler issues. But the question is given the magnitude of the \$6 million, one, was there anything else from an end market standpoint that impacted results? And 2, was it just equipment on the mobility side or did that have some collateral impact to the recurring sales as well?

**Luis A. Müller** - Cohu, Inc. - President, CEO & Director

The -- taking the first part here, it was really all mobility driven, Craig. We had a drop in essentially turret handler sales in the quarter associated with RF ICs, small power management ICs, discrete semiconductors, essentially products that go into mobility or, I guess, you could say also general consumer mobility products, IoT-related. Now that did create an impact, an associated impact to recurring, but as usual, the recurring impact is kind of an order of magnitude lower than it is for the equipment side.





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**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Yes, Craig, I would say it was probably an 80-20, where 20% of the miss was related to the recurring business. And then if you look on a percentage basis, our recurring was about 51% of revenue in the quarter, where generally over time it's about 45%.

**Craig Andrew Ellis** - B. Riley FBR, Inc., Research Division - Senior MD & Director of Research

And how much of mix was mobility in the quarter? Where are we as we enter the fourth quarter mobility?

**Luis A. Müller** - Cohu, Inc. - President, CEO & Director

I don't have that data point on my fingertips right now, Craig.

**Craig Andrew Ellis** - B. Riley FBR, Inc., Research Division - Senior MD & Director of Research

Okay. Well, maybe Rich or Jeff can get. I'll move onto the next question. So Jeff, just looking at guidance at \$175.5 million, I think, at the midpoint, it would seem like that guidance would imply that the Xcerra business would be tracking a little bit below \$100 million and the Cohu business a little bit below \$80 million. I know you don't want to give out specific numbers, but at least directionally, does that sound reasonable? Or was one of the businesses impacted significantly more than the other as we go through a period of capacity absorption?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Craig, yes, those are reasonable numbers, yes.

**Craig Andrew Ellis** - B. Riley FBR, Inc., Research Division - Senior MD & Director of Research

Okay. The next question is really a follow-up, but really focused on something different than Patrick's question with OpEx. So a nice job bringing home the early synergies. The question is if we have a demand environment that stays soft, are there levers that you can pull that are more structural and sustainable that would extend the \$20 million savings to something greater if we have a demand environment where we don't see something like a seasonal snapback sometime next year?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Well, I think, as we always do, right, we look to sort of the nonessential projects, whether it's in engineering or whether it's in G&A as well as trying to rationalize the sales and service organization and what's required there should we go into a downturn.

**Craig Andrew Ellis** - B. Riley FBR, Inc., Research Division - Senior MD & Director of Research

Okay. And then Jeff, just following up with 2 things on the slide that you had with the new midterm target model and some of the clarifying comments below that. One, as we think about the midterm target, what's the time frame that the company is thinking about? And what are some of the underlying assumptions on sales that you're using to get to the \$235 million?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Okay. So the assumption is it's midterm, so we define that as 3 to 5 years. And then in terms of achieving the \$235 million, it is a combination of low single-digit market growth for both the handler and the ATE markets. And then it's growth in excess of the market rates for contactors, and



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that's double-digit, low double digit, I'd say 10% plus, as well as growing the tester business in certain markets faster than the market growth as well.

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**Craig Andrew Ellis** - *B. Riley FBR, Inc., Research Division - Senior MD & Director of Research*

And then lastly, and then I'll jump back in the queue, there's a bullet on the same slide that states that Xcerra results in 34% earnings accretion for the fourth quarter. What's the basis for the earnings accretion that you're using?

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**Jeffrey D. Jones** - *Cohu, Inc. - VP of Finance & CFO*

In terms of the share count?

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**Craig Andrew Ellis** - *B. Riley FBR, Inc., Research Division - Senior MD & Director of Research*

No, in terms of earnings. The statement is 34% EPS accretion, and so I wonder -- you could either convey what the total amount is or what the basis is so that I can do the math and get to the total.

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**Jeffrey D. Jones** - *Cohu, Inc. - VP of Finance & CFO*

Well -- so I'm not completely following here you, Craig, on your question. EPS, if you follow the math on the guidance with the tax rate, you're somewhere in that \$0.19, \$0.20 range.

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**Operator**

(Operator Instructions) Your next question comes from the line of David Duley.

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**David Duley** - *Steelhead Securities LLC - Research Analyst*

One clarification. I think you said the size of your contactor market or contactor revenue was \$150 million, growing to \$300 million. Is that the right number? And then help me understand why it's going to grow so much. I would assume it's because you're going to increase the connection rate, but maybe just elaborate on that a little bit.

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**Luis A. Müller** - *Cohu, Inc. - President, CEO & Director*

Yes. Let me just correct one thing here, Dave. This is Luis. The size of the contactor business now is about \$125 million. And if we just look at the attachment rate to our handler sales, it's a business that has the potential to grow to \$300 million. Now that is over the long term. And as Jeff pointed out, we're looking at growing faster than market at low double digits, so in the low teens annual run rate, by basically deploying solutions in conjunction with our handling equipment and primarily focused at, initially at least, primarily focused at addressing automotive customers that are thermal control at test as well as capitalizing on opportunities in 5G with over-the-air and millimeter-wave contacting.

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**David Duley** - *Steelhead Securities LLC - Research Analyst*

No, help us understand. I think that Xcerra had a pretty high connect rate, and Cohu historically didn't have as high as connect rate. Could you share some of that math so we can understand how this might unfold?



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**Luis A. Müller** - Cohu, Inc. - President, CEO & Director

That is correct. I mean, Xcerra, or at least the business they acquired here from Dover a few years back, has been in the contactor space for a long time. And they have gotten to very close to 100% attachment rate of contactors to their handlers. On the Cohu front, we started this business about 2.5 years ago. We are running at about a 20% attachment rate to our handlers, and so significant room to expand there. And the plan is to leverage the Xcerra contactors' technology, the broader field applications and manufacturing infrastructure now to be able to deploy and service this larger base of opportunities that we have on the Cohu handlers.

**David Duley** - Steelhead Securities LLC - Research Analyst

Okay. And then you mentioned that you're going to move direct in China and Taiwan. And historically, I think Xcerra had viewed that relationship with Spirox as an important relationship. So if you could help us understand why you think you have an advantage going direct there. And then just as another follow-up, could you help me understand what your market share in handlers should be given the guidance you gave in the fourth quarter?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

So Xcerra has had a long-term relationship with Spirox. I think it goes back to perhaps even Credence. Nevertheless, over the last 2 years or more so 18 months, Xcerra has built 2 test development centers: one in Xinzhu, Taiwan; the other one in Shanghai, China, to bolster the capability and actually address a request from customers to deal directly with the Xcerra team not only in test program development, but also at a technical level, understand the instrumentation road map. So we're essentially leveraging on that infrastructure, plus Cohu's sales and service infrastructure in the region, to do what customers have already asked for, which is to go direct to increase the level of support. And as we believe here, that will open up the door for additional business in both of those countries. As for the second part of your question, I really don't have data to give you a number on market share. Needless to say, we are the leading handler supplier in the industry across the various segments outside of memory. But that's the extent of what I know today, and I don't have numbers on that.

**David Duley** - Steelhead Securities LLC - Research Analyst

Okay, one final question. As you mentioned that you're going to end-of-life some products, I'm assuming that's in the handler market. Without mentioning customers or products themselves, what kind of revenue exposure do you have to some of these overlapping situations where you're going to be end-of-life-ing products?

**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Dave, this is Jeff. So we've got minimal exposure in terms of any sort of revenue overlap in the markets. And so obviously, the goal is to end-of-life a particular product, but introduce a replacement product at the same time. So what we're modeling is pretty minor in terms of dissynergies, if you will. And we think that, that's achievable.

**Operator**

(Operator Instructions) Your next question comes from the line of Craig Ellis.

**Craig Andrew Ellis** - B. Riley FBR, Inc., Research Division - Senior MD & Director of Research

First question, Jeff, did you mention expected interest expense for the fourth quarter? And relatedly, how should we think about the use of cash as Newco generates cash in 4Q and beyond?



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**Jeffrey D. Jones** - Cohu, Inc. - VP of Finance & CFO

Sure. Yes, interest expense in 4Q is \$5 million. And then as we move forward, we're going to maintain about \$125 million of cash on the balance sheet. Again, that's to support the operations, to support capital expenditures, the dividend as well as the interest payments that I just talked about. So that's the strategy. Anything in excess of \$125 million will go to delever, pay down the debt as soon as we can, as fast as we can. We'll continue, though, to evaluate the situation and evaluate that strategy. But for now, that's how we expect to go forward.

**Operator**

I am showing no further questions at this time. I would now like to turn the conference back to Mr. Rich Yerganian.

**Richard Yerganian** - Cohu, Inc. - VP of IR

Thank you, Kyle. We want to thank everyone for joining us on the call today and hope you all have a good afternoon and evening. Thank you.

**Operator**

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may all disconnect.

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