Transcript of Cohu
Fourth Quarter 2017 Earnings Call
February 15, 2018

Participants

Jeff Jones – Chief Financial Officer
Luis Muller – President and Chief Executive Officer

Analysts

Craig A. Ellis – B. Riley & Co.
Patrick Ho – Stifel, Nicolaus & Company
Y. Edwin Mok – Needham & Company LLC

Presentation

Operator
Greetings, and welcome to the Cohu, Inc. Fourth Quarter and Full Year 2017 Earnings Call. At this time all participants are in a listen-only mode. A question and answer session will follow the formal presentation. [Operator instructions]. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Jeff Jones, Chief Financial Officer. Thank you, Mr. Jones. You may begin.

Jeff Jones – Chief Financial Officer
Good afternoon and welcome to our discussion of Cohu's most recent financial results. I'm joined today by our President and CEO, Luis Muller.

Following our opening remarks, we'll provide details of our performance for the fourth quarter and the full year 2017, as well as our outlook for the first quarter of 2018. If you need a copy of our earnings release, you may obtain one from our website www.cohu.com or by contacting Cohu Investor Relations.

Before we begin, you should all be aware that 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 but which by its nature is subject to rapid and even abrupt changes.

Forward-looking statements include our comments regarding growth and market share expansion through our PANTHER and Solstice products; specific share gain goals; increased test contactor sales; first half 2018 sales growth; our Cohu500 mid-term model and associated goals; revenue recognition on increasing Korean customer sales; future results including Q1 guidance and any other comments we make about the company's future in response to your questions. We encourage you to review the forward-looking statements section of the Earnings Release as well as Cohu's filings with the Securities & Exchange Commission, including the most recently filed Form 10-K and Form 10-Q.

Our comments speak only as of today, February 15, 2018, and Cohu assumes no obligation to update these statements as a result of developments occurring after this call. Further, our comments and responses to any questions will not make reference to any specific customers as we are precluded from disclosing such information by our non-disclosure agreements. Finally, during the call today we will also discuss certain non-GAAP financial measures. Please refer to our earnings release for a reconciliation to the most comparable GAAP measures.

Now, I'll turn it over to Luis.

Luis Muller – President and CEO
Thanks, Jeff. Good afternoon, everyone.

On today's call I will review Cohu's fiscal 2017 performance and business highlights in the fourth quarter. I will conclude with our views for 2018 and discuss our strategy.

Cohu delivered another year of solid sales and profitability growth in 2017, highlighted by market share gains in test handlers and accelerated growth in the tech contactor market. Orders were at record levels for the full year, increasing 41% over 2016. Sales were up 25% year-over-year to $352.7 million. And non-GAAP earnings per share increased 126% to $1.54.

We generated $39 million in operating cash flow, ending the year with approximately $156 million in cash and investments and a strong balance sheet. Cohu returned $6.6 million to shareholders through quarterly cash dividends.

We are off to a strong start in the first quarter. We forecasted book-to-bill above 1 and growing traction in the automotive and mobility markets.

As we look at the results in more detail, our test handler business grew 18% year-over-year as we capitalized on a strong industry environment and benefited from market share gains. Our test contactor business grew 131% year-over-year as we delivered on our strategy to expand in this adjacent market by selling these consumable products into our large installed base of handlers. Additionally, the acquisition of Kita has proven to be a great success with an over 450% increase in the number of Kita probes incorporated in our contactors and several design wins combined with Cohu handlers.

Looking in more detail at full year orders, 59% were systems and 41% recurring. And by device segment, digital and mixed signal represented 21% of system orders; applications processors were 16%; mixed signal and RF were 15%; small signal discreet were 12%; power management and discreet were 11%; sensors were also 11% and computing processors and LED were each 7% of system orders.

In 2017, we introduced two new major products, the PANTHER Prober for test and inspection of singulated wafer level chip scaled packages and bumped dies; and Solstice, Cohu's solution for system level test automation. PANTHER has been deployed at five different customers targeting mobility applications. And as previously mentioned, we also received a new customer order in early fourth quarter for test and inspection of automotive power management devices. Both PANTHER and Solstice will be major components of our market share expansion strategy as they address key test requirements aligned with technology trends in advanced packaging for integrative semiconductors.

Last year, we also announced a new vision inspection module for enhanced micro crack detection on wafer level chip scaled packages called Aquilae. This product has been installed in several Cohu handlers and is being used to improve vision inspection quality of bare silicon and LED devices.

Transitioning now to the fourth quarter, orders increased 46% over the prior year and established a new record. Sales were in line with our guidance and non-GAAP gross margin at approximately 42% once again exceeded our forecasts. This was a strong quarter in the applications processor segment as we received a large order for thermal subsystems to support next generation product launches in 2018, along with continued momentum in the automotive market for power management in MEMS sensors. We also saw an increase in demand for Cohu handlers in the computing segment that included capturing new business at a leading foundry for testing high end processors with forecasted volume expansion in the second half of 2018.

As we look to the coming year, we started 2018 with a strong backlog, share gain momentum, and customer traction as evidenced by our recently announced design win of a major European automotive customer with the MATRIX Pick-and-Place handler combined with our multi beam test contactors. We expect this win to be key to supporting our handler share gain objectives in 2018 as well as increased test contactor revenue.

Additionally, we have been making excellent progress with a major Korean customer who continues to provide repeat orders for a new hammer model. As a result, we have been increasing investments to support business prospects with this customer, which is expected to be an important contributor to meeting current projections for about 10% growth in the first half of 2018 over the same period last year.

To close out my remarks, I would like to confirm our strategic objectives in support of the Cohu500 midterm model, which includes growing share in handlers, expanding in the test contactor market, and making disciplined investments in probe and inspection. We expect the combined handler and test contactor markets to grow by mid-single digits year-over-year, and Cohu's plan is to outperform with another one to three points of share gain in each market.

As our model indicates, we're targeting to grow annual sales to $500 million with 45% gross margin and 20% EBITDA, both non-GAAP. Our increased confidence and excitement about the future of Cohu is driven by the successful implementation of past strategic actions, including the streamlining of our operations and cost structure with over 90% of system shipments now originating from our Asia operations, increased share in our core hander markets, successful expansion in test contactors with the acquisition of Kita early last year and now representing over 11% of 2017 revenue, as well as new product developments with the introduction of PANTHER, Solstice and Aquilae. Collectively, these initiatives have improved our operating model and margins, positioning Cohu to deliver continued profitable growth, cash flow and shareholder returns.

Now, I'll turn it over to Jeff for details on the fourth quarter and full year financials and our Q1 guidance.

Jeff Jones – Chief Financial Officer
Thanks, Luis.

Cohu's Q4 was in line with our expectations as we generated non-GAAP operating and adjusted EBITDA margins of 11.2% and 12.9% respectively on sales of $84.1 million. Full year 2017 operating and adjusted EBITDA margins were 14.4% and 15.8% respectively on record sales of $352.7 million. Non-GAAP gross margin for 2017 was 41.2%. That's up 560 basis points from 35.6% in 2016.

We generated $39 million of cash from operations in 2017 contributing to an increase of approximately $28 million in our cash balance, net of $12 million used to acquire Kita Manufacturing, and ended the year with cash of approximately $156 million. Our contactor business was 11% of sales for both the quarter and the year.

For Q4, the GAAP to non-GAAP adjustments include approximately $1.7 million of stock based compensation expense, $1 million of purchased intangible amortization expense, $1.2 million of costs related to the reduction of a tax and indemnification receivable recorded in connection with the Ismeca acquisition in Q1 of 2013, $797,000 of other acquisition-related costs primarily related to the valuation earn out from Kita, and $2 million related to the impact of US tax reform.

My comments that follow, including the Q1 guidance, are all based on Cohu's non-GAAP results, which exclude the impact of these items. Sales for the quarter were $84.1 million, consistent with our guidance of approximately $84 million and reflecting expected seasonality. Two customers in Q4 each exceeded 10% of sales; one customer in the automotive market represented approximately 13% of sales and one customer in the computing market represented 15% of sales. For the full year, one customer in the automotive market represented approximately 16% of sales and one customer in the computing market represented 11% of sales.

Q4 gross margin was 41.9% and above our guidance primarily due to product mix, including higher recurring sales than forecasted. Operating expenses for Q4 were $25.8 million and higher than our guidance due mainly to increased investment to support the growth prospects with our large Korean customer that Luis mentioned previously, combined with a $300,000 foreign currency loss and the timing of certain audit and other outside service fees.

As you know, the US Tax Cuts & Jobs Act was enacted on December 22, 2017 and introduced significant changes to US income tax law. Due to the timing of the enactment and the complexity involved in applying the provisions of the Tax Act, we have made reasonable estimates of the effects and recorded provisional amounts in our financial statements as of December 30, 2017. These provisional amounts totaled a net benefit to GAAP income tax expense of $2 million and included estimates of the one-time transition tax; meta foreign tax credits and operating losses on earnings of foreign subsidiaries that were previously deferred from US tax law; the impact of the US tax rate reduction and changes to net operating loss rules on our net deferred taxes; and the accrual of foreign taxes in the event certain funds are repatriated to the US. As we complete our analysis of the Tax Act and incorporate additional guidance that may be issued by the US Treasury Department, the IRS or other standard-setting bodies, we may identify additional effects not reflected as of December 30, 2017 that would be recorded in 2018.

The non-GAAP effective tax rate for Q4 was 15.1% and consistent with our previous estimate. Our tax rate continues to benefit from profits generated outside the US in countries with lower statutory income tax rates and in certain countries where Cohu has income tax holidays. The tax rate also benefits from profits generated in the US which do not currently incur a tax provision because of our valuation allowance. Looking ahead, we expect our full year 2018 effective tax rate to be approximately 17% and slightly higher than 2017 as a result of the expiration of the portion of our tax holiday in Malaysia.

Accounts receivable declined sequentially by $5.4 million and DSO improved by 4 days to 75. Inventory increased by $5.7 million sequentially with inventory days increasing by 26 to 120. Accounts payable days increased by 22 days to 72 days due to a $7.6 million increase at the end of the quarter. Overall, the cash conversion cycle was flat quarter-over-quarter at 123 days.

Fixed asset additions were approximately $1.4 million for the fourth quarter and $6.1 million for the full year 2017. Fourth quarter depreciation was $1.4 million and $5 million for the full year.

Deferred profit at the end of December was $6.6 million compared to $6.7 million at the end of the third quarter. The related deferred revenue at the end of Q4 was $10.4 million, up $500,000 sequentially.

Cohu's board of directors approved a quarterly cash dividend of $0.06 per share payable on April 13, 2018 to shareholders of record on February 27, 2018.

And now moving to our guidance for the first quarter, as stated in today's press release, we expect Q1 sales to be approximately $89 million. There are several aspects that are factored into our Q1 guidance. First, as many of you know, new revenue recognition rules went into effect on the first day of fiscal 2018. For Cohu, this resulted in approximately $1.3 million of deferred revenue and profit at the end of 2017 that will not be recognized in Cohu's 2018 Income Statement, but rather will be recorded as a cumulative effect of adoption adjustment to equity in Q1.

Additionally, as Luis mentioned, we headed into 2018 with a strong backlog and record orders with delivery expected over multiple quarters in 2018. This positions us well for continued growth with the timing of revenue contingent on the quarter in which the backlog shifts and, if applicable, when customer acceptance is received. Additionally, we continue to receive orders and ship product to our large Korean customer and expect our first revenue recognition from those shipments within the first half of this year.

As a result of these factors, we expect first half 2018 sales to increase approximately 10% over the same period last year. Gross margin in Q1 is expected to be approximately 50 basis points higher than Q4. Operating expenses for the first quarter are expected to be approximately $2 million higher than Q4, reflecting the continued investments in support of our large Korean customer.

That concludes our prepared remarks. Now we'll take your questions.

Operator
Thank you. At this time we will be conducting the question and answer session. [Operator instructions]. Our first question comes from the line of Edwin Mok of Needham & Company, LLC.

Q:
Great, guys. Thanks for taking my question. Good quarter. First, I want to understand the broader focus on the technical financial accounting. I guess I want to understand like the 10% growth in the first half of '18. With this quarter being flattish sequentially, if I did my math correctly the second quarter is going to have pretty decent growth rate year-over-year, so that's sequentially, is it just the timing of shipments more back into June or is it revenue recognition that causes that delay into the June quarter?

Jeff Jones – Chief Financial Officer
Yes, it's more about the timing of the shipments. There's also an aspect of revenue recognition, but I would say the primary driver is the timing of the shipments, and then secondarily revenue recognition.

Q:
If I look at your backlog, it's was a pretty big [indiscernible] last year, right? How much of that will be shipped in this first half or is that a way to think about it, just roughly half in the first half? Can you give some color on the backlog?

Jeff Jones – Chief Financial Officer
Most if it will be shipped in the first half. We do have some that extends out into Q3 and Q4, but 80% to 85% of that will ship in the first half of the year.

Q:
Great. That's helpful. Then maybe if you could provide some color on the European auto customer win you guys talked about, again, qualify there. Any way you can size that opportunity and what type of product you won there would be helpful.

Luis Muller – President and CEO
As we announced here what we did capture was business for our MATRIX Pick-and-Place handler, which is the most commonly used product today in the industry for automotive device test. In conjunction, we also captured business for our multi-beam test contactors that go with that Pick-and-Place handler.

As far as the size of the opportunity, it's part of that one to three points market share gain that we have projected for 2018, along with the Korean customer that we're still working on in getting new product acceptance.

Q:
Great. That's helpful. Then on the inspection side, just a quick question in terms of you guys provide some comment around that. I just want to kind of understand the progress there. It was a pretty sizeable market that you guys are coming with still a relatively small share in that space. How do you see the cadence of that growth? Is it just block and tackle or do you see some options for a more sizeable contract or award with any certain customer [indiscernible]?

Luis Muller – President and CEO
Well that market, as we said before, is about $140 million to $150 million for package inspection. We are participating today in the space via our current handlers. In fact, to the tune of a little over $20 million a year in sales, and that is more narrowly focused on small packages, small devices. So the efforts that we have here are to develop solutions that expand the field of view for larger perhaps more digital in nature semiconductors as well as solving some of the challenges that people have today, that customers have today, such as the one that we did last year with the Aquilae module that we are currently shipping with our third handler. So, there will be sort of a steady progression into that market. That's how we project it today.

Q:
Great. That's helpful. One last question. One thing I noticed was OpExthis quarter, and you guys look for it to go up a notch. Any way you can talk about how you think of the optics. Well first, what happened in the fourth quarter? Is it just this investment you talked about? And then long term, is there a way to think about how much you think you will grow your opex?

Jeff Jones – Chief Financial Officer
In Q4, Edwin, it was mainly driven by the support of a large Korean customer that we talked about from a product development standpoint, but also sort of an onsite support perspective as well. So when we look at Q2, we're expecting op ex to be closer to the Q4 rate. It's about $25 million a quarter. So expect that beginning in Q2 for Q3 and Q4 as well.

For R&D, we're modeling baseline costs to be about where they were in Q4. Likely to grow a little bit with revenue as we develop some of these new products in line with the plan that Luis articulated. But on a full year basis, we're expecting R&D to be approximately 12% of sales.

Then for SG&A, that's a baseline there, quarterly baseline of about $13 million to $14 million. And again, that will grow as sales grow, but the rate of growth there is about 1% for every $3 million increase in sales. So, for the year we're looking at SG&A in the 13% to 15% of sales range.

Luis Muller – President and CEO
I'm just going to add here to what Jeff stated. The momentary increase in R&D spending for this Korean customer is actually to some degree we're very happy to see the activity picking up earlier than we had originally anticipated for 2018. Obviously, it adds more stress to the organization, but the pulling in of the opportunity has been a very good thing for our projection here for the first half of the year.

Q:
Okay, great. Good job with strong bookings and backlog. That's all I have. Thank you.

Operator
Our next question comes from the line of David Duley of Steelhead.

Q:
I think you mentioned it, guys, but could you remind us, did you say that you thought the handler market would grow 8%? What was the number that you used?

Luis Muller – President and CEO
What I said was that we expect the combined handler contactor market should grow about mid-single digit in 2018.

Q:
Okay. And I guess with, I've seen projections of overall unit volume of semiconductor growing in the 9% or 10% range and it seems like you're forecasting a lower growth rate than that. Are you just being conservative or do you think the growth rate isn't going to be that high as far as units go? Help me understand how you came to that mid-single digit kind of projection.

Luis Muller – President and CEO
The way we do it is we poll our customers for a projection for the year and sort of the collective information we get shows I guess at about mid-single digit growth in the market for 2018. And along with that, we plan our one to three points of share gain for that market growth and that's essentially how we derive our projections for this coming year.

Q:
Okay. And as far as your 1% to 3% market share gains, help us understand where you thought the overall hander market was in 2017 as far as size goes and what the size of the contactor market was last year as well.

Luis Muller – President and CEO
We have not yet compiled the full data set for 2017, but I will tell you preliminarily that we believe the market was about $780 million for handlers in 2017 and probably on the order of $720 million for contactors.

Q:
Great. And could you help me understand, you mentioned a new Korean customer a couple different times, what sort of application will you be addressing with that customer? And then I think you mentioned a foundry win. Could you help us understand what that application is as well? Thank you.

Luis Muller – President and CEO
Sure. The initial application in this Korean customer is for small power management semiconductors. These are used in mobile products and I believe also in consumer products, general consumer products, but those applications are going to be expanding over time, so that's just the starting point.

As far as the foundry customer, that is a computing application, high end processor application, which we forecast to pick up volume towards the second half or the beginning of the second half of this year.

Q:
Is that driven by a transition to 7 nanometers or 10 nanometers, something like that? Is there some sort of tie to the end market as far as technology transition goes?

Luis Muller – President and CEO
No, I don't believe this one is tied to – this one in particular I don't believe it's tied to a node transition. More so the complexity of the device that we have captured, but I don't think so much driven by node transition on this particular case.

Q:
Okay. Thank you.

Operator
Our next question comes from the line of Craig Ellis of B. Riley & Co.

Q:
This is actually Peter Peng calling for Craig Ellis. Thanks for taking our question. Can you give us the gives and takes as you think about the business on a sequential basis, on an end market basis?

Luis Muller – President and CEO
So we have had a very strong end market in the fourth quarter across all segments, I would say, with the exception of the solid state lighting or LED segment that I would say was weaker than expected in the fourth quarter, but the other markets have been very strong. And now, getting into Q1 we continue to see strength across all those same markets, so much so that, as I stated, we're looking at again a book-to-bill of above 1 for the first quarter and momentum continues from last quarter.

Q:
Great. It seems like there's some high bandwidth memory ramping up. Can you talk about Cohu's participation in that market?

Luis Muller – President and CEO
Sure. Cohu is not really participating in the memory market today. We have some applications, high performance memory, but that's fairly limited in size and scope and not really a substantial portion of our revenue today.

Q: Okay. On the contactor business, it seems like that business declined kind of in line with the general handler business. Can you talk about that business and the seasonality and what you expect in the first quarter?

Luis A. Muller – Chief Executive Officer
Well, that business has, let me just start there, that business actually grew 131% year-on-year, but obviously within that there has been an acquisition, as you know, of Kita in Japan. Kita has achieved the growth objectives for 2017, and organically, post-acquisition, the whole business has grown a little over 20% year-over-year.

On a seasonality basis, we do tend to see a lower consumption of pins, spare pins, in the fourth quarter. Then again, a pick up for the balance of the year, the first three quarters of the year. So that's a seasonal pattern that we have observed. But with that said, we continue to see growth in the business, new design wins, opportunities, new product launches, and continue to model a 20% organic growth rate for 2018 for the total contactor business that we run.

Q: Okay. Great. On the gross margin, it seems like it's ticked up. Is that due to new product, or is that just the Osaka plant ramping up contactor sales?

Jeff Jones – Chief Financial Officer
Peter, it's a combination of things. First, it's leveraging more out of our Malaysia operation and so providing a lower fixed cost or lower product cost. Part of it does have to do with mix as well, so contactors is a contributor to that increase in margin.

As we look forward to 2018, we'll see new products that we've talked about also contributing to expansion of gross margin.

Q: Okay. And one question before I hop back into the queue. That $1.3 million in deferred revenue, is that rev recognition In the second quarter, is this going to be going below the line? How should we think about that?

Jeff Jones – Chief Financial Officer
As I stated, it will not go through the income statement. So we will not have the opportunity to recognize that as revenue or profits in 2018. We'll make an adjustment in Q1 to take the deferred revenue, deferred profit, off of our balance sheet, excuse me, take the deferred revenue and deferred profit and move it into equity, straight into equity. So again, we won't benefit in 2018 on the income statement or EPS from that $1.3 million.

Q: Great. Thank you, guys.

Operator
[Operator instructions.] Our next question comes from the line of Patrick Ho of Stifel. Please proceed with your question.

Q: Thank you very much. Luis, first off, in terms of the PANTHER and Solstice products, in terms of revenue recognition and the ability to recognize revenues this year, are you going to set any targets for this year? What are, I guess, some of the final hurdles you need to get through to get the revenue recognition on the systems you have out on the field?

Luis A. Muller – Chief Executive Officer
So, taking one at a time here, for Solstice we have already recognized a couple units. I'd have to go back and look, I think it was in the third quarter of last year when we had our first revenue recognition for Solstice.

For PANTHER, we do have revenues from PANTHER included in our Q1 guidance. As far as the full-year, we're not going to be giving product-specific revenue targets for the year, but they're definitely included in what we're modeling for 2018 including the growth for the first half of this year relative to the first half of last year of about 10%.

Q: Great. That's helpful. My follow-up question in terms of the contactor business, I think one of the things you mentioned when you acquired Kita was the leverage your handler business and even your own emerging contactor business could provide the Kita business, how much of it from a customer perspective have you seen that pull to-date, and is that the biggest driver of growth for the Kita solutions as we look at 2018 as a whole?

Luis A. Muller – Chief Executive Officer
Yes. To start from the end here, the answer is yes. We're seeing very attractive opportunities on a customer base for handlers, particularly Pick-and-Place handlers, because the Kita pins are predominantly used on digital, some mixed-signal applications that go in our Pick-and-Place products.

More specifically, we're seeing very, very good evidence of the thermal requirements in test at the interface layer where the contactors are going. We have solutions and products coming out specifically on that front that have been already qualified at one of our major customers that we're working to promote and get on the floor with some of the other customers that really ties very nicely the contactor thermal performance with the handler thermal performance as an augmented solution for, like I said, for our digital mixed-signal customers. So, yes, there's a very good tie between the Kita pins and contactors that we build surrounding that with our own Pick-and-Place handler customers.

Q: Great. Thank you very much.

Luis A. Muller – Chief Executive Officer
You're welcome.

Operator
We have a follow-up question from the line of Edwin Mok of Needham & Company, LLC. Please proceed with your question.

Q: Hi, guys. So just a quick follow-up here. For the year, I think you guys talked about that you expect the market to grow around mid-single digit range and you expect share gain to grow one to two points. So that would imply you expect your business to grow very high-single digits Is that a fair way to think about, it or am I missing something there? I just wanted to understand that.

And with the first half growing at 10%, does that mean the second half we'll see some slower growth there or are just [indiscernible].

Luis A. Muller – Chief Executive Officer
Just one quick correction. I mean you said one to two points share gains, we're actually modeling one to three points share gain in each of the markets. Frankly, just given our sheer size in handlers, it's more likely that handlers would be towards the high-end of that target, meaning towards the three points share gains on the total market. From a contactor perspective, simply by the fact that our size in the contactor market today, we're looking at about a point share gain which would represent about 20% organic growth.

You are also correct about the projected growth for the first half of the year of about 10% relative to last year. Now, we're not putting any number out today for the second half of the year. We're not prepared to do that today, Edwin.

Q: Okay. Great. I just wanted to make sure I got all the mechanics correct. Thank you. I appreciate it.

Luis A. Muller – Chief Executive Officer
You're welcome.

Operator
There are no further questions over the audio portion of the conference. I would now like to turn the conference back over to Mr. Jeff Jones for concluding remarks.

Jeff Jones – Vice President Finance and Chief Financial Officer
Thank you for joining us on today's call. We look forward to speaking to you at upcoming investor events or when we report our first quarter 2018 results. Have a good day.