# *Transcript of Cohu, Inc.*
# First Quarter 2017 Earnings Call
# April 27, 2017

## Participants
Jeff Jones - Vice President Finance and Chief Financial Officer
Luis Müller - President and Chief Executive Officer

## Analysts
David Duley - Steelhead Securities
Arthur Su - Needham & Company
Brian Chen - Stifel
Peter Kim - B. Riley & Company
Steve Marascia - Capitol Securities

## Presentation

**Operator**
Greetings, and welcome to the Cohu, Inc. 2017 First Quarter 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.

It is now my pleasure to introduce your host Jeff Jones, Chief Financial Officer for Cohu. Thank you, Mr. Jones. You may begin.

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Good afternoon, and welcome to our discussion of Cohu's most recent financial results. I am joined today by our President and CEO, Luis Müller. Following our opening remarks, we'll provide details of our performance for the first quarter of 2017, as well as our outlook for the second quarter of this year. If you need a copy of our earnings release, you may obtain one from our website, 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 the company's expectations for industry conditions, future operations, financial results, market share gains, expansion into new markets, and any comments we make about the company's future in response to your questions. Our comments speak only as of today, April 27, 2017 and the company assumes no obligation to update these comments.

We encourage you to review the forward-looking statements section of the earnings release as well as Cohu's filings with the Securities and Exchange Commission, including the most recently filed Form 10-K and Form 10-Q. 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.

Now I'll turn it over to Luis.

**Luis Müller - President and Chief Executive Officer**
Thanks, Jeff and good afternoon, everyone. Cohu had an excellent first quarter of 2017 with sales up 15% sequentially to $81.1 million and non-GAAP earnings per share of $0.35. Our Malaysia operation shipped over 90% of all Cohu handlers in Q1 which significantly contributed to improved gross margins. Measured test cell utilization across the installed base was 86%. Cohu's semi equipment orders were at an all-time high with strong demand for turret and pick and place handlers, as well as multiple contactor design wins, some of which we'll ship in the second half of this year. There is also robust demand for our just acquired Kita spring probe product lines.

This was another strong quarter in automotive, mobility and IoT markets with systems accounting for 60% and recurring 40% of total orders. Beginning today, we'll describe our business by semiconductor device segments that we believe better represents the dynamics of the industry.

High performance mixed signal were 35% of system orders in the first quarter mainly for automotive, industrial and consumer markets. Our tri-temperature pick and place handlers are today the leader in the industry. We had strong demand from several customers including follow-on business from our key 2016 design win as this customer continues to proliferate the MATRiX handler to their Asia volume test operations.

Analog RF and power discrete was 26% of system orders. Our RF business is particularly strong for turret handlers for tested inspection of amplifiers and soft filters. This segment has shown steady growth in the last year mainly driven by the expansion of wireless connectivity in mobility and IoT markets. Power discrete covers transistors, diodes, precision and power resistors that are mainly test on turret and gravity handlers.

Sensors including Micro-Electro-Mechanical Systems or MEMS and LED were 16% of system orders. Cohu MEMS test units can be used on any of our handler platforms but have traditionally been strongest combined with gravity systems due to package form factors used in automotive applications. We also had repeat orders from two Japanese customers for turret handlers and expect to expand our business with these customers in future quarters. LED business has been exclusively for turret handlers configured for test and inspection of high powered light emitting diodes used in automotive and mobile devices.

Processors were 14% of system orders in the quarter as we see the beginning of a ramp that is expected to continue into the second quarter. A key mobile customers recent market share gains will drive demand for pick and place handlers, especially the Eclipse that actively manages device temperature during test. Computing system orders continue to be driven mainly by a large leading customer, but we are also making progress at a well-known graphics processor manufacturer that is evaluating an Eclipse handler.

Power Management was 7% of system orders covering power amplifiers, voltage regulators and DC to DC converters. These devices are mainly tested on our turret handlers; however, we are in the process of developing a pick and place system that will expand our portfolio solutions. We have already received a repeat order even though this new system is still in development and planned for launch late this year or early 2018.

Other segments accounted for the 2% balance of system orders.

Moving on to an update on three key product developments: Cohu's new wafer level CSP prober is nearing completion. We successfully finished the key evaluation in the first quarter and plan to ship multiple systems in the second quarter to support this customer's production plan for the second half of this year. The transfer of product manufacturing to our Malaysia operation is already underway to achieve target profitability early in this product's lifecycle.

We plan to ship the first system level test platform in the third quarter.

In addition, we started the development of another handler platform to address requirements from our recently acquired, leading Korean memory and mobile processor semiconductor customer.

Moving on to contactors. Orders were up 16% quarter on quarter, inclusive after recently acquired Kita operation. We had several design wins in the quarter at customers in the Philippines, Malaysia and China. We subdivide the contactor market in three segments.

Digital and mixed signal had strong order activity mainly driven by capacity additions in conjunction with the MATRiX handler. Kita spring probe share in Cohu contactors grew to 21% in Q1 compared to an average of 3.5% last year, demonstrating the early potential for synergies and opportunities for future recurring revenue contribution as these consumable pins are replaced upon usage and wear.

In the analog power, sensors and LED markets, we shipped the first cCompact Kelvin Contactor to a leading customer and successfully completed the cHybrid contactor evaluation at another key customer using our turret platform. This new contactor has outperformed the competitors' product life and yield performance, and we established ourselves as the volume supplier for new device applications.

In the analog RF market, we introduced the new cDragon medium frequency contactor at the BiTS conference in March, received a repeat order from a lead customer and initiated evaluations at three new accounts that we expect to convert to sales in the next three to six months.

For the second quarter, end market dynamics and customer forecasts are strong and we expect another quarter of book-to-bill above one. Cohu continues to capture new device test and inspection applications for our handlers and benefit from increasing semiconductor package integration. With strong Q1 orders and continued momentum in Q2, combined with improved gross margin, we are well positioned for meaningful sales and profit growth in 2017.

Now I'll turn it over to Jeff for details in the financials and Q2 guidance.

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Okay. Thanks, Luis. Overall results for the quarter were much better than forecasted due in part to delivering over 90% of our handlers from Cohu's Malaysia manufacturing operation benefiting gross margin. Q1 was Cohu's 13th consecutive quarter of non-GAAP profitability generating 14% operating income and nearly 16% EBITDA. Strong order momentum in Q1 drove a 24% increase in backlog which sets the stage for sequential increases in shipments and revenue in Q2 and second half of the year. The Integration of Kita is on track and we remain very optimistic about contactor sales synergies.

For Q1, the GAAP to non-GAAP adjustments include approximately $1.7 million of stock-based compensation expense, $1.1 million of purchased intangible amortization expense, $104,000 of restructuring costs, $187,000 of costs related to the acquisition of Kita and $347,000 of costs related to the step up and valuation of inventory acquired. My comments are based on Cohu's non-GAAP results which exclude the impact of these items. A reconciliation of non-GAAP measures to equivalent GAAP measure can be found in our earnings release located on the Investor information section of Cohu's website.

Sales for the quarter were $81.1 million and higher than guidance due to increasing demand for our pick and place handlers, particularly from customers in the automotive and mobility markets. One customer in the automotive market represented 20.1% of sales during the quarter. No other customer represented 10% or greater of Q1 sales.

Q1 gross margin was 41.3% significantly better than our forecast and our financial model at this level of sales. Gross margin benefited from better manufacturing cost leverage in Asia and favorable product mix. We also benefited from one time cost of goods sold credits for inventory evaluation and warranty costs which contributed about 100 basis points to gross margin. We plan to increase our financial metrics at the mid-term sales target of $400 million to better reflect the improved leverage in operations, launch of new handler systems and increase in sales of higher margin test contactor sales.

Operating expense was $22 million and in line with our forecast.

The Q1 effective tax rate was 15% and lower than forecasted as all of the Q1 profit was generated outside the US in countries with lower statutory income tax rates and certain countries in which Cohu has income tax incentives. We are projecting an effective tax rate for 2017 of about 20%.

Accounts receivable increased sequentially on higher shipments of $4 million quarter over quarter and the addition of the Kita accounts receivable balance of $4 million. DSO increased by 5 days to 84. The inventory balance also increased sequentially mainly in preparation for an expected increase in shipments in Q2 compared to Q1 of approximately $12 million. Inventory days were essentially flat at 99. Accounts payable days were also flat quarter over quarter at 68. And the overall cash conversion cycle increased by 6 days to 114.

Fixed asset additions in Q1 were approximately $1.5 million and depreciation for the first quarter was $1.1 million.

Deferred profits at the end of March were $4.8 million, down $2.1 million quarter over quarter. The related deferred revenue at the end of Q1 was $5.7 million, that's down $3.6 million sequentially.

Cohu's Directors approved a quarterly cash dividend of $0.06 per share, payable on July 28, 2017 to shareholders of record on June 16, 2017.

And now moving to our guidance for Q2, shipments in Q2 are expected to be approximately $12 million higher than Q1, however, some revenue recognition will be deferred to Q3 as a result of shipping to new customers, as well as shipping new handlers to existing customers, both of which require customer acceptance prior to recognizing revenue. As a result, we expect sales will be sequentially 6% higher at $86 million. Gross margin in Q2 is forecasted to be approximately 40%.

Operating expenses for the second quarter are expected to be approximately $22 million essentially flat quarter over quarter. Our projection for Q2 non-GAAP operating expense excludes approximately $300,000 of Kita inventory write-up costs, which will flow through cost of sales. Additionally, any changes to our initial estimates of the fair value of Kita assets, including intangible assets acquired, may result in different amortization amounts being recorded in the second quarter or future quarters.

And before we conclude our prepared remarks, I want to mention that we will be hosting a Corporate Access Day with equipment demonstrations in conjunction with SEMICON West on July 13th at the Marriot in Santa Clara California. Investors interested in attending the Corporate Access Day can contact Cohu Investor Relations for all the details. Additionally, we will be presenting at the B. Riley Conference in Los Angeles in May, the Stifel Conference in San Francisco in June, and the CEO Summit in San Francisco in July.

That concludes our prepared remarks and now we'll take questions.

**Operator**

Thank you. Ladies and gentlemen, at this time we will be conducting a question-and-answer session. [Operator instructions]. Our first question comes from the line of David Duley from Steelhead Securities. Please proceed with your question.

**Q:** Yes. Thanks for taking my questions and congratulation on nice results. Just a couple things. Have you changed your expectations for the size of the handler market since the start of the year given the results that were a bit better than expected?

**Luis Müller - President and Chief Executive Officer**
Maybe we were towards the upper end of that expectation, Dave. I mean we talked before about the handler market likely going into an $800 million to $825 million in 2017. I believe that's the number we gave you a quarter ago and I would say it's pushing towards the upper end of that range.

**Q:** Okay. And just commentary about seasonality for you guys. I think I heard you say you thought you would see continued growth in shipments in the second half of the year but maybe you could just talk about what the puts and takes are for seasonality that you might see this year.

**Luis Müller - President and Chief Executive Officer**
Yes. Dave, we commented, it was back in Q4 of last year actually was that we didn't see the typical seasonality pattern for 2017. We thought 2017 would be more of a stable, flattish year. Obviously, there will be some variations but not to the extent that we had seen in the past in 2015 or 2016. And at this point I still hold to that. I think the degree of seasonality this year will be significantly lower than it was in the last couple of years.

**Q:** Okay. And then could you talk a little bit about—obviously gross margins I think were better than expected. It's great to see that they've cracked the 40% level there. Did you hint you were going to raise the target model? Did you mention what gross margins you might be able to target, $400 million now—or any color there would be helpful.

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Yes, you bet, Dave. And yes we are updating the metrics on our financial model as we talked about we're realizing greater cost benefits than we had originally projected from our high volume manufacturing operation in Malaysia. That's about the higher end of our financial model. Let's say in current range maybe about $90 million we'd expect gross margin in the 40% plus range. EBITDA 17%. Then when we looked to the mid-term target which again is annual sales of $400 million, that gross margin is increasing 200 basis points to 42% with an EBITDA of 18%.

**Q:** Great. Thank you, and congratulations on nice results.

**Operator**
Our next question comes from the line of Edwin Mok with Needham & Company. Please proceed with your question.

**Q:** Hey, guys. This is actually Arthur on for Edwin, but thanks for taking our questions and congrats on a great quarter. The first one is just earlier this morning Teradyne and it talked about how RO is particularly strong for them and in this quarter you mentioned auto was also strong for you, too. Just wanted to get a sense as to what is driving the strength for you in auto and how sustainable we should think about it going into the rest of 2017.

**Luis Müller - President and Chief Executive Officer**
Okay. So in the auto segment not much has changed from what we mentioned a quarter ago actually. If you recall we commented that particularly China was accelerating the implementation of some new tougher emission

standards that were originally planned for 2020 and now pulled in. It's pretty well known they have some of the worst air pollution in the world and they have to do something about it. So these are the so-called the National Six Standards that they have over there implemented. And that has been a significant drive of the auto segment for us in addition to just general in containment and electrification, and we don't see any letting go at the moment from the auto industry this year.

**Q:** Perfect. Thanks for confirming that. And then thanks for providing a little bit more color on the progress on your long-term growth drivers. With the wafer level prober, I think previously you had talked about a revenue target of $10 million to $20 million in the second half of 2017 and for your system level test product I think the target was $5 million to $10 million. Are those still applicable or do you think there is an opportunity for that to go higher as we move to the end of the year?

**Luis Müller - President and Chief Executive Officer**
At this point those are still applicable and you are correct on the numbers.

**Q:** Great. Thank you. And then maybe just the last question, what are some of the puts and takes for gross margin in that 40% next quarter versus the strong gross margin at this quarter?

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Yes, Arthur, Q2 has a less favorable product mix when compared to Q1. Then as I mentioned in my remarks there's about 100 basis points in Q1 due to what I call these one-time credits related to inventory and warranty. And so our Q2 guidance for 40%, in line with our financial model, and as I talked to Dave, we're seeing increases at the higher end of those ranges up to 42% at our mid-term target.

**Q:** Perfect, thank you.

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

**Q:** Hi, this is Brian Chen on for Patrick. Thanks for letting me ask a few questions. First just congratulations and to double back on gross margins, in a brisk market environment which is sensibly what we're in right now, can you talk about how you're able to upshift to 90% manufacturing from Asia? And I guess how much incremental could we expect to see in addition here throughout the rest of the year?

**Jeff Jones - Vice President Finance and Chief Financial Officer**
So we've shifted the manufacturing of pick and place and gravity. So we essentially have completed that whole transition of manufacturing to Malaysia. Our target has been to get to this 90% of handlers shipping in a quarter manufactured in Malaysia. So we essentially accomplished what the original objective is. I would expect that in future quarters that we're going to continue hover around that 90%, maybe 90% plus mark in this as you put it brisk environment.

**Q:** Okay, got you. I was going back to I think it was around 80% last quarter. It seems like a decent step up on improving revenues to get that level. Maybe secondly, computing, I have noticed at least from a recent quarter standpoint your big computing customer make it about the 10% threshold. Typically they're stronger kind of Q2, Q3 from a seasonality perspective. Is that the right way to think about that customer coming back in the fold maybe Q2, Q3 giving you little bit better visibility and strength?

**Luis Müller - President and Chief Executive Officer**
I don't tend to think of that customer having a seasonality pattern like the rest of the industry in as much. I think they are customers mainly driven by sort of technology, new node introductions and increased test coverage.

Obviously, still dependent on end markets, consumers and deployment of our server farms out there, no doubt. But I don't tend to see that customer particularly as a seasonal customer. Maybe you have found a seasonal pattern there but I generally don't see it that way for that particular customer. So I don't know exactly what is to be reserved. I mean there could be an increase on the second half of the year with that customer or not; I'm not 100% sure.

**Q:** Okay, yes, fair enough. Maybe one last question, it was alluded to earlier but a measure tester company is talking about the increased test complexity specifically for handset components leading to a very healthy capacity buying environment at the moment. What of those test complexities also benefit your thermal subsystem business? Is that maybe some relationship to your test handler business as well?

**Luis Müller - President and Chief Executive Officer**
Yes. I think the increased test complexity really ends up translating into increased test times and increased test times translate into additional capacity of systems in general. I mean it could also be handlers. We do sell handlers into mobile processor test. And, yes, it is always good when there is increased test complexity as it is when there is transition to smaller nodes and general speaking increased test coverage until silicon matures at the new node.

**Q:** Okay, great. Thank you.

**Operator**
Our next question comes from the line of Craig Ellis with B. Riley & Company. Please proceed with your question.

**Q:** Hi. This is Peter Kim calling in for Craig Ellis. Thanks for taking our question. The first question I have is on the deferred revenue of $12 million. Is this going to be rev rack over two quarters, three quarters or is this going to be mainly in Q3?

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Well, so let me clarify Peter. The $12 million that I referenced is an increase in shipments quarter over quarter. Now, not all of that gets deferred to a subsequent quarter. I'd say about $4 million of that increase will be deferred into, we expect, into Q3 revenue.

**Q:** And then on the kind of the 6% QonQ guide what are some of the gives and takes in your end markets?

**Luis Müller - President and Chief Executive Officer**
The sales growth, the activity continues to be pretty much in the same markets that have been in quarter one. We continue to be pretty strong in automotive. As I said there was a ramp that we saw in Q1 and continues into Q2 and the mobility market and here I'm talking particularly mobile processors. I would say the mobile RF segment, analog RF and power sort of remains the same visibility for Q2 as it was in Q1, both from the mobility as well as IoT application. So not much of a change more so I would say an ongoing ramp on the mobile processor side.

**Q:** Okay. And then on the Kita acquisition, it seems like it's slightly tracking ahead of the $16 million annual run rate. Is this kind of sustainable for the year or are you going to see kind of a take down this quarter?

**Luis Müller - President and Chief Executive Officer**
I don't see any take down this quarter but it's hard to know what it's going to be for the full year particularly as we—I made a comment here during my prepared remarks as particularly we start designing in Kita pins or their spring probes into our digital mixed signal contactor bodies, those probes over time are going to start seeing sort

of replenishment revenue or replacement revenue. They are the blades that wears out over time. And it's a little tricky for us to model how that could influence revenue in future quarters. So I don't know, to be honest with you, other than certainly not letting go in quarter two.

**Q:** Thank you. That's all I have.

**Operator**
Our next question comes from the line of Steve Marascia from Capitol Securities. Please proceed with your question.

**Q:** Thank you. Good afternoon, gentlemen, and congratulation on a good quarter. Just a couple of quick questions I think you've already touched on. Did you say that with revenues running at about $90 million you expect about a 40% gross profit margin?

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Yes, 40%, slightly over 40% plus; that's correct, Steve.

**Q:** And next quarter revenues coming in at somewhere about $86 million once you factor in or out all of the different things coming with sales recognition factors.

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Yes, that's right.

**Q:** Okay. And what about the run rate for your R&D and SG&A expenses going forward for the rest of this year?

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Yes. So as I guided $22 million for Q2, that's flat to Q1; that's OpEx. So our base run rate for operating expenses should be approximately $19.5 million per quarter. Then we've added Kita, so that adds another $1.3 million per quarter and as we've talked in past quarters, we are currently implementing an ERP system at couple of our major locations. So we've had about $400,000 to $500,000 of project costs each quarter. The base should be about $19.5 million plus the Kita, so talk about $21 million after we get past this ERP project.

**Q:** So should we expect any type of ramp up in that side of equation assuming your revenues keep growing towards $90 million or $100 million or do you guys pretty much see this as being predictable from these levels?

**Jeff Jones - Vice President Finance and Chief Financial Officer**
Yes, yes. It's very predictable. There's some variability to sales in SG&A as well as some in R&D as you can imagine, in omission, a bit of commissions, a bit of travel and then as customers continue to ramp, they will need additional engineering support. So there is some variable aspect to it but it's a minor piece of the OpEx.

**Q:** Thank you very much.

**Operator**
Gentlemen, there are no further questions in queue. I'd like to hand the call back over to management for closing comments.

**Jeff Jones - Vice President Finance and Chief Financial Officer**

Right. Thank you for joining us on today's call. We look forward to speaking with you at our Corporate Access Day in July or the investor conferences we will be attending over the next few months or when we report our second quarter results. Have a good day.