Company: **MTS Systems**

Conference Title: **MTS FY2016 and 1st Quarter FY2017 Earnings**

Moderator: **Jeff Oldenkamp**

Date: **11 April 2017**

Conference Time: **09:00**

Operator: Good day, and welcome to the MTS' Fiscal Year 2016 and First Quarter 2017 Earnings call. Today's conference is being recorded. At this time, I would like to turn the conference over to Andy Cebulla; director of Investment Relations. Please go ahead.

Andy Cebulla: Thank you, Tracy. Good morning and welcome to MTS' Fiscal 2016 Fourth Quarter, Fiscal 2016 full year and Fiscal 2017 First Quarter Investor teleconference. Joining me on the call today is Jeff Graves, President and Chief Executive Officer; and Jeff Oldenkamp, Senior Vice President and Chief Financial Officer.

I want to remind you that statements made today, which are not historical fact, should be considered forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Future results may differ materially from these statements depending upon risks, some of which are beyond management's control. A list of such risks can be found in the company's latest SEC forms 10-Q and 10-K.

The company disclaims any obligation to revise forward-looking statements made today based on the future events. This presentation may also include reference to financial measures, which are not calculated in accordance to generally accepted accounting principles or GAAP. These measures may be used by management to compare the operating performance of the company over time.

They should not be considered in isolation or as a substitute for GAAP measures. A reconciliation of any non-GAAP measures to the nearest GAAP measure can be found in the company's earnings release. Jeff will now begin his update on our fiscal 2016 fourth quarter, full year results and our fiscal 2017 first quarter results.

Jeff Graves: Thank you Andy and good morning everyone. Thank you for joining us for our investor call today. We appreciate having the opportunity to discuss our financial results for fiscal year 2016, which ended on 1 October and the first quarter of Fiscal 2017 which ended on 31 December. In addition to the recap of the 2016 results and the first quarter of fiscal 2017, we'll also provide you with our outlook for the full year of fiscal 2017.

There are four key takeaways for the call today, first, the investigation into potential violations of the company's code of conduct by former MTS employees involved with our Test business in China, which began in November just prior to our planed fiscal '16 earnings release, has concluded. As per best practice, the investigation was independently overseen by the audit committee of our board of directors, who engaged the legal firm of Simpson Thacher from New York and FTI Consulting Group, who helped with the forensic accounting; and related efforts in China.

Both firms are highly qualified and experienced in these matters. Based upon these exhaustive efforts, we were pleased with the fact that there were no restatements or modifications of the financial results that we were prepared to report on 30 November of last year. What we did confirm however, is that certain of our Chinese employees in our Test business did violate our MTS code of conduct and that we need to further enhance our compliance, oversight and monitoring efforts in China. I'll discuss the investigation in more detail shortly.

Second, with regards to our business performance, we were pleased with our results for the fourth quarter of fiscal 2016 and for the full year. Revenue for the fourth quarter increased 50% from the fourth quarter of fiscal ’15, which included 19% growth in our organic business; meaning the base business without the impact of the acquisition of PCB, which closed in July, the beginning of our fiscal fourth quarter.

The strong organic growth was driven once again by improvements in our Test operations, which resulted in more efficient backlog conversion, as well as 8% growth in our Test services business; both of which have been mayor initiatives for the company. Our full year revenue increased 15% in total. And was up 7% organically, including a 9% increase in the Test services business here over a year.

The operational and organizational improvements we implemented over the last 18 months in our Test business, have clearly improved our ability to more rapidly convert our backlog into revenue, given us confidence to deliver sustained growth in the future. Regarding earnings, we were pleased with the earnings that we delivered in the fourth quarter, which exceeded our expectations because of the strong revenue growth in our Test business, as well as higher margins from improved executional complex customs projects in our Test business in the fourth quarter.

Due to the strength of the fourth quarter earnings, our GAAP earnings per share for the full year came in at a high end of a range that was previously communicated in January, and exceeded the expectations provided during our Q3 earnings release. Third, the integration of PCB is progressing nicely since the close at the beginning of the fourth quarter.

Over the last several months, teams from multiple disciplines within the company have been highly engaged in working to combine the two Sensor businesses and to begin coordination with our Test business that brings important additional growth and cost synergies in the years ahead. The revenue in cost synergy that we previously outlined has been validated through this work and we feel strongly that we will be able to achieve them over the next four to five years.

Of immediate importance following the close of the transaction in July, was the opportunity to assess and optimize our combined Sensors operational footprint. Based upon this analysis, we have initiated the process of closing our factory in Machida, Japan and have begun to transition production from there to our other Sensor facilities, with most of our volume moving in to our U.S. operations in North Carolina.

This work will be completed by end of fiscal 2017. With this and other efforts that we have undertaken, we believe that we will begin to deliver more revenue and cost synergies in fiscal 2017. Although they'll be fairly modest in the first year, we'll ramp up on the years to come.

The fourth key message today is regarding our Q1 performance and our outlook for fiscal year 2017. Overall, we were very pleased with our results for the first quarter of fiscal 2017. As revenue increased by 42% to $199 million. The PCB acquisition contributed growth of 32% and very strong organic revenue growth provided the remaining 10%; again, driven by improved backlog conversion in our Test business.

Compared to the prior year, gross margin raid[?] on a gap bases for total MTS decrease from 37.4 to 36.9% due to acquisition integration and restructuring expenses. However, excluding these expenses the gross margin raised nicely to 41%, our highest in over 4 years.

Moving on to our fiscal year 2017 outlook, we are forecasting revenues on the range of $760 million to $790 million, and GAAP earnings per share are $1 to $1.40 for our fiscal year 2017. We believe the strength in our Test in-mark is as reflected in our record opportunity pipeline of over $1 billion, and the strong backlog of $356 million that we have at the end of the first quarter will enable us to achieve our forecasted revenue for the year.

In addition, we will further realize for all four quarters in 2017, the strength of our combined MPS and PCB Sensor business. Given the impact of acquisition integration cost in the China investigation expenses in addition to our GAAP guidance, we are also providing a forecast of adjusted non-GAAP EBITDA, as defined in the non-GAAP financial measures in exhibit E sections of our press release.

For fiscal 2017, we believe our adjusted EBITDA will be between $115 and $130 million, so again, our adjusted non-GAAP EBITDA will be between $115 and $130 million. Jeff Oldenkamp will provide more detail regarding our guidance in a few moments. A reconciliation of this non-GAAP measure to net income, the closest GAAP measure, is included in our earnings release, which is available in our website and the SEC's website.

With that, I'll provide more context on China and then, from a business standpoint, what we are seeing in our in-markets. As mentioned previously adhering to best practices, the China investigation was independently lead by our audit committee, who engaged outside experts that conducted a very thorough examination which was important given this China senior leadership on our Test business that were involved.

The investigation was by all measures comprehensive, with tens of thousands of emails reviewed, numerous transactions tested and over 75 interviews conducted from November of 2016 to March of this year. In total, approximately a total of $8 million was spent on the investigation; consisting on legal fees, forensic auditors, bank waiver fees, audit fees and internal investigation resources. With the independent investigation now complete, in short, we can say that there were no booking records misstatements; no theft of intellectual property - an important factor in maintaining or long-term strategic position - and no involvement by anyone in the finance organization or the MTS executive management team.

From a longer-term perspective, our competitors' strengths in China and elsewhere are fully intact, these were all important and positive findings. What was confirmed however, was that certain senior in middle of all Chinese employees in our Test business, did start a business to compete with MTS on the low-end of the Chinese materials testing market. This conflict of interests is clearly a violation of MTS code of conduct. We are disappointed and are taking appropriate actions with regard to all of the person implicated in the investigation.

Furthermore, the investigation highlighted opportunities to further improve and expand our compliance monitoring efforts, particularly over third parties used in our sales channels and local suppliers from which we occasionally source materials used in the fulfillment of large in-country projects, and the strength in our oversight monitoring to ensure consistent execution of our compliance policies and procedures in China. We cite these controlled deficiencies as a material weakness in our internal controls over financial reporting form 10-K as they created the potential for override of our China-controlled environment, even though no evidence of an actual override was found.

To strengthen our oversight compliance monitoring in China, which represents over 20% of our company's revenue and to look ahead more broadly at our overall risk environment around the world, I recently announced the creation of our new Office of Risk Management and appointed a Chief Risk and Compliance Officer, reporting directly to me, with the customary accountability to our audit committee at the board of directors. Under her direction, we'll be filling incremental positions over the coming months to expand the Compliance Department and will engage FTI, who performed very well on behalf of our audit committee and continued support of our on-going compliance monitoring in China.

In summary, we feel the company has done a very thorough investigation, we believe that plans are in place to drive continued improvement in our compliance efforts and overall risk management, as we grow in all of our key markets around the globe. Looking ahead, with the China investigation behind us and our filings now complete, we fully expect to file timely in future quarters, with our Q2 earning release scheduled for early May.

Moving on to our business updates, first, let's start with our Test in-markets, which are quite interesting. For the first quarter of fiscal 2017 Test orders where $118 million, down 20%, driven in part by a large custom order last year that did not repeat. However, due to the nature of a long fall cycle for large custom orders in our Test business and market feedback, we expect Test orders for the full year to support our revenue outlook for the remaining of fiscal 2017.

And, with the record $1 billion opportunity pipeline ahead of us over the next 12 months, we remain excited about our longer-term market outlook. However, this simple statement does not adequately capture the full color of our test market environment in recent months, and the implication of these market dynamics on our Test business. To better describe the current market dynamics, let's look first at the ground vehicle market in more detail.

It's a fascinating time in the automotive industry, with rapidly-emerging trends of electrification and autonomy in cars and trucks. Never before have our customers faced this pace of change in technology for vehicles, and compounding this challenge to do so in an ever more complex regulatory environment for emissions and fuel efficiency standards. The implications for our company, we believe, are quite positive, in that our automotive and truck customers are clearly planning for investments in new testing technologies and testing infrastructure; for which we are well positioned.

However, based on the details that we can see in our opportunity pipeline data, from a timing perspective they've earmarked more of these investments for late 2017 and 2018; when we assume the requirements for technology validation, as well as their understanding of the impact of new tax and regulatory policies being discussed by the U.S. government and others, will be better understood.

With our opportunity pipeline for Test at record levels, we believe that it's a matter of when and not if this investments by our customers will occur. Given the strength of our technology position, our long-term customer relationships and our improvements in Test operations; we believe we are well-positioned to capitalize on this future demand.

Moving to the structures Test market, there's been some contraction in the global demand and investment by our customers for civil seismic work at least in the short run, aerospace test systems as well. We believe the opportunities in this market will improve from incremental spending and new programs for civil infrastructure investments, energy generation and defense spending moving forward.

The materials Test market, after a long drought from low oil prices, is starting to see an improvement from customers in the oil and gas market. As well as the price of oil has begun to recover and exploration strengthen. This is important to us given our historically strong technology position in what we call Rock Mechanics; which are test systems that evaluate the behavior of rocks under the extreme conditions encountered deep underground or even under the sea.

The manner in which rocks crack during drilling or fracking is critical to the extraction process. The increased investment in fracking for oil and gas fuel development, as well as the pipeline transmission infrastructure in the United States is therefore good for our business. We are also seeing broad interest for our test services, through the demand of large service contracts, refurbishment of large systems and updated system software and spare parts.

So, to summarize our Test outlook, at the end of the first quarter our 12-month pipeline of opportunity stood at a new record level of $1 billion. Up 5% compared to the first quarter of last year and up 1% sequentially. This visibility in the future demands, builds confidence and our orders outlook for the future.

As we've discussed in prior earnings calls, a key metric we use to monitor the health of our opportunity pipeline is the deferral rate within the pipeline; which held steady on a sequential quarterly basis of 53%, slightly better than our historical average of mid the 50-percentile range. So, that while the timing might be skewed by short-term market dynamics that our customers are facing, the demand for technology-leading test products and services continues to be quite positive.

Looking next to Sensors, to provide a better understanding of the Sensors markets it's worth noting that [inaudible] order volume that flows to our Sensors business has a much shorter manufacturing cycle time, ranging from days to weeks; as compared to our Test business that takes months or even years to fulfill. This means that while Sensors is largely a build-to-order business, it carries much less backlog than our Test business.

As such, our forecasting revenues is more dependent upon our anticipated short-term bookings outlook and our macro view of the market place in the quarters ahead. From a market Sector perspective, we define four broad in-markets for our sensor sensing products. These are described as Industrial, which includes areas such as factory automation, reliability and energy applications.

Test, which includes sensor reviews and the testing of new products, such as cars, planes and trains. Systems, which are complete solutions that incorporate our sensors from measuring sound and vibration and Positional, which are sensors used for precise measurement of location and displacement of a critical industrial machinery in mobile hydraulic systems.

One point that I'll like to make for those who maybe have followed MTS for some time and may be less more familiar with Sensors markets and our expanded technology position. With the PCB acquisition our opportunity for growth in Sensors is greatly enhanced.

For example, you will hear us talk increasingly of opportunities in energy, in propulsion systems, as well as military and defense applications which we will anticipate becoming a meaningful opportunity space for us in the years ahead, as spinning on new programs by the U.S. government growth[?]. This increased exposure particularly to defense programs is new for our company and exiting to us as we look to the future.

With regard to the current business climate, while overall demand for our Sensors remained strong; as the year opened for the Sensors business, we saw mixed short-term demand across the different market sectors. Areas of strength were large multi-year-blanket orders that we've landed with customers in the automotive, defense, energy and basic materials industries; which would fit with our Test and Positional sensors market sectors.

Weaker to date have been those markets tied to factory automation and energy production, which we would classify in our Industrial market sector. However, based upon the improving economic outlook for the United States and Western Europe and the investments that are being discussed regarding the building of new more highly automated factories in the United States, we believe our Industrial markets will strengthen later in the year and into 2018.

With the PCB acquisition complete and our much broadened product offerings in the central areas of the economy that are now beginning to rebound, we believe we are positioned very well for growth across all of our market sectors. Now, I'd like to turn the call over to our CFO, Jeff Oldenkamp, for some additional financial detail on the quarter, Jeff.

Jeff Oldenkamp: Thank you, Jeff. My remarks today will briefly summarize our quarter four, full year results for fiscal year 2016 as well as our results for the first quarter of fiscal year 2017 based on a year-over-year comparison. Overall, as Jeff mentioned in his remarks, we are pleased with our results of both, the fourth quarter of the fiscal year '16, and quarter one of fiscal year '17.

Organic revenue growth for both quarters were very strong, fueled once again by strong conversion of backlog in Test. Earnings succeeded our expectations, driven by the higher than expected revenue partially offset by higher than anticipated acquisition related costs, which I will talk about shortly. I will first talk through the key information about Q4 fiscal year '16 and the full year results then, move on the Q1 fiscal year '17 and then the fiscal year '17 outlook.

Quarter four revenue for Sensors was $69 million, of $42 million compared to the prior year, driven entirely by the PCB acquisition, which contributed $45 million in the quarter. Moving onto Test, revenue was a record $146 million in the quarter, increasing 25%. The second quarter on a row of over 20% growth. Test services also experienced another strong quarter with 8% growth compared to the prior year, making fiscal year ’16 revenue growth for our test services business of 9%.

Moving on to fourth quarter gross margin by business. Sensors gross margin was $26 million, up $11 million driven by the contribution from the PCB acquisition. Partially offset by $9 million of acquisition related integration and restructuring expenses, included in gross margin. This was primarily made up of the fair value adjustment related to the PCB inventory, which negatively impacted gross margin by $8 million.

The gross margin rate decreased from 54.1% to 37.2%, resulting from the acquisition related integration and restructuring expenses that I just mentioned, which lowered the margin rate by 13 percentage points. Excluding these charges, the margin rate was approximately at what we expected for the combined business. Test gross margin came in at $50 million, up 30% on the higher revenue that I previously mentioned. The gross margin rate increased 130 basis points from 33% to 34.3%.

My next topic is quarter four operating expenses. Operating expenses increased $21 million, to $62 million, and were 29% of revenue. The increase in operating expenses primarily resulted from $6 million of acquisition related integration and restructuring expenses. Excluding the acquisition related and restructuring expenses, operating expenses were 26% of revenue. Slightly below our forecasted range due to the high volume of revenue in the quarter.

Next, I want to discuss net interest expense. Net interest expense in the quarter four was $7.7 million. The interest rate that we paid was a variable rate. As we previously discussed in our third quarter call, we issued $460 million of Term Loan B debt. On this debt, we pay an interest rate that is pegged to LIBOR, plus a credit risk spread of 4.25%. So, effectively we're paying a floating interest rate on the debt.

To mitigate a portion of this risk and the volatility in interest rates – in October we executed an interest rate swap, swapping $275 million of the Term Loan B debt from a variable rate to a fixed rate of 1.26%. The overall rate on the portion of the debt is 5.5%. The interest rate swap amortizes over the next four and a half years and expires on 3 April 2021.

We'll continue to pay a variable rate on the outstanding portion of the Term Loan B debt above the swapped amount. As we've previously stated, we are committed to paying down our debt as quickly as we can, and given our projected free cash flow, we believe that we'll be able to do that fairly quickly.

My next topic is taxes. The tax rate in the quarter was unusually low at 10.4%, driven by lower earnings before taxes, which I previously stated was largely due to the significant acquisition integration and restructuring expenses on the quarter. Earnings per share decreased from $0.61 in the prior year to $0.29, primarily driven by the acquisition related and restructuring charges, which negatively impacted earnings per share by $0.58 in the quarter.

Next, I'll provide a brief summary of the result for the full year fiscal year 2016. Revenue of $650 million in diluted EPFs of $1.70 were at the top end of the range that we've previously communicated. Revenue was up 15% compared to the prior year and was up 7%, excluding the impact of the PCB acquisition. This increase was driven by an 11%

increase in the test business from a proof[?] project execution enabling a more rapid conversation of our backlog. We were very pleased with the operational improvements in the test business driving this revenue growth, which were the result of the head counting investments and other actions we made during fiscal year ’15 and ’16.

Gross margin deceased 330 basis points to 35.6%. The acquisition related integration and restructuring expenses negatively impacted the rate by a 140 basis points. The project execution issues that we discussed during our second quarter call, as well as pricing pressures in our test materials business and higher compensation in benefits negatively impacted the margin rate during the year.

Operating expenses were up $32 million, in part due to the acquisition related integration and restructuring expense. Excluded in those charges, operating expenses were up $18 million, primarily from the impact of the PCB business and were 27% of revenue. The effective tax rate declined 18%. The tax rate was lower than our expected rate, primarily due to lower than anticipated earnings.

I want to briefly summarize the acquisition related acquisition integration and restructuring charges that we incurred during the fiscal year. We incurred pre-tax, $23 million in total, during fiscal year 2016. $13 million coming from acquisition related and integration activities. $8 million was related to the fair value adjustment for the acquired inventory and the remaining $2 million was from restructuring activities.

We will now move on to quarter 1 fiscal year ’17. Quarter 1 revenue for sensors was $68 million, up $46 million compared to the prior year, driven by the PCB acquisition, which contributed $45 million in the quarter. The remaining increase was from a 6% growth in our legacy sensors business. Moving on to tests, revenue was $131 million in the quarter, increasing 10% as we continued to convert our backlog into revenue.

Moving on to the Quarter 1 gross margin by business. Sensors gross margin was $27 million, up $15 million driven by the contribution from the PCB acquisition, partial offset by acquisition, integration, and restructuring expenses; included a gross margin of $8 million. This was primarily made up the fair value adjustment related to the PCB inventory which negatively impacted gross margin by $8 million.

The gross margin rate decreased from 53% to 39.1%, resulting from the acquisition, integration, and restructuring expenses that I just mentioned, which lowered the margin rate by 11.9 percentage points. Excluding those charges, the margin rate was down 200 basis points. Going forward, we expect the sensors gross margin to be in the low 50% range with improvements expected as the volume increases.

Test gross margin came in at $47 million, up 14%, mainly from the higher revenue that I previously mentioned. The gross margin rate increased 120 basis points from 34.5% to 35.7%. For fiscal 2017, we expect the test margin to be in the 33% to 35% range, representing a flat to two percentage point improvement over fiscal year 2016.

My next topic is Quarter 1 operating expenses. Operating expenses increased $24 million to $63 million and were 32% of revenue. The increase in operating expenses primarily resulted from $2 million of acquisition, integration, and restructuring charges; $2 million from the China investigation expenses and incremental expenses related to the PCB acquisition.

Excluding the acquisition, integration, restructuring costs and China investigation charges, operating expenses were 30% of revenue. Going forward, we expect operating expenses to be in the 28% to 30% range, excluding acquisition related costs, restructuring expenses and costs of the China investigation.

Next, I want to discuss net interest expense. Net interest expense in the quarter was $7.3 million, consistent with our expectations. We estimate that net interest expense will be approximately $7.5 million a quarter during fiscal year 2017.

Moving on to taxes. The tax rate in the quarter was 22%, driven by lower earnings before taxes, largely due to the significant acquisition, integration, and restructuring expenses in the quarter. We expect the tax rate to be approximately 20% to 22% in fiscal year ’17, driven lower from the costs associated with the integration, and restructuring, and the China investigation.

Longer term we would expect the rate to be 27% to 29%, assuming no changes from the Federal Government. Also, it is important to note that MTS is a net exporter with over 70% of our product manufactured within the United States. Earnings per share decreased from $0.78 in the prior year, to $0.09, primarily driven by the restructuring, acquisition, integration, and China investigation cost, which negatively affected earnings per share by $0.46 in the quarter.

Excluding these charges, non-GAAP earnings per share would have been $0.55, down 30%, primarily driven by the higher interest expense and amortization expense as previously discussed. A reconciliation of these non-GAAP earnings to GAAP earnings is included in our earning release, which is available on our website and the SEC’s website.

Moving on to a summary of cash. We ended with $96 million of cash. An increase of $11 million in the quarter. Operating cash flow is $29 million in the quarter, driven by improvements in working capital. We paid $5 million for dividends, $5 million for capital expenditures, and $2 million in debt payments associated with the tangible equity units.

Now, I'd like to update you on our fiscal year 2017 revenue and EPS guidance ranges. As Jeff mentioned in the headlines, we're forecasting revenue in the range of $760 to $790 million in GAAP diluted earnings per share of $0.80 to $1.20 for fiscal year 2017. We're also forecasting our adjusted non-GAAP EBITDA to be between $115 and $130 million. We calculate EBITDA by adding back interest, taxes, depreciation and amortization expense to net income[?].

Adjusted EBITDA is calculated by adding back stock based compensation, acquisition related expenses, acquisition integration expenses, acquisition inventory fair value adjustment, China investigation expenses and restructuring expenses to EBITDA. A reconciliation of these non-GAAP measures to net income, the closest GAAP measure, is included in our earnings release, which is available on our website and the SEC's website.

Regarding the revenue range, there are several factors that give us confidence in this guidance range. First, we remain excited about the PCB acquisition and the growth potential to combine businesses. Second, we have a strong Q1 [inaudible] backlog of $356 million and have improved our operational performance and our ability to convert the backlog into revenue. We expect to convert approximately 70% of this backlog into revenue during fiscal year '17.

Lastly, we are very pleased with the growth of the test services business in fiscal 2016 and feel that we will continue – this will continue and provide further opportunities for growth in fiscal year 2017 and beyond. With regard to diluted earnings per share, our guidance range is $0.80 to $1.20. Included in this guidance is $16 to $18 million of acquisition integration and restructuring charges in fiscal year 2017, which impact EPS by $0.60 to $0.65.

These charges include the fair value adjustment to inventory that I previously mentioned, which negatively impacted earnings by approximately $8 million in the first quarter fiscal 2017. Also, included in these charges are expenses associated with the closure of our Sensors factory in Machida, Japan, which we expect to have completed during fiscal year '17. The remaining acquisition integration charges that primarily resulted from acquisition integration activities to fully integrate the PCB business.

We expect to complete all the acquisition integration and restructuring charges during fiscal year 2017. Second, as Jeff Graves mentioned, the China investigation will cost approximately $8 to $9 million, or $0.27 to $0.30 of EPS, which is included in our EPS range. In addition, our forecasted EPS includes the year over year increase in net interest expense of approximately $22 million, or $0.73 per share, and high acquisition related amortization expense of $9 million, or $0.31 per share.

Lastly, we have not included in our outlook any potential charges associated with our China low end materials business. This concludes my remarks for today. I'll turn the call back to Jeff for his final comments. Thank you.

Jeff Graves: Thanks, Jeff. So, let's begin with a recap of our fiscal 2016 results. There were several noteworthy positives. Our organic test and Sensors businesses exceeded $600 million in revenue for the first time in company history. These achievements were driven by our consistent investments in R&D and sales over the last few years, our specific focus on growing the test service business, the expansion of our technology offerings and the introduction of exciting new products to the market.

These results also exemplify our continued commitment to being a leading provider of highly engineered tests and measurement solutions, that allow our customers to build and deliver new products that enable their success. Overall, we were happy with our financial performance in fiscal year 2016, driven by a strong second half as operational investments and process improvements took hold that generate consistent revenue growth and stabilization of our gross margins.

We also continue to focus successfully on managing our cash flow generation by reducing working capital as a percent of revenue, reducing it to the lowest level in four years, which also enabled us to meet our financial requirements without having to access our lines of credit.

Lastly, completing the PCB acquisition is simply transformational for MTS; enabling us to more effectively leverage financial resources, product expertise, and customer base, to expand our global reach, and provide customers with a broad array of product and service solutions, which are key enablers to the economy and to our customers for the future.

Looking ahead at the remainder of fiscal year 2017, our results for Q1 continue to validate the improvements seen in the latter part of fiscal year 2016, and that we're on the right track with the investments and process improvements that have been implemented. Although orders closed in recent quarters have not been as robust in our test business, the strength of our opportunity pipeline leads us to expect our markets to remain strong into 2018 and beyond.

We have a tremendous long term global customer base and continue to see rising demand for our technologies across the test markets. We continue to focus on enhancing our product capabilities to remain our technology – to maintain our technology leadership position in the markets that we serve, to develop new products to further propel our growth and to improve our operational capabilities and test.

With the long-term macro trends that we see supporting growth for both of our businesses, the large number of sensor sales pursuits that have been advanced to the customer prototyping phase, the strength of the test opportunity pipeline and the overall favorable market environment for R&D spending, we remain bullish about our long-term prospects for sustained organic growth and profitability improvements.

We're optimistic that the improvements in our order's conversion and product execution processes, a solid backlog and the increased contributions from our sensors business will allow us to deliver on our FY17 guidance. In addition, the integration activities with PCB acquisition, that are underway, are just in their early stages and the contributions from these efforts will increase in the future years.

We're very excited about our progress and the strategic transformation of MTS. That concludes our prepared remarks. So, Tracy, I'll turn the call back to you for the Q&A session.

Operator: Thank you. If you would like to ask a question, please signal by pressing *1 on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press *1 to ask a question. And we'll pause for just a moment to allow everyone an opportunity to signal for questions. And again, that's *1 to ask a question, and we'll go first to John Franthrab[?] with Thidody[?].

John Franthrab: Good morning, guys. Long time no speak. Could we start with the test segment? If I'm understanding what you're saying, it sounds to me that you expect the second half of fiscal 2017 to be weaker than the first half of 2017. Am I understanding that properly? Or – or not?

Jeff Graves: Yeah, from a revenue perspective, John, yeah, that'd be the timing of our backlog turn, yes.

John Franthrab: Okay. That's unusual given normal historical trends. What's the biggest detriment to the – usually a normal, strong fourth quarter?

Jeff Graves: John, we just see it very based simply on the turning of the backlog. Obviously, the backlog turn rates have been increasing in the last couple of quarters, it's shared some nice revenue growth and it's simply orders timing and then the flow of the backlog. So, nothing more profound than that. Again, the – what encourages me, John, is the strength of our opportunity pipeline looking out 12 months.

So, there may have been a lag of orders going in to backlog that we've now processed but we look at that opportunity pipeline and then back in nature of a right now and we're very excited about the long-term. We don't read anything into the economy that's a profound shift that would impact our business.

John Franthrab: I may have missed this in – and I apologize if I did, but in the first quarter, what was the total company wide orders and backlog?

Jeff Graves: Jeff, you want to take that one?

Jeff Oldenkamp: Yeah, it was in Jeff's script, in – for tests specifically. That was $120 million overall in Q1 total orders. From a company's standpoint – was roughly, hold on John I'm just looking for that number. Again, test was roughly $118 million, and I'll get back to the sensors number. So, John let's – we can go on to your next question.

John Franthrab: Okay, and what about the total backlog number, Jeff?

Jeff Oldenkamp: So, the backlog that I had mentioned before, John, at the end was about $350 million.

John Franthrab: And that was for the first quarter?

Jeff Oldenkamp: For the first quarter – you're right.

John Franthrab: Okay, and one last question; I'll let someone else chime in. Regarding restructuring benefits, okay, you kind of suggested that they would be modest for 2017 – I'm assuming more pronounced for 2018. Can you kind of quantify how much, in savings, you expect to realize in 2017 and 2018?

Jeff Graves: John, it's difficult to be that precise. There's a lot of moving parts right now. Clearly, the biggest initial activity we undertook was the consolidation of one of our operations in the Sensor business; the closure of our Japanese plant. So, that will be completed this year and the exact timing with those volume moves is to be determined but we'll get it done this year and we'll see some flow through and cost there.

We've got a lot of – the other major elements of cost synergies include some insourcing of machine parts for the test business that we can leverage the PCB infrastructure for and some other part manufacturers that we're going through first article qualification right now, there's actually quite a lot of that and it's just the timing of getting all of that done this year and how much will actually flow through. So, we haven't put numbers to that.

Similarly, on the revenue front we're in dialogue between the sensor and test business quite a lot right now and visiting new customers. We don't expect to realize substantial revenue benefits this year from a synergy standpoint, but certainly we're planting a lot of seeds that we fully expect to grow in year two and beyond. So, again, we're not overselling it where – it'll be a modest cost and revenue benefits this year, but we expect those to come to a very nice fruition over the next four to five years.

John Franthrab: I guess I lied – one last question. Regarding tax rate, I think you suggested that it might be 29%, if I did the math properly, it was less than that in the first quarter. But –

Jeff Graves: [Inaudible] for this fiscal year, John, 20% to 22%.

John Franthrab: 20% to 22%.

Jeff Graves: Yup, and then beyond this year, it's 27% to 29%.

John Franthrab: Thank you very much, Jeff, I'll get back into queue.

Jeff Graves: Thanks, John.

Jeff Oldenkamp: Thanks.

Operator: And we'll take our next question from Rich Quase[?] with Wells Fargo securities.

Rich Quase: Hi, good morning, everyone.

Jeff Oldenkamp: Morning Rich.

Rich Quase: Just – while we're on tax there, is that – Jeff, is that 20% to 22%, is that all saw in the adjusted basis, too? Is there anything funky when we're trying to get the adjusted DPS, or should we assume 20% to 22% also on it?

Jeff Graves: 20% to 22 %is what we're assuming for overall, you know, it's probably closer to 25% – 25% to 27% on a non-bottom line. So – but again, for total company, 20% to 22%, all in.

Rich Quase: Okay. That's on a GAAP basis, okay.

Jeff Graves: That's correct.

Rich Quase: Okay, and then, just – could you update us on the synergies from PCB, where you are – obviously, there's a lot of costs in '17 and probably very little in terms of synergy given the timing of the closure, but what's imbedded in the outlook for '17 in terms of synergies, both revenue and cost? And then, looking out beyond this year, now that you've had the business for, you know, 7, 8 months I guess; 9 months, what – how do you look at the cadence of the synergies here?

Jeff Graves: Yeah, so Rich, I'll take this one. Again, Jeff briefly touched on it but for fiscal year '17, there's no significant synergies in there. Our focus is really on integrating PCB into becoming a public company – they were a private company for 50 years. And also, making sure that we focus on combining the two business – combining the two sensors businesses. So, for fiscal year '17 there's no significant synergies.

Longer term we've stated that we believe there's $20, $30 million in revenue synergies and $5 to $7 million of net cost synergies and we expect to achieve those over the next four to five years. So, longer term we still believe the synergies are good. As you probably are aware, Rich, when you look at revenue synergies they take a little bit longer than the cost synergies, and as I mentioned, as well as Jeff in our script, we did close down or we're closing down Machida and we do expect to see a million dollars annually, starting in fiscal year '18. Anything you want to add Jeff?

Jeff Oldenkamp: You know Rich, it's really interesting what we've been able to validate since we closed the deal in July. One of the interesting things is our view of the market has gotten more rich in color, if you will. We've sold test equipment into, for example, the vehicle market for over four decades of our 50-year history now. So, we always have had a very nice long term view into investments in R&D and new product development for vehicles.

From the PCB acquisition, [inaudible] as we've highlighted in the past, they sell sensors for ongoing testing right now. So, sensors that are used on vehicles for testing right now. So, now we get a two-fold view out of the market of what kind of capacity[?] or utilization are labs running at today. How heavy is there spend on product development? And then, from our test business, what their longer-term outlook on investment – investing in capital for new capacity or new testing methods and stuff.

So, based on that color it gives us a lot more confidence in terms of our projects for demand in markets like vehicles. So, ground vehicles, air vehicles, airplanes, things like that. The extension of that is the revenue synergies. So, PCB was a smaller company, under $200 million in revenue. Our test business is much larger and much more global.

So, at the heart of our revenue synergies is taking their sensors into new customer laboratories in China and elsewhere in the emerging markets, where they may not have had the sales force to penetrate and selling them sensors for their real-time testing, right now. So, those dialogues take a while; it takes a little while to make the introductions. That's why we didn't bake in much benefit for fiscal '17.

But when you look at '18 and beyond, particularly '19, '20, '21, those years we expect to get some real traction with those revenue synergies between the businesses. The PCB brand was outstanding, it just wasn't as exposed as the MTS brand, which is also outstanding in the test markets. So, we remain really enthusiastic about it. Our customers love the acquisition that are buying equipment and sensors, they see the natural overlap and we remain very bullish on the revenue synergies.

On the cost side, as I mentioned, it's just a matter of getting through all of the pain of producing high quality parts, insourcing some work to PCB on machining, cable manufacturing, things like that. Getting through the first article qualification will take the bulk of the year before you can more from current suppliers to an insource situation, but the savings are real and they're substantial.

What we could harvest immediately was the consolidation of the footprint. So, we set out right away to close our factory in Japan, move that volume back into the States for sensor manufacturing. So, we haven't put short term numbers out there for '17 – frankly it's a lot of seed planting and initial work. We expect to see much more of it in the out[?] years and we'll certainly highlight that when it comes.

Rich Quase: Okay, and then Jeff Graves, a real quick one. Did you say auto – there's been some push outs on the test side of things, not cancellations obviously, but push outs? And then, just real quick if you could address this as well, is the energy markets – so it sounds like in the shorter cycle sensors, you haven't seen any real pick up there.

Curious kind of the cycle for you because others have talked about improvement and MRO spending in North America in terms of energy, oil, gas, etc. and just curious if there's just some kind of lag there with your business. Thanks.

Jeff Graves: That's very – it's a fascinating time, Rich, on both those questions, so, let me take both of them. On the energy side first, I've been quite surprised at the softness at the outset of the year and the consumption of sensors that go into the energy generation market. Now, this is not exploration or transmission for oil and gas, this is in electricity generation.

So, we actually have some exposure to that market through PCB and historically it's been very strong and it's certainly lagged in the first part of the year. I fully expect that to come back. It's not that the business has been lost, it's just been down. And you may have seen some of that in the OEMs that have either announced earnings or have talked about it; that market just seems to be surprising soft at the beginning of the year. So, that impacted the – what we've put into our industrial sensor market. That had some impact there.

On the test side of things, Rich, I would tell you it is an extremely dynamic market. Our customers continue to share their longer-term investment plans with us and they're exceptional. I had a meeting last week, here in Minnesota with one of our larger OEM customers, and I won't mention obviously who it is or where they're located, but the investment plans they have over the next several years are just exceptional to me and it's driven by the rapid change in technology for vehicles.

When you think about the electrification of cars and think of the move toward autonomous vehicles and just the range of product offerings they have to deliver to market. The testing needs, just from a capacity standpoint, are growing. The methodologies are all changing. It is a remarkable environment right now and I think in the face of a political change in the United States and the initiative on reinvestment of – in factories and labs in the United States, they're sitting back and thinking about that.

About what – where are they going to spend their money, how do they position themselves for the next – because these laboratories are going to be around for decades. So, where do they want them, how big do they want them, they're clearly going through a lot of thought process. So, they haven't changed the direction and the magnitude of their spending; if anything, it's up. It's the timing and what we detect right now is just a little bit of a pause in the first half of the year, maybe late '16, early '17, after the election, and in terms of them thinking, what's going to happen to the regulatory environment? What is the new technology mean for me? And where do I need to spend this money?

Are we expected in the long term to be robust? I would suspect based on our pipeline, which again, is at a record level ridge[?] of a billion dollars. That money will start flowing through into orders we would expect by later '17 and certainly into '18 and I think we're positioned very well for it based on our technology and the operational improvements in our test business. So, I remain very excited. The ordered timing was a little bit difficult because it leads to a revenue softness in the second half for us; we'll be flat to slightly down in our test business, we think, based on the backlog turns in the second half. But, our outlook remains very robust in terms of demand for the business.

So, thanks for asking about the automotive sector; it is a fascinating time. I was struck with that yesterday again, with the Tesla versus General Motors market cap situation. I mean, it just go – I think it's reflective of changing technologies and changing preferences in the market and you see it profoundly manifest everywhere. So, maybe more than you wanted to ask, Rich, but I – it's a fascinating time for us.

Rich Quase: Thanks for the color, appreciate it.

Jeff Graves: Thanks, Rich.

Operator: As a quick reminder, it's *1 if you would like to ask a question. And there are no other questions in the queue, so I would like to turn the call back to Dr. Graves for any additional or closing remarks.

Jeff Graves: Thanks, Tracy. Thank you all for participating in our call today. We look forward to updating you again on our progress in May, on our second quarter performance. Thanks, and have a great day.

Operator: This does conclude today's conference. We thank you for your participation. You may now disconnect.