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Moderator: **Laura Fox-Anderson**

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Operator: Good day everyone and welcome to the today's MTS First Quarter 2018 Earnings conference. Just a reminder that today's call is being recorded. And at this time, I'd like to turn the conference over to Mr. Brian Ross, MTS Senior Vice President and Chief Financial Officer. Please go ahead sir.

Brian Ross: Thank you, Lorie. Good morning and welcome to MTS Systems' fiscal 2018 first quarter investor teleconference. Joining me on the call today is Jeff Graves, President and Chief Executive Officer.

I want to remind you that statements made today, which are not historical facts, 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 future events.

This presentation may also include reference to financial measures, which are not calculated in accordance with 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.

I will now turn the call over to Jeff, so that he can give his update on the industry, MTS first quarter business performance and our expectations for the reminder of the fiscal 2018.

Jeff Graves: Thank you, Brian, and good morning everyone. Thank you for joining us for our investor call today. We appreciate having the opportunity to discuss our results for the first quarter of fiscal 2018, which ended on December 30, as well as providing an overall update on the business and our outlook for the reminder of the year.

In short, we were pleased with our execution in the first quarter as our financial performance metrics either mattered or exceeded our expectation at this point in the year. We are also pleased with the outlook for our markets moving forward, as we will discuss in a few moments.

Highlights for the quarter can be summarized in four key points. First, as we exited fiscal 2017 last September, we had high expectations for the growth of our sensor business in the New Year and we were very pleased with what we're seeing now. In Q1, sensors delivered double-digit revenue growth for the third consecutive quarter on strong global demand across most end markets and geographies.

In addition, sensors delivered a book to bill ratio above one and exited the quarter with a record backlog. We expect this trend to continue accompanied by strong gross margin and EBITDA margin performance, as we move through the rest of the year. Second, our test business performed in line with our expectations for the quarter on the hills of the record orders performance in the fourth quarter of fiscal 2017.

Test continues to perform on this trajectory we expect for fiscal '18 with revenues and margins rising in the second half of the year, driven by the timing of our large project backlog conversion into revenue.

Third, during the quarter, we accelerated the deleveraging of our balance sheet with an additional $18 million of principal payment on our term loan B debt and will continue to focus on deleveraging along with our quarterly cash dividends to shareholders, as we generated strong cash flows and experienced benefits from the new tax laws moving forward.

Fourth, MTS is a significant benefactor of the Tax Cuts and Jobs Act of 2017, which was enacted in December of last year. This tax reform will significantly reduce our tax burden and with roughly 65% of our sales being outside of the United States will allows us to more readily repatriate our foreign earnings.

Our priorities for cash usage remains the same. That is investment in our businesses for continued growth in the phase of strengthening markets, payments of our dividend to our shareholders, and continued deleveraging of our balance sheet. Brain will provide more details in his prepared remarks regarding the positive impact of the tax reform on our company.

As and aside, we were very happy to have marked our 40th year of continues dividend payments to our shareholders with no reductions occurring since inception, a testament to the long-term strength of our cash performance and our commitment to shareholders through our many business cycles over these past four decades.

With that introduction, let me now provide some additional color on each of our businesses and our key markets after which Brian will discuss our financial results in more detail. I'll begin with our test business in the three broad market sectors that we serve vehicles, structures and materials test. Vehicles test orders remains somewhat soft in Q1, due to customer investment timing decision, which has delayed a few large custom systems to later this year.

We anticipate vehicles test will strengthen over the remainder of the fiscal year on renewed demand for custom systems, as OEMs refocus for CAPEX investments and support of new testing protocols consisting with the development of electric, fuel efficient and autonomous vehicles.

As the testing requirements these vehicle applications emerge, we continue to believe that there will be strong demand for this testing equipment as these new vehicle designs will have broad global appeal to both mature automotive markets as well as rapidly growing markets in places such as India and China.

The demand for our core tests products including tire and vehicle durability systems, controllers and key high performance test components continues to be strong, as customers look to expand and update their existing laboratory capabilities.

Our structures test business continues to experience broad global demand for civil seismic testing systems especially in Asia and other regions prone to threats from earthquakes and tsunamis, along with continued strong demand for structural and aerospace testing systems. In addition, we successfully closed on a large project to be used in a basic research and education environment a particularly strength of our test business in all parts of the world.

The materials test business reported strong overall demand in the first quarter, driven significantly by customers in Asia and especially with our monotonic testing products in China. Europe also grew nicely during the first quarter while US demand was tempered by the timing differences we expect to recover during the rest of the year.

Growth in the materials business included rising demand from companies involved with oil and gas exploration, which we commonly refer to broadly as rock mechanics test systems as well as specialized high temperature test systems for aerospace applications.

In addition customers making investments to expand and upgrade contract test ride capabilities also contributed to our accelerated growth in materials test systems. This is a direct reflection of the need for new capacity for testing advanced materials such as carbon fiber composites and components made through additive manufacturing techniques.

We expect these trends to continue for several years, driven by the need for light weighting of automobiles and aerospace systems for new aircraft turbine materials that are essential to improve performance and emissions. And to support the advancement of energy extraction techniques all of which leads the vibrant and growing market for MTS to capitalize on its technology leadership and customer intimacy, which has been the foundation of our company since its founding over 50 years ago.

Moving next to our sensors business, I'll briefly walk through the four major market sectors that we serve. The first sector is position sensors. The position sector had an excellent Q1 on a revenue increase of 19% versus Q1 of the prior-year. Mobile hydraulics products were particularly robust with very strong demand from major OEMs and construction and agricultural machinery.

Overall, global manufacturing remained strong and this was reflected in our industrial machine OEMs having a solid quarter. Mobile hydraulics remains the fastest growing segment and is projected to remain strong driven by the rebound in the construction and mining equipment industries.

Geographically, the market has been very positive in the Americas, Europe and Asia and especially in China. We expect the remainder of the year to remain solid, as we benefited from key platform wins over the last several years, while demand in our core industrial markets is expected to stay strong.

The test sector for sensors was mixed in Q1 with lower order demand sequentially however revenue was up versus Q1 of the prior-year. The test and measurement program business were both strong while aerospace and defense and automotive groups showed slowed slightly entering the holiday period.

Aerospace and defense revenues were impacted by having multiple opportunities slide from Q1 and Q2 due to the availability of project funding. But this is expected to cure itself in the short-term. We anticipate our automotive related test business for sensors to be similarly strengthened providing a solid year of performance.

Finally, we continue to be excited about the US Department of Defense programs we see ahead of us which now span multiple product platforms. Our first contract which we are currently completing is expected to be followed by substantial future awards, as we move into late fiscal '18 and into the fiscal '19.

The industrial sector for sensors was impacted by the significant decline in industrial gas turbine business that began at fiscal 2017. We now expect the industrial turbine business in fiscal '18 will be down from '17 levels as demand across the power industry continues to bottom up.

A positive offset to the weakness in electricity generation markets is the strong performance of the predictive maintenance market for industrial machinery, which saw strong orders and revenues in Q1, the contributions from both domestic and international sales channels. Growth from renewables and our sensors used for general predictive maintenance will offset the decline in energy markets and we expect the industrial sector to finish fiscal '18 above fiscal '17 levels. The system sector for sensors had excellent results for Q1 on strong revenue growth driven by specific aerospace programs.

We expect solid double-digit growth in fiscal '18 from new products that we recently launch to support airport and environmental noise monitoring and strong calibration system sales in the aerospace, defense and the energy markets. Continue growth by our digital smart sensor technologies is also strengthen across global distribution, giving further confidence to this systems sectors point for an exciting 2018.

So in summary, our Sensors business is firing at all cylinders from an execution standpoint and taking maximum advantage of a strong and growing demand for industrial sensors that are essential for the launch of our customers new products and the growth of industrial automation and smart systems.

Geographically, our scale allows us to access all markets globally which is paying dividends in the US, Europe, and Asia and particularly China. The combined strength of our product portfolio and our maniacal focus on total customer satisfaction is now enabling us to meet the expectation of the diverse and expanding market.

This concludes my prepared comments and I would now like to turn the call over to our CFO, Brian Ross, to further discuss our financial results and outlook. Brian.

Brian Ross: Thank you, Jeff. I will now discuss our financial performance for the first quarter of fiscal 2018 based primarily on a year-over-year quarterly comparison. In addition, I will provide an update on our financial guidance for fiscal year 2018. Let's begin with the total company Q1 performance.

We are pleased with our results for the first quarter of fiscal 2018 as orders, revenue and operating profits were in line with our expectations. Total company revenue was $194.2 million. And although a decline a quarter-over-quarter basis, it is worthy to note that this financial performance was consistent with that we believed, we would delivered given our backlog level existing fiscal 2017, the timing on conversion of backlog to revenue for certain projects in the order patterns over the last 18 months.

In addition, these financial results indicate there is a greater clarity in our end markets and that we've successfully adapted to the changes brought on by fiscal 2017 market trends. Our sensors business also performed according to expectation with double-digit revenue growth of 11%.

Gross margin of 40.1% for consolidated MTS improved 3.2 percentage points quarter-over-quarter as a result of the non-recurrence of acquisition inventory fair value adjustment in acquisition integration expenses that reported in fiscal 2017 as well as from increase in the proportion of higher margin sensors revenue in the overall MTS mix. The decline in test revenue partially offset these improvements.

The next topic I will discuss is operating expense. For the quarter consolidated operating expenses declined $2 million to $61 million compared to the same quarter in fiscal '17, which included PCB acquisition integration expenses, the cost of the China investigation and higher fees for professional and legal services. Offsetting increases to operating expenses were primarily attributable to an increase in competition and change in foreign currency.

My next comments will address interest expense. For the quarter net interest expense of $6.8 million was lower than the prior year by $0.5 million due to a decrease in the interest rate that resulted from the debt reprising completed in July of 2017. And a decline in our debt levels for making access cash payments. We continue to forecast quarter net interest expense of approximately $6 million to $7 million per quarter in fiscal year 2018.

Now let's move on to income taxes. The Tax Cuts and Jobs Act that was passed during our first quarter resulted in net tax benefit of $25 million for the quarter or $1.32 of EPS. The majority of this benefit resulted from the re-measurement of our estimated deferred tax liabilities and is net of the estimated full tax associated with our historical foreign earnings and cash associated within those profits.

Our effective tax rate for the quarter was a benefit of 250%. Excluding discrete items, our effective tax rate for the quarter was 17.9% which reflects a transition rate for the first quarter due to the effective date of the new tax structure after the end of our first quarter. This change, as a result of the tax reform, is an overall significant benefit for MTS and our shareholders for the reduction to our overall effective tax rate, ability to more efficiently utilize foreign cash and solicitation of continued benefits of the research and development credit.

The next item that I'm going to discuss is earnings per share. On a GAAP basis earnings-per-share was $1.72, which includes a discrete tax benefit of $1.32 per share due to the Tax Cuts and Jobs Act. Excluding this item EPS of 40 cents per share was higher than the prior year GAAP results of 9 cents per share due to the non-recurrence of the acquisition inventory fair value adjustment, acquisition integration expenses and China investigation expenses that were incurred in the first quarter of fiscal year 2017.

Non-GAAP adjusted EPS was $1.73 per share for the quarter which includes the same discrete tax benefit of $1.32 per share previously discussed in the GAAP EPS. Excluding this item, non-GAAP EPS would have been 41 cents per share. A reconciliation of non-GAAP earnings-per-share to GAAP earnings-per-share is included in our earnings release which is available on our company's website and the SEC's website.

Now I will discuss revenue and gross margin for each of our business segments starting with sensors. Sensors revenue was $76 million for the quarter, an increase of $8 million or 11% from the prior year comparable quarter. This growth was driven by continued broad demand from industrial markets and increases in the sensors test systems market that is consistent with the orders growth and our test business during the latter part of fiscal 2017.

Test revenue was $118 million for the quarter. A decrease of 10% versus the prior year comparable quarter. As I previously mentioned, we had been projecting these lower revenue levels due to the delayed timing effect on revenue that was going to result when customer started to push the orders decisions into the latter part of fiscal year 2017. Test recorded orders of $109 million and ended the quarter at $305 million in backlog.

I will now discuss gross profit for each business segments. Sensors gross profit for the first quarter was $39 million or 51.1% of revenue as the improvement in gross profit rate compared to fiscal year 2017 was primarily due to the non-recurrence of acquisition inventory fair value adjustment and acquisition integration expenses that were incurred in fiscal 2017.

Gross profit for our test business was $39 million or 33.1% of revenue and $8 million decreased to the prior year due mostly to the decline in revenue. In addition the lower volume created unfavorable leverage on cost and we incurred expenses on projects scheduled for later in the current fiscal year and beyond that will also drive revenue growth.

We continue to expect the same annual gross margin ranges for each of the test and sensor businesses as we have provided in our full fiscal year 2018 guidance back in November. Moving onto to review our total company cash position and balance sheet items, we ended the quarter with cash and cash equivalents of $94 million a decrease of $15 million from the prior quarter end.

Operating cash flow for the quarter was $9 million. During the quarter we paid dividend of $5 million invested $3 million in capital projects and made long-term debt payments of $22 million, which included an $18 million excess cash flow payment on our term loan B debt. Our average working capital rate of 26% of revenue remains near the lowest rates achieved during the last five years.

Finally, with the ability to more quickly repatriate foreign cash with the tax reform changes, we expect that we will utilize this capital to more quickly de-lever the business. The final topic I would like to discuss is our fiscal year 2018 guidance ranges. We are reaffirming our fiscal 2018 full-year revenue guidance of $780 million to $820 million and our non-GAAP adjusted EBITDA range of $120 million to $140 million as we continue our execution strategy for the year.

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 and restructuring expenses to EBITDA. Our reconciliation of the range for these non-GAAP measures to net income the closest to GAAP measure is included in Exhibit D of our earnings release, which is available on our Web site and the SEC's Web site.

As a result of the change in tax reform, we're raising guidance for GAAP diluted earnings per share to be in the range of $3.55 to $3.85 for the fiscal year versus the prior range of $2.05 to $2.30 per share. We now expect the full year effective tax rate to range from 16% to 19% versus prior expectations of 21% to 25%.

This change in GAAP diluted earnings per share is solely reflective of the discrete tax benefit of $1.32 per share recognized in the first quarter and the new effective rate going forward for the remaining three quarter of the year.

This concludes my remarks for today. I will now turn the call back to Jeff for his final comments. Thank you.

Jeff Graves: I'd like to conclude our earnings call with a few comments about our performance in the first quarter of fiscal 2018 and the expectation for the remainder of fiscal '18. We went into fiscal '18 knowing that there will continues to be tremendous opportunities for MTS to take advantage of its strong brands, distinguish technology to be a leader in creating critical products and services for test and measurement markets worldwide.

Delivering on our first quarter commitments was gratifying because it demonstrated that our test business with a current backlog in place is now poised to generate increase in quarterly revenue and profitability throughout the remainder of the fiscal year. In addition, the high level of interest in our test solutions is a reflection of our breath of our products and services even as we see a shift across different technologies in the end user markets.

Our sensor business executed very well in the first quarter recording double-digit revenue growth, which is a further confirmation that this high margin business is well positioned to provide industrial sensor solutions to a rapidly growing global customer base.

Furthermore, the management team at MTS is also focusing on initiatives to sustain long-term revenue growth in both test and sensors businesses, increase gross margin rates, enhance scalability and efficiencies and optimize our balance sheet structure.

These operational and financial goals will enhance the strong foundation that already distinguishes MTS and will help ensure that we remain a preferred choice by our customers because MTS has the innovation, the global reach and tailored solutions they create enterprise value for our customer base. It's through this intense focus on meeting our customers' needs that will lead to a long-term success of our company.

That concludes our prepared remarks and I will turn the call back to you Lorie for the Q&A session.

Operator: Thank you, sir. And to our audience today, if you'd like to ask a question please press star 1 on your touch-tone telephone. Just a reminder, if you're joining us via a speakerphone today, make sure your mute function is turned off to allow the signal to reach our equipment. Once again, star 1 for any questions. And we'll pause for just a moment.

And we'll go first to John Franzreb at Sidoti.

John Franzreb: Good morning Jeff and Brian.

Jeff Graves: Morning John.

Brian Ross: Morning John.

John Franzreb: Tax change is a nice benefit for you guys, huh?

Jeff Graves: Yes, the tax change, John. Yes, it's a nice – it was a nice change, especially for a US manufacturer like ourselves that exports a lot of product overseas. It's just a terrific change in the climate.

John Franzreb: So what do you think about how much cash you actually need to keep overseas and how should we think about repatriation, the timing of it and debt levels maybe a year from now?

Brian Ross: Good question, John. So, we're currently evaluating the current operating cash needs of each of our location, and about 70% of our cash is still overseas. And with this repatriation and the full tax on it, we're more freely to be able to bring that back. So, we're looking at levels just a little bit south of 50% of that that we can bring it back in this current fiscal year. And our use of that would be to deleverage the company and pay down our debt more quickly.

John Franzreb: Right. And Jeff, you know, the funds we're seeing in the custom side test, is that entirely isolated into the ground vehicle market? Does that reflect in any way maybe customer concerns about drop in production rates in North America vehicle market ((inaudible)) to converse cash? Just talk a little bit about the dynamic that's going on there.

Jeff Graves: Yes, John, so you asked two good questions in that one. The first one is that really focused on the ground vehicle market and that's yes. Really the custom change in our mix, if you will, in orders is largely driven by the automotive industry. And it's a function John of the automotive technology changing so fast to electric vehicles, autonomous vehicles.

It's really changing the nature of the equipment they want to have us built for them. And they want to build in flexibility for continued changes in those cars. So, they're trying to customize machinery a lot more than they used to. So I think that's a way of life for us. We have really a great foundation of that business worldwide with all the leading OEMs to right at the forefront of that, and that's really driving this custom content.

The second part of your question was also good. What was the second part?

John Franzreb: North American concerns ((inaudible))

Jeff Graves: Oh, yes. No, no. The answer is clearly no on that one, John. I think the automotive industry is very bullish. They're struggling with these changes because they're happening awfully fast. But no, they have a strong balance sheet, they're investing a lot in technology, and they are very bullish on the future.

When you look at the opening up of consumption now in China and in India and the severe problems they have with pollution and fuel efficiency issues as well, it's really driving this technology change and the consumption rates remain very high. So I don't think they have any real concerns about the volume of their business. It's more what cars you are going to actually be developed.

So, the answer -- your first part of your question on customization, yes, it's vehicle driven. On the second part of it, are they concerned about future demand? We see no indications of that. The pipeline for us stays really strong in vehicles, but we are going through a lot more discussions with customers about this whole customization concept. What does it cost to make a custom machine? What kind of value do they get from it?

So, it's just leading a protracted sales cycle. And that's why you see our pipeline growing of opportunities. It's well over a $1 billion now, but a lot of those keep pushing out as we have ongoing sales discussions because we want to be careful. These were often first of the kind machines and we do fix price contracts so we want to be sure and protect ourselves and the customer in fulfilling those before we take them.

John Franzreb: And switching to the sensors side of the business, mobile hydraulics has been doing really well. I wonder if there's any change in some of lead times for ordering a sensor product given some of the businesses ((inaudible)) other sensors companies their lead times are actually starting to get little bit longer. Are you seeing a similar dynamic as demand continues to ramp?

Jeff Graves: Well, I can tell you in our case John, we're staying ahead of that curve. I mean we're keeping our lead times down. We're ramping production nicely. We went through some changes last year in consolidation of factory footprints. So we're really beginning now to feel the benefit of that. We made those volume transfers. Those factories are settling into the new production volume and really setting records every month, John.

But we continue to have upside in terms of our capacity. We continue to manage our lead times down the minimal levels. Once cultural aspect when we bought PCB and we merge our businesses, they have an intense focus on customer satisfaction, which means, you know, minimal lead times, high responsiveness, and that's really the mantra of the business that that team is driving and it's working extremely well.

That's why you see double-digit growth rates in revenue and book to bill ratios above one. Like I said, we exited Q1 with another record backlog of bookings that we'll ship out here in the second quarter. So, we feel great about the model and about our ability to fulfill it and the rising demand that we see.

John Franzreb: So sensor bookings aren't expanding into Q2 and Q3?

Jeff Graves: No, no. We still have the occasional exotic sensor, some unique application that might extend out there, but no we're still fine on lead time. Our general lead time is a few weeks John. We turn -- we book an order at the beginning of the quarter, we generally turn that -- all of those orders within the quarter. A few may straggle out in the next quarter, but we're talking three to four kind of lead times.

John Franzreb: Okay. Thanks Jeff. Thanks for the color, I appreciate it.

Jeff Graves: Thanks for your questions John.

Operator: And once again ladies and gentlemen if you do have a question please press star 1. And we'll go next to Rich Kwas at Wells Fargo.

(Ronnie): This is (Ronnie) ((inaudible)) on for Rich.

Jeff Graves: Hi (Ron).

Brian Ross: Hi (Ron).

(Ronnie): Just wanted to drill down a little bit on the test gross margin. The year-on-year decline in that, was that primarily related to raw materials content or is there anything in the mix factors that could be driving that?

Brian Ross: No, it's not necessarily related to the overall material content in the cost of that it's in there, at least just from a leverage on our current production, our revenue is down year-over-year. So we saw a slight decline in the margins from that standpoint. We also have the usual complexity and uniqueness of the test projects, and sometimes we retain in resources in times were things a little bit slower.

We talked about the second half of the fiscal 2018 being stronger then the first half. So we retained employees to be able to full fill that revenue cycle. And we have seen just a little bit of decline in the service margin mainly as we're continuing to bring out field service engineers for our growth in our overall service business. So the revenue on our service continues to grow very nicely.

Jeff Graves: So, (Ron), the way to think about as we had record bookings in Q4 in the test business. And those projects are largely in the design phase right now. And we kept our cost structure intact because they’re going to fairly quickly now move into production and we’ll start realizing revenue on those.

So, if you add that up, you see a drop in revenue in Q1 that's reflective of those projects being in the design phase. As materials came in and we start building those projects on the factory floor we'll recognize revenue and revenue decline through the year, and you will see margin improvement throughout that.

And on the service side, which has been a growing element for us, we were up 10% in the quarter on services. We're just having to hire people, and the new service person takes about a year to come up to speed on servicing our equipment. So, there's bit of a drag on the P&L just from the headcount in the services organization.

(Ronnie): Yes, makes sense, actually my next question was on the service margin. Just kind curious on, if we exclude the factors of adding headcount there what the drop-through margins are versus your test product business?

Brian Ross: So, we generally see the service margins a little bit greater than 40% for the overall business and then the equipment side of it is a little bit north of the 30% range. So the mix of that is really nice. And for the year, we still have projections. We haven't changed our overall gross margin percentages for the year for either of the businesses.

(Ronnie): That's really helpful color. Thanks guys.

Jeff Graves: Thanks (Ron).

Operator: And just a reminder ladies and gentlemen if you do have a question please press star 1 at this time. And we'll go next to Mike Wallace at White Pine Capital. And sir did you have a question? Please check your mute button.

Mike Wallace: There we go. Sorry, I was on mute there. Hi Brian and Jeff. Good morning.

Jeff Graves: Morning Mike.

Brian Ross: ...Mike.

Mike Wallace: Yes, just a little clarity on the test business and kind of what you're seeing there. You know, with the increased customization and the fixed price contract nature of that business, does that increase in that customization any way reduce the ability to possibly cross-sell the platforms to others? And could you talk a little bit about that?

Jeff Graves: No, it’s a great question Mike and in fact that’s a big initiatives of our is, we're trying to pick the custom jobs that we do very, very carefully, wisely in order to pick them in markets that are going grow. And then resell the basic hopefully the whole platform, but at least some of the basic sub elements of it.

You know, our strategy for 50 years is we do fix price contracts, we own the IP from the contracts and the way we really make money over time is to replicate these custom jobs, so turn them into a standard product. We’ve done that very successfully in the tire testing business for example which goes back now over 20 years.

We did some really unique first of a kind tire testing machines and then sold them to both auto companies and then the tire companies and expanded that over time. That continues to be our strategy as we face in now through electric vehicles and more autonomous vehicle technology, is to try to pick the platforms that we think will appeal to the broad customer base and do those as first of a kind projects.

So, again, there’s a little bit of margin impact on the first one and then that starts getting diluted, as we sell the second, third and fourth one because we we’re able to leverage our design work.

Mike Wallace: So, margins were up -- op margins were 4.7 this quarter, which is about half of what they were a year ago. And are we at the bottom of the margin structure there this quarter and as we go through the rest of this year we should see a more normalization of the op margin, and what would be a reasonable level of normalization given this new customization and some of the issues going on there?

Brian Ross: Sure. Hi Mike, this is Brian. So as far as our overall op margins a lot of it is again due to the reduced revenue for this quarter-over-quarter comparatively in the test business. As we stated, the first half is going to be a little bit slower from test and much better in the second half, and we should those margins start to get back to a little bit more normalized rate just overall in the test business.

(Crosstalk)

Mike Wallace: And what kind of a range or rate would be considered a normalized rate then?

Brian Ross: So if you think it's like 7% to 9% range that should be a much closer range for us.

Mike Wallace: Okay. So, then just by the end of this year, fiscal year, it would be reasonable to expect them to move towards that range and possibly get within that range?

Brian Ross: Yes, that's correct. So, yes, the leverage will get much better in the second half of the year on operating margins. So it should be at the higher end of that range.

Jeff Graves: And Mike that work's largely in backlog, so that's, you know, that's why we go through such pain to talk about orders rates and test and what the backlog is. It's a long cycle but it ((inaudible)) backlog which reduces the risk in realization.

Mike Wallace: So we should feel pretty confident that that's going to happen as the year goes on, that's something we'd watch for, of course. The cost customization, are you getting any pricing power with the customer as you have to create and develop these new testing solutions for them? Can you talk a little bit about the pricing?

Brian Ross: Yes, it's really interesting give and take, Mike. The problem our customers have is it's a capital request take a long time to go up through for example in automotive company. So they often have their budget fixed a year in advance. And then it's an engineer to engineer discussion between their organization and outs on what they get for that money.

So what we're working on hard is trying to be disciplined about what level of capability we can put in the machine for budgets that are relatively fixed the prior-year. So now with the tax law change and repatriation, they have a little bit more flexibility. So, we're hoping to see them be a bit more aggressive not only in overall volume but in inflexibly put more high end technologies in a machine which gives us more pricing power.

So we work that every -- the shorter answer is we work it every day and the only fly in the ointment is the long time it takes for capital request to get approved within the customer base. So, you know, by the time we get to an engineer the budget's pretty well defined and you got to figure out what you could do for that cost.

Mike Wallace: So when you are looking at the backlog as it's flowing through this year and some of the, I don't know, call delays or just things, how much of that is -- is it being caused by the customer going back to the budgeting committees and requesting greater amounts in order to get what the engineers really need?

(Crosstalk)

Mike Wallace: Can you give us some characterization of how much of that's going on in that business?

Brian Ross: Yes. So again it's primarily automotive market driven and I think we see a fair bit of that prior to them placing an order. So, they'll come to us with an idea of what they want the machine to be able to do, we'll reiterate that back and forth. If they decide, hey I need more than that capability they may go back to our whole discussion internally about funding and what they do with that.

So we see a lot of churn in the vehicle space in terms of order rates coming through. Now, all of those orders still sit in our opportunity pipeline out there and as we measure them. But you see churn in that number, it's a big number, but you see churn in the timing of it because they're still in discussions.

And the problem they have quite frankly Mike is the automotive technology is moving so fast. These are big capital investments for them often tens of million dollars, and they want to make sure they buy the right machine which is going to last them the next 20 years. So, I understand their difficulty. At the end of the day, we're trying to land orders that we can execute very well and that'll appeal to a broad range of customers later on.

So, we have our own process we go through. But, that's why you see a little bit of lumpiness in the vehicle market right now. It's not lack the demand, it's lack of order placement timing from the customer base.

Mike Wallace: Just refresh how big is the auto business for you in test? The percentage of the total test business, how much is it?

Jeff Graves: So what we say is about 40% is directly or indirectly related to automotive industry, it could be full-scale car testing, it could be subassemblies, suspension systems, it could be key components to go into automobiles; and those are all being affected. And then of course you have the materials testing which we measure separate from that, which is about a quarter of the overall test business.

Because a lot of these new electric vehicles are starting to use very lightweight aluminum and carbon fiber composites, so we address that market through our materials test business. But vehicles components and full scale vehicle, that's about 40% of our business Mike in test.

Mike Wallace: Okay, yes, so components and suspension systems and things like that, those I would think there probably some reengineering work that needs to be done to accommodate the new vehicles and materials and weight of the car and all sort of…

Jeff Graves: Correct. Correct.

Mike Wallace: ...issues that would come up. I would think those items wouldn't be the really big ticket items, they'd be tweaks on the existing platform. Or is that...

(Crosstalk)

Jeff Graves: It just depends on how much they want to -- how much technology they want to use Mike. And you can link those machines to computer models, we call it hybrid stimulation. You can link into models and do real-time iterative testing with a computer module, driving one of our test systems. So it just depends on how sophisticate they want to get and how many engineers they want to hire to do the testing themselves as well.

Mike Wallace: Okay. So, out of that 40%, just generally what percentage would be really affected by this increase customization? That's pushing things out and perhaps needing some refresh on some additional money versus the basic stuff that wasn't required as much customization work that you just tweak what you've got. You got any sense of that?

Jeff Graves: Well, I don't have numbers Mike, but just in short, it's a lot. It's -- you look at these new electric vehicles and hybrid electrics and the move toward autonomy, virtually every significant component in the car's changing. It's amazing. It's an amazing transformation in the automotive industry right now.

And that's why you see the rise in new players and you see some older players following out and it's an amazing pace in this industry right now.

Mike Wallace: So you mentioned churn in this auto space, are you seeing much competitive pressure from others? And if you lose the business to somebody else, why are you losing it.

Brian Ross: Mike, this is Brian. So as far as overall Q1 performance in our full year, orders, the one thing to keep in mind is that, that where you see some variability, once those orders are defined, they usually flow through our factory and that's how quickly we churn those items. And what I would state overall is our business performed as we expected in Q1 for the test business, the revenue came through as expected.

So overall, we expect the same and continued path for the rest of the year as we describe that the end of our fiscal 2017 earnings call as well.

Mike Wallace: Okay. So you're not seeing much in terms of people -- other competitors coming and offering a similar customization product for a more competitive price?

Brian Ross: No, it’s a very static industry in terms of the competitive landscape, Mike. There’s not lot of new people who can get into this business. It’s a difficult long-term business to be in. We should probably Mike move on.

Mike Wallace: Okay. No, that’ good. I appreciate the dive into that. It's an area to watch...

(Crosstalk)

Mike Wallace: I appreciate your comments so much. Thank you.

Brian Ross: No problem at all. Happy to follow up any time.

Mike Wallace: Okay. Perfect. Thank you.

Operator: And ladies and gentlemen just a final reminder, if you do have a question please press star 1. And Mr. Graves it appears I have no additional questions at this time. So, I’ll turn the program back over to you.

Jeff Graves: Okay. Thanks Lorie. Thank you all very much for participating on our call today. We look forward to updating you on our progress again next quarter. So thank you and have a great day.

Operator: And ladies and gentleman once again that does conclude today’s conference. Again I’d like to thank everyone for joining us today.