MTS SYSTEMS

Moderator: Jeff Oldenkamp
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Operator: Please continue to stand by. Your conference will begin...

Operator: Good day and welcome to the MTS Systems First Quarter 2016 Earnings call. Today's conference is being recorded.

At this time, I would now like to turn the conference over to Andy Cebulla, Director of Investor Relations. Please go ahead sir.

Andy Cebulla: Thank you, Craig. Good morning and welcome to MTS Systems fiscal 2016 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 a 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. Jeff will begin his update on our first quarter results.

Jeff Graves: Thank you, Andy, and good morning everyone. Thank you for joining us for our first quarter investor call. We appreciate having the opportunity to discuss our financial results for the quarter and update you on our outlook for fiscal 2016.

First, let me remind you about the focus of our company and the nature of our two business units. This may be particularly helpful for those newer to following MTS. Our company's mission is simple. We're dedicated to making our customers new products more precise, safer, more reliable, and we enable them to get to market more quickly and confidently each year.

We carry out this mission through two operating units. The larger of our two businesses is Test which provides highly engineered testing systems and services largely to R&D and product development groups within automotive, aerospace, energy and infrastructure OEMs, as well as leading research laboratories and universities worldwide.

Our test business is fueled by our customer spending on research and new product development, markets that are less sensitive to the short-term economic swings that have generated such volatility for many companies in recent years.

Our second business unit is Sensors, which provides products that are essential for automating heavy industrial equipment and increasing the precision and safety of heavy vehicle systems that utilize hydraulic controls.

These sensor markets are tied more directly to industrial capacity utilization and heavy equipment demands than our test business markets. With this backdrop, I'll start with the headlines for the quarter. There are three key takeaways for the call today.

First, we were very pleased with our overall orders growth in the quarter, which were up 24%. The orders increase was driven by a 33% increase in our test business orders. This continued strong test orders growth demonstrates worldwide demand for our technology offerings across virtually all of our test markets as our customers continue investing in new products to satisfy their diverse and increasingly complex end market requirements.

We were particularly pleased with the orders growth in our test services business which once again experienced strong double-digit growth, up 16% in the quarter. The sales growth demonstrates the demand potential of our installed base of equipment, which now exceeds $4.5 billion.

From a geographic perspective, we were very pleased with our orders performance in China, which despite slowing industrial economy which makes frequent headlines today delivered for us a whopping 63% in the quarter. I'll provide you with additional orders related information in a few moments.

Second, revenue for the quarter came in largely as we had expected and earnings were stronger than originally anticipated. Revenue was solid and increased 3% on a constant currency basis. Earnings were higher than expected largely driven by disciplined cost control. We're excited about the strong start to the fiscal year and believe it positions us well as we move into the second quarter.

Finally, our third key message today is regarding our outlook for fiscal 2016. Given our strong orders performance in the quarter from continued demand for our test technologies, our record backlog of $373 million and a solid start to the fiscal year were confirming our full year revenue range of $570 million to $670 million and earnings per share range of $3.03 to $3.28. I'll provide some additional color around our guidance later in the call.

With that, I'll now review orders in more detail for the quarter. As I mentioned, total company orders increased 24% to $168 million in the first quarter. Drilling down one level, Test orders were up 33% while Sensor orders were down 16%, reflecting their higher direct exposure to the industrial markets worldwide.

With a strong orders performance, our backlog ended the quarter once again at a new record level of $373 million, an increase of $59 million or 19% compared to the prior year and up 6% on a sequential quarterly basis, a trend that reaffirms our views of current market conditions.

All of the increase was expectedly test driven given the comparative short lead times for our sensor products. While all of our major product categories were strong, the custom content and our backlog at the end of the quarter increased slightly to 77% compared to 72% at the end of our fiscal year 2015.

Looking forward, we continue to see strength in our core markets. Despite the strong test order growth in the quarter, the test opportunity pipeline, that is the opportunities we see ahead of us in the market over the next 12 months, actually increased to a new record level of $955 million by the end of the quarter.

Obviously we're very pleased with this continuing demand profile as it demonstrates the strength of our core test markets around the world reflecting the continued investments our customers are making in research and new product development.

Now I'll provide you with some additional context on orders by business unit and I will begin with sensors. As I mentioned, sensors orders in the quarter declined 16% and were down 10% on a constant currency basis. The macroeconomic environment for sensors continues to be challenging.

We saw continued weakness in the broad global industrial market specifically in steel and fluid power and the oil and gas markets. Approximately half of the orders decline is directly related to weakness in the global steel markets.

The most dramatic reduction we are seeing in steel is in China from the decline of construction and infrastructure projects. Steel demand in the Americas is also down driven by the oil and gas market. On the positive side, we did see some modest strength in the wind energy market in the quarter driven by demand in Europe.

From a market perspective, the industrial center market was down 22%, compared to prior year driven by market weaknesses that I just mentioned. The mobile hydraulics market was a bit of a bright spot from sensors with orders up 10%, but on with a still a relatively small base.

Growth in this market resulted from new design wins moving from development into production, along with the addition of new customers. Certain of our traditional customers in mobile hydraulic applications with large exposures to commodity productions such as mining remain depressed so this overall growth was very encouraging to us.

Next, let's review the sensor orders from a geographic perspective. American orders were down 19% with the largest driver being in the steel markets that I previously mentioned. European orders were down 16%, but down 5% on a constant currency basis, while Asia orders, excluding China, were relatively flat.

China orders were weak in the quarter down 25%, driven by a general slowing in the Chinese industrial economy and specifically the impact of the declining Chinese steel market. Next, let's turn to our test business unit.

Now before I begin the discussion on our test business, I'd like to recap the question I’ve been asked so many times from investors about why we continue to pursue first of the kind or highly custom products in testing, which often have lower margins associated with them.

The rationale is simple, as the technology leader in our markets we’re always striving to raise the technology level for testing with the customers we serve. They count on MTS for this and it is been our commitment to them for the last 50 years.

Our customers need this new testing technology both to appropriately test their new products, which are increasing rapidly in complexity and to continue reducing their time to market. Many of these new marvelous machines have now demonstrated their abilities in key markets around the world.

As this level of new performance is now understood in the industry, we see a rapid increase in demand for these new highly complex test products. Once sold to a launch customer, we then strive to standardize the design and production of these machines as rapidly as possible increasing our productivity and our operating margins as we gain volume. This is the business model and you see it now reflected in the orders volume for our test business.

To recap the quarterly results, as I mentioned in the headline, test orders increased an impressive 33% in the quarter to $148 million. We saw broad based demand across all of our major markets and geographies. The order increase was driven in part by strong demand in the ground vehicles market, which was up 47% as customers continue to prioritize their investments to improve vehicle emissions, fuel economy and alternative powertrains driven by stricter standards that are now coming into effect. These orders reflect our leading technology position in Test solutions for aerodynamics, durability, and tire testing.

In addition to our ground vehicle market, orders related to the structures market increased 71%, driven by strong demand for expansion of testing control requirements in the aerospace market, as well as continued investments for civil seismic testing.

And finally, orders from the materials market were relatively flat for the quarter as demands for standard and advanced materials testing solutions was largely offset by weak demand from the oil and gas industry.

The vast majority of orders in the quarter were from existing long-term MTS customers demonstrating continued confidence in MTS technology and quality, which is enabling them to me their ever more demanding customer expectations.

Geographically for our test business, Americas and Asia were both very strong, up 61% and 39% respectively. Europe was down 8%, but was up 4% on a constant currency basis. For China specifically, we were extremely pleased with growth in the quarter. Despite the slowing industrial economy in China, as I previously mentioned, the demand for laboratory equipment to support research and new product development remains very strong.

Our orders were up 63% this quarter, driven by strong demand across all of our core markets, including ground vehicles structures and advanced materials testing in China. We remain very bullish about our future in China and it remains a key growth market for our test business going forward.

Next, I would like to spend a few minutes discussing our test service business. As I previously mentioned, our test services continue to gain momentum this quarter with orders increasing 16%.

This increase was driven by the growing demand of our customers to upgrade their lab operations for their significant installed base.

This success reflects progress against our strategic goal of building deeper higher value customer relationships with services that range from providing rapid response to the need for critical spare parts and the proactive maintenance to the implementation of a full service intelligent lab value proposition that enhances the productivity and efficiency of our customers laboratories around the world. We continue to receive a positive reception from our customers regarding our service offerings.

Our large and continually growing installed base of test equipment worldwide, which is now over $4. 5 billion, continues to provide us with an opportunity for sustained profitable growth in our test service business. We are continuing to add feel service engineers as quickly as we can to support the service business and help drive future growth.

And finally, I would like to comment on the test opportunity pipeline as its good indicator for future growth. At the end of the first quarter our 12 month pipeline of opportunities stood at a record $955 million, up 8% sequentially and up 3% to the first quarter last year.

These identified opportunities for future sales are reflective of the healthy continuing demand we see for expanded and enhanced testing capability in R&D and new product development by our customers worldwide. This visibility into future demand builds confidence in our ability to deliver sustained growth going forward.

As a key metric, we used to monitor the health of our opportunity pipeline is the deferral rate within the pipeline. This is measured as total dollars deferred as a percentage of the beginning quarterly pipeline.

This metric was relatively flat at 53%, compared to54% a year ago and decreased slightly from 60% on a sequential quarterly basis. The current deferral rate is at our historical average rate of the mid-50th percentile range. As a reminder, as the deferral percentage in the pipeline increases, the volatility of orders performance tends to increase.

This gimmick predictability and resource planning more challenging compared with the volatility we experienced when the deferral rate is lower. Since the rate drops sequentially, it provides us more confidence in our ability to secure future orders and deliver on these orders in the most productive manner.

We will continue to update you on this view of our markets in the quarters ahead. Now, I'd like to turn the call over to our CFO, Jeff Oldenkamp, for some additional financial detail in the quarter.

Jeff Oldenkamp: Thank you, Jeff. My remarks today will summarize our first quarter results based on a year over year comparison. Overall, as Jeff mentioned in his remarks, our results for the first quarter were better than we originally forecasted.

Revenue came roughly in line with our expectations and earnings were higher than we were expecting. The higher earnings resulted from cost management actions that we took in the quarter.

Now moving on to more detail about the quarter. First quarter revenue of $141 million decreased 1% but was up 3% on a constant currency basis. Looking more specifically at revenue by business, sensors revenue of $22 million was down 11% and down 5% on a constant currency basis. All regions were down double digits on a GAAP basis.

On a constant currency basis, Europe was up 1% while the Americas was down 13% and Asia was down 6%. The decline in the Americas and Asia was principally driven by the broad industrial market weakness around the globe, specifically in the steel, fluid power, oil and gas markets that Jeff mentioned in his remarks.

Moving on to test. Revenue of $119 million increased 1% and grew 4% on a constant currency basis. The solid performance resulted from higher service revenue and greater revenue conversion from the high opening backlog. We are beginning to see indications of improvements in our operational throughput, which allowed us to turn some of our backlog more quickly. Test backlog ended the quarter at $361 million, another record level.

As Jeff mentioned, custom backlog as a percent of total backlog was approximately 77%, up from 72% at the end of our fourth quarter. As we stated in our fourth quarter conference call, the high level of slow returning custom mix and backlog will take some time to convert into revenue.

Also, we believe the high mix of custom projects and backlog will likely continue to have a negative impact on margins over the next few quarters as we work through the custom backlog. However, the negative mix was anticipated in our guidance range for both revenue and EPS.

We believe the slight increase in custom backlog from our fourth quarter will not significantly impact our results relative to our guidance. We will continue to monitor our mix of orders as we progress through the year.

Moving on to the rest of the P&L. Gross margin was $53 million, a decrease of 8%. As a rate to revenue, gross margin decreased 250 basis points from 39.9% to 37.4%. Sensors gross margin was down 12% to $11 million on lower volume.

The gross margin rate decreased 40 basis points from 53.4% to 53% primarily resulting from lower volume. We expect the margin rates to stay in the mid-50% range going forward. Test gross margin of $41 million was down 6% and the gross margin rate decreased 250 basis points from 37% to 34.5%.

Higher compensation expense from investment and engineering resources that we mentioned in our fourth quarter call contributed 1.2 points of the decline. Although, it will take a few more quarters from the engineers to get fully trained, we believe this investment will better position test for future growth.

In addition, investments in IT systems and merit increases each contributed .6 points of the margin rate decline in test. We expect margin rates in test to remain under pressure through the first half of the year and then anticipate gradual improvements in the second half as revenue volumes increase and we implement operational efficiencies.

My next topic is operating expenses. Operating expenses decreased $2 million or 5% to $39 million and were 28% of revenue. The decrease in operating expenses primarily resulted from lower legal costs and favorable currency translation. Going forward, we expect operating expenses to remain in the 27% to 29% range.

EBIT decreased 12% to $13 million primarily driven by the lower gross margins in both the test and the sensors businesses partly offset by lower SG&A cost. EBIT as a rate to revenue decreased 110 basis points to 9.5%. My next topic is taxes.

The tax rate in the quarter was 10%, which was unusually low and well below our expected range of approximately 30%. The rate was favorably impacted by the retroactive reinstatement of R&D tax credits, which provided a tax benefit of $2.3 million in the quarter.

This reduced the effective tax rate by 17.4 percentage points in the quarter. We anticipated the retroactive expansion of the R&D tax credits in our full year earnings per share guidance range. In future quarters, we expect the tax rate to return to the 30% range.

Earnings per share decreased 13% to 78 cents compared to 90 cents in the prior year. Prior year earnings per share included a $1.8 million or 11 cents per share discrete tax benefit from the favorable resolution of IRS examinations of prior year tax returns. Excluding this tax benefit, earnings per share was relatively flat.

Moving onto a summary of cash. The cash balance increased $8 million in the quarter and remain strong at $59 million. The net debt level is now $18 million of net cash. In the quarter, operating cash flow was solid at $11 million. We spent $11 million to purchase approximately 183,000 shares, spent $7 million on capital expenditures and paid out $4 million in dividends.

As a reminder, the majority of our cash is overseas and not immediately available for use. To fund the dividend, share purchases and capital expenditures, we borrowed $20 million from our short-term line of credit during the quarter.

Finally, I will conclude my remarks with a brief update regarding the reported material weaknesses in internal controls over financial reporting. As we outlined in our 10-K, we are implementing a variety of actions to improve our control environment and remediate the material weaknesses.

We have made progress on the various initiatives that we are pursuing and are on track to remediate the material weaknesses by the end of our fiscal year. This concludes my remarks for today. I will turn the call back to Jeff for his final comments. Thank you.

Jeff Graves: Thanks, Jeff. Now I would like to update you on our full year revenue and EPS guidance ranges. As I mentioned in the headlines, we are confirming our full year revenue range of $570 million to $600 million and our earnings per share range of $3.03 to $3.28 per share.

We continue to see confirmation of demand for our technologies across our test markets and the robust global R&D market. This is evident from the strong order performance in the quarter, record ending backlog and record test opportunity pipeline.

This coupled with our solid first quarter revenue and strong earnings performance and the operational efficiencies we're pursuing in test, this should begin to yield margin improvements in the second half of the year, provide us with confidence for our 2016 and beyond.

As we look at the current backlog mix and delivery schedule, we continue to anticipate that revenue and EPS in the first half of the year will be less than the second half of the year as we described previously. That concludes our prepared remarks. I will turn the call back over to (Craig) for the Q&A session.

Operator: Thank you very much. Ladies and gentlemen, at this time we will begin the question and answer session. If you do have a question today, please press the star followed by the 1 on your pushbutton phone. You may also decline from the polling process at any time by pressing the star followed by the 2.

And as a reminder, if you are on speakerphone, you will need to lift the handset first before making your selection. And our first question does come from the line of John Franzreb with Sidoti & Company.

John Franzreb: Good morning, Jeff and Jeff.

Jeff Graves: Good morning, John.

Jeff Oldenkamp: Hi, John.

John Franzreb: Really impressive results coming out of China. Could you just talk a little bit about test in China? The sustainability of that demand, it’s kind of counter to what we are reading as you referenced before Jeff.

Jeff Graves: Yes, it is, John. Compared to the headlines that everybody sees every day, it is counterintuitive. The overall Chinese industrial economy as you can see from the sensors side of our business is in tougher shape than it was a year back and that's continuing. But in terms of the test markets, it is very interesting, John.

You know, we’ve - I’m out traveling a lot with customers and it's very hard to surprise me, but I - and I knew China was hanging in there and, you know, continued to express a lot of interest in our products. But even I was surprised in the quarter, just a tremendous outpouring of interest in our testing machines and that it’s very broad based, I mean, encouragingly to me.

We see it in our ground vehicles segments and there you see the rise of the domestic Chinese OEMs, which are building fantastic new laboratories for developing cars in China. And the basic driver of that John is the challenges the local population faces on pollution and the new pollution standards they are implementing as well as fuel economy standards.

My layman's - my word for it is, they are taking the toughest regulations from both the US and Europe and implementing them in China. But at the same time there is a tremendous growth and demand for cars and they are trying to get ahead of their challenges.

So for us, it is a great benefit because they need the most modern laboratories in the world to develop these cars and the domestic companies in China right at the front of that, they are buying a lot of our equipment’s. And we worked hard the last couple of years to get good reference site established in China and demonstrate the technology and it's just paying tremendous dividends for us right now, so there is a nice demand.

But encouragingly, John, as I said, it’s also across the other market segments for us. We see it in the structures area. For example, civil seismic testing systems. The Chinese are trying to get out in front of building construction standards and prove the survivability of earthquakes and other natural disasters and improve the design of their buildings and the best way to do it is to buy our civil seismic testing machines.

So they’re investing a lot in universities and laboratories, national labs to do that. And then the materials testing segment, their automobiles and future aircraft, they’re developing advanced materials for those applications and we see a lot of it manifested in terms of demand for those products as well.

So I was thrilled not only with the overall growth at 63% in orders, which is astounding to me, but the breath of the demand over there. So I would expect it to continue. I don't know, if we can sustain 63% growth year over year. But my goodness, I think it will remain, you know, strong, you know, year over year for the foreseeable future. It’s a big and growing market for us.

John Franzreb: And then the large project awards that you garnered in the quarter, what - did they have a geographic or end market bias ((inaudible)) structures or anything? Are you seeing any commonality there?

Jeff Graves: I’m sorry, John. I missed the beginning of that. So...

(Crosstalk)

John Franzreb: The large awards that you got in the quarter.

Jeff Graves: Oh, you know, I would say it's fairly broad based again. I mean we see, you know, obviously, civil seismic systems are very large. But we also are selling some very large sophisticated automotive testing systems, truck and bus systems, large tire testing systems. So, again, it is kind of across the board.

And I would put this in the materials category as aircraft manufacturers and automotive guys are looking to make more components out of composites, the large structural beams and things that go into those vehicles require very sophisticated testing, which I'd put in the materials category.

So, again, very broad around the world. The advanced material stuff is being driven a lot out of the West, so Western Europe and the US and China is racing to catch up as fast as they can. So it's again very broad.

John Franzreb: Got it. Now on the product side, test seems to be doing well. The service side despite revenues being up nicely year-over-year had much lower gross margins than I was expecting. Could you just walk me through what's going on there.

Jeff Graves: Yes, we're basically putting a lot of expense into services to support its growth, John, and it's primarily in the form of people. So we continue to hire field service engineers as rapidly as we can because there is a big demand out here for our services, so we're hiring and training a lot of guys in the field.

And as we’ve talked about before, it takes them about a year to come up the curve on training and productivity, and we're going to continue adding those folks. It's extremely well received by customers.

In fact, John, I would tell you, it's part of the reason why we are growing the equipment side of that business so nicely right now as well is they see as being very serious about servicing that equipment over the next 20 to 30 years by investing in people.

So there’s a drag on margins with less productive folks that we’re hiring and then we’re also investing obviously in our IT systems and things for scheduling those resources in the most efficient way. So there is a lot of expense investment.

We’re also taking on, you know, work that we’re learning how to optimize and improve from a cost standpoint, improve how we deliver that service. So there’s a bit of a learning curve in that too, which probably drags on the margins a little bit. But that’s - all in, that’s the reason for it.

There’s no reason to expect our service margins. I would be surprised if they got back to the old historical norm of 50% gross margins. But there’s no reason to think they can’t be a very strong contributor to the business in the 40s.

John Franzreb: Okay. Perfect and...

(Crosstalk)

John Franzreb:...one last question. The tax rate, I guess, certainly caught me by surprise. Is there any other onetime items that are embedded in your guidance for the full year that we should be cognizant of?

Jeff Oldenkamp: No, John, that tax rate, you know, was contingent on the Congress passing and the President passing the retroactive R&D credits, which happened in December. So we did anticipate that in our guidance range. And there's nothing else unusual or one-time benefits that would be out there.

John Franzreb: Okay. Thank you very much. I will get back into queue.

Jeff Graves: Thanks, John.

Operator: And our next question does come from the line of Jim Ricchiuti with Needham & Company.

Jim Ricchiuti: Hi, good morning. Why don't you talk a little bit about the range that you have for both revenues and EPS for the full year? Wondering if would you discuss some of the dynamics that maybe gets you to the high end of that range.

It sounds like it's going to come from the test business, but maybe you could talk a little bit more about that, what some of the drivers would be to get you to the upper end.

Jeff Graves: Yes, sure, Jim. And good morning to you as well. So, the - it comes down very simply, Jim, to how fast can we turn the test backlog, which actually internally I was very pleased in the first order. I mean, I think our rate of turning the backlog in terms of what we control internally and our supply chain is improving.

And improving out rates we would have expected or better, so that's good. We have to bear in mind that we are often tied to facilities that our customers are putting in to house the new equipment. So we would like that to be the constraint rather than our internal operations.

So that's our goal, but it does provide some dampening of the rate of improvement we can see in turning backlog. Obviously, the mix of backlog is a big driver of the overall revenue realization. The more custom content, the slower the backlog turns, the longer the revenues drag out for. So those are the kind of the factors.

We were pleased with the rate of progress in Q1 with our test business and I would hope that trend will - while I certainly expect it to continue and I would hope the rate would stay high of improvements ((inaudible)) so we can turn it, again, what's in our control.

One swinger is the industrial sensor markets and how rapidly that economy stabilizes and gets better. You know, we're modeling some, at least stabilization and some improvement as the year goes on in the second half, so not dramatic, there's some improvement in that business turns very fast.

So, our assumption right now is there will clearly be a shortfall in our internal expectations in sensors because the industrial market in the first half that moderates in the second half. And then our Test business fills in the gap and hopefully more than compensates for it.

So if you add all that up that's why we're, you know, sticking to our original guidance range. And that's what, you know, hitting those expectations and a bit of favorability could drive us to the upper end of our guidance range.

Jim Ricchiuti: And Jeff that variability in that range to the extent you were able to get to the upper and that would be more of a, do you think of a second half phenomenon?

Jeff Oldenkamp: Absolutely, Jim. I expect no surprises in the second quarter I think it's largely in the books now and we're turning the backlog. I don't, I wouldn't, you know, I don't want to encourage exuberance in the second quarter, but I'm very happy with the growth in our backlog which will start impacting the second half of the year as we planned and maybe a bit better and then cascade into 2017. So, again it'll be a second half effect and a '17 effect.

Jim Ricchiuti: Okay. With respect to visibility in the business, I would assume you've gotten reasonably good visibility in the current quarter with the test business. So, you know, is it the sensor business or primarily that you know is a little bit less clear or frankly is there some conversion issue within the test business as well with respect to the current quarter? I know you don't give current quarter guidance.

Jeff Oldenkamp: Well, you know, that's the debate we always have on these calls, but I would say you touched on the big variability. We're watching sensors very closely. You know, I think it's following right now our expectations, which we internally dramatically lowered based on Q1 in terms of the industrial economies.

I think they were softer around the world and we would have expected, fortunately for us our exposure to those is relatively small, it is just limited to that business. But still it was disappointment in Q1 and it dragged us and we're worried about that as we go forward. So we will watch that closely. The variability in turning the backlog in Test is getting better quarter-by-quarter. And I'm encouraged by that.

But we're still working our way through and I think it'll be the whole balance of this year as we increase our predictability in turning that backlog and can tighten up our guidance range. So, we'll revisit it at the middle of the year and see if we can tighten things up a bit, it largely depends on the industrial economy and what happens with sensors.

But hopefully we will get confirmation on our test improvements and those will keep going.

Jeff Graves: Yes, Jim, I'd just like to add, you're right, we generally don't give quarterly guidance. But as you mentioned and Jeff mentioned we're expecting the second half to be better than the first half. You know, within Q1 we delivered 78 cents per share. That, of course, included some discrete tax benefits.

So, we don't give quarter two guidance or quarterly guidance, but if you're looking at your quarters, the second half should be better. What I would recommend when you're looking at it or when you're looking at your Q2 just take into account the discrete tax benefits we had in Q1 because those will not repeat in Q2.

So...

Jeff Oldenkamp: I think you just gave Q2 guidance.

Jeff Graves: There was no number there. Just make sure you take that into account.

Jim Ricchiuti: Thank you, guys.

Jeff Oldenkamp: Thanks (Jim).

Operator: And our next question does come from the line of Matt Sherwood with Cooper Creek.

Matt Sherwood: Hi guys, congrats on a great quarter with ((inaudible)) here.

Jeff Graves: Thanks Matt.

Jeff Oldenkamp: Hi Matt.

Matt Sherwood: Just had a quick question here on the guidance and the tax benefit. So, the tax benefit was in both the low end and the high end of the guidance.

Jeff Oldenkamp: The tax benefit was, yes. We anticipated that they would approve the R&D tax credits.

Matt Sherwood: Got you. And then in terms of next year since there it was approved for two years, does that repeat or is that just this year event?

Jeff Oldenkamp: So, it's happened in the last couple of years, one of the things that happened Matt is they made it permanent. So going forward, we should not have, you know, within our first quarter, a four quarter benefit. So, it should become much more predictable in the future.

Jeff Graves: That's the big take away Matt, hopefully it takes that variability out of - because it is a big deal for us and hopefully it takes that variability out if they stick to this permanent idea and that it rolls through.

Matt Sherwood: So next year you'll have the same tax rate as you do this year, it just won't happen all in one quarter?

Jeff Graves: So what we've said Matt and as our tax rate would be around that 30% range. We would not have unusually low tax rate in a quarter of 10% in the future.

Matt Sherwood: Okay, great. Then I guess just as you look at your guidance range, you know, how much of the variability, you know, within the range is driven by test versus sensor? You know, given your backlog shouldn't you have a pretty good read on test for the balance of the year.

Jeff Graves: I would tell you, our predictability is, you know, internally is getting better in terms of, you know, modeling our backlog turn. These are, you know, a lot of our revenue is driven off projects and you have to predict, you know, hundreds and hundreds of milestones in these projects to predict your revenue flow. We put in a lot of IT systems and worked on processes to get better at that and I think we're more and more confident of that.

The problem Matt in large part is the external piece of that. Sometimes customers delay things in terms of approvals or building construction stuff like that, we don't control. Also currency can throw us a curveball, which is always, which we built into guidance this year, currency volatility assumptions and risk factors around that.

So, there remains a lot of risk even when you have a backlog driven business. And then you've got sensors on top of that, which is a quick turn business and, you know, we go into a quarter with very little backlog. It's mainly a book and ship business with build times in the two to three weeks range per sensors. So, we count on a modeled orders flow throughout the quarter.

Matt Sherwood: Got you. So I guess just to paraphrase that what you said earlier, you would be saying that sort of sensors thus far has been weaker than you would have anticipated. But given the strong orders in, you know, Q1 test may shakeout better so you're sort of where you were - you originally thought it's just driven by different drivers.

Jeff Graves Yes, different mix of business Matt. You got it. The industrial sensors, which is 80% of that sensors business, okay. Now fortunately, our sensor business is small relative to test, but 80% of its driven off the industrial economy and a big chunk of that is the steel industry. And obviously that's even weaker than we would've modeled this year as we went through the first quarter.

I think, you know, coming up to the holiday period and things our customers were very conservative on buying sensors. So, hopefully that flattens and then turns positive. You know, when it does swing it's a big impact on our businesses. It's very profitable business for us.

So, we hope to see the industrial economies do better and we've got our model. You know, and part why we're sticking to our range for the year is risk factors around that.

Matt Sherwood: And I guess last one on the sensors side. You guys were able to sort of not see negative incremental margin, you're able to keep the margins relatively constant despite weak revenue. I guess can that continue or at some point is there sort of a deleveraging effect.

Jeff Graves: Well I take my hat off to the general manager of that business and the employees. They did a great job on cost control, you know, watching their operating expenses and really trying to adjust to the volume decline. You know, beyond a point that gets harder and harder, but they did hold margins on a percentage basis and we're really pleased with that.

The pricing environment's okay and it consists of what we told you guys before. When we get designed into an application pricing tends to be very stable. So that's good because it's driven by the life of that platform. So that's a good thing.

But in terms of volume effects, clearly you know it was a challenge for the business and they really did a nice job in Q1 of managing their margin performance, but the overall dollars from that margin were down.

So that's something that test had to accommodate.

Matt Sherwood: Thanks a lot.

Jeff Graves: Thanks Matt.

Jeff Oldenkamp: Thanks Matt.

Operator: Ladies and gentlemen, if there are any additional question please press the star followed by the 1 at this time. Again, as a reminder, if you are on speakerphone, you will need to lift the handset first before making your selection. And our next question does comes the line of Ben Hearnsberger with Stephens Inc.

(Brandon): Hi, thanks for taking my question. This is (Brandon) in for Ben. Just real quick on the large test orders in the quarter. I guess what's driving these physically large orders and also I'm assuming that these would be at the higher end of the engineering man-hours required.

Maybe even more so than your regular more regular custom orders, so would that imply kind of a slow return for these?

Jeff Graves: Hi, good morning, (Brandon). Thanks for calling in. You know, so with regard I think you're asking about the large custom jobs, large custom projects, So when we do the very first one of those machines and then the next couple to follow, the engineering content - the required engineering hours are very high Brandon and it's a drag on our margins.

Our approach is then once we do the first of a kind and maybe follow with the second couple of variations on that, we standardize the design and sell it broadly across the market. So the incremental engineering hours drops off fairly dramatically once you get to the first few units if we are successful in standardizing the design.

So we landed a lot of orders in the quarter obviously and a lot of those were these large systems, but I wouldn't necessarily conclude that the engineering hour for those systems goes up rapidly. I think with volume growth, you always have more hours required but the percentage of hours can drop off pretty nicely once you have a repetitive business, if you followed that.

(Brandon): Got it, yes, that makes sense. I appreciate it. And then I know you commented on the backlog custom standard mix. When you look at the pipeline kind of how does it compare here and what are you seeing in terms of the mix there? Thanks.

Jeff Graves: I think we see a lot of stability, (Brandon). So in terms of the percentage mix, what we would classify as large jobs, large projects or in custom category, it's running about the same percentage as backlog right now. And, again, our hope is we can standardized those designs as we book the order and drive engineering productivity or engineering benefit from the prior jobs.

So that's the approach. It is nice that the orders are coming in so closely in time because the technology is not expected to evolve substantially over a period of months instead of years. So we should be able to standardize that design and sell it broadly.

(Brandon): Sounds great. And just one last housekeeping question, on the services engineering headcount. What was the beginning quarter I guess headcount and then versus the end? Thanks.

Jeff Graves: So (Brad), I'll give you a general answer and then Jeff if you have any more detail you can add it or if not we can follow-up with (Brandon). (Brandon), we're adding about 10% headcount a year on our workforce, round numbers of about 300 people for our services business.

We're adding about 10% a year distributed fairly uniformly over the course of the year in general and it takes about a year for those folks to become productive. So you can back into about 30 folks. Jeff, if you have any more...

(Crosstalk)

Jeff Oldenkamp: (Brandon), just looking, you know, Q1 to Q1, you know, the service headcount has increased about 50 heads or so year over year. So, you know, and compared to the end of the year, it's gone up, you know, roughly, you know, 15 people or so.

(Brandon): All right. Thanks for the color and congrats on the strong orders.

Jeff Graves: Thanks, (Brandon). Appreciate it.

Operator: Ladies and gentlemen, if there are any additional questions, please press the star followed by the 1 at this time. Again, as a reminder, if you're on speakerphone, you'll need to lift the handset first. And our next question is a follow-up question from the line of John Franzreb with Sidoti & Company.

John Franzreb: Guys I just wonder if you could just talk a little bit about what you're seeing in Europe. I guess with both product lines, but I'm more interested I guess on the test side of the business. Can you just talk about conditions in Europe?

Jeff Graves: Yes, John. I would tell you Europe for us has been a very good story. I mean, you see some quarter-to-quarter variation. But Europe for us, you know, again, dominated by the European automotive manufacturers, the Germans and the French and others. The standards in Europe for emissions are rising rapidly.

The complexity of vehicles is going up so fast that they're having to reinvest in testing capability. So a little bit is most probably capacity driven but a lot of it is capability driven. These vehicles just require much more accurate and complex simulation to validate the design.

And by simulation I mean simulation in the lab, testing a prototype car or subassembly on the car. So I'm delighted. The regulatory environment for emissions and fuel efficiency is going up fast.

The move to autonomous vehicles and the complexity that that drives under the hood is great for our business.

Because frankly speaking because it’s very hard to simply rely on computer models, you have to do the testing and the most efficient way to do testing is not on the road but in a laboratory on our equipment. So that’s the story in Europe and Europeans are leading the way in a number of technology areas both in aeronamics and in performance and handling.

They’re among the technology leaders, so they’re often the first to demonstrate our new machines and then the rest of the world follows. It’s not always the case, the American companies are very good as well, Japanese companies we see a lot of investments happening and the Koreans. And then obviously the Chinese are running quickly to catch up.

So in broad strokes, Europe and the Americas lead a lot, Japan leads on a lot, and Koreans are catching up very fast, and the Chinese are doing their best to enter the race as well. So it's very good for our business. I can repeat that same story across aerospace and advanced materials.

John Franzreb: And has currency made it more challenging on the competitive side?

Jeff Graves: That’s a great question, John. You know, what impresses me is the continuing demand for our technology in spite of the currency changes. You look at what’s happened with the dollar in the last year and a half, a lot of our costs are in US dollars and we’ve had to price accordingly. And in spite of that the technology demand has been strong enough to I believe not only compensate but even shift a bit of share toward us too.

So our guys have done a great job in explaining the value of the systems what technology brings and benefits, and we’ve been able to overcome currency. That said I’d love to see currency help us instead of hurting us at some point right. So if you can influence that John, I'd be ever appreciative but...

John Franzreb: That's beyond my control, Jeff.

Jeff Graves: In spite of that, it's been a great story for us.

John Franzreb: Okay. Thanks for taking my follow-up.

Jeff Graves: Thanks, John.

Operator: And at this time, there are no further questions. I would now like to turn the call back over to Jeff Graves for any closing comments. Excuse me. Actually, it looks like we did have another in queue and it does come from of the line of Kevin Sonnett with RK Capital.

Jeff Graves: Morning, Kevin.

Jeff Oldenkamp: Morning, Kevin.

Kevin Sonnett: Good morning, gentlemen. Sorry for the late dial in there. Just one quick question. I think you guys usually give the mix of business, the mix of orders that comes from large test orders versus space test orders. Would you mind breaking that out?

Jeff Graves: So, large versus standard breakdown again. You guys have numbers? Yes, give us just a...

(Crosstalk)

Jeff Oldenkamp: Yes, I mean, you know, we had three large orders that totaled, you know, $30 million compared to $1 million last year. So, I can do the rough calculations there.

Kevin Sonnett: No, that's okay. Tha's perfect. And I have it historically, I just don't have the last quarter. Would you mind just filling in that blank for me?

Jeff Oldenkamp: Kevin, Q4?

Kevin Sonnett: Correct.

Jeff Oldenkamp: I do not have that in front of me. I can get it back to you Kevin though.

Jeff Graves: We could follow-up...

Jeff Oldenkamp: Yes.

Jeff Graves:...with you Kevin if you give us a call, because we publish those numbers. What I don't like about that demarcation Kevin is some of the large orders can be, you know, on a product that we're maturing pretty quickly and the kind of custom content is declining.

So it doesn't always correlate to margin when you just do a big versus small order.

Kevin Sonnett: Sure. Sure.

Jeff Graves: It doesn't always correlate to margin and sometimes it does if those large orders are true custom jobs. Other times we can have a fairly standard but large project from a dollar perspective. So just with that caveat and Jeff do you have...

Jeff Graves: So, Kevin there was no large orders in Q4 of fiscal year ‘15.

Kevin Sonnett: Okay, great. Okay, thanks for that.

Jeff Graves: Thanks, Kevin.

Operator: And we do have another question. It does come from the line of John Krulock with Millrace Asset Group.

John Krulock: Hi guys. I just have a quick question on modeling on - with regard to the tax rate. So, I think you guys said that you expected the full year really to be around 30% and that the guidance incorporated the lower tax rate in Q1.

So from a modeling standpoint, is it fair to say that over the course of the year it still evens out the 30% or what’s the best way to think about tax rate for the rest of the year?

Jeff Graves: Yes, so in my - in - during the script, John, I said the future quarters would be around 30%. So if you drop that in and then you put in the Q1 tax rate, it would get to - get you to a full year tax rate that would probably be in the mid to high 20% range.

John Krulock: Okay, great. Thanks a lot.

Jeff Graves: Thanks, John.

Operator: And at this time, there are no further questions. I would now like to turn the call back over to Jeff Graves for any closing comments.

Jeff Graves: Thank you, Craig. You know, thank you all for participating in our call today. We look forward to updating you on our progress again next quarter. So thank you and have a great day.

Operator: Thank you very much. Ladies and gentlemen, that will conclude the conference for today. We do thank you for your participation. You may now disconnect your lines at this time.

END