MTS SYSTEMS

Moderator: Jeff Oldenkamp
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Operator: Please standby, your program is about to begin. Good day and welcome to the MTS Systems Second Quarter 2016 Earnings conference call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Andy Cebulla. Please go ahead.

Andy Cebulla: Thank you, (Roxanne). Good morning and welcome to MTS Systems fiscal 2016 second 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. 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 overtime, they should not be considered in isolation or as the substitute for GAAP measures. A reconciliation of any non-GAAP measures to nearest GAAP measure can be found on the company's earnings release.

Jeff will now begin his update on our second quarter results.

Jeff Graves: Thank you Andy and good morning everyone. Thank you for joining us for our second 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 our company. Our company's mission is simple. We're dedicated to making our customers new products more precise, safer and more reliable, and we enable them to get to market more quickly and confidently each year.

We carry out this mission through two operating segments. 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 demand than our test markets.

With this backdrop, I'll start with the headlines for the quarter. There are four key takeaways for the call today. First, we're disappointed with our results for the quarter. In a few moments I'll cover in detail factors that drove our results and outline key actions taken and our plans to concretely address these issues.

Second, I'd like to reiterate that our base business remain strong although overall order growth was down 6% when excluding large custom projects we saw over 20% year-over-year growth including strong test services growth of 15% and our sergeants in sensor growth.

Third, we're taking some cost actions to reduce our corporate structure and selectively streamline our test business unit. Importantly we're maintaining our investment in test resources dedicated to our technology initiatives, our engineering foundation and our fulfillment functions. This is critical given the continuing strong in-market demand for our test products and services worldwide.

Fourth, we're reconfirming our previous revenue guidance for the year where we're lowering our earnings per share guidance to reflect the inefficiencies we experienced in our second quarter. I'll now provide more detail for each of these key topics.

First, let me address our quarterly results. Both revenue and earnings fell significantly short of our expectations. The revenue shortfall was primarily driven by two factors. First, a short is direct manufacturing labor delayed the timing of conversion in the backlog in the revenue pushing the revenue into the second half of the fiscal year.

We're working hard to fill the gap in direct labor by increasing our efforts to find qualified personnel outside the company and also moving a portion of indirect labor into some of them open position on an interim basis. We're confident with these efforts we'll have adequate labor to achieve the second half revenue target.

The other driver of the revenue shortfall was from several highly technical complex projects that required increased engineering resources to meet our customers' high performance requirements and the associated timetable. This negatively impacted both revenue and earnings in the period. The additional cost had the effect of lowering the expected margin on these projects while delaying revenue into the second half of the year and increasing the overall cost to complete the project which will ultimately affect the full year results.

We've a process to evaluate individual projects on a monthly basis including assessing the progress completed to-date and the estimated remaining costs and compare that to the forecasted amount. It's through this process to identify the issues we encountered in the quarter. We believe we now have a clear path to deliver these projects and feel confident that we've quantified the necessary cost to complete them.

With the new developments in the quarter we've completed additional detailed and thorough review of the projects that are currently in our backlog in an effort to identify all projects that would be considered higher risk from a technical standpoint. We did this to ensure that we've appropriately identified areas with increased risk and quantified and incorporated an appropriate level of contingency for those projects.

Further, as a result of this review we believe there are no other projects in our current backlog that have an equivalent level of technical risks to the projects that cost, the cost over runs in second quarter. Based on this review we believe that our revised guidance incorporates and considers an appropriate level of project risk.

Relative to what we expected in the quarter both of these items negatively impacted revenue by a total of approximately $9 million and earnings by approximately $6 million. In addition there were few other items that negatively impacted our earnings mainly from higher medical expenses and inventory write-down, increased warranty costs that we generally do not expect to repeat in the second half of the year.

As I said, the revenue impact was timing related and we'll see that rebound in the second half of the year, but approximately $4 million of the negative effect on earnings will impact our expected full year results.

Moving to new orders, as I mentioned at the outset, we're pleased with the overall orders growth in the quarter although overall orders were down 6%, this was driven by the timing of large custom project orders which we define as orders in excess of $5 million. The large orders in the second quarter of fiscal 2016 totaled $14 million compared to $46 million of large custom orders in the second half of last year.

Excluding large custom projects, orders were up 20% year-over-year. The orders increase was driven by continued strong test orders growth demonstrating 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 once again very pleased with orders growth in our test service business which experienced strong double digit growth up 15% in the quarter, the third consecutive quarter with very solid double digit growth. This sales growth demonstrates the demand potential of our $4-1/2 billion installed base of equipment and the investments we've made over the last few years in expanding our field service organization and to modernize the tools that used to serve our customers.

We believe we're still in the early stages of growth in this exciting facet of our test business. From a geographic perspective, we're once again delighted with our orders performance in China which delivered a 46% increase in the quarter demonstrating continued demand for our testing solutions in that region of the world. This reflects the unabated investments our Chinese customers are making in new research laboratories and new product development capability.

Another bright spot from an orders' perspective is our sensors business which have 5% orders growth in the quarter. We're very encouraged by this development as it marks the first time in six quarters that our Sensors business had orders growth. This growth is largely attributed to completion of qualification efforts on new sensor applications rather than a strong resurges in the end markets. We believe this bodes well for further strengthening as the global economy gains momentum in the future.

I'll provide you with additional orders related information in a few moments. The third key message that I mentioned is regarding some cost actions we're taking in the third quarter. In an effort to reduce our cost structure we're eliminating in the aggregate 55 to 65 positions primarily in our corporate organization and on a very selective basis our test organization through terminations, elimination of certain open positions and reductions in our contractor base.

This will allow us to focus our resources in areas that enable technology innovation, improve our operations and drive profitable revenue growth. The reductions are part of our ongoing process to look for opportunities to optimize the company's organization and cost structure and to not expect the impact the ability to generate strong organic growth or drive technological advances.

These cost saving efforts are expected to generate approximately $2-1/2 million to $3 million in cost savings in the second half of our fiscal year and approximately $9 million in annualized savings. Severance and related charges are expected to be between $1-1/2 million and $2 million and will largely be recorded in our third quarter of fiscal 2016.

Finally our fourth key message today is regarding our outlook for fiscal 2016. With regard to revenue as I mentioned most of the issues that impacted the current quarter were timing related and will not impact our full year revenue guidance.

Based on this the continued strong order activity we are seeing in both businesses and the record backlog level that we have of $388 million at the end of the second quarter, we are reconfirming our full year revenue range of $570 million to $600 million excluding any benefits we may see related to the PCB acquisition.

To be clear the $600 million to $650 million revenue range we provided last month was inclusive of a contribution from the PCB acquisition, which is expected to close in our fiscal fourth quarter ending in September. With regard to earnings, the project execution issues and test that we experienced in the quarter will negatively impact our full year earnings results.

In addition we are not seeing as rapid and improvement in our operations as we had expected and as a result we do not expect to realize the full amount of the improvement since second half of the year that was contemplated in our original guidance. These two factors lead us to lower our guidance excluding any contribution from the PCB acquisition.

All acquisition related expenses and severance charges from the cost actions we're taking to $2.60 to $3 per share for fiscal 2016 from our prior guidance range of $3.03 to $3.28. I will provide some additional color around our guidance range later in the call as well as the expected impact related to the PCB acquisition.

With that, I'll now review orders in more detail for the quarter. As I mentioned total company orders decreased 6% to $149 million in the second quarter. The drilling down one level, test orders were down 8% but up 24% excluding large orders which as many of you that follow the company know from previous calls have been uncharacteristically high over last 18 months.

Sensors orders were up 5% reflecting strengthening in both the industrial and mobile hydraulics end markets with the solid order performance our backlog ended the quarter once again at a new record level of $388 million, an increase of $63 million or 19% compared to the prior year and up 4% on a sequential quarterly basis.

The trend that continues to reaffirm our view of the current conditions of the end markets that we serve. The majority of the increase was Test driven given the comparative short lead times for our sensor products. However, the sensor backlog increased as well $1 million to 12% on a sequentially quarterly basis.

Now I will provide with you some additional context on orders by business units and I will begin with sensors. As I mentioned sensors orders in the quarter increased 5%, we are particularly pleased with this development given the macroeconomic environment that sensors business has been facing for some time.

Both the industrial and mobile hydraulics markets were up but the mobile hydraulics market was a significant price for sensors with orders up 15% marking the second quarter in a row of double digit growth. Certain of our traditional customers and mobile hydraulics applications with large exposure to commodity production such as mining remained depressed, so this overall growth was encouraging.

Even some of our customers are reporting reduction in sales we were able to grow by continuing to make progress and getting designed into new platforms to drive our growth. This is especially significant since this positions us for potentially greater growth when our customers’ end markets begin expanding.

The industrial sensor market was up 3% compared to prior year driven by significant strength in the medical market as well as improvements in construction machines, machinery for plastics and rubber and machine tools and manufacturing systems.

On the negative side, we continue to see weakness in the heavy industrial segments of steel and fluid power particularly in China where we're seeing delays and cancellations of customer projects and increasingly intense competitive environment.

Next let's review sensors orders from the geographic perspective. We saw improved demand in all regions with the exception of China. Americas order increased 14% from improvements in both industrial and mobile hydraulics end markets.

European orders were up 4%, well Asian orders excluding China were up 33%, but on a relatively small base. China orders were weak in the quarter down 26% driven by general slowing in the Chinese industrial economy and specifically the impact of the continued decline of the Chinese steel market.

Next let's turn to our Test business unit. To recap the quarterly results, test orders were down 8% overall driven by the timing of large custom orders. Excluding large orders in both periods test orders increased 24% compared to the prior year.

We saw broad base demand across all of our major markets and geographies. The increase was driven by continuing investments to improve fuel efficiency and reduce emissions driven by raising regulatory requirements and a heightened sensitivity among OEMs to emissions performance.

We experienced strong demand for systems to measure tire properties such as rolling resistance due to the direct impact these attributes have on safety, performance and environmental response for a vehicle as well as testing systems for advanced materials used in aircraft and automobile applications to help me raising performance and environmental requirements.

The ground vehicles market once again had a good orders quarter up 6% driven by demand for investments to improve vehicle emissions, fuel economy and alternative power trends. This is being driven by stricter emissions standards that are now coming into effect and reflect our leading technology position and test solutions for aerodynamic durability and tire testing.

Orders from the materials market were up 8% for the quarter reflecting strong demand for standard and advanced materials testing solutions particularly in Europe and the Americas. This was in part driven by the expanding use of composite materials which requires additional testing capability.

Our customers have been focusing on expanding the lab capabilities to meet these new demanding requirements from their customers. We continue to experience weak demand from oil and gas industry, but it’s a relatively small exposure for our company.

Orders related to the structures market decreased 68% driven by the timing of large non-recurring large custom orders that I previously mentioned. Excluding these large custom orders the structures market increased 9% in the quarter driven by continued investment related to civil seismic testing capability, the trend with which we are pleased.

Geographically for our test business Europe was up 20% and the Americas were flat year-over-year. All of the large orders I previously mentioned were in Asia in both fiscal periods, as a result Asia was down 17% but up a very strong 42% when you exclude large custom orders.

For China specifically we continue to be very pleased with the order activity and growth we are seeing in that region. Orders grew 46% compared to the prior year, which follows 63% growth in the first quarter of the fiscal year. The demand for durability and aerodynamic testing remain strong.

Chinese domestic customers are continuing to upgrade and expand their testing capabilities in their labs driving strong demand across all of our core markets. We remain very bullish about our future in China and remain the key growth market for our test business going forward.

Next I'd like to spend a few minutes discussing our test service business. Test service has once again continued to gain momentum this quarter with orders increasing 15% following an increase of 16% in the first quarter. The increase was driven by continued focus on strategic relationships with customers to extend the life of their existing installed based and full service contract wins in Asia and Europe.

We have completed numerous lab assessments for key customers around the world resulting in building deeper engagement with customers and generating orders for critical spare parts and lab upgrade services that will enhance the productivity and efficiency of our customers' laboratories. These are being well received by our customers.

Our large and continually growing installed base continues to provide us with an opportunity for sustained profitable growth in our test services business. We are continuing to add field service engineers and to invest in service infrastructure as appropriate to support the test service business and help drive future growth.

Finally, I'd like to comment on the test opportunity pipeline as we believe it's a good indicator of future growth. We define the Test opportunity pipeline as orders we believe have a probability to be placed in the next 12 months. At the end of the second quarter, our 12 month pipeline of opportunities stood a new record $950 million relatively flat sequentially and up 3% to the second 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.

The key metric we use to monitor the health of our opportunity pipeline is the deferral rates within the pipeline. This is measured as the total dollar deferred as a percentage of the beginning of the quarter pipeline. The metric was relatively flat at 54% compared to 53% on sequential basis and is at our historical average of the mid 50% ROE range.

As a reminder, as the deferral percentage in the pipeline increases the volatility of orders performance tends to increase as well. This can make predictability in resource planning more challenging compared to the volatility we experienced when the deferral rate is lower.

Since the rate is relatively flat sequentially, it provides us more confidence in our ability to secure future orders and deliver on these orders for the most productive manner. We'll 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 on the quarter. Jeff.

Jeff Oldenkamp: Thank you, Jeff. My remarks today will summarize our second quarter results based on a year-over-year comparison. Overall, as Jeff mentioned in his remarks our results for the second quarter were disappointing and fell short of our expectations.

Revenue and earnings were both lower than what we anticipated driven by the challenges in converting the high level custom backlog in the revenue as well as project execution issues in the Test business. We are working diligently to address these issues and are confident in our ability to deliver our revised guidance as we move through the remainder of the year.

Now moving on to more detail about the quarter. Second quarter revenue of $137 million decreased 5%. Looking more specifically at revenue by business sensors revenue of $23 million was down 8%. Asia was down 23%, but on a relatively small base. Europe was down 4% and the Americas were down 3%.

As Jeff mentioned orders for sensor in the quarter were up 5%, the timing of those orders were late in the quarter and we are not able to fulfill those orders in time and ship prior to the end of the quarter. This caused revenue to decline in the quarter. Moving on to test.

Revenue of $114 million decreased 4% and fell well short of our expectations. As Jeff mentioned, revenue was negatively impacted by shorter of direct manufacturing labor and project execution issues, both of which delayed the timing of the conversion of backlog into revenue, pushing the revenue into the second half of the fiscal year.

Test backlog ended the quarter at $374 million, custom backlog as a percentage of total backlog was approximately 77% flat compared to the end of our first quarter. The midterm backlog is in-line with what we anticipated and supports our revenue guidance. We will continue to monitor our orders as we progress through the year. Moving on to the rest of the P&L.

Gross margin was $45 million, a decrease of 20% as a rate to revenue gross margin decreased 640 basis points from 39.3% to 32.9% primarily driven by the decline in test gross margins. Sensors gross margins was down 12% to $12 million on lower volume.

The gross margin rate decreased 280 basis points from 54.% to 51.4% primarily resulting from lower volume. We expect the margin to return to the low mid 50% range going forward. Test gross margin was disappointing and came in at $33 million, down 23% and the gross margin rate decreased 700 basis points from 36.1% to 29.1%.

Each quarter we normally experience a certain level of project costs in excess of the anticipated amount. We refer to these costs as project cost adjustments. As Jeff discussed in his remarks this quarter we incurred an unusually high level of project cost adjustments driven by certain highly complex projects.

The excess cost resulted from the higher than anticipated labor and material cost required to complete those projects.

These excess cost negatively impacted the margin rate by approximately 2-1/2 points in the quarter. Of the remaining 4-1/2 point drop in the test gross margin rates, approximately 2-1/2 points was driven by higher compensation decisions expense from the investment and engineering resources that we mentioned in previous quarters.

Approximately 1 point from higher warranty cost and medical costs and approximately 1 point result from moving engineer resources and other R&D activities into continuation engineering activities in an effort to drive future cost savings initiatives and enhance product capabilities.

Although this had no impact on the test EBIT, it did temporarily reduce margins with an offsetting reduction in R&D expense. The test gross margin range for the first half of the year was 31.9%. We anticipate the test margins will be in the 35% range in the second half of the year. The improvements in the gross margin are expected to be driven by a variety of factors.

Approximately 1-1/2 points of the improvement is expected to come from less project cost adjustments as we do not expect to incur similar level of project cost adjustments in the second half of the year compared to the first half of the year.

As Jeff mentioned in his remarks, we have thoroughly reviewed the projects in the backlog and believe we have identified the high risk projects from a technical standpoint. We are confident that we have applied an appropriate level of contingency risk and quantify the incorporated into our revised guidance.

Approximately another point of improvement in gross margins is expected to come from leverage on higher volume and another point is from the cost actions that we are taking. My next topic is operating expenses. Operating expenses increased $2 million or 5% to $41 million and/or 30% of revenue. The increase in operating expenses primarily resulted from $1.4 million of acquisition related expenses.

Also higher headcount resulted in $1-1/2 million of additional costs, which were offset by $700,000 in lower legal costs and $700,000 from temporarily transfer of R&D engineers to continuation engineering activities I previously mentioned. Going forward we expect operating expenses to be in the previously communicated 27% to 29% range excluding acquisition related expenses.

Operating income decreased 75% to $4 million primarily driven by the lower gross margins in both the Test and Sensor businesses. Operating income has a rate to revenue decrease 910 basis points, 3.2%. My next topic is taxes. The tax rate in the quarter was 29%, which was slightly below the prior year rate of 30.6%.

The rate was favorably impacted by the enactment of legislation that made the US R&D tax credit permanent. In future quarters we expect the tax rate to remain at approximately 29%. Earnings per share decreased from 77 cents in the prior year to 20 cents primarily driven by the lower growth margins that I previously discussed.

As I mentioned, the second quarter earnings per share included $1.4 million of acquisition related expenses. Excluding these expenses non-GAAP earnings per share would have been 27 cents in the quarter. A reconciliation of these earning to GAAP earnings is included in our earnings release, which is available on website or the SEC website.

Moving on to a summary of cash, the cash balance increased $4 million in the quarter and remain strong at $63 million. The net debt level is now $42 million of net cash. In the quarter, operating cash flow was strong at $30 million driven by improvements in working capital which accounted for $23 million of operating cash flow.

We've been focusing on improving our working capital and we are clearly seeing positive results. We reduced our debt balance by $20 million spent $6 million to purchase approximately 111,000 shares and spent $5 million in capital expenditures.

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

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

Jeff Graves: Thanks, Jeff. Now, I'd like to update you on our full year revenue and EPS guidance ranges. As I mentioned in the headlines, we are reconfirming our full year revenue range of $570 million to $600 million excluding any benefit from the PCB acquisition.

We're confident our ability to achieve this revenue range given the confirmed demand for our technologies across the test markets as evidenced by strong work performance in the first half of the year and record ending backlog as well as the recent past the border activity we are seeing in our Sensor business.

Also depending on the timing of the close of the PCB acquisition we're estimating that our fiscal 2016 revenue could increase by approximately $30 million to $50 million as a result of PCB's contribution to our fourth quarter providing a full year revenue range for the combined company of $600 million to $650 million.

However, as I mentioned we are lowering our earnings guidance for fiscal 2016. This is driven by two primary factors, first the project execution issues that we experienced on some of our large complex projects will impact our full year earnings.

These projects were generally first of a kind technology leading endeavors where required cost to meet the project milestones and deliver to the projects specifications were higher than we had originally anticipated. Although these types of cost adjustments are not uncommon on our Test business, the magnitude we experienced in the quarter was extremely high relative to a normal quarterly amount.

I previously mentioned our effort to perform a risk review of the remaining projects in our backlog and quantify and incorporate an appropriate level of contingency for those projects. As a result of the project execution issues in the second quarter and the risk review, our full year earnings will be negatively impacted by approximately $6 million related to these custom projects.

Second, our original guidance contemplated achieving a certain level of efficiencies in our operations. As we have discussed in prior quarterly calls, we hired a significant number of engineers to drive project execution. These hires have had a drag on our operating margins in the test business for several quarters.

We were expecting to gain labor efficiencies as these engineers became fully trained, however, given the complex nature of the projects and backlog we are not seeing the efficiency improvements as quickly as we had anticipated. We also expected to see further operational efficiencies from the investments we made in our IT systems to support the operations.

Although we did see some traction in the first quarter of the year, our progress and achieving efficiency improvements as plateaued. While we still believe that we can achieve improvements in our operations we do not see a clear path to achieve the expected improvements in the second half of the fiscal year negatively impacting our forecasted earnings by approximately $4 million.

We're taking definitive organizational actions to address the rate of efficiency improvements in our operations, but these actions are not expected to generally benefit from the second half of the year. In a longer term, we believe our focus on Lean Six Sigma combined with improvements in the use of our planning systems and select talent upgrades in our test operations will yield improved operational efficiency in our test business unit.

Finally, the cost actions we're taking will offset a portion of these negative impacts reducing our cost by $2-1/2 million to $3 million. Combining all of these factors we are lowering our earnings guidance for fiscal 2016 excluding any contribution from the PCB acquisition along with all acquisition related costs and severance charges to $2.60 to $3 per share for fiscal 2016.

As we previously stated, the PCB acquisition will have a negative short term impact on our GAAP EPS for fiscal 2016 primarily resulting from non-recurring transaction related expenses, interest costs, transaction related amortization and a higher share count resulting from the equity financing we are anticipating partially offset by any additional revenue and earnings from PCB.

However, as a result of the additional work completed on the acquisition to-date we believe the impact will not be as significant as we had originally anticipated. Based on these factors we are revising our previously issued earnings guidance including the contribution from PCB acquisition to $1.22 to $1.60 per share for fiscal 2016. As we look at the current backlog mix and delivery schedule, we continue to anticipate the revenue in EPS in the third quarter will be less than the fourth quarter.

In summary we did have a challenging and disappointing second quarter. We continue to experience operational inefficiencies in our test business which damped our earnings performance in the quarter. We're committed and determined to address these issues in the short term and process improvement on organizational changes.

On the positive side, we have a tremendous long term global customer base and continue to see rising demand for our technologies across all of our test markets and we are beginning to see signs of expansion in our sensors markets. This is evident from the strong order performance in the quarter, a record ending backlog and near record test opportunity pipeline.

Our test services businesses is gaining more traction each quarter reflected in the strong double digit growth and our business in China is booming. All of this provides us with confidence to deliver the revised guidance for 2016 and growth in 2017 and beyond.

Looking further ahead, the completion of the PCB transaction, the integration with our current sensor business and the outstanding value we'll be able to deliver to both our sensors and our test customers worldwide, we anticipate strengthening margins sustained strong organic growth and very strong cash generation that will support the investments needed to meet our rising customer demand for products and services that MTS is uniquely positioned to deliver.

In short, the future is very bright for MTS systems in the years ahead and we are committed to making that happen. This concludes our prepared remarks and (Roxanne), I'll turn the call back to you for our Q&A.

Operator: At this time if you'd like to ask a question please press the star and 1 on your touch-tone telephone. You may withdraw your question at any time by pressing the pound key. Once again, to ask a question, please press the star and 1 on your touch-tone telephone.

And we'll take our first question from (Ben Hearnsberger). Please go ahead.

(Brandon): Hi. thanks for taking my question this is (Brandon) in for Ben, Just curious on the highly technical jobs that came through and impacted the quarter, just if you guys could provide any additional color on kind of the nature of these that'd be great. Thanks.

Jeff Graves: Yes, thanks (Brandon). Very good question. So, these were couple of very unique projects. And one of which we've been working on for some time is coming to attend now and getting very close to shipping to the customer and it was related automotive testing to a large Korean OEM. It's truly a novel machine that is doing integration between testing and modeling that's never been done before.

It's a very large project, very late in its phase before shipment and we had to do some tunes and tweaks to meet the customer demand, which is evolved over the last couple of years and to accommodate the facility that is going into. So, some fairly special requirements for that project near the end before ships from the factory.

So, it observed a significant amount of engineering and manufacturing effort very late in the quarter, this quarter. But it's very close to shipment and we're very excited about being in the field and running and we have no more of those in our backlog. So, it was frustrating quarter in that sense, but the machine's a marvelous machine that'll do things to tie testing and simulation together that never been done before.

The other unique project we had in backlog or set of projects was related to hybrid electric vehicles and this was creating, taking our electric motor technology which is marvelous and adapting it for what's called Formula E, which is the new racing series around that are entirely electric driven cars. Taking that motor technology and adapting it for those cars.

This motor technology is special to us. It goes in both our testing equipment and increasingly on hybrid electric vehicles and we had extremely difficult performance challenges, which we well understood, but the schedule requirements were very tight. And to accommodate the schedule the customer needed to meet the upcoming race season we had to apply lot more engineering resource than we had planned.

So, while I'm very disappointed in our planning performance, if you will, I'm extremely excited about the technology, the hybrid electric system is simply fantastic and it will allow the testing machines that have never been fielded before and has applications broadly and hybrid electric vehicles that we're very excited about for the future.

So we're excited about both of those. They raise the technology level and the industry to a level never seen before. But clearly it was very frustrating in terms of the final execution of those projects and the inability to plan appropriately in our factories to accommodate it.

So we've made adjustments for that in terms of our leadership in that aspect of our business and using use of our planning tools. So I'm thrilled with the project themselves and the technology level they bring and the broad application, I'm disappointed in the impact they had on the quarter.

(Brandon): Got it. That's excellent color, I appreciate that. And just a quick follow-up housekeeping, I may have missed this but can you provide the mix of custom test as a percent of backlog and orders?

Jeff Oldenkamp: I covered in the backlog, it's 77%. It's remained pretty consistent quarter after quarter. And then, in regards to, you know, when we look at, you know, the pipeline, which we referred to in the past, it's pretty consistent. So there hasn't been significant shifts there.

Jeff Graves: I will tell you (Brandon), what we are very pleased with is rise of our base order business. We quoted some numbers in the prepared remarks. You know, we're up in excess of 20% in terms of base order performance and that's the kind of resurgence that we need to see in terms of smoothly flowing product to the factory and improving efficiency to the future.

So, I think the orders performance in the quarter bodes well for our future and as we quoted we saw a decline in large projects orders, but a strong resurgence in base orders within the quarter.

(Brandon): Got it. Thanks for the color guys.

Jeff Graves: Thanks (Brandon).

Jeff Oldenkamp: Thanks (Brandon).

Operator: And we'll take our next question from (Liam Burke). Please go ahead.

(Liam Burke): Thank you. Good morning Jeff.

Jeff Oldenkamp: Good morning Liam.

Jeff Graves: Hey Liam.

(Liam Burke): When we're looking at the initiatives taken in terms of identifying the backlog, the complexity of the projects, the resources required, will - do you have enough time to the balance of the year to re-size everything so as we go into future years we can look at more a normal profit and loss results that historically MTS has been able to drive?

Jeff Graves: There's absolutely no reason to think that historical normal assumptions you make about MTS over the long term have fundamentally changed. What is unusual, you follow us closely and what is unusual about the last 18 months is the strength of custom project orders from our customer base.

And personally my belief is that and is particularly driven out of automotive, that there's been such a drive for shortening development product cycles in the OEMs and the rising requirements for fuel efficiency and emissions that there's been - that they're looking for a new generation of technology in their laboratory, to basically bring together testing and simulation more closely than ever.

And it led starting at least 18 months ago, maybe longer, to a significant spike in our custom order business. And especially first of a kind machines, which as you know are the riskiest machines we manufacture. So, that's why we were scrambling last year to hire engineers to fulfill those orders and this year we're focused on our operational efficiencies.

Clearly, that didn't work well in the second quarter, as these projects are maturing now and moving out of the engineering phase and more into manufacturing. We've got work to do there on that coordination and our operational efficiencies. They are at a size now that they haven't before. We invested heavily in the planning tools; we have to get better at using them.

But that said, as you fast forward in to the future, there's no reason to expect both the product mix and the efficiencies we anticipate not be realized. So, I believe it's a step function change in technology in the industry they're looking for. MTS is beautifully positioned to capitalize on that. It's just a rate of change has even caught us by surprise.

So, we've been struggling with that over the last year and certainly bit us in the second quarter.

(Liam Burke): Okay and just as an additional point. On the composition of the pipeline, is that looking more normal historically than what you would expect in terms in relation to complex orders?

Jeff Oldenkamp Well, it's interesting. I'll give you a bit of color, Liam. The numbers, if you look at the percentage of large versus small or custom versus standard products, it's pretty steady at a mid-70% kind of number. But encouragingly, the number of first of a kind systems, which we love to do occasionally because they do raise the technology level in the industry but we don't like them to the magnitude that we had them in the last 18 months.

So, I would tell you the risk profile is coming down, the number of first of a kind projects within that custom mix is coming down. And frankly speaking, we're looking really hard at presale risk analysis and shared risk with customers, things of that nature, on these very first of a kind highly complex custom projects, I mean, to the point where we've had a walk away from some because we just believe the risk is too high.

So, we're scrutinizing our opportunity pipeline to a level never seen before in our business. And even though the custom to standard mix is relatively costing in that pipeline, the amount of first of a kind projects in that custom mix is declining and we're looking at that with a lot more scrutiny from applying engineering upfront before we take the order.

So, that - those were all changes we're making, where changes were seeing in the demand. And since you follow us closely, you would understand that subtlety but it is a big deal. Custom isn't bad historically, it's just first of a kind customers challenging.

(Liam Burke): Great. Thank you, Jeff.

Jeff Oldenkamp: Thanks, Liam.

Operator: And we'll take our next question from (Cezary Nadecki). Please go ahead.

Cezary Nadeki: Good morning, gentlemen.

Jeff Oldenkamp: Good morning, Cezary.

Jeff Graves: Good morning.

(Cezary Nadecki): Let's sugar coat it, it's a bitter pill to swallow. You know, if I look historically at the operations in the last four years, we've revised EPS now over four times. The average four quarterly DSOs went from 100 to 110, the DIOs inventories went from 85 to 95. You know, this seems to indicate me a little bit inability to forecast, plan and execute on financial goals in the current environment they we're present.

You know, reading your Q, it sounds like you're compensating sales force based on orders brought in, not the results provided to shareholders through execution. It's bit of a disconnect there on your expenses and revenue transient. And it sounds like you don't have a sound control on your project pricing and or execution; however you want to structure this.

You know, these problems are internal problems and they seem to indicate need for more management focus going forward, not less. And at the same time, we still don't know the growth profile of the business you're about to spend $580 million for, which is almost equal to your current valuation.

So, if I look at this, I have two questions. One, can you give me a sense how you're going to do better job managing current operations with less managerial focus due to your PCB; need to manage PCB acquisition as well? And two, can you give me some reason why this deal should not be up for shareholder approval considering everything I just said?

Jeff Graves: Yes. So, I think there are several embedded questions there. Let me. So, every company faces positives and negatives. What I would tell you about our company from a positive standpoint, I would always rather play this end. From positive standpoint we have outstanding customers who are financially very strong, you know the automotive OEMs, the aircraft OEMs, those guys, they are more technology dependent than ever.

They're driving for shorter lead times there in their laboratory and we're the technology leader in helping them. Okay. So, our problem is not in demand. We have focused heavily on our technology development, our sales activity with these customers to try to address their needs globally which are revolving especially in Asia.

So, that is going very well. So, we got strong orders profile continuing strong orders profile for the business. Our issues are internal now. Our issues are first and foremost meeting the engineer, having the engineering capacity and tools to do our job.

(Cezary Nadecki): Jeff, you're reemphasizing what I tried to state. I totally agree, there's nothing external that I brought up. I mean, this is a lot internal and it seems to lack internal focus, hence my questions.

Jeff Graves: Yes, exactly, that's what I'm getting to. So, our issues now within our four walls, we face an issue late last year mentioning capacity, we addressed that. We brought on new tools and methods. We're not focused on both using those tools well and on the raw talent in organizational structure and operations. It is our intent focus that is the focus of our management team all the way through me. I'd love to spend time with our customers and it served me very well in the last few years.

My focus right now to me personally to our test general manager and to the whole test organization is executing our backlog. It's managing our risk in new orders and making sure we scrub those well, so that we're taking orders that we can execute well on from both customers and shareholder perspective and delivering on those.

We did not do a good job with that in the second quarter. I in no way want to candy quote that. We had some stressful projects, yes, first of a kind technology marvels. And we own the IP for those. So, that's great for the future, we did not deliver on our commitments revenue and earnings and that's what we're focused on doing for the rest of the year.

With regard to the PCB acquisition, it is very special, Cezary. We would not have undertaken this size of an acquisition for anything less than something very special. I would tell you there is tremendous synergy between the sensors that they manufacture and both our sensor and our test business.

I was with a test customer a long term test customer two weeks ago. And they walked me through the labs they use MTS testing machine and directly into the lab they use PCB sensors, the same management structure, the same focus, and the same very positive feedback on having all of this technology under one roof. So, I believe it brings substantial and unique value to our company.

I mean, you can always say “Well, gosh, I wish the timing were different” or something else but as they came on the market, it had tremendous management team that’s been in place there for a long time in PCB. And we are focused on them doing a reverse integration of our sensor business, which allows us to focus our current management team primarily on the test business. PCB has a very seasoned leader and a very seasoned management team. They’re going to be integrating our sensor business into their company and coming under the MTS roof.

So, all that require from our management team, the current MTS, is to make sure we get the revenue synergies between their business and our test business which is a natural. It’s what customers want and what they look for from us and PCB combined.

So, the integration is very straightforward, the focus is on internal execution in test. I can absolutely assure you it occupies every minute of every day.

(Cezary Nadecki): I hear you Jeff and I wish you guys all the best. It’s just my comments are related to the last four years of your forecasting planning and execution, not just this quarter. And that’s why I’m a little bit worried about the bend with that you have to manage this acquisition and at the same time straighten the ship here.

And it seems like you’re taking on water and all I’m hearing is about the new engine you’re going to buy for your boat. It just I’m not worrying about PCB, I’m worrying about you the management being able to consolidate these operations and at the same time do a better job than you have historically on executing your financial goals for the main MTS. That’s all I have. Best of luck.

Jeff Graves: Yes, I hear you Cezary, thank you for bringing it up. It certainly is a challenge, no doubt about it. And some of that we don't control the timing of but it's too good of an opportunity for our owners to miss. I could not have passed on the PCB deal; it's a fantastic long-term thing for the company. Our intense focus, I assure you again, is on operational execution within our test business. Okay.

Operator: And we'll take our next question from (Paul Moomaw). Please go ahead.

(Paul Moomaw): Yes. With regard to PCB, what indicators or signpost will help determine when you raise the equity and debt for the acquisition?

Jeff Graves: I really can't comment anymore on the financing activities that we've already done. So, I think it's well publicized what our plan is for financing the acquisition and I just been prohibited from talking about it any more detail on that.

You know, in terms of our confidence in the synergies, the basic strategic crash down for the deal, it is been nothing big on up since we sign the merger agreement. I have had gross confirmation from our customer base that they like the deal, that they really enjoy bringing these brands and technologies together.

So, I feel very confident on attaining the synergies that we've talked about publicly. I can't comment anymore on the financing activity.

(Paul Moomaw): Okay. One related thing, why would you have bought in stock in the quarter at relatively high prices when you're about to issue a huge amount of stock to buy PCB? Were you completely surprised by the emergence of the acquisition opportunity or what - how did that unfold?

Jeff Graves: The acquisition opportunity came on rapidly and those stock purchases were done very early in the quarter, if I'm not, correct it, so it was at January February timeframe.

Jeff Oldenkamp: Yes.

Jeff Graves: Yes. So, we then after that we halted, we halt the stock purchases. So, we haven't been in the market for some time now.

(Paul Moomaw): Okay, thank you.

Jeff Graves: Thanks.

Operator: And we'll take our next question from (Seth Rosen). Please go ahead.

(Seth Rosen): Hi.

Jeff Graves: Hi, Seth.

(Seth Rosen): Can you hear me? Hi. I just want to make sure I understand the second half guidance and maybe if you could just talk to the cadence of that because it looks without PCB, the numbers are coming down, I think it's 28 to 43 cents, but it implies that the back half is maybe even up a little bit at the midpoint versus consensus.

So, just kind of all the puts and takes of the back half, how should we think about the cadence and what are the offsets to a couple of negative things that you mentioned?

Jeff Graves: You mean the - our earnings estimates without PCB or the earnings estimates with them, Seth?

(Seth Rosen): Without.

Jeff Graves: Yes, without.

(Seth Rosen): The $2.60 to $3.

Jeff Graves: Sure. So, it's - I mean at a high level it's very simple and Jeff I'll ask you to elaborate ((inaudible)). But at a high level set, it's very simple. The revenue issue we had in Q2 is more of a timing issue. It was a short ((inaudible)) labor at the end of the quarter that we get back as these projects move forward with the hiring plan we have in place for direct labor. So, that's a pretty easy one, we get that back in the second half.

The earnings drag that we talked about, the EPS drag, is from the cost experience in the second quarter. And then the efficiency projections we have in the second half, we had assumed our engineering operations team would be gaining efficiencies faster than were modeling now. So - and part of that is, I mean, obviously we brought in a lot of new folks.

Part of it is the usage of the tools and making sure they're comfortable using the planning tools we put in place, and part of it's the complexity of the backlog. So, we modified our projections for the second half of the year in terms of efficiency improvements and other than that it was the cost impact in the second quarter.

Jeff was there any more color?

Jeff Oldenkamp: Yes, a couple of things Seth I just want to highlight. First, you know I mentioned the project comps adjustments, I was very specific in speaking to the $4 million that would flow through from an EPS standpoint in Q2. So, when we look at the second half of the year we have projected project comps adjustments which just not to the level.

Jeff already mentioned that the revenue timing and the other thing I want to bring in is the cost actions. And when you're modeling in Q4 we'll get three months of benefit versus only one month of benefit in Q3. So, it's those three items.

(Seth Rosen): Okay. And so the original estimates for realizing the operational efficiency improvements that are coming in a little light, how light are those in the back half? Could you just put some numbers around that?

Jeff Graves: Yes, we're at - at this point, I would tell you we're assuming that we've plateaued on those until we clear this backlog that we plateaued on those and we're holding steady for the year. You know, I hope there would be some further improvements made, we're certainly driving for that.

We've already made changes in some of the leadership team and operations to drive that harder, if you will. And it kind of gets back to the earlier question on focus. We're intensely focused right now on our operational performance and that planning process between engineering and manufacturing and manufacturing efficiencies.

So, we've made some people changes, some talent upgrades here in the last month and we're intensely focused on them. From a modeling perspective we've assumed it's plateaued for the year and we're not going to realize any benefit of that in - within fiscal '16.

(Seth Rosen): Got it. And so besides the new 2-1/2 million to 3 million at cost saves which you just said you get one month in the third quarter and three months in the fourth quarter, is there anything else to call out in terms of seasonality? Like, just some - I'm just trying to get a ballpark on roughly what zip code we should be in for the third quarter earnings versus the fourth quarter earnings?

Jeff Oldenkamp: No, I mean, there's nothing from a seasonality, the revenue's pretty evenly split.

(Seth Rosen): Got it.

Jeff Graves: Is it fair to say, Jeff, revenue split and EPS is back in is more fourth quarter than third quarter?

Jeff Oldenkamp: Right.

Jeff Graves: So - because of the timing of the benefits Jeff mentioned, Seth, so we get one month of benefit in Q3, we get three months in Q4 which will impact EPS. In terms of revenue, it's pretty evenly split between the quarters.

(Seth Rosen): Got it, okay. Thank you.

Jeff Oldenkamp: Thanks, Seth.

Operator: And we have no further questions at this time. I would like to turn the call back over to Jeff to any additional or closing remarks.

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

Operator: This does conclude today's call. You may disconnect now and have...

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