ADVANCED FORMING TECHNOLOGY

Moderator: Drew Kelley
September 9, 2016
7:30 am CT

Operator: Good morning. Welcome to the ARC Group Worldwide conference call. With me on the call are Jason Young, CEO and Drew Kelley, CFO. This call is being recorded. Before we begin the formal discussion I would like to turn the call over to Mr. Kelley to make a statement regarding forward-looking information.

Drew Kelley: Good morning everyone. As most are aware this call will contain forward-looking statements as defined by federal securities laws. Forward-looking statements are indicated by such words as expect, anticipate, plan, believe and other similar words considering future events. All future events are inherently uncertain and actual outcomes may differ materially.

We do not guarantee future performance and past performance is not necessarily indicative of future results. Further we undertake no obligation to update our forward-looking statements. We encourage you to review the risks that we face and other information about our company in our filings with the SEC including our annual report on Form 10K and quarterly reports on form 10Q. At this time I'd like to introduce Jason Young, ARC's CEO.

Jason Young: Thanks Drew. Good morning everyone and thanks for taking the time to join our call. We announced earlier today results for our fiscal quarter ended June 30, 2016. The sales for the quarter were $27.8 million -- a 5% increase sequentially compared to the third quarter of 2106. Adjusted EBITDA was $3.4 million in line with the prior sequential quarter.

2016 was a transitionary year for us and was really all about coalescing our strategy which we think started to come together quite well as the year progressed. While the first fiscal quarter of 2016 was challenging due to the loss of several key programs, it reinforced the necessity of driving a more sales driven culture. As a result we were, and remain very focused on driving a proactive sales culture, which in ended up resulting in sequentially up sales for the second, third and fourth quarters of fiscal 2016.

We continue to make strides in underscoring these new sales driven culture and building a solid foundation for the future. While margins were muted in the fourth quarter which was primarily due to several sales driven efforts mainly the launching of a considerable number of new tooling programs, increased sales and marketing efforts and new part production ramp ultimately all items we view as positive long term.

New tooling programs add very little to contribution to margins therefore the high mix of tooling dragged down margins during the quarter however the new tools should be indicative of future part production ramp as the mix over time transitions more to our full production business. Our fast and holistic manufacturing approach remains quite strategic in solving our customer’s problems and we see considerable opportunity to further broaden our reach in the market.

I will now turn it back over to ARC CFO, Drew Kelley for some additional substantial commentary.

Drew Kelley: Thanks Jason. To briefly follow-up on Jason’s comments regarding quarterly performance. I would note that overall margins were also somewhat impacted by incremental costs associated with the end of the fiscal year, notably those related to the audit. Going forward we expect SG&A and other items of this nature to return to more normalized levels.

Separately the company also reported a rather large tax income expense relative to its pretax position during the quarter. In short our current tax expense has little to do with our current operating results and more with our deferred tax asset valuation allowance. As our financial profile improves so too should our effective tax rate.

On the balance sheet front, we remain committed to reducing the companies leverage while increasing our financial flexibility. Given our asset heavy balance sheet and cash flow generation we believe we have numerous avenues in order to accomplish this. We've been working on several strategic and financial opportunities that we expect will strengthen our balance sheet and will update our investor base as we finalize such endeavors.

At this point I will turn it back over to Jason for some concluding remarks.

Jason Young: We were excited to recently kickoff our new fiscal year particularly with our growing sales centric culture and with our strategy really starting to come together. As long as we can continue to execute our game plan well we see lots of opportunity in our core business. We also continue to see considerable opportunity in our metal 3-D printing business which has been growing quickly and is starting to get some scale.

As some of you may have seen earlier this week GE made two large acquisitions in the metal 3-D printing space which we believe underscores the considerable opportunity in metal added technology. Our expertise in powder metallurgy has been key to our leadership in metal 3-D printing and we see that segment as a key growth driver for the future of ARC. Technology also remains at the center of ARC, and we will continue to invest in innovation to further automate, streamline, speed up and improve the efficiency of our operations. We appreciate everyone's time on the call today and we'll now open for questions.

Operator: Thank you. If you would like to ask a question please signal by pressing star 1 on your telephone keypad. If you're using a speakerphone please make sure your mute function is turned off to allow your signal to reach our equipment. Again that is Star 1 to ask a question. And we will take our first question from Saliq Khan with Imperial Capital.

Saliq Khan: Good morning Jason and Drew.

Jason Young: Hey Saliq.

Saliq Khan: Hey guys. Good to finally see some growth during this quarter. However as I'm taking a look at the year all together what I wanted to ask about and talk about was you guys continue to do very well in 3DMT side of things. However the wireless group which is just much smaller portion of the business continues to be impacted adversely.

And also on to - on the PCP side or the PCG side excuse me that's another area where could you clarify what types of things you guys are working on right now to make sure what we saw over the last 12 months would not happen and repeat itself again the following year?

Jason Young: Sure. So I guess to tackle your first question regarding wireless, that statement has had kind of typical fluctuations, however given the size of it, it's not very material to the outcome of our overall operation. So frankly it's not something we focus on that much given it's somewhat non-core to what we're doing. So I don't think it's something we really view as material one way or another.

As far as the Precision Components Group, which is core, that kind of goes back to some of my earlier commentary regarding, our overall failed focus and really driving that business.

And that's really what we view as kind of core to the future and per some of my commentary I think that the first quarter of 2016 was kind of a chopped quarter for us given the loss of a couple of key programs and, really with our sales focus and driving sequential sales as we have throughout the course of the fiscal year that's really the focus of what we're doing and where we see a lot of opportunity. So as long as we can continue to keep that up we're fairly optimistic about the opportunity there.

Saliq Khan: And Jason with the renewed focus that you've had over the last several quarters on the sales side of things and given the challenges that we've seen in Europe over a couple of quarters is there anything that you're seeing right now within Europe and the increased effort by the sales team to give us more of an optimistic overview of what might happen in that region?

Jason Young: Things, at least as far as the European operation, have really begun to turn around. So, while our European operation did take a hit about a year ago things have been sequentially up for them as well and frankly we don't see anything today that should reverse that.

Drew Kelley: I might add just on the European front, our fourth quarter performance was up more than 15% from the first quarter. In addition the market there is served by several long dated platforms. And we are generally bullish on our opportunity there as it relates to next generation as turbocharger veins which are coming to fruition in short order.

But as Jason mentioned that the turnaround has begun, performance has certainly stabilized and I think the outlook while not necessarily immediately this quarter or next is certainly positive as we look to the latter half of the fiscal year and thereafter.

Saliq Khan: And guys one last one on my end. You know, one of the things you noted earlier in the call was the acquisitions that were recently announced. So if you take a look at the consolidation of the overall industry how does that impact your overall business?

Jason Young: Well that's an interesting question Saliq and I actually have a lot of thoughts about that. But just to briefly summarize I think that firstly those acquisitions by GE were frankly somewhat of a - or I guess more than somewhat of a surprise for most people in the industry including ourselves. So I think that there has been a lot of consolidation.

Those two acquisitions were on the equipment manufacturer side. So, while not directly competitive with us I think that it's definitely a sign that metal 3-D printing is going to get considerable more investment by the likes of GE. And the fact that they're willing to pay what they paid to really gain that foothold we think it's a pretty big statement on the opportunity.

And frankly on the service provider side on metal printing where we sit there's already been so much consolidation that there are very few players actually left. I think that if all of the consolidation on the manufacturer side and services side continue to happen it's definitely a sign of the opportunity that's coming.

GE has been very aggressive in getting a kind of early move or advantage in this space. So I think we're pretty optimistic about what's going on there.

Drew Kelley: And I think just to go back on Jason thoughts, not only are there few metal service providers out there, there are certainly even fewer providers that know how to operate with the precision and the complexity that we do when you talk about the industries the highly technical industries in which we serve. So it's both the scarcity and the complexity give us a tremendous amount of confidence as to our capabilities and our ability to grow that business significantly going forward.

Saliq Khan: Thank you guys.

Jason Young: Thanks Saliq.

Operator: And next we will hear from Ananda Baruah with Brean Capital.

Ananda Baruah: Hey thanks guys for taking the questions. A couple if I could, probably actually more like a few. So the first is so it sounds like you guys are seeing increased momentum kind of both in metal and injection molding and Jason you made reference to sort of some ongoing increased energy in 3-D metal printing. Could you give us what the context that you think we should have with regards to kind of breadth and depth of what's going on with the metal injection molding?

And kind of on a go forward basis, what do you guys how should we for modeling purposes - and it's actually bigger the modeling purposes. Just when we begin to continue to synthesize, sort of, how the company lives and breathes for us how should we think about how you want us to think about just kind of what the normalized kind of growth rate is for metal injection molding in the intermediate term now that it appears we're coming off of some sort of bottom and there's a dynamic to underpin that across some of these programs you've talked about?

And then sort of in addition to that as incremental can you context for us what's going on in the 3-D metal printing business? Did you get the three printers added that you have been looking to do, kind of coming into the summer I think that was the number you guys talked about and what's on the horizon there? And then I have a follow-up on the margin side. Thanks.

Jason Young: Sure. So I'm kind of the core business side including the metal injection molding, I think it's too early for us to put out a specific growth range. But what I can say is that we spent a lot of time with our customers and there is considerable opportunity with numerous customers to grow with them in our core business in material ways. And we see opportunities with call it half a dozen customers that could potentially be $5 million, or $10 million, or even $20 million customers over time as we ramp our relationship with them and help them solve their problems.

So we see a lot of opportunity to grow the core business in a material way. How that shakes out and the timing and such I think it's too early for us to say other than the fact that we have been very proactive on the sales side. We know our solutions make a lot of sense for our customer base. It's a very differentiated solution and it solves the two things that they need which is speed and supply chain consolidation.

So from that standpoint we feel confident in our offering and in fact it's been very validating over the last year or two where we've been much more customer centric. And really when I talk about bringing our whole strategy together really the last piece of it was the sales side and really having a customer centric focus.

And as we've done that not only has it been validating to our strategy and as well as the opportunity there but really getting in front of our customers and doing the missionary work to get our message out there about what we're doing has been exciting, and it's a unique strategy. Also I think that the key for us is to stay in front of our customers, solve their problems and make sure we're producing quality on time parts for them. So that's the key and we see a lot of opportunity there.

On the metal 3-D printing side we would expect that to grow much quicker than the other part of our business. We see lots of exciting new applications out there in aerospace and defense. As Drew mentioned we're one of the few players that actually has the technical expertise to actually make these parts. So where we won a lot of our PEs is really frankly we were able to produce metal parts that our competitors can't.

So that's been exciting. And we've also been working with our customers to basically come up with new ways of making parts taking away from machining, or casting or other legacy processes where we're actually able to make technically superior parts for actually less money and obviously much quicker.

So it's really a win-win for us and our customers. It's just pointing to the whole GE acquisition I mean there's very considerable amount of opportunity to grow that.

I think it's hard for us to predict exactly what that growth will look like but we think there's a very significant opportunity to use metal printing to displace inferior legacy manufactured processes. And we see a lot of applications across, not only aerospace and defense, but also medical and probably automotive over time as well.

So it's a statement that we think will be a key driver. We have a good line of sight with some of our aerospace customers what the future growth of that looks like. And we feel fairly optimistic that over the next several years that business can grow in a meaningful way.

Ananda Baruah: When - and then just getting back to the opportunities in kind of medical, aerospace, auto and then even on the firearm side what in the core MIM business as we move through this summer what are the dynamics that you saw there? It feels like things are probably improving a little bit. Drew mentioned, you know, kind of 15% growth in the June quarter. I'm going to assume that primarily it's not entirely turbocharger engines Drew I think you mentioned new programs coming on also.

So what are the dynamic in I guess in the MIM business in the core areas maybe those four core areas? And this is going to sound like a bit of a detail question but if you can give us a sense of how much of that is being impacted by sales force versus just market improvement verses new product cycles things like that. Thanks.

Jason Young: I would say the growth on the core side it's really being driven by just staying in front of our customers. The opportunity to apply our solutions to the marketplace probably outweighs any larger macro factors. If we frankly stay in front of our customers and educate them about our solutions I mean that's really going to be what drives growth.

I mean obviously cycles and macro and all that will affect kind of on the margin and on regular way business. But I think that a lot of the growth we can simply divine by just having a strong sales effort. I think the results that we've seen over the last three quarters is a reflection primarily driven by that.

Ananda Baruah: Got it. So it's stuff you can control which is good news?

Jason Young: Yes exactly.

Ananda Baruah: ((Inaudible)) performance. And then just going through the margin you guys mentioned kind of the incremental tooling costs which sounds to me sort of like set up costs but make that distinction if that's not accurate please? I'd like to know that. But could you talk about which parts of the businesses those - that were driving those incremental costs and to what magnitude sort of how should we think about that dynamic taking place going forward and then kind of what should be our view on the margins over the next few quarters if that dynamic is still persistent?

Jason Young: Yes, that's a good question and this quarter the fourth fiscal quarter of 2016 on the one hand we were excited about the sales but we weren't super excited about the margin levels. That being said it's a bit of a high class problem because as you noted those margin levels are reflective of these new programs launching.

So in some ways we actually view it as a positive because the more programs we launch the more kind of run rate business we have and most of our production business tends to be fairly sticky and long term and recurring.

These kind of upfront costs ultimately are a good thing and an indicator of the future. And to be specific to your question Ananda a lot of these tooling costs we're referring to are on the MIMs side we're launching a considerable number of tools at the moment. Frankly I think we're launching probably far more tools then we have collectively over the last call it probably couple of years.

And so because we've got such a ramp right there that has kind of in some ways almost clogging the system a bit. And we had to outsource some of our tools so we take kind of the margin hit there. And also we don't typically view our tooling as a profit center. So it has a natural kind of drag.

But ultimately, as far as the future goes, I think that it's hard to say we continue to grow our business in a material way that will at least, given our size right now, have a bit of a drag on margin in the short term but long term that will obviously ramp it to more run rate margins which should improve.

So again it ultimately depends on what the mix of growth versus run rate business is on a go forward basis but obviously we're in the business of growing the company. We'll see how that shakes out over time but that's kind of what the dynamic is.

Drew Kelley: I think it's important to add that while, as Jason mentioned, tooling is sort of a high class problem they're adherence with our MIM business is a tremendous amount of operating leverage. Whether we're producing the ten parts or 100,000 parts to a certain extent our fixed costs are covered by those initial parts. And so as we ramp up we would expect dollar for dollar those new incremental products and incremental product sizes to better our margins through the operating leverage of inherent again in MIM.

So I think not only are we excited about the general mix, the pipeline of growth and associated business that we see inherent in our business model is the ability to drive some significant cash. And we're excited about that both from a financial perspective along from a structure and the flexibility that it gives us to not only de-lever the company but of course then to reinvest for growth for future organic growth.

Ananda Baruah: Drew I'm glad you mentioned that because I was going to ask a follow-on to Jason's comment and I decided I'd wait to talk to you off line but now that you sort of talk to it I'll just ask it. Doesn't all this beget that in the coming quarters we should see an acceleration in the sequential revenue growth and then to your point margin expansion from the drop through for the leverage?

Drew Kelley: Well again we don't provide specific guidance as you know but, you know, in general I think, you know, we're very excited about the potential. As Jason mentioned our business model and the MIM solution quite frankly sells itself. Typically it's an opportunity for us to produce better parts, more economic parts for our customers. And as such we've seen this move towards the sale culture be adopted much quicker than I think are even somewhat aggressive expectations are.

The implications for future growth are pretty exciting from our perspective. We think it's broad based. It's across a number of our key customers our key industries and across our business units. And then for all those reasons and more we think that we should see a return to more normalized growth levels, those are historically what we sort of talked about what our expectations are for the business.

And I think again based on the inherent value of our of our manufacturing capabilities cash flow and EBITDA generation should outpace topline growth as we again ramp of full production. So for those reasons and more we're very excited about our upcoming fiscal 2017 year.

Ananda Baruah: That's very helpful. Thanks a lot guys.

Drew Kelley: Thank you Ananda.

Operator: And as a reminder to hit Star 1 if you would like to ask a question. And we will take our next question from Jon Tanwanteng with CJS Securities.

Jon Tanwanteng: Hi guys. Thanks for taking my questions. I just wanted to ask if the tooling and new product ramping issues is that more of a one quarter thing or do you think that mix stays where it is given your efforts to continue to increase sales?

Jason Young: John I think it's hard to say. As Drew mentioned given our operating leverage on the production side as we improve utilization that should counteract some of the margin drag. So over time absolutely expect our margins to improve. Again how that shakes out over the next one or two quarters it's hard to say given product ramp and new product growth.

It's tough for us to predict at that kind of level what things will look like but I think over time certainly our operating leverage will outweigh any of the new product ramp that we're doing.

Jon Tanwanteng: Okay. Is it fair to say that maybe revenue growth has been a little bit better than you may have expected but gross margin is a little bit worse just because of these ramping issues?

Jason Young: I would say yes. I would probably say that the revenue growth that we had in fiscal 2016 was probably more than what we were expecting. I think that we were very focused on kind of rebuilding or actually building frankly the sales side of our business. And honestly given our typical sales cycle we weren't expecting it to kind of get traction as quickly as a frankly did.

So from that standpoint I think absolutely. I think that on the margin side I guess where it's less that margins weren't what we were expecting I think it's probably more that we weren't expecting revenue to ramp as quickly as it did. And so that knock on effect was probably something we weren't necessarily expecting given the pace of the revenue growth through the fiscal year.

That's kind of at least how we were thinking about it. And frankly at the beginning of the fiscal year we weren't even staffed to handle the level of revenue that we ended up with at the end of the year. So we've had to in some ways play catch up from that perspective.

Jon Tanwanteng: Okay great. That's helpful. And I wanted to touch a little bit more about the GE purchases. It looks like they bought tool producers. Do you buy from those specific producers and if so how does that impact you if at all? Does it mean that GE is going to direct those machines to their own internal use and starve the market for tools or what are the other knock on effects that may occur?

Jason Young: Yes. That's a good question. So the 3-D printers, the metal printers, that we buy currently are EOS and Concept Laser. So we actually don't buy anything from Arcam or SLM. We think they're great companies. So it doesn't really have any direct effect on us because we don't buy their equipment.

We'll see what GE does with them. Frankly we don't know if they're going to shut them off to the market or if they're going to sell them to people like us going forward. So it'll be interesting to see how that plays out but I think that from an industry standpoint GE has been super aggressive and over the years in the metal printing.

Everyone was surprised at how aggressive they were here. So if anything I think it's ultimately a positive for everyone in the industry because, they're clearly ramping investment in the space because they believe in it.

Jon Tanwanteng: Right. I think of the past you and other people in the industry have talked about GE as being the prime customer for metal 3-D printing overall just a parts that does this change the amount that they potentially would outsource to service firms like yours given that they have their own tool manufacturing now?

Jason Young: I don't know what GE knows. I mean they may but I think that it could still go either way right now for them. I mean obviously they'll be producing a significant volume of metal parts. Ultimately whether that stays in house or out I think it's - I don't know that anybody knows. But regardless - I would say the other thing I would add to that is certainly they're further ahead than most other companies.

There was some other companies in the aerospace side that are actually pretty advanced as well. I mean they're - GE is not the only one, although they probably spent the most money in the space. But even if we never sold anything to GE I think that it's such a huge opportunity that even if we didn't sell anything to them I don't think it would really matter.

Drew Kelley: John I think it's important to underscore GE may be one of the more vocal and publicly visible 3-D utilizers, but they certainly are well absent when there is such a unique and tremendous opportunity in the global marketplace that I don't see any real competitive impact to ARC from these recent decisions. And again I think personally it underscores the importance or the attractiveness of metal 3-D as a whole.

Jon Tanwanteng: Got it. That's...

Jason Young: And John I suggest to one of the points, I think we're still in the very early innings of metal printing. And so if anything I view and I think a lot of people view things like GE's acquisitions ultimately as huge positives because the more investment and the more awareness that metal printing has the quicker the adoption will be on a broader basis.

So frankly the fact that GE is out there touting this technology is going to make other companies start to pay attention to it, experiment with it, evaluate it adopt it. And so frankly we're so early right now that in many ways the competition almost doesn't matter and awareness, and adoption and a willingness to use the technology is what matters.

And the fact that firms like GE who will likely continue to invest a considerable amount of money in developing the technology that's only going to help advance the capabilities, which will help advance the adoption, which will help raise awareness which ultimately will help us provide these services for many, many other companies.

Jon Tanwanteng: Okay great. And can you just touch on -- I'm not sure if you did this before -- but can you touch on the various end markets, where specifically are you seeing strength or weakness heading into the back half of the year whether it's firearms, medical, auto et cetera, et cetera?

Drew Kelley: I can...

Jason Young: Go ahead Drew if you want to take it.

Drew Kelley: What we've generally seen is that a strengthening in many or if not most of our industries. In particular as we close the fiscal 2016 the largest industry that we serve is the firearms and defense industry. And we did see relatively robust growth year over year in that overall market. At the same time there were several other fast growing industries in which we serve including medical and dental.

Obviously the auto industry remains important to us for our KECY business as in our European operations. And aerospace also is an important business especially as it relates to 3-D. So we've generally seen a robust growth across the board. And so I think it's not tied to any one particular industry in particular or customer but obviously have been able to benefit in particular by some of the firearms growth. And Jason I don't know if you have additional thoughts there?

Jason Young: Yes. I mean the only other thing I would add is that going forward I wouldn't necessarily expect to see growth from one segment or another for - due to say particular industry reasons. Obviously firearm's has been strong for us as Drew pointed out. But broadly it's really just a function of our sales efforts. I think that's really what's driving things rather than some other underlying force per se.

Jon Tanwanteng: Okay great. Drew you mentioned that there are things you're going to do to strengthen the balance sheet. Is that prelude to more M&A or investments in say 3-D machines or are you simply trying to reduce the leverage to where you're more comfortable?

Drew Kelley: Well I think it's a combination of all those. Importantly we view our success and growth in being able to finance the growth whether it be organic or through acquisitions. As I mentioned before we do think that acquisitions are a good way to supplement our organic growth and at the same time supplement our holistic approach as we help our customers achieve their goals.

So we continue to look at acquisitions. We continue to look at ways to grow our existing footprint both our 3-D business as well as our traditional MIM and other businesses. We think that we have a tremendous amount of relationships in the financial sector that there's no shortage of capital available for those opportunities if they meet our return thresholds.

At the same time we view ourselves as a prudent investor and look to de-lever and reduce our cost of capital whenever we can. Especially important is of course continuing to increase our financial flexibility. And so for all of those reasons my time is spent largely looking at those opportunities.

And I think we're very close to executing on some of those opportunities for which it will continue to lay the groundwork for the growth of the company for not only, the next several quarters but beyond. And of course as we need to expand the business especially on the 3-D side we'll have the capital necessary to make a material investment in incremental machines and capabilities.

Jon Tanwanteng: Great thanks. And finally one more just on the taxation just given the surprise amount in Q4 how should we think of that going forwards?

Drew Kelley: All right that's a good question. It is a convoluted topic for which we could spend too much time talking about it and I probably still wouldn't do a good job explaining it. In short while we're so close to breakeven our taxes are not dictated so to speak by our operational performance but by the other issues and opportunities we do to work within our tax capabilities and to deferred taxes or otherwise receive refunds.

I sense this was a bit of a unique quarter for us as it relates to the to the implied tax rate. I think conservatively we still forecast a relatively high tax rate going forward almost 44% at least for our internal models based on our conversations with our tax professionals.

But again as our business ramps and our profitability does as well we would hope and expect that level to be reduced as we move forward through fiscal 2017. So that's probably as short as and simple of answer I can give but it is a bit of a very convoluted tax structure by being a relatively small company.

Jon Tanwanteng: Got you. Thanks again guys and nice job on the revenues.

Drew Kelley: Thanks John.

Jason Young: Thanks.

Operator: And that concludes today's question and answer session. I would now like to turn the call back over to your host for an additional or closing remarks.

Jason Young: Thanks everyone for the time today and we'll talk to you on the next call.

Drew Kelley: Thanks all.

Operator: That concludes today's conference. Thank you for your participation. You may now disconnect.

END