Fiscal Year 2014 Q2 Financial Results Conference Call Transcript
February 6, 2014
1:30 p.m. PDT (4:30 p.m. EDT)

Operator:

Greetings and welcome to the Pro-Dex Fiscal 2014 Second Quarter Conference Call. At this time all participants are in a listen-only mode. A brief question and answer session will follow the formal presentation. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Hal Hurwitz, CEO. Thank you, Mr. Hurwitz, you may begin.

Harold Hurwitz, Chief Executive Officer, Pro-Dex, Inc.:

Thank you, Rob, and thank you all for joining us to review the results for the fiscal 2014 second quarter and six months ended December 31, 2013. On today's call I will provide a synopsis of our operating results, as well as some comments. Then, as Rob mentioned, we will open up the call for your questions.

Before beginning, however, I ask our participants and listeners to note that the comments made on this call may include statements that are forward-looking within the meaning of securities laws. These forward-looking statements may include, without limitation, statements related to anticipated industry trends and the Company's plans, products, prospects, and strategies, both preliminary and projected. Actual results or trends could differ materially. We undertake no obligation to revise or publicly revise the results of any revision to the forward-looking statements in light of new information or future events.

For more information, please refer to the risk factors discussed in the Company's Form 10-K for the year ended June 30, 2013, which has been filed with the SEC, and Form 10-Q for the quarter ended December 31, 2013, filed with the SEC today, and the Form 8-K filed with the SEC today, along with the attached press release issued today, all of which can be obtained from the SEC or by visiting our Web site at www.pro-dex.com. And now let's cover the quarter's results.

Net sales for the three months ended December 31, 2013 decreased $367,000, or 12%, to $2.6 million, from $3.0 million for the three months ended December 31, 2012, due primarily to decreases of $428,000 in medical device development and manufacturing revenue, and $48,000 in motion control product revenue, which were partially offset by an increase of $152,000 in dental product revenue. Contributing to the $428,000 decrease related to the Company's medical device product line, was a $275,000 decrease in repair revenue from our former largest customer, which was partially offset by an increase of $161,000 in product and repair revenue from our current largest customer.

Pursuant to an agreement with our former largest customer, which commits that customer to a minimum amount of inventory purchases at the agreement's termination in June 2014, the Company expects sales to that customer to continue to decline through the agreement term, after which it expects no further revenues from that customer. The increase in sales to our current largest customer reflects the resumption of orders from that customer which had been curtailed since March 2013. We expect to continue receiving such orders through December 2014, the termination date of that customer's current purchase commitment. Negotiations for future arrangements with that customer have not yet commenced.

Medical device sales to other customers decreased $181,000, and medical device design revenue decreased $133,000.

Gross profit for the three months ended December 31, 2013 decreased to $484,000, or 47%, to $549,000, from $1.0 million for the same period in 2012. Contributing to this decrease was the reduction in sales volume described in my previous remarks, and the effects of unfavorable changes in the mix of product sales which reduced gross profit by $126,000 and $139,000, respectively.

Also contributing to the decrease in gross profit was an increase of $199,000 in the accrual for anticipated losses from the development services portion of certain contracts, and an increase of $166,000 in unfavorable production variances related to reduced manufacturing volume. These were partially offset by a decrease of $60,000 in warranty expense.

Other than the reduction in sales volume, the factors affecting gross profit, as I've just described them, also resulted in a decrease of gross margin as a percentage of sales to 21% for the three months ended December 31, 2013, from 34% for the corresponding period in 2012.

Operating expenses, which include selling, general, and administrative, and research and development expenses for the quarter ended December 31, 2013 decreased 35% to $925,000, from $1.4 million in the prior year's corresponding quarter, reflecting primarily the effects of the Company's cost reduction program.

Loss from continuing operations for the quarter ended December 31, 2013 was $338,000, compared to a loss from continuing operations of $364,000 in the corresponding quarter in 2012. Net loss for the quarter ended December 31, 2013 was $338,000, or $0.10 per diluted share, compared to a net loss of $348,000, or $0.11 per diluted share for the corresponding quarter in 2012.

Turning to the six month period, net sales for the six months ended December 31, 2013 decreased $1.3 million, or 20%, to $5.2 million, from $6.5 million for the six months ended December 31, 2012 due primarily to decreases of $1.2 million in medical device development and manufacturing revenue, and $341,000 in motion control product revenue, which were partially offset by an increase of $246,000 in dental product revenue.

The $1.2 million decrease related to our medical device product line was comprised of a $201,000 decrease in repair revenues from our former largest customer, and a $679,000 decrease in revenues from our current largest customer. As I discussed in greater detail previously, we expect sales to our former customer to decline to zero over the balance of this fiscal year 2014, and sales to our current largest customer in fiscal 2014 to exceed prior year amounts pursuant to the resumption of orders from this customer, which commenced in December 2013, after having been curtailed since March 2013.

Also contributing to the decrease in medical device revenues was a $130,000 decrease in product sales to other medical device customers, and a $175,000 decrease in medical device design revenue.

Gross profit for the six months ended December 31, 2013 decreased $775,000, or 34%, to $1.5 million, from $2.3 million for the same period in 2012. Contributing to this decrease were the reduction in sales volumes that I previously described, and the effects of unfavorable changes in mix of product sales, which reduced gross profit by $493,000 and $143,000, respectively.

Also contributing to the decrease in gross profit was an increase of $212,000 in the accrual for anticipated losses from the development services portion of certain contracts, and an increase of $198,000 in unfavorable production variances related to reduced manufacturing volumes, which were partially offset by a decrease of $213,000 in warranty expense resulting from lower sales volume in the 2013 period relative to the 2012 period, and the warranty expiration in the 2013 period related to units sold in prior years.

Other than the reduction in sales volume, the factors I've just described that affected gross profit also resulted in a decrease of gross margin as a percentage of sales to 29% for the six months ended December 31, 2013, from 35% for the corresponding period in 2012.

Operating expenses, which includes selling, general, and administrative, and research and development expenses for the six months ended December 31, 2013 decreased 32%, to $1.8 million, from $2.7 million in the prior year's corresponding period, reflecting primarily the effects of the Company's cost reduction program.

Loss from continuing operations for the six months ended December 31, 2013 was $320,000, compared to a loss from continuing operations of $418,000 for the corresponding period in 2012. Net loss for the six months ended December 31, 2013 was $126,000, or $0.04 per diluted share, compared to a net loss of $365,000, or $0.11 per diluted share for the corresponding period in 2012.

Also during the six months of 2013 we received net proceeds of $900,000 from the sale of our former facility in Carson City, Nevada. Cash and cash equivalents, which exclude our investments in public company equity securities, at December 31, 2013 were $1.6 million, compared to $1.7 million at June 30, 2013.

With all of that, now some brief commentary. As I stated in today's press release, our results for the quarter ended December 31, 2013 were materially influenced by factors adversely affecting gross margins. As we had previously publicly discussed, much of our activity this fiscal year relates to the engineering phase of projects to develop a next generation platform to power surgical instruments that we believe will result in manufacturing revenues commencing at the end of fiscal 2014 or early fiscal 2015. Most development efforts of this nature, however, have inherent unexpected costs, and the projects in which we are engaged are no different. We anticipate that our development project costs will exceed the development project revenues we expect to earn. Accordingly, we recorded accruals for these excess costs amounting to $199,000 for the quarter, and $212,000 for the six months ended December 31, 2013 that eroded gross margins for those respective periods.

In addition, we incurred unfavorable manufacturing variances for the quarter and six months ended December 31, 2013 as a consequence of our relatively low sales volumes that also eroded gross margins.

While it is desirable to maintain manufacturing capacity in anticipation of future activity, we may reduce this capacity as necessary to staunch these unfavorable variances.

With our cost footprint now right-sized, as evidenced by our year-over-year operating expense performance, the fundamental agenda for Pro-Dex is unchanged: to rebuild our revenue base. To this end, we have restructured our business development capabilities this fiscal year to more efficiently identify and pursue additional business opportunities, and I look forward to reporting on the results of these initiatives in the future.

I am now happy to invite any questions you might have with regard to the quarter or our business operations. And with that, I'll turn the call back over to Rob for Q&A.

Operator:
Thank you. We'll now be conducting the question and answer session. (Operator instructions) Thank you. Our first question is from Jesse Feinberg with Apex Asset Management. Please proceed with your question.

<Q – Jessie Feinberg>: Hi. There's a lot of moving parts with accruals and such, and I'm just wondering, can you give a sense of what normalized gross margins might look like.

<A – Harold Hurwitz, CEO>: Historically, the Company, Jesse, has run in the mid 30% range, give or take a couple of points either way.

<Q – Jessie Feinberg>: Is there any reason to believe that won't be what the future looks like as well?

<A – Harold Hurwitz, CEO>: I don't have any reason to believe that. That's why I emphasized in my remarks the accruals that we've made, because these accruals, we certainly hope, are not recurring. We made an accrual in the first fiscal quarter, and certainly we made a very large accrual in this fiscal quarter, but it's not something that we hope to have recur for the future. Again, that relates to our non-recurring engineering services, the engineering portion of contracts that we have going on that have not yet hit manufacturing, so these accruals have nothing to do with manufacturing.

Now, I also mentioned that we did have some manufacturing variances that came as a result of low volumes going through our manufacturing floor during the quarter, and we'll asses those, because, as I mentioned, we do have some ability to adjust our capacity for manufacturing in order to reduce those variances.

<Q – Jessie Feinberg>: Okay, thank you. Do you expect future business with the largest customer post-2014? You said that the contract lasted until December, is it the normal course of business to renegotiate and extend that into the future?

<A – Harold Hurwitz, CEO>: It has been. We go from year to year with them, and generally those conversations haven't commenced until at most I think six months before the end of their current purchase period. So I would anticipate that sometime during the summer, and perhaps into the fall, is when we would have our conversations with that long standing customer.

<Q – Jessie Feinberg>: So no reason to read anything negative into those remarks?

<u><A – Harold Hurwitz, CEO>:</u> No. There was nothing intended of a negative nature.

<Q – Jessie Feinberg>: No, I was surprised in the press release, it seemed a little worrisome, but I'm glad it's not. And can you give a sense of the opportunities that you're looking at, if there's any quantification you could put around them.

<u><A – Harold Hurwitz, CEO>:</u> They really run the gamut. Our revenue base can be segmented into two parts. The more traditional product lines that Pro-Dex had before getting into medical device, those being industrial and dental primarily, have a shorter sales cycle, but also on a per transaction basis have a lower sales volume relative to medical device. Medical device, as I've commented on for many, many quarters, as has my predecessors, has a much longer sales cycle, but the reward at the end are much larger revenues per transaction.

<Q – Jessie Feinberg>: Okay.

<u><A – Harold Hurwitz, CEO>:</u> It's difficult because we are pursuing both segments at the same time, and so it's difficult to look forward and give any sense, especially on the medical device side, again, because of the long sales cycle. It's not unusual to become aware of a promising medical device customer prospect and not have that germinate into manufacturing revenues for perhaps a two or three year period.

<Q – Jessie Feinberg>: And then just one last question. I assume there's no buyback which you have authorized. Could you clarify this thinking? On one hand you have, it looks like excess cash, you announced a repurchase program, but on the other hand you announced the rights offering. Can you give an update on that and just maybe the thinking of yourself, or the Board, with both the repurchase and the rights offering out there?

<u><A – Harold Hurwitz, CEO>:</u> Well, I'm going to disappoint you a little bit, because I can't share a whole lot. Obviously, with respect to the rights offering, we're mid registration right now, and so it wouldn't be appropriate for me to comment on that other than to refer you to the Use of Proceed section in the S-3 that we filed.

With respect to the repurchase program, again, it's very much in line with what we've already disclosed, that with the initiation of our investment committee there were a variety of approved investments that that committee could consider. And the Board felt it was appropriate to include, as one of those potential approved investments, our own stock, if market conditions are warranted.

<Q – Jessie Feinberg>: Okay, great. Thank you very much for your time.

<u><A – Harold Hurwitz, CEO>:</u> Thank you.

<u>Operator:</u>

Thank you. Mr. Hurwitz, there are no further questions at this time, and I'd like to turn the floor back to you for additional comments.

<u><A – Harold Hurwitz, CEO>:</u> Okay, thank you, Rob, and my thanks to all of you for joining us today. All of us at Pro-Dex appreciate your interest, your time, and your support of the Company, and we look forward to speaking with you in May when we report our fiscal 2014 third quarter and nine month financial results. Thank you very much.

Operator:

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.