Fiscal Year 2014 Q3 Financial Results Conference Call Transcript
May 12, 2014
1:30 p.m. PDT (4:30 p.m. EDT)

Operator:

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

I would now like to turn the conference over to Mr. Harold Hurwitz, Chief Executive Officer of Pro-Dex. Please go ahead, Mr. Hurwitz.

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

Thank you, Brock, and thank you all for joining us to review the results for the fiscal 2014 third quarter and nine months ended March 31, 2014. On today's call I will provide a synopsis of our operating results as well as some comments. Then, as Brock 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 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, the prospectus filed with the SEC on March 24, 2014 in connection with our recently completed rights offering, and Form 10-Q for the quarter ended March 31, 2014 filed with the SEC today, as well as 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 website at www.pro-dex.com.

And now let's cover the quarter's results. Net sales for the three months ended March 31, 2014 decreased $656,000, or 21%, to $2.4 million, from $3.1 million for the three months ended March 31, 2013, due primarily to decreases of $659,000 in medical device development and manufacturing revenue. The decrease in our medical device product line was primarily due to a decrease in product and repair revenues from our largest customer arising from the revised terms negotiated with the customer in December 2013 following the customer's suspension of orders from March through November 2013. These revised terms provided for lower monthly shipments in the 2014 period relative to the 2013 period prior to the suspension.

Gross profit for the three months ended March 31, 2014 decreased $343,000, or 39%, to $540,000, from $883,000 from the same period in 2013. Contributing to this decrease was a reduction in sales volumes that I had previously discussed and the related effects of increased under-absorption of manufacturing costs which reduced gross profit by $67,000.

Also contributing to the decrease in gross profit was an accrual of $47,000 for anticipated losses from the development services portion of certain contracts, which did not occur during the corresponding period of the prior fiscal year. These factors were partially offset by an aggregate decrease of $102,000 in inventory and warranty charges.

Other than the reduction in sales volume, the factors I just mentioned that affected gross profit also resulted in a decrease of gross margins as a percentage of sales to 22% for the three months ended March 31, 2014, from 29% for the corresponding period in 2013.

Operating expenses, which include selling, general and administrative, and research and development expenses, for the quarter ended March 31, 2014 decreased 41% to $978,000, from $1.7 million in the prior year's corresponding quarter, reflecting primarily the effects of our cost reduction program.

Loss from continuing operations for the quarter ended March 31, 2014 was $358,000, compared to a loss from continuing operations of $765,000 in the corresponding quarter in 2013.

Net loss for the quarter ended March 31, 2014 was $385,000, or $0.12 per share, compared to a net loss of $747,000, or $0.22 per share, for the corresponding quarter in 2013.

Turning to the nine month period, net sales for the nine months ended March 31, 2014 decreased $1.9 million, or 20%, to $7.6 million, from $9.5 million for the nine months ended March 31, 2013, due primarily to decreases of $1.6 million in medical device development and manufacturing revenues and $315,000 in motion control products revenue, which were partially offset by an increase of $231,000 in dental product revenue.

The $1.6 million decrease related to our medical device product line was comprised of a $1.2 million decrease in revenues from our current largest customer arising from the effects of the suspension of orders that I previously discussed during the first five months of the nine-month period in 2014, and a $278,000 decrease in repair revenues from our former largest customer. We expect sales to this former customer to decline to zero over the balance of fiscal year 2014.

Gross profit for the nine months ended March 31, 2014 decreased $1.1 million, or 35%, to $2 million, from $3.2 million for the same period in 2013. Contributing to this decrease were the reduction in sales volume I previously described and the effects of unfavorable production variances which reduced gross profit by $475,000. Also contributing to the decrease in gross profit was an accrual of $278,000 for anticipated losses from the development services portion of certain contracts, which did not occur during the corresponding period of the prior fiscal year. These factors were partially offset by an aggregate decrease of $363,000 in inventory and warranty charges.

Other than the reduction in sales volume, the factors I just mentioned that affected gross profit also resulted in a decrease of gross margin as a percentage of sales to 27% for the nine months ended March 31, 2014, from 33% for the corresponding period in 2013.

Operating expenses, which include selling, general and administrative, and research and development expenses for the nine months ended March 31, 2014 decreased 35% to $2.8 million, from 44.4 million in the prior year's corresponding period, reflecting primarily the effects of our cost reduction program.

Loss from continuing operations for the nine months ended March 31, 2014 was $679,000, compared to a loss from continuing operations of $1.2 million for the corresponding period in 2013.

Net loss for the nine months ended March 31, 2014 was $512,000, or $0.15 per share, compared to a net loss of $1.1 million, or $0.34 per share, for the corresponding period in 2013.

With all of that, now some brief commentary. Our results from continuing operations for the quarter and nine months ended March 31, 2014, while improved on a year-over-year-basis, were adversely impacted by low sales volume, which most directly affects gross margin in the form of underutilized manufacturing capacity. We continue to closely monitor the relationship between manufacturing capacity and anticipated future sales volume in determining whether further cost reductions will be necessary.

Also affecting margins are accruals, amounting to $47,000 for the quarter ended March 31, 2014 and $278,000 for the nine months then ended, relating to anticipated losses on fixed price engineering services portions of certain large projects currently underway. These projects are complex and require that we meet stringent customer and regulatory specifications.

Nonetheless, I am pleased to report that we recently conducted a test of a prototype instrument for one of our customers and we look forward to conducting a test of another prototype instrument for a second customer this month. We continue to believe that these engineering projects will result in manufacturing revenues in fiscal 2015.

Our improved year-over-year results derive primarily from the right-sizing of our cost footprint over the last year. However, as I have previously publicly noted, the nearly singular objective on Pro-Dex's agenda remains that of rebuilding the revenue base. To that end, I can report that we had a good showing at two important industry conferences in March and April of this year that resulted in promising leads. Of course, converting such leads into customer purchase orders is the goal on which our integrated team of business development, engineering and operations leaders is focused.

These challenges notwithstanding, it should be noted that we generated positive cash flow from operating activities during the quarter ended March 31, 2014 of $300,000. This improvement results primarily from the partial liquidation of the inventory buildup undertaken in the first quarter of fiscal year 2014 to reduce lead times and accommodate anticipated customer requirements. As we have previously publicly disclosed, the buildup was exacerbated by our largest customer having suspended its orders from us from March through November 2013 ostensibly due to lagging demand for its product, and the inventory liquidation this past quarter results from the resumption of shipments to this customer.

In addition, we recently announced the completion of our rights offering of common stock that raised proceeds of $1.65 million, before expenses, through shareholder subscriptions for 868,732 shares of common stock representing a 59% participation rate. Of the total amount of shares issued, an aggregate of 473,420 shares were issued to AO Partners I, LP, and Farnam Street Partners, L.P., our two largest shareholders, who each exercised its full pro rata allotment of rights in the offering.

Nick Swenson, Chairman of our Board of Directors, and Ray Cabillot, also a member of our board, hold positions that allow them to direct the investments of AO Partners I, LP, and Farnam Street Partners, L.P., respectively. The remaining 395,312 shares were issued to 178 other shareholders that participated in the rights offering. We are grateful for the participation of our two major shareholders and we were particularly pleased with the participation of the remaining broad base of shareholders whose subscriptions constituted nearly half of the offering proceeds.

The purpose of the rights offering was to raise equity capital in a cost effective manner that provided all of the company's shareholders the opportunity to participate on a pro rata basis. We intend to use the proceeds from the rights offering to pursue strategic opportunities as they present themselves from time-to-time or, if not used for pursue strategic opportunities, for working capital and general corporate purposes, including to fund ongoing research and development and product initiatives. Also, to the extent net proceeds of the rights offering are not deployed, some of the funds may be invested in accordance with the terms of our previously disclosed Surplus Capital Investment Policy.

Under the terms of the rights offering we had the right to reduce subscriptions in order to preserve certain of the company's tax attributes such as the utilization of net operating loss carry forwards. Similarly, we had the right to reduce shares purchased pursuant to the standby commitment from AO Partners, LLC and Farnam Street Capital, Inc., to whom I will refer collectively as the "standby purchasers."

The standby purchasers had agreed to purchase any and all shares of common stock that were not subscribed for by shareholders in connection with the rights offering. On the basis of the company's analysis of its tax attributes, the company did not reduce the subscription of any shareholder in the rights offering but did reduce to zero the number of shares that standby purchasers could have otherwise purchased pursuant to the standby commitment. As a result, no shares will be issued to AO Partners, LLC or Farnam Street Capital, Inc. pursuant to their standby purchase commitment.

I am now happy to invite any questions you might have with regard to the quarter or our business operations, and, to that end, I'll turn the call back over to Brock for questions and answers.

Operator
Our first question today comes from Matthew Melchione of Valor Capital.

<Q – Matthew Melchione>: So I have, actually, a couple of questions. The first one relates to the rights offering. I'd imagine that the standby purchase commitment wasn't taken up because of the tax implications of them possibly moving too far in an ownership percentage basis, but I'm just wondering, if there was no reason for them to over-subscribe, why weren't over-subscription rates given to other shareholders?

<A - Harold Hurwitz, CEO>: Well, first of all, your assumption with respect to why we reduced to zero the standby purchase commitment ability to otherwise purchase shares is correct. An over-subscription process was never contemplated, frankly, in the original offering and I think that was somewhat borne out by the results, which we're pleased with. I don't want that misunderstood. At the participation rate, it didn't seem reasonable to complicate the transaction anymore and have to endure that much more review of it before it could go effective by putting in the over-subscription feature.

<Q – Matthew Melchione>: Do you have any information about what the net proceeds will be after any expenses related to the rights offering?

<u><A - Harold Hurwitz, CEO>:</u> I would anticipate the net proceeds to be around – let's see, we raised $1.65 million, so I'd say $1.625 million, $1.63 million, somewhere around there [(1)].

<Q – Matthew Melchione>: Could you possibly provide some additional commentary about these prototype tests and maybe some of the leads that you hear from the industry conferences you were at? I mean, we keep hearing about these, but I'm just wondering what the process is after these prototypes are tested. How many more stages are involved, when and potentially how much could come from these as far as revenue down the road? Just any sort of additional color would be beneficial.

<u><A - Harold Hurwitz, CEO>:</u> I'll give you as much color as I can. As we've previously discussed and as is rather typical, particularly for medical device contract manufacturers, nearly all of our agreements with our customers are governed by pretty stringent confidentiality arrangements, that would govern most, if not all, of the terms of the contract. With that as a backdrop, I'll address what I can.

The prototype testing for the customer was rather significant because it involves technological aspects of each of these instruments that, frankly, the marketplace hasn't seen a whole lot of, and, in these particular applications, maybe not at all. So these were significant milestones for us.

As far as what lies between the prototype testing and eventual manufacturing revenues would be quality assurance testing that we have to undertake. I believe that the instruments likely will be put into the hands of each of our customer's key opinion leaders one last time before they give their final buy-off as to design and maybe even functionality aspects. I, frankly, would hope that if that does occur that there are not yet continuing changes, but you know, we do need to pay attention to the end user. So there's every reason that they would want to place that in the hands of the physicians one more time just to get their final buy-off. Then we start gearing up for production.

<Q – Matthew Melchione>: And then on the leads at the industry conferences, are those more right to manufacturing or is that a situation where you'll need to also go through the development process like these larger contracts?

<u><A - Harold Hurwitz, CEO>:</u> I would say, Matthew, it's a potpourri. Of the meetings we had, some were very general in nature but from major names in the medical device OEM community. But because they're general in nature and these meetings are not yet covered by non-disclosure agreements they remain general in nature.

I will say that even in that context the conversations more often than not were for development and manufacturing as opposed to just one or just the other. We did have conversations with some smaller entities that might have been, in one case, just for development, just for engineering, and we as a company will be more open to those types of agreements than we have in the past.

In the past, we've been far more receptive to arrangements that included both development and manufacturing or just contract manufacturing, but we do want to leverage more off of the engineering resources we have, so we're more amenable to strictly engineering agreements as well.

<Q – Matthew Melchione>: Then just one final question about the current situation with the largest customer. Is that now on an even plane? Can we expect this to kind of moderate or is it going to be put through more ups and downs like last year?

<u><A - Harold Hurwitz, CEO>:</u> Well, that's a good question. We certainly hope that it's on an even plane, but we are in, I'd say, more frequent communication with that customer than we ever have been. Their practices, as I discussed, I believe, in the last conference call, is to not want to engage in a lot of forward-looking conversation until maybe six months before their existing agreement expires. So I would anticipate that we'll have more definitive discussions starting in the summertime.

Operator
Mr. Hurwitz, there are no further questions at this time. Would you like to make any closing remarks?

<A - Harold Hurwitz, CEO>: Okay, thank you, Brock, and thank you, everyone, 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 September when we report our fiscal year 2014 fourth quarter and full year financial results. Thank you.

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

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(1) Mr. Hurwitz inadvertently erred in his response with respect to the estimated net proceeds to be realized from the rights offering, which should have been expressed as "$1.525 million or $1.53 million," consistent with related disclosures made in the Company's Form 10-Q for the quarter ended March 31, 2014 as filed with the SEC on March 12, 2014.