March 7, 2024
9:30am ET

Operator

Good day, and welcome to the CPS Technologies Fourth Quarter and Year-End 2023 Earnings Conference Call. At this time, all participants have been placed on a listen-only mode. The floor will be open for your questions and comments following the presentation. It is now my pleasure to turn the floor over to your host, Chuck Griffith, CFO at CPS Technologies. Sir, the floor is yours.

Charles Griffith

Thank you, operator and good morning, everyone. Today, I'm joined by Brian Mackey, our President and CEO. We look forward to discussing our fourth quarter results with you. But first, Chris Witty, our Investor Relations Advisor will provide a brief safe harbor statement. Chris?

Chris Witty

Thanks, Chuck and good morning, everyone. Before we begin the business portion of today's call, I would like to point out that statements in this conference call that are not strictly historical are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and should be considered as subject to the many uncertainties that exist in CPS's operations and environment.

These uncertainties include, but are not limited to, the wars in Ukraine and Israel, other geopolitical events, economic conditions, market demands and competitive factors. Such factors could cause actual results to differ materially from those in any forward-looking statements. Additional information can be found in our filings with the SEC. Now I will turn the call over to Brian to offer his perspective on the fourth quarter results, after which Chuck will review the financial results in greater detail. Brian?

Brian Mackey

Thanks, Chris. Today, we're pleased to announce fourth quarter revenue of $6.7 million and an operating profit of approximately $144,000. While revenue rose significantly year-over-year, operating profit continued to be negatively impacted by a quality problem with a major customer that we discussed previously. We ended the year with our best top line ever, $27.6 million, and are pleased with the backlog of $20 million as we begin fiscal 2024.

Chuck will provide more detail in a minute. In addition, we recently announced two new developments that reflect our strategy for growth and bode well for our long-term outlook. First, CPS signed a manufacturing license agreement for fiber reinforced aluminum or FRA composites with Triton Systems, which gives us the exclusive global rights to make and sell products using this technology.

FRA composites are comprised of high-strength aluminum alloys discontinuously reinforced with short ceramic fibers. Given its superior performance characteristics, this technology will facilitate the introduction of many new products for our military, commercial and industrial end markets, which makes it a great fit for the company.

CPS is already known as the world leader in advanced metal matrix composites, but adding FRA capabilities will complement our core competencies, broaden the company's target markets and strengthen our mission to accelerate growth going forward. Over the coming weeks and months, we will be working to initiate manufacturing trials of FRA composites here at CPS and begin to engage customers in relevant markets.

We think this will be an excellent addition to our product portfolio. Second, and also announced earlier this week, we received an award for the Massachusetts Manufacturing Accelerate Program known as MMAP in response to a proposal submitted by the company in the fourth quarter of 2023. This award valued at

$200,000 will support the purchase of a 5-axis CNC machine and expand the company's manufacturing capabilities to better serve our clients.

This 5-axis machine, our first will pave the way for sales opportunities in hermetic packaging and other products with new and existing customers for which we would otherwise not be cost competitive. These two recent developments, the licensing agreement for FRA and the purchase of a new 5-axis machine, enable us to continue to broaden our revenue base and expand avenues of growth with clients in markets that are very familiar to us.

In terms of the business today, among other things, we will continue to fulfill long-term supply agreement announced last year, providing power model components and systems for a variety of rail and other applications to a multinational semiconductor manufacturer. We're on track for the shipment of product under this contract over the course of 2024.

At the same time, we are working on our most recent Phase 1 SBIR grant from the Department of Energy and we'll soon be submitting a Phase 2 proposal to extend this program. We continue to invest in innovative next-generation technologies, advancing the company's long-term growth profile and have several other government R&D opportunities in the pipeline. For example, a Phase 2 SBIR proposal for thermal energy storage is under review by the Navy.

We're preparing a Phase 2 STTR proposal for tungsten material for the Army and we're submitting several additional new Phase 1 SBIR proposals with various federal agencies. Overall, we find these externally funded R&D opportunities very productive and rewarding, so we will continue pursuing them even as we invest internally to broaden our range of products, expand the company's client base and rapidly respond to changes in industry demand.

Our unique metal matrix composite technology brings innovative cost-effective solutions to durability and efficiency problems faced by a host of customers and markets across the globe. For fiscal 2024, however, I want to remind our audience that shipments of our HybridTech Armor panels for Kinetic Protection Navy contract are expected to be complete as of the middle of second quarter. For the last year or so, these sales have generated, on average, quarterly revenue of just over $2 million.

So the completion of our subcontract will have a material effect on near-term revenue. However, we see growth in other product lines mitigating some of this impact, which we estimate will cover roughly half the revenue shortfall. Further out, we expect our other products as well as the potential for the additional armor orders that we are pursuing to enable us to resume and exceed our recent revenue run rate. We're actively pursuing other opportunities for armor products across several military programs.

We are hopeful of future contracts to support other ship classes but remain uncertain as to contract timing, particularly given the protracted continuing resolution. In addition, as previously explained, we're pursuing business on potential ground vehicle applications, but these efforts have been hampered due to testing that did not go as well as anticipated. We continue to work to address the relevant deficiencies, but cannot determine when such initiatives will move forward. Overall, based on current developments and a solid backlog, we remain well positioned for the future.

We're pursuing a number of new opportunities and taking steps to expand both the breadth and depth of our product portfolio, which should lay the groundwork for growth acceleration. While headwinds related to armor exist in the near-term, we're committed to improving our top line profile, strengthening operating results and in turn, improving total return for our shareholders.

I'll now turn the call over to Chuck to provide more details about our financial results, after which we will open it up for questions. Chuck?

Charles Griffith

Thanks, Brian. As mentioned earlier, the company's revenue totaled $6.7 million in the fourth quarter. That's compared with $6.1 million last year, which represents a substantial growth year-over-year. We expect to continue posting solid results in the quarters to come. However, as Brian indicated, the negative impact from the completion of our armor contract outfitting the U.S. carrier fleet will cause a different revenue near-term.

While our partner Kinetic Protection is cautiously optimistic about additional work for other Navy ships, the length of the impact remains to be seen. Gross profit in the fourth quarter totaled $1.1 million or approximately 17% of sales and that compares with $1.6 million or 27% of sales last year. The decrease in both profit and gross margin year-over-year was predominantly due to the quality issue with a major customer that we've discussed in the past.

Not only did this result -- excuse me, not only did this result in $0.5 million of write-offs and returns, but we've also devoted significant internal engineering hours set to investigate and solve this problem. While we're not ready to claim victory yet, we have seen signs of significant improvements and are optimistic that any impact on 2024 will be minimal.

Selling, general and administration expense -- administrative expenses totaled $1 million in the fourth quarter versus $1.3 million in the prior year period. We maintained our cost discipline in terms of overhead, and we're happy to do so. The company generated operating income of $144,000 in the fourth quarter compared with approximately $309,000 last year.

Turning to the balance sheet. We ended the year with $8.8 million of cash, up from $8.3 million at the end of 2022. And this increase was in spite of the reduction in deferred revenue by almost $2.5 million during 2023. Trade accounts receivable as of December 31 -- December 30, 2023 totaled $4.4 million versus $3.8 million as of December 31, 2022. Inventories totaled $4.6 million at the end of 2023 versus $4.9 million at the start of the fiscal year.

Turning to the liability side. Payrolls and accruals totaled $3.6 million at the end of the fourth quarter versus $2.7 million as of December 31, 2022. Deferred revenue decreased, as I mentioned earlier, $2.3 million from $2.8 million at the end of 2022. As a reminder, deferred revenue predominantly represents prepayments for large orders to help defray the impact on cash of large inventory purchased for those orders.

A number of these shipments in 2023, resulting in recognition -- or resulted in recognition of revenue and thus decreased deferred revenue. So thank you. This concludes my discussion of the financials. So now we will open the call up for questions. Operator?

Operator

Thank you. At this time, we will be conducting a question-and-answer session. If you have any questions or comments, please press **STAR ONE** on your phone at this time. We ask that while posing your question, you please pick up your handset if listening on speakerphone to provide optimum sound quality. Please hold while we poll for questions. The first question is coming from Jim McIlree from Dawson James. Jim, your line is live.

Q: Thank you. Good morning. I was hoping you could give a little bit more detail on the Triton license. Is it limited to certain end markets, the time frame of the license? And then where are you going to manufacture this product?

Brian Mackey

Yes. Thanks, Jim. The FLRAA license is an exclusive global license to use that technology for any application. So it's quite broad. The time frame is essentially, I would interpret it as perpetual unless we sort of fall down on the job and the Triton Systems decides to pull that back, but there's a pretty high bar for that type of activity and the ability to cure and those kind of things. So it's sort of not ended in a term -- there's a lot of joint interest and alignment between Triton Systems and what we'll be trying to do. Success for one of us is a success for both of us. So we're very excited about the opportunity.

It's a very well-tested material whose benefits are known. To answer your question, we will be manufacturing that material here at our facility in Norton. And it's a metal matrix composite material. So just like the MMCs we've been making for 39 years, it's a preform infiltrated by aluminum. The armor products that we make is a preform infiltrated by aluminum. Of course, the first one is for primarily thermal conductivity and the latter one is primarily for ballistic protection.

In this case, it will be lightweight but also strong. So the kind of area one is aircraft, like pushing or a bearing liner for a helicopter. Obviously, lightweight is of high value. And there's any number of applications. We can make net shape products from these, and we can also make essentially ingots or blocks which can be machined. It's a machinable material to add a through haul or other feature. So it's very well in line with our core competencies. We will be on the learning curve for some of the nuances based on our relationship with Triton Systems. But once that handoff is complete, this will be ours to manufacture and sell with their support.

Q: And just a couple of more questions on -- again on the Triton license. So one, do you have minimum commitments that you need to satisfy? And then it seems like that this will be something that would contribute to revenue, maybe 12 to 18 months down the road. Is that too optimistic, too pessimistic?

Brian Mackey

Yes. It's certainly not this quarter. I mean we'll be on the learning curve and making trial pieces and things like that. The intriguing part of it is also that there are interested customers who have dialogued with Triton Systems in the past, who are looking for a reliable supply chain before they can turn this on. Having said that, obviously, you don't get into a helicopter without sufficient testing given set of specifications, given the OEM or whoever the case may be.

So there will be a time frame to it that will play out. If anything, this year, it's going to be small revenue of early pieces and that kind of thing, and it will go from there. And the other question about minimums, it's more just about making material efforts to succeed in this market. So there's not a high bar for success as long as we're continuing to work on it, which we certainly intend to do.

Q: Okay. I have three other questions, I'll just throw them all out at you. You talked about the revenue impact of the Navy completion. I was hoping that you could talk a little bit about the margin impact. And then on the quality issue, it sounds like there's still going to be some although small impact on Q1. And then you opened up indicating that backlog was $20 million. I was hoping you could tell me what it was a year ago?

Charles Griffith

Okay. Well, this is Chuck. Let me answer that. So in terms of the armor, that does tend to be higher margin than our other products. So there will be somewhat of an impact on the bottom line from that standpoint as well. Although, again, I think that when it comes to that bottom line margin, more than half of our overhead is fixed. So it's really a function of getting the throughput through the factory in order to increase the margin in the bottom line.

So we're certainly working to do that. As Brian mentioned, we do have other items that are -- or other orders that are going to increase this year that are going to somewhat mitigate the loss of the armor revenue. What was the second question again?

Q: The quality issue, if there is some impact, although small in Q1?

Charles Griffith

Yes. From what we've seen so far, it's probably -- I would say it's probably not material to Q1 as whereas it was certainly for the last three quarters of last year. As I said, it hasn't gone away, but it appears to have significantly decreased to the point where -- well, as I said, we're not declaring victory. We're still trying to get it down to virtually zero, but we're at the point where it's more of a nuisance maybe...

Brian Mackey

I mean part of the trick, which makes it thorny technically is that the defect doesn't show itself until it's been shipped and process downstream. So connecting cause and effect has been challenging. But what we're now receiving from the customer are reports with a dramatically reduced defect rate based on product that we ship to them let's say, December time frame that they processed in January.

Q: Okay. All right. And you have one backlog a year ago?

Charles Griffith

Yes. I want to say it was probably about $27 million at the top off my head, but a big chunk of that was armor. And I think in terms of the backlog, one thing to keep in mind is that with the exception of armor, typically, the orders that we're going to be receiving orders today that are going to ship in late Q2, early Q3. So there's still a lot of additional business to get out of that backlog before we...

Brian Mackey

Yes. And on the armor side, we don't enter the year with significant backlog, but I mean there are very real opportunities that we're actively pursuing. We don't control Navy decision-making and things like that, but that remains an active area going forward.

Q: Understood. Okay. Great. Thanks a lot guys. That's it for me.

Brian Mackey

Thank you, Jim.

Operator

Thank you. And the next question is coming from Michael Weitz. Michael is a Private Investor. Michael your line is live.

Q: How you doing guys. Just a question on the interest income. And I know it's down significantly from '22 to '23 and your cash balances were up significantly, and I just want to have an answer about your cash management strategy?

Charles Griffith

Yes. Let me address that. So that's actually other income. And last year, that other income included $600,000 of -- for the ERTC, the tax credit, the employer tax credit -- the employer tax credit.

Brian Mackey

Employee retention.

Charles Griffith

Yes. So actually, interest income was up this year significantly. I want to say it was probably $10,000 for 2022, and this year was closer to $240, $250 something in that range. So actually, the interest income is up significantly compared to the prior year.

And in terms of cash management, I think that one thing that we've done is -- which I think is good from a risk standpoint is our bank has a sweep product, whereby every night, $250,000 of cash goes to different FDIC-insured banks around the country. So that basically, we're protected from that standpoint if there's another Silicon Valley Bank or something like that. We don't have too many concerns about that kind of thing because it's basically automatically spread out every night. So we don't have issues from that standpoint. Other questions about cash or anything else?

Q: Yes. What type of rates are you getting on that sweep?

Charles Griffith

We're in the -- I want to say we're in the high 3s, close to 4.

Q: Any thought of laddering treasury bills gaining over 5%, which is a very liquid market. If you ever needed the cash, you can always sell them, but the latter not three months, six months, nine months?

Charles Griffith

Yes. So we have discussed it sort of how do I say that? What is the word I want? We've discussed it but not really to the point where we would want to pull the trigger on something like that. It's a good idea. And yes, but it's not something that, as I said, we pull the trigger on. But it's definitely something that's on the radar, let's say that.

Q: Yes, $8.8 million. That's a nice cash flow what you're sitting on. And the stock, if you take that away from the market cap, the stock seems very undervalued. Any thought to using some of your future free cash flow? I know in the past, you want to have a large cash for, but use some of your future free cash flow to buy back stock?

Charles Griffith

We have not discussed that. I don't believe. Yes, I don't think we've discussed doing something like that at this point. I think we're looking at a number of opportunities. I think the FRA, the fiber reinforced aluminum is an opportunity, the $200,000 grant from the state or from MMAP is another opportunity where we're looking at being able to invest cash in order to better grow the company. And I think that we're kind of looking to use the cash for that purpose as opposed to buying back stock, for example.

Q: All right. Like I say, I'm not saying use all the $8.8 million, but if you had 25% to 30% of future cash, it's been a message to the market that, hey, we believe the stock is undervalued. And if you did even 25% or 30% of future free cash flow, that's a significant number of shares you'd be buying back?

Charles Griffith

Yes. I'm glad you brought it up and it's something that we can put on that radar screen.

Q: All right. I look at the premarket and the stock price going down to $201, so it looks pretty appetizing.

Charles Griffith

Yes.

Q: All right guys. Thanks for your time.

Charles Griffith

Thank you.

Operator

Thank you. Once again it is star 1 on your phone if you wish to ask a question. The next question is coming from Greg Weaver. Greg your line is live.

Q: All right. Good morning, Brain, Chuck. Thanks [indiscernible] [0:24:43]. All right, Chuck, going to beat you up a little bit here because this gross margin situation, I mean, the reserve didn't cover what you needed, obviously, from Q3 for Q4 issue. So you cited $500,000 hit. So I think that's both periods or ever since the problem started.

Charles Griffith

Yes, that would cover the year, but most of it was probably in the fourth -- more than half of it was in the fourth quarter, let's say, yes.

Q: Got you. So the production issue, is that precipitated by changes made by CPSH or the customer or supply inputs? Any sense there?

Brian Mackey

What we believe is there's a confluence of issues that individually from a few years ago, individually did not seem to indicate any concern. But over time, culminating in 2023 resulted in the downstream appearance of this defect, because it's kind of a multifactor cause, it has been a thorny issue to get to the bottom of. And as I mentioned earlier, it doesn't show itself till later.

Tying back a single product with a defect back to its origin, et cetera, has been challenging, but it's -- at the root of it seems to be a number of factors that literally go back a few years, but didn't show themselves until 2023.

Q: Got you. Okay. Helpful. So these are field failures and not you mentioned at some point.

Brian Mackey

They are not in the field. They're at the customer.

Charles Griffith

Yes. So basically, just to be more clear, the customer, when they get our product, they bake it and the product -- and the issue shows up when they bake it. So they haven't put it into any of their production at that point. They just -- it's more or less their own process, because if it goes beyond that, and then it has a problem and they not obviously costs the customer.

Brian Mackey

They see it before it would leave their facility.

Charles Griffith

Right.

Q: Good. Okay. So they're not adding any value other than baking it, so they're not -- it's not in the field and they're not adding parts to it and then having to throw it all away.

Brian Mackey

Correct. It's not in the field. And it's limited to a certain small family of products that are processed in a certain way. We're certain of that. It's limited to this handful of things, but they have shown this defect that we've been working through.

Q: All right. That's helpful. That sounds a lot more manageable. And is this related to that $7.7 million customer? Or this is something else?

Charles Griffith

It's something else.

Q: Something else, okay. and so the reserve, Chuck, you mentioned you didn't think there'd be a material impact in Q1, that's a function of the reserve. Obviously, it's an unknown because the guys tend to back, right?

Charles Griffith

Yes.

Q: I see. Okay. So I think Jim asked a question about the gross margins. But so post armor, what should we think about as a target corporate gross margin, assuming we've got through this production issue?

Charles Griffith

I would target like in the mid-20s. I think that I'm kind of hesitant to predict the future, but that would certainly be what we would be shooting for. And certainly, I think it's achievable.

Q: Okay. So then if we get some more armor business, then it will actually back to this 30% neighborhood hopefully?

Charles Griffith

Hopefully. Yes.

Brian Mackey

[Indiscernible] [0:28:33].

Q: Well, it's nice when the company makes more money operating the company as opposed to interest income, right?

Charles Griffith

Right.

Q: So we'll focus on trying to get the operations going. So good. And I guess, it sounds like, Brian, your focus is obviously for good reasons, kind of more on this armor from a growth perspective going forward with this new deal with the Triton here?

Brian Mackey

Yes. The FRA is a very interesting avenue of growth. I mean, really, as of a week ago, I would say we have R&D plus three product lines, which are MMC, hermetic packaging and armor. The FRA is kind of, you could call it, number four. So you have MMC, hermetic packaging, armor and fiber reinforced aluminum. But it suits all of our capabilities well. It suits our customer relationships very well. I mean, it's a lot of the same trade shows and same dialogue just with a different benefit from the properties of the material that we produce.

And the other point that is that even though where we are with armor in the near term, gives us some challenges. The other, the hermetic packaging and the MMCs are growing. Those are growing numbers. They're just not at the moment growing fast enough to take up that entire near-term dip from armor. So we see continued growth in those. And then we'll be adding FRA to the product portfolio here over the coming months and are excited about what that does for us as well as we continue to work very real opportunities on the armor side.

Q: Okay. All right. That's my fault. So this FRA, you mentioned about using like bearing liners and things. So this is never meant to be like sheet form, just smaller little parts that are light and strong?

Brian Mackey

Yes, exactly. I mean, a helicopter might have these components, they might have one helicopter might have 60 to 80 of these components that are of different diameters, and that's what we'll be looking to make.

When we make our, for example, a base plate from MMC, we make the net shape product that the customer is going to use. So we can readily take our knowledge in how to make a net shape component and apply it to fiber reinforced aluminum. So instead of making a block of FRA, and then needing to machine that down to a component, as soon as our team looks at this technology, they say, well, we can make a net shape.

And when you produce it, you might have to do a little cleanup, but you basically will have of bearing line and ready to sell. So then it's making different diameters and confirming that they meet the product requirements for customer testing and things like that. And there are customers that are interested that Triton has worked with in the past who are eager for a reliable supply chain. So there's a lot of things that are very interesting about it for us.

Q: Got you. Okay. So historically, it hasn't got taken off that much because maybe cost and having to machine it down, but you guys think you can reduce the cost by near net to molding it?

<u>Brian Mackey</u>

Yes. And I think some of the hesitation was, well, what's the supply base, as an OEM, you're not going to adopt a family of products and incorporate them and go all the way to introduction, unless you know that five, 10 years down the road, your supply base is going to be there.

So when we say, well, we've been doing this for 39 years, we're Metal Matrix Composite company, et cetera, et cetera, we're domestically located, no foreign entanglements, all that kind of good stuff, currently working on different things with the DoD. It satisfies a lot of those questions. So then you're talking about product capabilities and product introduction, and we're excited about it.

Q: Got you. Okay. Thank you. Appreciate the color. Good luck.

<u>Brian Mackey</u>

Thanks.

<u>Operator</u>

Thank you. Once again please press star 1 on your phone if you wish to ask a question. Okay. At this point, there are no other callers in the queue, so I will turn the call back to management for any closing remarks.

<u>Brian Mackey</u>

Okay. Thank you for joining us today. And for your ongoing interest in CPS Technologies. We look forward to speaking with you again at the end of the first quarter which is upcoming. If you have any questions in the interim, please reach out to our Investor Relations advisor. Thanks.

<u>Operator</u>

Thank you. This does concludes today's conference. You may disconnect your lines at this time and have a wonderful day. Thank you for your participation.