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CYBE - Q3 2019 CyberOptics Corp Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the CyberOptics Third Quarter 2019 Earnings Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Dr. Subodh Kulkarni, President and CEO of CyberOptics. Please go ahead, sir.

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Thank you. Good afternoon, and thanks for participating in CyberOptics Third Quarter 2019 Earnings Conference Call. Joining me is Jeff Bertelsen, our CFO and Chief Operating Officer, who will review our operating results in some detail, following my overview of our recent performance. We will then be pleased to answer your questions at the conclusion of our remarks.

In keeping with Regulation FD, we have made forward-looking statements regarding our outlook in this afternoon's earnings release. These forward-looking statements reflect our outlook for future results, which is subject to a number of risks that are discussed in our Form 10-K for the year ended December 31, 2018, and other filings with the Securities and Exchange Commission. We urge you to review these discussions of risk factors.

This year's third quarter was a difficult period for CyberOptics as we continued facing the headwinds of weak conditions in the surface mount technology and semiconductor capital equipment markets as well as the uncertainty of trade relations with China. Weighing on our performance were sharp declines in sales of legacy inspection systems and OEM sensors. Despite near-term headwinds, we are continuing to invest in research and development to further strengthen our ability to capitalize on strong growth opportunities for our 3D MRS-enabled sensors, inspection and metrology systems and semiconductor sensors. In all, our confidence in CyberOptics' future is undiminished.

CyberOptics reported sales of \$12.4 million for the third quarter of 2019 ended September 30, down 26% from \$16.7 million in the third quarter of 2018. We also reported a net loss of \$353,000 or \$0.05 per share in this year's third quarter compared to earnings of \$1.1 million or \$0.15 per diluted share in the third quarter of 2018.

Sales of sensors and inspection and metrology systems based on 3D MRS technology declined to \$4.5 million in the third quarter of 2019 from \$6.4 million in the year-earlier period. These MRS-based products, combined with semiconductor sensors, accounted for 66% of total revenue in the third quarter of 2019, up from 59% in the year-earlier period. Sales of legacy sensors and systems, excluding MX600 memory module inspection systems, fell 47% year-over-year in the third quarter of 2019.



Turning now to an overview of our product lines. Our family of semiconductor sensors [bumped] the prevailing market weakness by posting 6% year-over-year sales growth to \$3.7 million in the third quarter of 2019 and increased by 18% on a sequential quarterly basis. These yield and productivity enhancing sensors are forecasted to post double-digit year-over-year growth in this year's fourth quarter.

Sales of inspection and metrology systems declined 29% year-over-year in the third quarter of 2019 to \$5.5 million. Within this category, sales of 3D MRS-enabled SQ3000 inspection systems fell 24% year-over-year to \$3.3 million. However, reflecting the demonstrated competitive advantages of 3D MRS technology, SQ3000 sales have increased 14% year-over-year for the first 9 months of 2019. And given the outlook for robust fourth quarter sales, SQ3000 sales growth are forecasted to exceed 20% for all of 2019. In a promising development, during the third quarter, we received an order for \$1.3 million for shipment of SQ3000 CMM systems through the second quarter of 2020, which will be used in the production of micro LED displays. Micro LED displays consume less power, are brighter, thinner and lighter than LCDs or OLEDs and can be deployed in a range of markets, including consumer electronics, automotive applications and outdoor signage. A recent research report from Yole Développement estimates that Apple has spent \$1.5 billion to \$2 billion on this technology over the last 5 years, while such panel makers as Samsung Display, LG Display, AUO and Innolux have also increased their research efforts in this area. All of this makes us believe that micro LED technology represents a significant potential growth opportunity for CyberOptics.

During the third quarter, we also received a \$1.2 million order for 3D SQ3000 CMM systems for use in manufacturing process for printer cartridges. The majority of this revenue will be recognized in the fourth quarter of 2019.

Also during the third quarter, we received customer acceptance for our remaining backlog of MX600 memory module inspection systems. The same customer placed a new MX order during the third quarter with acceptance expected in the first quarter of 2020.

In addition, customer evaluations of our new high-precision 3D memory module inspection systems has started, and we are cautiously optimistic that initial sales will occur in 2020. Sales of inspection and metrology systems are expected to post strong growth on a sequential basis in the fourth quarter of 2019 given our forecast for solidly higher sales of SQ3000 systems during this period. However, the impact of lagging legacy sales will result in lower fourth quarter inspection and metrology system sales on a year-over-year basis.

Finally, sales of OEM sensors fell 41% year-over-year in the third quarter of 2019 to \$3.2 million. Within this category, sales of 3D MRS-enabled sensors were down 30% year-over-year. Due to ongoing market weakness, sensor sales are forecasted to decline in the fourth quarter, both sequentially and on a year-over-year basis. We believe revenue from our 3D MRS-based OEM customers will rebound nicely starting in early 2020. Recovery for legacy OEM customers may take longer given difficult conditions in the pick-and-place market, although we do expect revenues from these customers to eventually improve as well.

As an update, interest in our MRS-based NanoResolution sensor for semiconductor wafer level and advanced packaging inspection and metrology applications remains very high. We recently received a PO from a new OEM customer for our NanoResolution sensor and have many other potential OEM and system integrators evaluating this product. Given this high degree of interest, we are adding sales and field engineering resources to pursue opportunities for this important new product. We believe inspection and metrology for semiconductor wafer level and advanced packaging applications represent promising long-term growth opportunities.

CyberOptics ended the third quarter of 2019 with an order backlog of \$14.4 million compared to \$13 million at the end of second quarter. Our quarter-ending backlog includes a significant order for 3D MRS sensors from an existing OEM customer that are scheduled for delivery primarily in periods after 2019. We are forecasting sales of \$13.5 million to \$15 million for the fourth quarter ending December 31, 2019.

Looking ahead, we believe the third quarter marked the bottom of the downturn for SMT and semiconductor capital equipment markets. Along with many industry observers, we believe conditions will strengthen as we progress through 2020. We believe that our industry-leading 3D MRS and semiconductor sensor technologies have positioned CyberOptics to capitalize upon a full range of opportunities in our targeted markets. For this reason, we are highly confident about CyberOptics' future.

Thank you. Now Jeff Bertelsen will review our third quarter numbers in greater detail.

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Thanks, Subodh. Since Subodh has already covered our sales results in some detail, I will provide additional information regarding other aspects of our third quarter performance. Our gross margin percentage in the third quarter of 2019 was 44.4%, up from the second quarter of 2019 and roughly equal to the year-earlier period. Our gross margin percentage in the third quarter was impacted by an obsolescence charge for a legacy OEM sensor product and incremental warranty expenses. These 2 factors combine to reduce our gross margin percentage in the third quarter of 2019 by over 1 percentage point. Looking ahead, we expect our gross margin percentage in the fourth quarter of 2019 to improve by about 1 percentage point on a sequential basis from the third quarter level. Total operating expenses of approximately \$6.3 million in the third quarter of 2019 were up modestly from the level in the year-earlier period, mainly due to increased R&D expense.

Reflecting our confidence in CyberOptics future, investment in R&D is continuing as we pursue significant growth opportunities for our 3D MRS and semiconductor technologies.

Depreciation and amortization expense totaled \$744,000 in the third quarter, and stock compensation expense was \$244,000. Total operating expenses in the fourth quarter of 2019 are expected to be virtually unchanged on both a year-over-year and quarterly sequential basis. Our effective tax rate of 40% for the third quarter of 2019 includes a noncash benefit from a reduction in income tax reserves. We anticipate an effective tax rate of approximately 25% in the fourth quarter of 2019.

Cash and marketable securities of \$25.3 million at September 30 were down slightly from \$25.8 million at the end of the second quarter. During the third quarter, we used cash of approximately \$353,000 to acquire approximately 26,000 shares of CyberOptics stock under our existing \$3 million share repurchase authorization that is effective through June 30, 2020. Our capital resources are adequate for achieving our growth objectives given our available balances of cash and marketable securities.

Thank you. We would now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Jaeson Schmidt with Lake Street.

Jaeson Allen Min Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

I just want to start with the order for the micro LED market. Is that from a current customer or a new customer?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Jaeson, this is Subodh. The order is from a new customer. This is -- it actually is a -- effectively a contract manufacturer that is making the displays for a larger consumer electronic customer, so the order is from the contract manufacturer. So it's a new customer.

Jaeson Allen Min Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. That's helpful. And then I know your visibility doesn't fully extend into 2020, but can you discuss some of the commentary and body language you're getting from some of your customers in regards to how they're viewing next year? I know some of your prepared remarks make it sound like you believe you've seen the trough in some of your businesses here in Q3?



Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Yes. That's a good question. We definitely believe that Q3 was the bottom, if you will, in the semi and SMT capital markets right now. We are -- clearly based on our guidance we have provided in the fourth quarter, we are expecting sequential growth. And all indications right now are 2020 should be a decent year for semi and SMT markets. External reports are saying that the semi cap market is expected to grow about 5% to 7% in 2020 compared to 2019, and those numbers may change. Right now, analysts are expecting 2021 to have significant growth in the semiconductor market, almost on -- -- north of 25% to 30% driven by 5G deployment. But then as you may have seen from press releases from companies like TSMC last week saying the deployment for 5G may happen sooner rather than later. And if those kinds of movements happen, 2020 numbers could be better than what I just told you for semi cap. So overall, we feel pretty good about semi cap and SMT the markets in 2020 compared to 2019.

Jaeson Allen Min Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. And final one for me. I'll jump back in the queue. With you guys adding to address the NanoRevolution market, is that really in anticipation of demand? Do you have the pipeline and visibility to a pipeline to really -- is that really the driver behind wanting to build out the team today? Or is this really to drive future demand?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes. It's really to drive future demand. I mean we've shown the sensor to quite a few customers. We're getting a high level of interest, and so the resources really are to flush those opportunities out and to make sure we continue to push them forward. So it's really based on the interest and reception that we've seen but I would say mainly for the future.

Operator

Moving on, our next question will come from Dick Ryan with Dougherty.

Richard Allen Ryan - *Dougherty & Company LLC, Research Division - VP & Senior Research Analyst of Industrials*

Subodh, it looks like you delivered the last piece of the memory business in Q3. How much was in Q3? And then you talked about an additional order from the same customer. What was the size of that? And is that 2D or 3D related?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes, Dick. So the amount of revenue from MX in the third quarter was roughly \$600,000, and that was the final piece of the order that we had gotten last year. The new order was for one system that is from our current customer. It is 2D. So that will be in the same ballpark range of roughly \$600,000.

Richard Allen Ryan - *Dougherty & Company LLC, Research Division - VP & Senior Research Analyst of Industrials*

And that's Q4?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

No. We said we would book it in Q1.



Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes. I think...

Richard Allen Ryan - *Dougherty & Company LLC, Research Division - VP & Senior Research Analyst of Industrials*

Oh, Q1, Q1. Okay.

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes. For the new order in Q1.

Richard Allen Ryan - *Dougherty & Company LLC, Research Division - VP & Senior Research Analyst of Industrials*

Okay. And, Subodh, you mentioned you're adding staff, field staff for the Nano. Can you give us a sense of kind of the adds you're looking at and what particular areas you're staffing up in?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Right now, it's just a handful number of people. I mean we are adding key resources in Asia, particularly on the engineering area, where we need to do these demonstrations. And we are looking at some additional salespeople right now in California and also in Asia where most of these customers are located. So don't expect a big number, but it is more the key resources in those local regions.

Richard Allen Ryan - *Dougherty & Company LLC, Research Division - VP & Senior Research Analyst of Industrials*

Okay. And sorry I didn't catch what your expectation was for WaferSense in Q4.

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

So we have guided WaferSense to a good sequential growth and good year-over-year growth as well. So...

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes. So we're looking for -- to have 10% growth in WaferSense revenue.

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Year-over-year.

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Year-over-year, correct.



Richard Allen Ryan - *Dougherty & Company LLC, Research Division - VP & Senior Research Analyst of Industrials*

Now how does the customer count look there? And are you adding -- is that driven by new applications? Or haven't you introduced anything yet in that -- on that front?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We've introduced some new applications beginning of the year, if you recall, with some new developments in the particle sensor and a couple other smaller things. But clearly, the overall growth that we are seeing in WaferSense continues to be from the existing portfolio, not necessarily driven by the new application. It is just really the same group of customers the TSMCs, Samsungs, Intels. Lam Research continues to be a good customer, ASM and a few others. But as an overall portfolio, it's doing pretty well right now.

Operator

And next will be Greg Palm with Craig-Hallum.

Danny James Eggerichs - *Craig-Hallum Capital Group LLC, Research Division - Research Analyst*

This is actually Danny Eggerichs on for Greg Palm today. Just in general, I was wondering about your total visibility throughout 2020 at this point. And over last few months, how has that changed?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

As I mentioned earlier, Danny, certainly 2020 looks like a growth year for the overall markets we play in, which is primarily SMT and semiconductor capital markets. Right now, when we start forecasting a 5% to 7% growth for 2020 and a 25% to 30% growth for 2021, these numbers are bound to change as we go further out, and we'll keep you updated. So given that backdrop, we feel it's a very good, healthy dynamic that we play in, plus we have a differentiated portfolio and we continue to get -- gain market share in areas where we compete with our competitors like the 3D AOI market. These are differentiated SQ300 systems. So overall we feel fairly good about 2020 and 2021 at this time given the backdrop. Does that answer your question?

Danny James Eggerichs - *Craig-Hallum Capital Group LLC, Research Division - Research Analyst*

Yes, great. And then going back to that MX. You said the new order was with that same customer, and you have mentioned having conversations with those additional customers before. How are those additional customer conversations progressing?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Good. Overall, very good. As we mentioned in our comments, the existing customer ordered one more. So that kind of takes care of all their lines with 2D MX at this time. And the other 2 -- there's only large memory customers left in the voyage. The other 2, we are talking to them. Their interest is more in the 3D version of the MX product, so it's basically the same concept. But instead of using a 2D sensor, we are using our 3D MRS sensor. And they seem to like that concept that we are demonstrating. And as we disclosed, we are cautiously optimistic we'll start booking sales in 2020 with these other 2 customers.



Danny James Eggerichs - *Craig-Hallum Capital Group LLC, Research Division - Research Analyst*

Great, great. And then I guess just jumping over to the auto end market. Obviously, a lot of companies have been highlighting weakness in this market, and it's not anything really new. But just kind of curious what you guys are seeing right now and how -- what you think their -- your exposure is and what the direct or indirect impacts of the weakness in auto you're seeing.

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We have some exposure, but it's fairly small. The good exposure is more on the pure-play foundry semiconductor markets, which go more in the CPU, GPU space more than auto. But obviously, we have some exposure to auto, particularly with our SPI and AOI-type products.

To be honest, we haven't noticed any significant change in their buying patterns over the last few months, so we haven't seen anything slowing down. Now again, keep in mind, in general, 3D AOI market is growing in auto because a lot of the existing auto market is using 2D AOI inspection, and they do need to move to 3D, and that's where we play in. So we will be getting the benefit of a transitioning technology in auto, and we are not directly exposed to the overall auto investment cycle. So overall, the number is fairly small as far as auto exposure is concerned. And from what we can see, we haven't seen any significant differences between last year and this year. Jeff, you want to add something?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

No. I would agree. I mean I think the main driver there is the growth in 3D AOI, which we've seen with the SQ products.

Operator

And next will be [Eric Slade] with [Acme Analytics].

Unidentified Analyst

Can you hear me? Okay. Here we go. Okay, one question. Jeff, what did you buy those shares back at? What was the average price of the -- of your buyback?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

The average price that we acquired them at was about \$13.60.

Unidentified Analyst

Okay. Nice. Now -- so really, as we wrap the year up, if you -- your guidance is \$13.50 million to \$15 million?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Correct.

Unidentified Analyst

So let's say kind of \$14 million. So would that -- what would that be for the year?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Well, for the first 9 months, we were at [42.4], so that would get you to [56.4], if the number is \$14 million.

Unidentified Analyst

Then really, the difference between this year and the last year was your -- more your legacy product and OEM. It was not your WaferSense or MRS. Is that correct?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes. I mean if you look at our key growth drivers, the WaferSense product, which are semiconductor sensors, they are up through 9 months, and we're projecting to have a really good fourth quarter there. And then SQ products are up 14% through 9 months, and we're projecting to have a really strong quarter there. So the main areas where we are soft this year are legacy products and the OEM sensors.

Unidentified Analyst

Okay. So the question I have, you might know, Jeff or Subodh. The capital equipment industry for -- not the stocks, there's a lot of stocks. But as far as just contraction, the semiconductor equipment, at this pace, by the end of the year contract about what, 15%? Is that about right?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

I think it's closer to 20%. You'll see, I mean, as various companies announcement. Don't be surprised when the whole year is done for semi cap to show about a 20% contraction from last year.

Unidentified Analyst

So -- but your new products were flat, which is the ship goes to shore...

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

I see our new products as growing.

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Right. Our -- right. Our SQ product, as I've said, is growing. So that will be up for 2019, and WaferSense will be up for 2019. So it's...

Unidentified Analyst

Now...

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Go ahead, [Eric].



Unidentified Analyst

I was going to say, on the OEM side and also the, I guess, some of the legacy product, I mean, the OEM -- they will come back at some point, right? I mean it always goes that way. They're -- I think they may very well come back in 2020 because they pretty much took the year off, right?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes. I mean our expectation would be that they will rebound.

Unidentified Analyst

Okay. And now to the new -- to those 2 wins you've got, the more -- I guess I'll start with the one that looks like it's obviously a lot -- bigger potential, and that's the situation with Rohinni, right?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Rohinni is a technology developer, and then the rest are coming from subcontract manufacturers for large companies.

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

I think you're referencing micro LED. And as we had indicated, there is really good growth potential for us, assuming that technology gets adopted in a bigger way. It's just starting now.

Unidentified Analyst

Right. No. I'm aware of that. With Rohinni, who is your competition to get in there? Or do you have any?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Well, the Rohinni process, if you are familiar with it, it's a unique proprietary process with them where they are taking existing micro LED dies and leasing them on different types of substrates using SMT processes. So that's their core IP. They are licensing the technology to various different large manufacturers right now, and that's where we are getting orders from those manufacturers or their contract manufacturers.

Unidentified Analyst

I guess my question is you're doing the inline inspection for these, so...

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Right. So there are multiple steps in the Rohinni process which need in-line inspection, like inspecting the dies that are coming in, looking at the solder pads where the dies are going to be placed, then place the dies, look at the position of the dies with respect to the solder pads, take them through the -- I want to fix them then do a post inspection. So effectively, there are 6 places where in the Rohinni process you need to do inspection. And right now, SQ CMM is qualified for all 6 steps.



Unidentified Analyst

Yes. So I guess my question is -- and that's fantastic. I guess my question is did you have competition to get designed in this? Or was there's -- they just saw you're the only one who does this type of thing?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

No. There is competition. There's always competition. There are some applications where the SQ CMM is significantly superior, so they really haven't bothered to look at any other competitor. There are some areas where the requirements are a little less stringent, and there is -- we will see some competition. So it's not like...

Unidentified Analyst

But basically, the micro LED could go, I guess, every -- I mean, as far as like displays on phones like Apple. They could go on scoreboards, we saw that with (inaudible), pretty much everything, big-screen TVs.

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Yes. Right now, the demand -- I mean the expected growth in micro LED is projected to be fairly high over the next decade or so. I mean there are many reports about micro LED and the benefits of micro LED. Now clearly, we have a good starting position with Rohinni and their licensees, and we definitely intend to capitalize on that. Over time, clearly, this is going to be a big area. We will have some competition, so we definitely have a first-mover advantage, if you will, right now. And we are (inaudible) sections that are needed. But over time, we expect this to be a significant contributor, but we will also get some competition.

Unidentified Analyst

And now the other one you got, the inkjet. I would assume -- isn't like Hewlett-Packard one of the big companies in that area, the inkjet printer?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We cannot comment on which customer. We don't have permission to comment on which customers...

Unidentified Analyst

Oh, no. I know that. But is that the industry I'm thinking of, the HP or whoever?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Yes. It's a printer cartridge company, and it is a large printer cartridge company. And we are...

Unidentified Analyst

Now how -- what kind of potential is in that market?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Again, it shows that what they have started doing is they make millions of cartridges a year. Right now they are expecting, on a sampling basis using conventional technology, like an optical measurement module. They want to go in line and inspect all of this -- millions of cartridges using SQ CMM, and that's what we qualified for -- the product for. So right now, we're just starting. It's a few units. That's what the order is about, and we are placing it in their different locations worldwide. Assuming they get good ROI on those measurements, they will definitely scale up from there. And of course, we are approaching their competitors and other customers who could use those kinds of measurements.

Unidentified Analyst

Okay. So I'm going to tie these together, both these products. Now we know about MRS, SQ, WaferSense, the memory. That's been pretty much articulated you have business already going on. These 2 wins that you got, I had -- maybe I just fell asleep, but I had no idea you were working on these 2 industries, I guess, inkjet and also micro LED. Is this something you've been working on for how long?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We launched SQ CMM more than a year ago now. And fundamentally, as we have said before it is the world's first in-line CMM tool. And it is kind of a product a little ahead of its time, to some extent. And I think we have been talking to many customers, and there are many interesting applications that we are pursuing right now because there is no in-line CMM that exists in the world today till SQ CMM came about. I mean we are expecting 100% of all dimensions in 10 seconds or less, and we haven't seen anything like that before. So it is kind of creating some interesting opportunities for us, and we are working one application at a time. We are a relatively small company, as you know, so we have to be careful with our resources and how many opportunities we can pursue. So we try to evaluate the customer, the potential, the size of the opportunity and work with those customers, as you have seen in Rohinni and their customers gets us in micro LED or this large printer company for their printer cartridges. And we have a few other teams like that in the hopper. We feel pretty good about SQ CMM and the in-line CMM capability and what we could do in the next decade or so.

Unidentified Analyst

So we might see more of this stuff coming at us because of the -- well, basically the technology, right?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Yes. Exactly. It's a very unique, differentiated technology, and it is opening very interesting opportunities for us. But it does take time to hit the market and position to customers.

Operator

(Operator Instructions) Our next question come from [Ross Strehlow], a private investor.

Unidentified Participant

So I'm surprised that the OEM sensor business still remains so soft. Is it your customers' sales softness or did they just get too much inventory?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We're not completely sure what -- how much of it was inventory that they purchased towards the end of last year they are trying to clear and how much is overall softness. Clearly, there's confidence on both. The industry did soften as we entered the end of last year and they may not have



anticipated so they may have purchased some and then they backed off quite a bit. Within the OEMs, there are 2 types of OEMs. One is the legacy sensor OEMs and there the softness is much more than the MRS OEMs. The MRS OEMs we expect them to start picking up relatively soon because the industry is turning the corner. We clearly see that. The legacy OEMs are going to take a little bit longer we suspect because of the China trade war going on, intrinsically the pick and place market seems to be soft right now.

A little bit of that is because of all the excitement we are seeing with our nano sensor in the advanced packaging area, [Ross]. Advanced packaging is essentially stacking multiple chips, faster components, all of that stuff together is a package and that's why they need the nano and [auto] sensor to do the inspection. But if you think about what that is replacing, to some extent it is replacing conventional PCB and that's where our legacy OEMs do play in that market. So I think our advanced packaging is causing a little bit of hurt in the conventional PCB area and our legacy OEMs are definitely feeling the pinch over there. Does that help answer your question?

Unidentified Participant

Yes, a little bit, Subodh. I was referring to the 3D OEM sensor business. When you look at your back end of the semiconductor industry customer that is the dominant player. How much are their sales down for this year? Any idea?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Quite a bit. I mean, we cannot disclose because that would be giving away some valuable information for them, but they are down quite a bit. They definitely are telling us that they expect them to pick as this current quarter continues and next year they are feeling pretty bullish right now. So we expect both of our MRS OEMs to pick up nicely in 2020.

Unidentified Participant

That's great. You and I talked about this earlier and I'm just surprised it still remains soft, but that's the way cycles go and with the overall industry. Okay. That's great. The other -- when you're talking about your new sensor business, how many new customer engagements are you guys involved with right now?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We are dealing with about 10 new customers, OEMs or system integrators, both with our current generation MRS sensors as well as the new nano MRS sensors and we are getting...

Unidentified Participant

How many?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

About 10 customers, potential customers.

Unidentified Participant

How many of those are on the new OEM side?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

About half of them are new OEM, the new for nano and about half are for the current generation. Roughly 5 each.

Unidentified Participant

Okay. Good. And what type of -- so based upon those conversations, when do you expect to have some revenues really start to ramp with that new sensor?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We definitely expect the revenues to start ramping in 2020. It will be still, I mean, they will buy 1 and 2 because many of these people are OEMs or system integrators. So typically they buy 1 or 2 sensors from us, build equipment which takes a couple or 3 months. Then they are showing their equipment to their customers and usually, that's another 2 to 3 month cycle. So we are expecting that once somebody buys from us, it typically we expect to see real feedback from them about the potential, roughly 6 months after we have sold our [full] sensor to them. So we expect second half of 2020 to be a good indicator of what happens with the customers we are selling the nano sensor today to.

Unidentified Participant

Okay. So how many of those 5 new OEMs in the new nano sensor, Subodh, how many of those have actually purchased 1 or 2 so far to give it that test?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

We have sold nano to 2 so far and we just received another order from a (inaudible) shipped (inaudible) in the next couple of weeks. So, so far we have 3 customers for nano. We expect to get another few out of that group of 5 or so we are talking to. So we will probably have 4 to 6 nano customers in the next few months, and then it really depends on how successful they are with their customers.

Unidentified Participant

That's great. That's really good. Okay, and then my final question -- Yes, I was talking about nano, right. Okay. And then my final question is when you look at this older 2D systems, what you call your legacy business, what do you think that overall market on a multiyear basis is doing? It sounds like the growth is actually negative. Am I right about that and if that's -- or what do you think? How much is it? Is it negative and by about how much?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Clearly, this year has been a negative year for the legacy with the sensor as well as the inspection system business. Assuming the older semi (inaudible) market grows 5% next year, we expect that legacy business to be flattish. I don't think it's going to continue at a negative run rate like this year. This year, the market did decline by a solid 20% and we definitely saw that in the legacy business. But next year assuming the overall market is decent, it will be flattish. I don't know, Jeff, do you want to add something?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

I think it's going to recover, but obviously it's not going to be a growth driver for us, so that's fair. But definitely it's down pretty good this year.



Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

But that legacy business has become only 1/3 of our business right now.

Unidentified Participant

No, I understand. Just trying to get a good feel for everything. So, okay, so that was obviously down this year and you're expecting it to be -- to improve. But would you say that overall, I mean, over the next few years, is that business slowly decreasing? Or do you think that market is going to stay relatively flat over the years?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

I think there'll be some small decline. I think it will be fair to say there's going to be some small decline coming in that market overall, and our legacy business will see some small decline. But regarding the question of how much decline, I don't think we're looking at double-digit decline, to be honest, here in that legacy business. I mean, these are pick and place machines. You know the kinds of customers we have, [Azuki], ASM Pacific Technology, [Ekientis], solid industrial companies have been around for a long time. And I don't want them to change their product portfolio or disappear by any means. And then the SPI and 2D AOI business, there will be some decline in the 2D AOI business, maybe some decline in the SPI business. But again nothing significant. And then we also include our conventional scanner turned scanning services in the legacy and that's actually in the legacy LED business that staying kind of flattish. So over time, our model, internal models at least, we are projecting a flattish business over the next 5 to 10 years. It's maybe a small decline, but nothing significant.

Operator

Our next will be Bill Dezelle with Tieton Capital.

William J. Dezelle - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

My first one is in response to an earlier question, you referenced that there are 6 steps that are involved in the micro LED market. How many of those steps did you say that you are involved in?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

All of them.

William J. Dezelle - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

Any more insight that you'd like to share beyond that?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Basically, SQ CMM has been qualified for all the steps that are involved in micro LED inspection. Some of them are very demanding. As far as we know, SQ CMM is only qualified inspection tool at this time. Some are less demanding and there is some competition and that may impact that area. But SQ CMM can pretty much do the job for all the inspections that is needed in micro LED assembly.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

And of those 6 steps, Subodh, how many would end up in the category of more demanding that only SQM would be qualified for? And how many would be less demanding that others may have an opportunity to address?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

That, too, depends on the application. So there are some applications in micro LED that are relatively less demanding. For instance, backlight, that is replacing regular LED. But then there are some areas where the application is more demanding like a direct display in an auto area. So depending on what exactly the customer is making, the 6 steps requirement changes quite a bit. We are, as I said, we are well suited for all of them. Our competition, if there is any, will have some challenges to overcome. So we, ideally, we obviously want micro LED to go after the most demanding applications out there. We are the only qualified tool that will be an ultimate victory for us but, clearly we are going to get some competition in some steps for less demanding applications.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

And for the application that you announced in the release today, how many of those 6 steps would be more demanding and how many would be less demanding?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Again, there are multiple customers that are involved at this point. In some cases, all the steps are demanding. In some cases, about half of them are demanding.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

I'm sorry, I misread the press release. I thought the order was for 1 specific contract manufacturer, it was selling to 1 consumer electronics company.

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

That is correct. That is just the 1 order that we disclosed, but we are talking to multiple customers at this point.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

Fair enough. And that 1 customer that you disclosed, the contract manufacturer, the consumer electronics company or end customer that they are selling to, is that a new or an existing customer?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

The contract manufacturer is a new customer for us. The consumer electronics customer is an existing customer for us.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

Great. And then I'm going to expose my ignorance here. The legacy business, the dramatic decline that you saw there, is that a function of just the general uncertainty that the trade environment has created? Is it because of capacity that these end markets have? Or is it a switch to a new technology? Are you able to broadly address what's behind that decline?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

I think there's a couple things going on so the capital equipment markets, as we've said, they clearly have been in a downturn. And then when you look at our legacy products, a greater percentage of that revenue bucket tends to be OEM-type customers, so there you also have this inventory interplay where they have a need to rebalance their inventory. So those are a couple of the reasons why that bucket gets hit harder. And then puts our newer products like SQ that has the MRS technology which gives us competitive differentiation and then also the 3D AOI market, in general, is a growth market, even in a tough overall global environment.

Operator

And next will be [Eric Slade] with [ACME Analytics].

Unidentified Analyst

I had one more question. True knowledge, is Samsung -- and on the -- I would imagine they would be on the micro LED side, is Samsung a player?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Eric, we really cannot comment on the specific customers who are signing up and (inaudible) plans.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO and Chief Compliance Officer*

Not your customer, just in general is Samsung approaching? Are they in not with you necessarily?

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

In general, if you look at micro LED as a category, clearly Samsung is heavily invested in that. In fact, in the recent Consumer Electronics Show in Las Vegas, they displayed the biggest display of micro LED technology. So you know Samsung is very much interested in micro LED and has significant plans in this area.

Operator

And moving on to [Miles Jennings], a private investor.

Unidentified Participant

I was just curious if you could give me the depreciation accrual for the third quarter. I see that your after-tax loss was \$353,000. I seem to remember, it seemed to be about the same amount as your depreciation accrual, but I just can't see that yet in your reports.

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Our depreciation and amortization expense in the third quarter was \$744,000.



Unidentified Participant

So you were cash flow positive in the third quarter?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Well, our cash --

Unidentified Participant

As I defined it, of just a simple net income, net loss plus the depreciation accrual.

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

I guess if your calculation is to take net income and add back what depreciation and amortization was, that would yield a positive number. That's the way the math would work.

Unidentified Participant

About \$400,000 to the positive side, right?

Jeffrey A. Bertelsen - *CyberOptics Corporation - VP of Finance, CFO, COO & Secretary*

Yes. 3 -- \$353,000 negative plus \$744,000 would get you a positive \$400,000.

Unidentified Participant

This quarter was difficult for a lot of companies, and it's good to see that you were cash flow positive in a simple way.

Operator

And that does conclude the question-and-answer session. I'll now turn the conference back over to you for any additional remarks.

Subodh K. Kulkarni - *CyberOptics Corporation - President, CEO & Director*

Well, thank you for your interest and questions. We look forward to updating you at the end of the year. Thanks again.

Operator

Well, thank you. And that does conclude today's conference. We do thank you for your participation. Have a wonderful day.

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