ADVANCED FORMING TECHNOLOGY

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

Drew Kelley: Good afternoon, everyone. As most are aware, this call will contain forward-looking statements as defined by the Federal Securities laws. Forward-looking statements are indicated by words such as, expect, anticipate, plan, believe and other similar words concerning for future events.

All future events are inherently uncertain and actual outcomes may differ materially. We do not guarantee future performance, and past performance is not necessarily indicative of future results. Further, we undertake no obligation to update our forward-looking statements.

We encourage you to review the risks that we face and other information about our company in our filings with the SEC, including our annual report on Form 10-K and our quarterly report on Form 10-Q. At this time, I would like to introduce Jason Young, ARC's CEO. Jason?

Jason Young: Thanks Drew. Good afternoon, everyone, and thank you for taking the time to join our call. We announced earlier today results for our fiscal quarter ended April 2, 2017. Sales from continuing operations for the quarter were $25.5 million, 2.4% increase compared to the third fiscal quarter of 2016.

Growth in sales from our new product development efforts was offset by a slowdown in the firearms and defense industry. Gross profit for the period was $3.1 million, a decrease of $1.9 million, while facility EBITDA from continuing operations was $2 million, compared to $3.9 million to the third fiscal quarter of 2016.

Driving shot-term margins has been a challenge for us given our new product launch momentum and we are not happy with margins level from last quarter. However, the exciting part is our significant momentum in sales with the largest committed volume with new program launches that we never had.

Once these programs move in to full production, volume and yield, they should provide improved margins for almost typically a long period of time. So all the upfront investment came for the long-term production nature of the programs tend to make a lot of sense.

Going back to fiscal 2016 and 2015, driving sales growth is a big challenge for us. But we are now in a side of that, with a much more customer centric in sales driven culture which is reflected in our large committed pipeline with new product development. Our challenge now is to get these new products launched quickly and efficiently in prioritizing our best opportunities.

As we noted in our earnings release, getting these new programs launch scale at the right yield takes time, roughly about a year. So, there is margin pressure through that ramp process, particularly given the significant volume of new programs coming online all around the same time.

Therefore, we're trying to optimize our launch process in order to minimize inefficiency in scrap, where we are making steady progress on this quarter. Related to that, we also announced that Mr. Eli Davidai would be our new General Manager of Operations.

Mr. Davidai has been a key operational leader for us. And based on the success at several divisions at ARC, where we very now consolidate our metal and plastics under him, not only to help and apply our approach internally and externally, but also to further increase productivity and efficiency across our clients.

In other news, our metal 3D printing business also had significant momentum. We've recently launched one of the first full production metal 3D printing programs of its kind and are developing numerous new metal additive programs, a lot of which are for production in aerospace industry.

Total of 50 metal printers are additive businesses, quickly becoming one of the largest and most technically complex providers in the country. We are also very excited about the new state-of-the-art dedicated metal additive manufacturing technology center that we are in the process of creating which will have very unique capabilities. We will be providing more details on that in a little bit.

With that, we appreciate every ones time on the call today and we'll now open for questions.

Operator: Thank you. If you'd like to ask a question, please signal by pressing star 1 on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, press star 1 to ask a question.

We'll go first to Andrew D'Silva with B. Riley.

(Sameet): Hey, guys. This is actually (Sameet) on for Andy. How are you?

Jason Young: Good. How are you?

(Sameet): Good. Just a couple of quick questions on RN. So as you guys are going to transitioning from - or already completed transition from a more engineering focused culture to a sales driven culture, where you've been more focusing on the customer now and that's kind of round up your sales reps and are investing all these new products.

How you think about the long-term kind of margin profile business on a going forward basis in both gross margins and EBITDA margins as you kind of complete the investment and kind of ramp up the scale?

Like, what's your view with long-term margins could be in this kind of newer model?

Jason Young: It's a good question. So, you know, I'd answer it in two ways. One is, you know, back a couple of years ago before we kind of made that sales customer transition we were operating around kind of 20% EBITDA margins and 30% roughly gross margins.

So I think that the margin profile on a kind of run rate production basis, that's really what we're kind of aiming for. Once we get things kind of normalized from a ramp standpoint.

And then I think the other factor there that weave into that is what the balance of the mix is of kind of the traditional NIM business versus the new metal additive business, which should frankly have a better margin profile, again once that business reaches full scale.

(Sameet): Got it, make sense. And as you noted on the call, like, the sales pipeline is pretty - looking pretty good for you guys right now. Could you discuss how you kind of think about the sales pipeline right now in a little more granular detail, I guess, specifically regarding customer dynamics?

And I guess also with the new administration's focus on more US manufacturing, like, have you found that a lot of your current customers and ((inaudible)) customers are reaching out to you more just given that most of your manufacturing is US based and obviously much real lead times?

I'd love to hear any thoughts on that.

Jason Young: Yes, sure. So, I'd certainly say, you know, with major focus on manufacturing and technology particularly under the new administration, I think that there is much more keen interest on domestic manufacturing. So I'd say that backdrop certainly helps.

But, on really a day-to-day basis, what we've found particularly as we move from - move towards much more customer driven culture, frankly filling our pipeline at this point is probably one of the least challenging things that we have to deal with in that, you know, with the pipeline that we have in place today with kind of the committed programs we have under development. I mean, that's tens of millions of dollars of kind of theoretical production - annual production volume.

So the challenge we have today is just launching that as quickly as possible. And frankly what we've found with our customer base and given the fact that, ((inaudible)) in particular, there aren't a lot of people that can provide not only a scaled solution, but one that can meet very complex technical dimensions.

What we've found is, if we went to our customers and worked with them they could probably soak up all of the capacity that we have. So for us, while driving sales certainly kind of our number one initiatives or challenge rather, call it, 14, 15 months ago at this point. If we could basically speak for all the capacity, we could possibly produce.

The gaining factory being launching that in a quick and efficient manner. So what we're really trying to focus on today is how much can we push through the system in a way that can maintain yields and efficiency properly. So that's really kind of the gaining factor for us at this time.

(Sameet): Got it, make sense. So just another kind of quick question cost on RN. So, I think as you noted in the press release that one of the reasons for the higher costs outside of the increased staffing levels was higher kind if scrap costs.

As you think about the correlation between your guys' margins and scrap costs? Like, is there a rule of thumb to kind of keep in mind? Like every 1% increase in scrap impacts the margin by X basis points? Like what kind of rule of thumb should we keep in mind?

Jason Young: I think that's an interesting way to look at it. I'm not sure that we could give any clear parameters along the line what you're looking for, because I think in many cases the situations can be quite fungible, so it depends where on that program and the time and sensitivity and the technical parameters that we have to meet.

So, I'd be hard pressed to kind of draw a specific corollary there. But what I would say is I think in particular for the third quarter a big part of what we were trying to solve for given we had such a pretty huge backlog was one thing that we kind of experimented with was, if we kind of tried to push the envelope. And drove resources at launching quicker could we get more through the system.

And I think part of what we realized was there is maybe an upper limit to what it can push through the system with resources. Because as we've learned through last quarter and through some of the costs we mentioned in scrap was that we can throw a lot of resources at it but that won't more necessarily increase throughput in an efficient way.

So part of what we turned out back was rationalizing some of our cost structure, because adding additional resources didn't necessarily improve yield ,and some of that yield just takes time. And so that's what we really try to find that balance on which is how much can we focus on producing quickly adding additional yield versus having the right amount of resource to allocate towards it.

So ultimately what we're trying to do is do everything we can to maximize growth. But at the same time do it at a more reasonable and acceptable efficiency than yields, which frankly in the last quarter we kind of didn't really optimize

So, ultimately, as we launch, you know, we're going to try to do it in a way that's much more scrap - less trapped intensive than what we faced last quarter.

(Sameet): Got it, that's helpful. I have a final question on RN before we kind of turn the call over and get back in queue. But I guess this quarter I noticed you guys divested your wireless business and in the past you guys divested the techno business.

How do you think about the current lines of business you are in right now? I mean obviously 3D printing is probably going to be business in focus, the metal injection business is another business in focus. But flanges and fittings, it's a smaller business for you guys, realize it has higher gross margins in other segments. But what are your thoughts on that business?

And with the divestiture, the wireless business, what's your thought on use of proceeds there? Are you looking to invest - reinvest in the current business lines or in the past you guys have done some ((inaudible)) M&As?

Will you guys talk about that thought process as well and reinvesting the business versus some other strategic M&A assets which you probably have in mind throughout there?

Jason Young: Sure. So I think as we think about the core business, the core business is really centered around the metal injection molding or plastics as it relates to that and our metal additive business. And so to your point I think that's really where we center the core around in our tooling, machining fit nicely into that and our stamping to a certain degree.

I think our flange business in some ways it's strategic, but it's probably not a perfect fit. So, for the time being, it does actually generated strong cash flow for us. So, I wouldn't call it part of like the inner circle of what we're doing. But, you know, it's certainly a precision metal solution that generates good cash for the business.

So for the time being it's part of what we're doing. It's part of the inner core of what we're doing. I think that can be up for debate, but that's kind of how we think about that. And then as far as the wireless business, the sale was not for a very material amount.

So, I don't think that that is going to really implicate much as far as use of proceeds. But, to more broadly answer to your question, I think for the time being in the short-term at least there are numerous opportunities within our core MIN and metal additive businesses that for now at least we wouldn't turn away a great M&A opportunity.

We have plenty of opportunities in-house that we're very focused on executing on. And that's where we'd likely apply additional resources.

(Sameet): Got it, that's all for me. Thank you so much for the color.

Jason Young: Thanks.

Operator: Once again, it is star 1 to ask a question. We'll go next to Jon Tanwanteng with CJS Securities.

Jon Tanwanteng: Hi, Jason, thanks for taking my questions.

Jason Young: Hey, Jon.

Jon Tanwanteng: How should we think about the slowdown in the firearms businesses? Is it a volume or price issue or both, and how do you see that trending in the existing products that are shipping now as we head out into the next two quarters or so?

Jason Young: You know, that's a great question. I wish I could tell what the future will hold there. I don't think anybody really knows at the moment. But what I can say is that kind of starting in the beginning of the first of the New Year there was a drop off in certain aspects of the firearms industry.

I mean, I think that that background checks are generally stapled up. So, I think from a broad firearm industry standpoint from what we hear from our customers, there's actually decent buoyancy but there's been pull off in kind of key kind of what would be perceived as higher legislative risk categories like high capacity magazines, for instance, there was a huge drop off there.

So certain aspects of magazines in the AR market have kind of come back quite a bit from the first of the New Year. So we certainly -- a lot of that being kind of built up inventory at the retail level. So, we know that's kind of what happened and unfortunately that pullback, you know, offset a lot of the growth that we had which was kind of disappointing.

The flipside of that, from our perspective is that we didn't lose any customers, we didn't lose any programs, it was purely just a volume pullback of existing stuff to compensate for some of the inventory buildup pre-election. So, over time we expect those programs to kind of normalize back to not where they were in October, but certainly not to where they went to in January, which was kind of a pretty massive drop off.

So, that's kind of what we know about where things are and what would happen. I think from the general conversations we had with our firearm customers, no one really knows where things are headed. No one is expecting any major further drop offs, but I think that people are kind of in wait and see mode for the next three, four months going into the fall.

So, we're not expecting any major impacts. But I wouldn't say that it's going to bounce back or that there's going to be major strength in the next one to two quarters. So beyond that, it's tough to say. But I think what the firearm companies are trying to do is launching products which they're doing and that can help offset some of the attrition of the existing platforms.

But then the other part of it is that there's also going to be winners and losers in firearms space and ones that are going to be growing market share and ones that are going to fall irrespective of market issues. So, part of what we're also trying to do is align ourselves with the ones that are going to be able to grow through some of the industries slowdown, which frankly some of them are.

And so, again, at the end of the day that hurts existing platforms. But, aligning ourselves with the winners there, new platforms, will help us grow our way out of it, which again goes back to the initial thing which is all of our sales problems will be solved with us launching what's in our pipeline.

Jon Tanwanteng: Got it, that's all very helpful. And you mentioned obviously these new opportunities that are in the pipe that you're incurring a lot of costs for. Can you quantify how big these opportunities are if they all hit? You know, what the volume look like or the revenues?

And then have there been any changes to when those actually are going to ramp in the last, call it, 60 to 90 days?

Jason Young: Well, there's a lot of aspects that'll impact our ability to launch notwithstanding yields efficiency, et cetera. So I don't think we want to put specific number out there and timeline. But what I can say is that in the pipeline of new products, I mean, it's well in excess of 20 million of annual production dollar volume.

And so, the main question - the main issue that we're grappling with is if I could snap my fingers and launch that all tomorrow, you know, our customers would take it. But the problem is we can't do that overnight. And so that process of launching, it can take upwards of a year or more and that's what we're really trying to work into the system and figure out how quickly we can absorb.

Jon Tanwanteng: Got it. And I don't know if you mentioned in the prepared remarks, did you quantify what the actual startup cost impact was in the quarter? I think you've done in the past. And maybe on top of that, have you figured out any way to call back those costs in the long-term either guaranteed volumes of better pricing or something else that may be contractual?

Jason Young: We didn't put a specific number out there, but I mean you can kind of back into it based off of the year-over-year numbers and our change in profitability. So with that, I think that what we've been able to hone in on to your question are kind of two things.

One is this time last year we had virtually no pipeline. So, we're in a very different spot today given where we were a year ago. And so I think part of from a call back perspective to your question, I think that we can be kind of in some ways maybe less aggressive, or to put it another way, more picky with who we decide to launch programs with.

And so from an onset perspective, that will enable us to absorb less cost upfront. So that's kind of one way we can deal with it where we've kind of changed our policy of how we look at acquiring new business. So that should help a lot mainly because our pipeline's mostly spoken for at this point.

So that's kind of a one go-forward major. And then the other is that to one of my earlier points, part of what we've been trying to hone in on is how quickly we can actually launch programs. And part of what we've been kind of experimenting with is, you know, ((inaudible)) resources or bodies or other things to speed it up.

In some cases we've been able to take time out of that process and by in other way throwing bodies at it isn't going to, to a certain degree, speed things up. And so part of what we have done as well is rationalize the cost structure as we've kind of honed in on what the right amount of resources is to optimize production launch and efficiency.

And so part of what we've done is pare back on some of that cost structure, which again should help things kind of self-adjust as we go forward. So it will be less of a margin impact in the future.

Jon Tanwanteng: Okay. Great. And then just jumping to the wireless business that you sold. What was that generating in terms of current quarterly revenue and EBITDA? Just remind me.

Jason Young: It wasn't material. Annual revenue was $500,000 and the EBITDA cash flow contribution was marginal.

Jon Tanwanteng: Okay. Great. And then you got about $10 million for that ((inaudible)) the cash flow statement?

Jason Young: No, that was for the Tekna Seal business.

Jon Tanwanteng: That was Tekna Seal. Okay. Okay.

Jason Young: Right.

Jon Tanwanteng: Got it. Thanks. And then finally just on the investment in the 3D printers that you recently made. First, how much did that increase capacity or ability to track new businesses?

And second, are those investments based on orders that you already have in hand or programs that are soon to launch? Just help me quantify or qualify how confident you are in that business.

Jason Young: Yes, those printers were for a program that we've been in development on for the last year, which launched in the full production about a couple of months ago. And the capacity for those printers is fully spoken for that program.

So we bought it in specifically to support this program. And, which we have long-term agreement on and we put those printers on operating uses.

Jon Tanwanteng: Got it. Thank you very much.

Jason Young: Yes. Thanks for the questions.

Operator: And once again it is star 1 to ask a question. And it appears there are no further questions at this time. Mr. Kelley, I'd like to turn the conference back to you for any additional or closing remarks.

Drew Kelley: Jason and I ((inaudible)) everyone, thank you for joining the call. We appreciate your time and of course we look forward to further conversations. So thank you very much.

Jason Young: Thanks, guys.

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

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