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LUNA - Q1 2015 Luna Innovations Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Dale Messick** *Luna Innovations Incorporated - CFO*

**My Chung** *Luna Innovations Incorporated - President, CEO*

## CONFERENCE CALL PARTICIPANTS

**Edward Perry** - *Private Investor*

## PRESENTATION

### Operator

Good day ladies and gentlemen and welcome to the Q1 2015 Luna Innovations Incorporated Earnings Conference Call. My name is Alex and I will be your operator for today. At this time all participants are in listen-only mode. We will conduct a question-and-answer session towards the end of this conference.

(Operator Instructions).

I would now like to turn the conference over to your host for today, Mr. Dale Messick, Chief Financial Officer. Please proceed, sir.

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### Dale Messick - *Luna Innovations Incorporated - CFO*

Thank you, Alex. Good afternoon everyone and thank you for joining us today as we review our operating results for the first quarter of 2015. A recording of this conference call will subsequently be posted on our website.

Before we proceed with our presentation today, let me remind each of you that statements made in this conference call, as well as in our public filings, releases and websites which are not historical facts may be forward-looking statements that involve risk and uncertainties and are subject to changes at any time, including but not limited to statements about our expectations regarding future operating results or matters related to the completion of our merger with Advanced Photonix and the prospects of our combined company.

We caution investors that any forward-looking statements made by us are management's beliefs based on currently available information and should not be taken as a guarantee of future results or performance. Actual results may differ materially as a result of a variety of factors discussed in our latest forms filed with the Securities and Exchange Commission.

We disclaim any obligation to update any such factors or to announce publicly the results of any revisions to any of the forward-looking statements to reflect future events or developments except as required by law. There is more complete information regarding forward-looking statements, risks and uncertainties in the company's filings with the SEC available on the SEC's website and our website.

And at this time I'd like to turn the call over to My Chung, President and CEO of Luna Innovations.

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### My Chung - *Luna Innovations Incorporated - President, CEO*

Thank you, Dale and thank you all for joining us today. Before we update you on our first quarter results I would like to take a few minutes to talk about our merger with Advanced Photonix.

This past Friday morning, May 8, the stockholders of both Luna and Advanced Photonix voted to approve the merger of the two companies, with more than 98% of the shares voted being in support of the transaction on both sides. We greatly appreciate the high level of confidence and support on the part of our stockholders. And we welcome our many new stockholders to Luna.



We believe this merger will provide greater value to our stockholders than either company would realize standalone.

Combining API's high-speed optical receiver and Optosolutions' product offerings, with Luna's test and measurement products provides opportunities for additional growth as we leverage the combined capabilities across a broader market base.

The two companies in many cases sell into the same industry, and sometimes also to the same customer. We anticipate that the relationships that each of our individual sales forces has with their customers, can potentially open doors to expand a now broader portfolio of products we offer. Also as the deployment of 100 gigabit optical networks continues to grow, we expect the products of both the API brands and the Luna brands to benefit.

We expect top line growth to be realized from the investments that each of the companies has made to sensing platforms. Luna's ODISI products provide unique capabilities to measure strain in composite materials. And we continue to see growing interest in our solution, particularly within our primary target markets of aerospace and automotive, as we continue to expand our sales force to capture these opportunities.

For the benefit of our new stockholders I'd like to give a brief primer on our ODISI platform. Unlike aluminum or steel, composites are non-uniform in their structure. Therefore in order to adequately test the structural soundness of something like a composite aircraft wing or fuselage, one needed to previously install thousands to several thousands of individual electrical strain gages, trying to cover as much of the surface area as possible.

Each of these individual strain gages would be glued onto the structure then connected back to a single strain-gage data acquisition channel. Therefore, to test a composite aircraft, one would need a data acquisition system with a thousand to several thousands of channels. This is contrasted to using fiber optic cables, each with the equivalent of a thousand sensing points but only a single connection back to our ODISI system. Our solution offers higher resolution, is far easier and faster to install and is significantly less expensive.

The ODISI product also has the unique capability to provide fully distributed temperature sensing with sub-centimeter spatial resolution, which we believe will provide tremendous value in applications where temperature profiles along a structure are important: such as in the automotive industry relative to lithium ion battery designs, heat distribution across brake-pads, efficiency of cooling systems and engine temperature profiling, as well as many other applications.

The combination with API brings to Luna an additional sensing platform with growth opportunities, API's Terahertz Solutions, which has unique capabilities for the non-destructive measurement of individual layers of a product and provides greatly enhanced process control in manufacturing environments.

Terahertz operates in wavelengths close to infrared radiation. It is an optical measurement and therefore does not provide a health risk unlike the nuclear gauges that are used today for similar density measurements.

In addition to the potential revenue synergies of the combination, we expect to benefit from substantial cost savings as part of the merger. There is tremendous cost associated with just the compliance infrastructure of being a public company. And consolidating those costs and functions into a single entity provides a significant synergy value.

As you can see, with opportunities for enhancing revenue growth and the expectation for reduced operating costs, once we get past the merger consummation and integration costs over the next couple of quarters, we are excited by the prospect for growth and an accelerated path to profitability that this transaction provides.

Looking back now over the first quarter of 2015, we did have a very strong quarter.

And I will turn the call over to Dale to review our results.



**Dale Messick** - *Luna Innovations Incorporated - CFO*

Thank you, My. Before I begin, let me clarify that the results we are reporting today relate only to the results of Luna Innovations for the first quarter. The results of operations from API for the March quarter are not included in these amounts and will only be consolidated with our results for activities in periods subsequent to the merger date.

For the first quarter of 2015 we recognized revenues of \$5.3 million compared to \$4.5 million for the first quarter of 2014, an increase of 19%. Product and licensing revenues grew 37%, to \$2.5 million for the first quarter of 2015, compared to \$1.8 million for the first quarter of 2014.

The growth in product sales this quarter was realized largely in our OBR line of products. Technology development revenues also grew 7% to \$2.9 million in the first quarter of 2015 versus \$2.7 million in the prior year quarter.

Overall margins improved to 43% of revenues in the first quarter of 2015 compared to a gross margin of 35% for the first quarter of 2014. The improved gross margin resulted from revenue mix as product sales typically carry a higher margin than our contract research activities and product and license revenue accounted for 46% of Q1, 2015 revenues compared to 40% of our revenues in the first quarter of last year.

Our product revenue mix in Q1, 2015 also returned a higher average margin than did product sales in the first quarter of 2014, and an inventory reserve charge of \$108,000 taken in Q1 of 2014 did not recur on the first quarter of this year.

Our resulting gross profit was \$2.3 million for the first quarter of 2015 versus \$1.6 million for the first quarter of 2014. Operating expenses increased to \$4.9 million in the first quarter of 2015 compared to \$3.5 million in the first quarter of 2014. The increase in operating expenses were driven by \$1.8 million in costs recognized related to the merger transaction, including such costs as legal and accounting fees and costs for preparing registration statement.

Excluding those transaction related expenses, our operating expenses would have been \$3.1 million for the first quarter compared to \$3.5 million in Q1 of last year. Because of the impact of the transaction costs on our results for the quarter, our operating loss grew to \$2.6 million compared to \$2.0 million in Q1 of last year.

Again, excluding those transaction costs, our operating loss would have improved significantly to approximately \$817,000 which would have been a \$1.1 million improvement over the prior year quarter.

The sale of our medical shape-sensing business to Intuitive in January of 2014 provided a total benefit of \$10.4 million in discontinued operations and income taxes to the bottom line for Q1 of 2014.

There were no discontinued operations in our results for Q1 of 2015. Accordingly, with this \$10.4 million benefit, we reported a net income of \$8.5 million or \$0.58 per share in Q1 of 2014 compared to a net loss including transaction related expenses of \$2.7 million or \$0.18 per share for the first quarter of 2015.

With these significant non-recurring benefits and charges in the first quarters of both 2014 and 2015, the improvement in our operations may be better understood by looking at adjusted EBITDA. When we back out the benefits associated with the shape-sensing sale in 2014 and the transaction related costs in 2015, our adjusted EBITDA improved \$1.1 million with an adjusted EBITDA loss of \$389,000 in Q1 of 2015 compared to an adjusted EBITDA loss of \$1,482,000 in Q1 of 2014.

We ended the first quarter of 2015 with cash of \$13.3 million compared to \$14.1 million at December 31, 2014. Cash payments in Q1 2015 also included approximately \$415,000 of the transaction related expenses that we recognized.

And with that I'd like to turn the call back over to My.

**My Chung** - *Luna Innovations Incorporated - President, CEO*

Okay. And this point in time, if we could open up for any questions.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions).

And we do have a question from the line of Edward Perry, Private Investor. Please proceed.

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**Edward Perry** - *Private Investor*

Hello.

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**Dale Messick** - *Luna Innovations Incorporated - CFO*

Hello Ed.

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**Edward Perry** - *Private Investor*

Nice to talk to you people, and congratulations on your accomplishments. Couple of four questions here, when will you be publishing an interim consolidated statement prior to Q2 which will include the API combined with the Luna?

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**Dale Messick** - *Luna Innovations Incorporated - CFO*

Yes, so, we're going to be publishing our 10-Q for Q1 here in a couple of days, that's not going to include any pro forma information, it's just not practical to get that into this Q. We will probably have a pro forma statement in the footnotes for the June quarter.

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**Edward Perry** - *Private Investor*

So, there will be something pro forma coming between the Q1 and Q2 then?

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**Dale Messick** - *Luna Innovations Incorporated - CFO*

Yes. In our filing for Q2, I would expect we'll probably have a pro forma in there.

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**Edward Perry** - *Private Investor*

Good, okay. And when will the complete merger be reflected in the financial statements?

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**Dale Messick** - *Luna Innovations Incorporated - CFO*

The merger will go into the financial statements as of May 9 in essence would be our first day as a merged company, the merger closed on May 8. And so, from May 9 forward we'll include the combined results.

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**Edward Perry** - *Private Investor*

Great. And do you have a handle yet on the total debt long-term and current for both Luna and API combined?

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**Dale Messick** - *Luna Innovations Incorporated - CFO*

Yes, we did - as we talked about in the pro forma - I'm sorry in the S4, we did do a debt financing in order to repay the outstanding loans from API, plus a little bit that will head outstanding. And so, we did execute a new facility with Silicon Valley Bank, that's a \$6 million term debt repayable over four years in monthly installments.

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**Edward Perry** - *Private Investor*

That's good. And roughly speaking, what is the - on the Luna side, what is your current workforce count or employee count?

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**Dale Messick** - *Luna Innovations Incorporated - CFO*

We and API are very similarly sized in terms of employees. We both have somewhere in the 115 to 125 range. So, we're looking at about 250 on a combined basis.

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**Edward Perry** - *Private Investor*

All right. And will there be any consolidation in product lines on the API side? For example, here when Luna does its manufacturing, is it outsourced or will it be shifted over to API's manufacturing facilities?

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**My Chung** - *Luna Innovations Incorporated - President, CEO*

Currently, our plans are to continue the manufacturing as it is. Optosolutions in Camarillo has their manufacturing site, they also do manufacturing overseas. Likewise, the HSOR operation as you know have an extensive manufacturing capability there Ann Arbor. We would continue that. And then also we're currently manufacturing the Terahertz Systems in Ann Arbor as well.

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**Edward Perry** - *Private Investor*

Good. Thank you for the answers. Again, congratulations on the consummation of the merger.

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**My Chung** - *Luna Innovations Incorporated - President, CEO*

Yes, thank you.

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**Dale Messick** - *Luna Innovations Incorporated - CFO*

Thanks very much, Ed.

**Operator**

And at this time there are no additional questions in queue. I'll turn it back over to management for closing remarks.

**My Chung - Luna Innovations Incorporated - President, CEO**

Okay. Well, thank you everyone for joining us today. But before we wrap up the call, we'd like to just reiterate how excited we are about the potential that our merger with API brings for our stockholders, our employees and our customers.

Later this week, Dale and I will be participating in the B. Riley Investor Conference in Los Angeles. And if you are there as well, please do seek us out in person. We'll be setting up conferences Wednesday afternoon into Thursday. We look forward to updating you on the next call on the progress that we're making. Thank you.

**Operator**

Ladies and gentlemen that concludes today's conference. Thank you for your participation. You may now disconnect

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