



TTM Technologies, Inc. (TTMI) Q4 2022 Earnings Call Transcript

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Q4: 2023-02-08 Earnings Summary

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Press Release

EPS of \$0.41 **beats by \$0.03** | Revenue of \$617.16M (3.18% Y/Y) **misses by \$40.17M**

TTM Technologies, Inc. (NASDAQ:[TTMI](#)) Q4 2022 Earnings Conference Call February 8, 2023 4:30 PM ET

Company Participants

Sameer Desai - Senior Director, Corporate Development & IR

Thomas Edman - President and CEO

Todd Schull - EVP and CFO

Conference Call Participants

James Ricchiuti - Needham & Co.

Mike Crawford - B. Riley Securities

Matt Sheerin - Stifel

Operator

Good afternoon ladies and gentlemen. Thank you for standing by. Welcome to TTM Technologies Fourth Quarter and Fiscal 2022 Financial Results Conference Call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be open for questions. [Operator Instructions] As a reminder, this conference is being recorded to get today February 8th, 2023.

I would now like to hand the call over to Samir Desai, TTM's Vice President of Corporate Development and Investor Relations to review TTM's disclosure statement. Please go ahead, sir.

Sameer Desai

Thank you, Sherry. Before we get started. I would like to remind everyone that today's call contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements related to TTM's future business outlook.

Actual results could differ materially from these forward-looking statements due to one or more risks and uncertainties, including the factors explained in our more recent annual report on Form 10-K and other filings with the Securities and Exchange Commission.

These forward-looking statements are based on management's expectations and assumptions as of the date of this presentation. TTM does not undertake any obligation to publicly update or revise any of these statements, whether as a result of new information, future events, or other circumstances, except as required by law.

Please refer to disclosures regarding the risks that may affect TTM, which may be found in the other reports on Forms 10-K, 10-Q, 8-K, the registration statement on Form S-4, and the other company's SEC filings.

We will also discuss on this call certain non-GAAP financial measures such as adjusted EBITDA. Such measures should not be considered as a substitute for measures prepared and presented in accordance with GAAP, and we will direct you to the reconciliation of non-GAAP to GAAP measures included in the company's press release, which was filed with the SEC and is available on TTM's website at www.ttm.com. We've also posted on the website a slide deck that we'll refer to during the call.

I will now turn the call over to Tom Edman, TTM's Chief Executive Officer. Please go ahead, Tom.

Thomas Edman

Thank you, Sameer. Good afternoon and thank you for joining us for our fourth quarter and fiscal year 2022 conference call. I'll begin with a review of our business highlights from the quarter and a discussion of our fourth quarter results, followed by a summary of our business strategy. Todd Schull, our CFO will follow with an overview of our Q4 2022 financial performance and our Q1 2023 guidance. We will then open the call to your questions.

The quarter's highlights are also shown on slide three of the investor presentation posted on TTM's website. In the fourth quarter of 2022, TTM delivered solid results in a difficult business environment, while revenue softened, non-GAAP EPS was above the midpoint of guidance despite a challenging supply chain and the labor environment and the continued impact that COVID-19 is having on our business.

Demand in our Aerospace and Defense market remained strong with record bookings and backlog, offset by weaker demand and bookings in our commercial end markets. We also saw improvement in our profit margins year-on-year in Q4. I am proud of our employees for delivering solid results this quarter in a tough environment.

As we look into Q1, production inefficiencies in our Asia-Pacific facilities due to Chinese New Year, inventory adjustments, and weaker demand from some of our commercial end markets, are causing revenue and margin declines, but we will continue to see strong demand in our A&D market, which now represents 40% of our revenues.

For the full year of 2022, excluding the acquisition of Telephonics, TTM grew revenue 5.4% with improved year-on-year profitability despite the challenges I previously mentioned.

Full year cash flow from operations was \$272.9 million, enabling us to purchase Telephonics and strengthen our balance sheet, while returning capital to shareholders. In addition, we repaid \$50 million of our Term Loan B on January 3rd, 2023. I am proud of what our employees have accomplished in the face of these challenges despite one of the most difficult manufacturing environments that we have ever experienced.

I would now like to provide a strategic update. TTM is on a journey to transform our business to be less cyclical and more differentiated. Over the past several years, TTM has consistently emphasized that a key part of our strategy is to add value to the product solutions that we deliver to our customers, particularly in the Aerospace and Defense market.

In 2018, we acquired Anaren, which broadened TTM's product portfolio into highly engineered RF components and sub-assemblies, as well as adding critical RF engineering capability and resources.

In 2022, we acquired Telephonics, which builds on Anaren and TTM's customer-driven culture and disciplined approach to engineering and manufacturing. The addition of Telephonics expands TTM's Aerospace and Defense product offering vertically into higher level engineered system solutions and horizontally into the surveillance and communications market, while strengthening our position in radar systems.

As a result of these strategic moves, over 50% of A&D revenues are from engineered and integrated electronic products, with PCBs being less than 50% of the overall contribution.

An example of how this strategy is strengthening our business is our recent announcement of the multiyear agreement with Raytheon Technologies for the SPY-6 family of radars. This is an agreement to provide radiofrequency assemblies, electronic hardware, and printed circuit boards for the SPY-6 family of [Indiscernible] radars.

The agreement has the potential to reach \$500 million over five years. The SPY-6 radar will be on 40 ships of seven different classes by 2030. TTM designs and manufactures the beamforming network, along with PCBs and specialized assemblies for these radars. This type of multiyear commitment for supply allows TTM to increase value to our end customer.

Another important element of our differentiation strategy is the current construction of a new state-of-the-art highly automated PCB manufacturing facility in Penang, Malaysia. The decision to build this new factory is a direct response to our customers' increasing concerns about supply chain resiliency and regional diversity diversification. And in particular, the need for advanced multi-layer PCB sourcing options in locations outside of China.

The new facility in Malaysia will assist customers in our commercial markets, such as networking, data center computing, and medical, industrial, and instrumentation. We made great progress on the Malaysian facility this past quarter as we completed the pilings required for the building, laid the majority of the foundation, completed the power substation, and the roof.

We also received multiple deposits from customers with whom we have signed long-term agreements, which provide a business base for over 70% of the planned capacity in this new building.

Finally, I'd like to discuss today's announcement regarding the consolidation of our manufacturing footprint. After the market closed today, we issued a press release announcing that we plan to close three small manufacturing facilities in order to improve total plant utilization, operational performance, customer focus, and profitability.

PCB manufacturing operations in Anaheim and Santa Clara, California and Hong Kong will be closed and consolidated into TTM's remaining facilities. The planned closures are expected to improve both facility and talent utilization across our footprint, resulting in improved profitability.

TTM is offering customers of the affected PCB plants continued support at our remaining manufacturing sites. We plan to close the Hong Kong facility by the end of our second quarter and the two North America facilities by the end of the year in order to allow for necessary customer approvals at other facilities.

We expect the actions we are announcing today will allow us to better serve our customers with more focused operations as well as a more efficient cost structure. We will be working with our employees to transfer them into other facilities and where that is not possible to treat all of these employees with the respect that they are due for their dedication to TTM. Todd will later discuss the financial impact.

Now, I'd like to review our end markets which are referenced on page four and five of the earnings presentation on our website. The Aerospace and Defense end market represented 40% of total fourth quarter sales compared to 30% of Q4 2021 sales and 38% of sales in Q3 2022.

The majority of the year-on-year growth was due to the inclusion of Telephonics. Excluding that impact, our Q4 A&D revenues grew 3.4% year-on-year organically. We continue to experience a positive defense climate with our A&D program backlog at \$1.36 billion, including Telephonics.

Excluding Telephonics, program backlog was \$1 billion compared to \$768 million a year ago. This solid backlog was driven by a second quarter of record bookings of \$464 million, including Telephonics.

The solid demand in the defense market is a result of a positive tailwind in defense budgets, our strong strategic program alignment, and key bookings for ongoing franchise programs.

During the quarter, we saw significant bookings for key programs, including the SPY-6 radar and MH-60R program. We expect sales in Q1 from this end market to represent about 43% of our total sales.

For the full year, Aerospace and Defense revenues grew 1.2% excluding Telephonics. Our revenue growth was limited by labor, supply chain, and production challenges. In the US, we are encouraged by the continued strong support for national security, including overwhelming bipartisan support for a 10% spending increase in the fiscal year 2023 defense budget that was passed in December. In 2023, we expect end market growth to be above market projections of 3% to 5% driven by the defense side of our business.

We also recently announced that pending confirmation by the Defense Counter Intelligence and Security Agency or DCSA, the TTM Board of Directors has adopted a Special Board Resolution or SBR, replacing the Special Security Agreement, or SSA, that the company had entered into with the DCSA in 2010.

The replacement of the SSA with the SBR is a result of the significantly reduced foreign ownership of TTM. The company plans to maintain much of the robust infrastructure developed during the adoption of and compliance with the SSA to continue to serve our customers and to maintain our focus on the national security of the United States in our Aerospace and Defense sector as one of the top 40 US-based defense companies.

The medical industrial instrumentation end market contributed 17% of our total sales in the fourth quarter compared to 19% in the year ago quarter and 19% in the third quarter of 2022.

A number of our customers have been reducing inventory as well as quick turn business. In addition, the instrumentation segment is weighted toward automated test equipment for the semiconductor capital equipment market, which is seeing weaker demand.

For the first quarter, we expect MI&I to be 18% of revenues. For the full year, MI&I grew 16.7% following 11.5% growth in 2021 and 12.4% growth in 2020, well above industry forecasts three years in a row as we took advantage of mega trends and faster growing subsegments of this end market.

In 2023, we expect growth to be below the 2% to 4% industry forecast, as these segments feed moderated demand following the extraordinary strength of the past three years.

Automotive sales represented 16% of total sales during the fourth quarter of 2022 compared to 19% in the year ago quarter and 15% during the third quarter of 2022. We saw stable trends sequentially for automotive PCBs despite the combined impact of supply chain and demand disruptions caused by COVID, the Ukraine-Russia conflict, and semiconductor shortages that had been impacting automotive OEM production.

We expect our automotive business to contribute 17% of total sales in Q1, a slight decline from Q4 resulting from a reduced number of working days in Q1 due to Chinese New Year.

For the full year, automotive increased 4.2%. In 2022, advanced technology was 31% of our automotive end market compared to 24% in 2021, due to strong growth in our HDI and radar product areas.

In 2022, we won new designs with a lifetime value of \$530 million, with a record \$279 million in wins in the fourth quarter. This compares to \$532 million in 2021. Designs that we are winning this year will contribute to revenues in future years. We expect this market in 2023 to be below longer term forecasts of 6% to 8% after the strong post-COVID recovery.

Sales in the data center computing end market represented 14% of total sales in the fourth quarter compared to 15% in Q4 of 2021 and 14% in the third quarter of 2022. We expect revenues in this end market to represent approximately 12% of first quarter sales due to a slowdown in the data center market, coupled with ongoing weakness in the semiconductor market.

For the full year, data center computing grew 16.7% as we saw continued solid growth across our data center customers following 25% growth in 2021 and 9.1% growth in 2020. In 2023, we expect to be below the forecasted end market growth of 9% to 12%, driven primarily by inventory digestion in the data center market.

In regards to our networking communications end market, we have renamed it networking, given the focus on networking customers. Networking accounted for 13% of revenue during the fourth quarter of 2022. This compares to 16% in the fourth quarter of 2021 and 14% of revenue in the third quarter of 2022.

In Q1, we expect this end market to be 10% of revenue as customers manage their inventory levels and some customers see weak demand. For the full year, networking declined 4.4% with declines in telecom customers, partially offset by growth in networking customers. We expected this market to be below the longer term forecasts of 3% to 6% growth in 2023 due to the anticipated soft start to the year.

Next, I'll cover some details from the fourth quarter. This information is also available on page five of our earnings presentation. During the quarter, our Advanced Technology and Engineered Products business, which includes HDI, rigid flex, RF subsystems, and components and engineered systems, accounted for approximately 39% of our revenue. This compares to approximately 31% in the year ago quarter and 41% in Q3.

We are continuing to pursue new business opportunities and increase customer design engagement activities that will leverage our advanced technology and engineered products capabilities and can new programs and new markets.

PCB capacity utilization in Asia-Pacific was 75% in Q4 compared to 88% in the year ago quarter, and 78% in Q3. Our overall PCB capacity utilization in North America was 40% in Q4 compared to 50% in the year ago quarter and 45% in Q3.

The lower rate in Asia-Pacific was caused by a decline in production volumes, while the lower year-over-year rate in North America was due to additional plating capacity added earlier in the year and direct labor shortages in certain regions.

Our top five customers contributed 37% of total sales in the fourth quarter of 2022 compared to 33% in the third quarter of 2022. We had one customer over 10% in the quarter.

At the end of Q4, our 90-day backlog not including Telephonics, which is subject to cancellations was \$546.7 million compared to \$615 million at the end of the fourth quarter last year. Including Telephonics, our backlog at year end was \$603.1 million. Our book-to-bill ratio including Telephonics was 1.05 for the three months ended January 2nd, reflecting a stronger Aerospace and Defense book-to-bill, offset by a weaker commercial book-to-bill.

Our A&D bookings also shipped over a longer period of time compared to our commercial bookings. As we looked into Q1, we are seeing our commercial market soften. As a result, we are taking extraordinary actions, including consolidating our facilities as I already explained, setting down for the full Chinese New Year holiday season, freezing new hires except with special approvals, reducing discretionary spending, and putting travel restrictions in place.

We also continue to focus on managing supply chain bottlenecks, particularly in our A&D business, which has limited our ability to deliver on several key A&D programs and will constrain revenue in the first half of the year.

I am confident that with the effort of our employees, we will be able to overcome these challenges as we work our way through 2023. In the meantime, I wish to thank our employees for continuing to contribute to TTM and our critical mission of inspiring innovation for our customers.

Now, Todd will review our financial performance for the fourth quarter. Todd?

Todd Schull

Thanks Tom and good afternoon, everyone. I will be reviewing our financial results for the fourth quarter that were included in the press release distributed today as well as on slide seven of our earnings presentation that is posted on our website.

For the fourth quarter, net sales were \$617.2 million compared to \$598.1 million in the fourth quarter of 2021. The year-over-year increase in revenue was due to the inclusion of Telephonics as well as organic growth in our Aerospace and Defense end market, partially offset by declines in our commercial markets.

For the full year, revenues grew 5.4% excluding Telephonics, driven by our medical, industrial and instrumentation, data center computing, automotive, and A&D end markets.

For all of 2022, revenue was \$2.5 billion. This compares to \$2.2 billion in 2021. GAAP operating income for the fourth quarter of 2022 was \$97.6 million and includes a gain of \$51.8 million in December 2022 from the sale of the property occupied by our former Shanghai EMS entity. This compares to \$33.1 million in the fourth quarter of 2021.

On a GAAP basis, net income in the fourth quarter of 2022 was \$6 million or a \$0.06 per diluted share. Our fourth quarter 2022 results include a tax reserve of \$51.7 million to establish the valuation allowance for certain US deferred tax items, and \$14.7 million associated with the gain on the sale of the property noted earlier. This compares to GAAP net income of \$8.4 million or \$0.08 per diluted share in the fourth quarter of last year.

The remainder of my comments will focus on our non-GAAP financial performance. Our non-GAAP performance excludes M&A related costs, restructuring costs, certain non-cash expense items such as amortization of intangibles and stock compensation, gains on the sale of property, and other unusual or infrequent items, such as the tax valuation reserve I mentioned earlier.

We present non-GAAP financial information to enable investors to see the company through the eyes of management and to facilitate comparisons with expectations in prior periods.

Gross margin in the fourth quarter was 19.8% and compares to 16.7% in the fourth quarter of 2021. The year-on-year increase was due to the addition of Telephonics, better product mix, favorable foreign exchange, and lower material costs, partially offset by higher year-on-year labor costs, particularly in North America as we raise wages this year to be more competitive, and lower revenue in our commercial markets.

Selling and marketing expense was \$18.8 million in the fourth quarter or 3% of net sales compared to \$15.6 million or 2.6% of net sales a year ago. Fourth quarter G&A expense was \$37.4 million or 6.1% of net sales compared to \$30.4 million or 5.1% of net sales in the same quarter a year ago. The inclusion of Telephonics added \$2.5 million and \$4.1 million to sales and marketing and G&A respectively.

In the fourth quarter, R&D expense was \$6.4 million or 1% of revenues compared to \$4.8 million or 0.8% in the year ago quarter. \$1.5 million of the increase was due to the inclusion of Telephonics.

Our operating margin in Q4 was 9.7%, a solid result given the macro challenges we've been facing. This compares to 8.2% in the same quarter last year. For the full year, 2022 operating margin was 9.4% compared to 8.4% in 2021.

Interest expense was \$12 million in the fourth quarter compared to \$11.2 million in the same quarter last year. During the quarter, there was a negative \$3.2 million foreign exchange impact below the operating line.

Government incentives and interest income decreased this to \$1.9 million or a \$0.02 negative impact to our EPS. This compares to a loss of \$1.1 million or \$0.01 impact on EPS in Q4 last year.

Our effective tax rate was 6.5% in the fourth quarter, resulting in tax expense of \$2.9 million. This compares to a rate of 1.6% or tax expense of \$0.6 million in the prior year. For the full year, our effective tax rate was 13.1%.

Fourth quarter net income was \$42.7 million or \$0.41 per diluted share. This compares to fourth quarter 2021 net income of \$36.2 million or \$0.34 per diluted share. For the full year, net income was \$181.2 million or \$1.74 per diluted share compared to \$138 million or \$1.28 per diluted share in 2021.

Adjusted EBITDA for the fourth quarter was \$81.6 million or 13.2% of revenue compared with fourth quarter 2021 adjusted EBITDA of \$70.4 million or 11.8% of revenue. For the full year, adjusted EBITDA was \$343.1 million or 13.8% of revenue.

Depreciation for the quarter was \$24 million. Net capital spending for the quarter was \$20.8 million. Cash flow from operations was very strong at \$77.6 million or 12.6% of revenue, exceeding our target of 10%. Free cash flow was also very good at \$56.8 million or 9.2% of revenue.

For the full year, cash flow from operations was \$272.9 million or 10.9% of revenue. Free cash flow for the full year was \$176 million or 7.1% of revenue. Cash and cash equivalents at the end of the fourth quarter of 2022 were \$402.7 million and our net debt divided by last 12 months EBITDA was 1.5 times, at the bottom of our targeted range of 1.5 times to 2 times. Following the end of the fiscal year, we repaid \$50 million of our Term Loan B.

Before I discuss first quarter guidance, I'd like to discuss the financial impact of today's facilities consolidation announcements. The company expects to record between \$22 million and \$28 million in separation, asset impairment, and disposal costs related to this restructuring, primarily between now and the end of 2023. Approximately 80% of these costs are expected to be in the form of cash expenditures and the rest in the form of non-cash charges.

Today's actions are expected to yield an annual operating profit increase of approximately \$22 million to \$27 million, after the facilities are closed and the transferred business is fully assimilated within our remaining footprint.

Now, I'd like to turn to guidance for the first quarter. As Tom mentioned earlier, we expect a sequential decline in revenues due to weaker booking trends in our commercial end markets, resulting from inventory adjustments, weak end market demand, and the Chinese New Year holiday.

We expect a sequential decline in margins due to lower revenues, the inefficiencies associated with the Chinese New Year holiday, higher material costs, and unfavorable mix.

Given these factors, we project total revenue for the first quarter of 2023 to be in the range of \$550 million to \$590 million, a non-GAAP earnings to be in the range of \$0.16 to \$0.22 per diluted share. The EPS forecast is based on a diluted share count of approximately 104.6 million shares, which includes dilutive securities such as options and RSUs.

We expect that SG&A expense will be about 9.5% of revenue in the first quarter and R&D will be about 1.2% of revenue. We expect interest expense to total approximately \$11.9 million. Finally, we estimate our effective tax rate to be between 13% and 17%. To assist you in developing your financial models, we offer the following additional information.

During the first quarter, we expect to record amortization of intangibles of about \$11.7 million, stock-based compensation expense of about \$5.9 million, non-cash interest expense of approximately \$0.7 million dollars. And we estimate depreciation expense will be approximately \$24.5 million.

Additionally, as you're building your financial models for 2023, I'd like to call your attention to three items. First, interest rates have risen and may rise further in 2020 to our average borrowing rate on our term loan, which is a variable rate debt was 1.7% plus a margin of 250 basis points. Today, we are already incurring a rate of 4.6% plus our margin.

Second, in 2022, we realized favorable foreign exchange below the operating line of \$12.7 million. We cannot predict how the Chinese; US exchange ratio will move in 2023. Consequently, we do not forecast this item. And third, we are investing in a new plant in Penang, Malaysia, we expect to start production in the second half of the year and begin ramping towards full volume production.

During the 2023 startup phase, we expect to incur a negative impact to our margins of between 30 and 50 basis points. We estimate that approximately 75% of that impact will be weighted towards the second half of 2023.

Finally, I'd like to announce that we'll be participating in the Cowen Aerospace, Defense and Industrials Conference on February 16. The JP Morgan High Yield and Leveraged Finance Conference on March 7 and the JP Morgan Industrials Conference on March 16. That concludes our prepared remarks.

And now we'd like to open the line for questions. Sherry?

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] And today's first question will come from the line of James Ricchiuti with Needham & Co. Your line is open, sir.

James Ricchiuti

Hi. Thank you. Good afternoon. So, maybe putting aside the aerospace and defense where you have pretty good line of sight, which are the commercial markets as you look at them today, do you believe perhaps the most uncertainty attached to them and you're clearly seeing weakness in several of them?

Thomas Edman

Yes, I think -- to two areas, Jim, in terms of, areas of weakness and we saw during the course of the quarter, a pronounced weakness in data center. And so, that was that affects our computing and data center computing and market which two-thirds of that is really data center and the third is semiconductor both, both now really, really showing signs of weakness and in the case of data center, a lot of discussion around inventory control and digestion. But I think a market that that certainly in the first half I think will continue to be weak.

Networking is the second similar, similar in nature, right, I think the networking by and large by the inventory control, discussion around softening, demand environment, spending environment and a lot of discussion around the first half of the year telecom. Really, everyone holding their breath for India investment, which is coming, but it's coming slowly. And, frankly, that's a pretty small part of that networking end market for us.

So those are the two markets. From a challenging standpoint, I'd say our, our there was a softening demand. And just to finish the discussion MII, Medical Industrial Instrumentation, it's really the instrumentation side that is showing the pronounced weakness, medical and industrial relatively better, though, a lot of discussion around inventory control. But I think that shorter term in nature, automotive, continuing to really hold up pretty well.

We are taking the Chinese New Year time off in our facilities there. And so our revenues will be down in Q1. But if you do the quick calculation, and you add back that that week and a half to two weeks of production that we lose, you'd be right back on top of the Q4 numbers on automotive. So holding up pretty well.

James Ricchiuti

Got it. Follow-up question I have, as you may have -- made some reference to this in the opening remarks, but to the announcement today with respect to the manufacturing footprint, does that in any way change the investment plans? Or timing for Malaysia?

Thomas Edman

No, no, absolutely not. And we -- yes, that that really, for us. And, we look at our footprint, regularly, these small -- smaller facilities in Hong Kong, and the two facilities in California, really been struggling in terms of profitability and their plant charter. And that that's been the struggle. And as we looked into our forecasts, they also don't look much better for the long term.

So difficult actions to take but necessary, and we will continue the investment in Malaysia to our customer base is counting on this, it's a critical investment for TPM to make in terms of supply chain resiliency, automated highway account, efficient production volume production capability. So, we're moving proceeding there as scheduled and holding to our schedule at this point.

James Ricchiuti

Got it. Thank you.

Thomas Edman

Thank you.

Operator

Thank you One moment for our next question, will come from the line of Mike Crawford with B. Riley Securities. Your line is open.

Mike Crawford

Thank you, I heard from your remarks that you basically have 70% of your capacity, generally sold with customers for the Malaysia plant that's opening? Is that a case where you're hoping to run that facility at what 80% plus utilization? Or what -- where -- is that going to be the same maybe type of metrics that you had for your China facilities? Or is it going to be slightly different?

Thomas Edman

So the goal, the goal will be to run it north of that. I mean, ideally, you'd love to be in between that 80% and 90% utilization rate, but you're absolutely right, Mike. It's very similar in terms with our China facilities in terms of volume capabilities, and the need to, to leverage your manufacturing foot footprint and keep that utilization at a high level. And these will be volume requirements for these customers.

And, we'll obviously, we won't we won't hit that about 80%. Right away, we've got it, we've got a good ramp that'll carry -- begin the end of this year, and then carry us through next year to get there. But again, yes, it's a very strong backdrop for us to have those customers lined up and willing to, to sort of with their deposits to help us with as we invest in this critical capability.

Mike Crawford

Okay. Thank you. And then my second question switches to a CSO what is potential upside for, a, more ships being included onto that program, perhaps as a result of the forthcoming budget and budget requests we'll see in a few weeks? And secondly, for potential for military sales to allies?

Thomas Edman

So I can't it's always hard to speak for our customer. I would say that that. There certainly is upside there. And you're right, there's possibility of foreign military sales as well. The we have to stick to their announcement I think I think even that is a very strong base for us. And we've continue to see, of course, a number of other radar systems and programs, move to ESA that are that are really allowing us to grow strongly in that market. So not relying solely on that program, but it is a -- it's a program that has potential upside for sure.

And our focus will be on servicing the customer, making sure that that we ramp here successfully through the course of this year for our aerospace and defense market. And critical to that is that we solve supply chain bottlenecks in that market. And that's a big area of focus for us as we ramp. It's great to be to have a program backlog as strong as we have at the beginning of the year, allows our operations to really focus on getting the job done.

Mike Crawford

Great. Thank you. Thank you.

Thomas Edman

Thank you.

Operator

Thank you. [Operator Instructions] One moment for our next question. That will come from the line of Matt Sheerin with Stifel. Your line is open.

Matt Sheerin

Yes, thanks and good afternoon, everyone. Just question on the outlook for the automotive sector. Sounds like you're looking below the market growth there. And I know you're starting out down, I guess mid-teens year over year. In Q1, most of the suppliers sound more optimistic. Some are seeing a little bit of inventory, but most expect some production growth this year, and content growth. Do you expect auto to grow for the year, even though you're going to be down significantly in the first half?

Thomas Edman

So the answer is yes, the impact if you start to look sequentially, and that's probably the best way to look at this, you'll see the Chinese New Year impact. And so you can -- and that's really what this is. But last year, we ran full out Chinese New Year. We ran we were -- we -- and the interesting thing last year that was a bit different than other years is that, we had COVID out there, the government was encouraging employees to just sit -- stay in place.

So we had our full complement of labor, as well. So we ran as hard as we could in Q1. And that's the difference you're seeing is that Chinese New Year difference. Now demand environment, overall, a little bit off from where we were and Q1 last year, but not substantially. So the market is holding up well. We think it will -- it looks to hold up well through the first half. So, yes, as we go, again, difficult to predict the back half of the year, and that's mainly because there still are critical shortages out there and parts. But what we see in the first half is a good strong demand environment. And yes, we would expect to be able to grow in automotive this year.

Matt Sheerin

Okay. Thanks for that. And I know someone just asked about, the commercial markets being weak, in terms of the cloud as a computing, inventory correction you're seeing and same thing in the related semiconductor markets. Are you getting seeing signs that all of that bottoming in the next quarter or two, or will it get worse before stabilizes?

Thomas Edman

Yes, I think we're looking at -- I think the key there's a quarter or two, because I think this is really a -- the indications we have are for the first half. Now we'll see how demand that -- what shifts there in terms of demand as we go into the second half of the year. But most of the commentary we've had from customers around is related to the first half and digestion. Digestion as they put it, that is necessary in the first half. And it's due to substantial inventory buildup and bringing those inventories down before they can start to see again true levels of demand impacting the supply chain.

Matt Sheerin

Okay. Thank you. And then Todd had a couple of modeling questions. I don't remember you or you may have talked about the OpEx guidance for the quarter, did you give that number out?

Todd Schull

What I -- what we would think kind of give you in terms of insight into Q1. We're expecting SG&A expense to be about 9.5% of revenue, and then R&D to be an additional 1.2% of revenue in Q1.

Matt Sheerin

Okay, so 10.7% total. Okay. Okay. Great. And so that implies your gross margin is actually still up year-over-year. Is that primarily due to the mix with the acquisition? Or I know you're difficult, obviously, a tough year had some issues, I know in Q1 of last year, I was just trying to figure out, given the big revenue decline, how margins can actually be up?

Todd Schull

Well, okay, so that's good discussion. I think, when we're looking at Q1 and comparing that to Q1 last year, okay, year-over-year. Revenue was only down slightly, but there's a big mix shift, right, we added Telephonics. So when we look at year-over-year Q1 a year ago at the midpoint of guidance, our revenues are down about \$11 million. But aerospace and defense is up almost \$75 million. If you take all the guide that's given. So that implies the commercial markets are down substantially...

Matt Sheerin

Is down about 20%, yes.

Todd Schull

Right. But when you look at the margin impact, okay, so you have some mix shifting, we added Telephonics, we lose commercial PCB business, they have different economic profiles. The PCB business at that kind of volume is pretty lucrative and Telephonics is we brought that on there. We're working with synergies to improve their profit profile, but it's not yet quite dollar-for-dollar exchange in terms of profitability.

We're also going to see year-over-year some pricing challenges, but we've got some favorable effects up in our cost structure. Exchange rates are -- that the Chinese currency is a little weaker in this quarter we're seeing compared to a year ago, and so that gives us a little bit of tailwind.

So kind of works off better mix, a little FX help. And that's offsetting some of the challenges that you see in our annual kind of pricing and less premium revenue this year compared to last year. And it all kind of breaks either right margins stay relatively consistent, maybe up slightly. But even though there's a big mix, there's a lot going on underneath the covers.

Matt Sheerin

Got it. Okay, very helpful. Thank you.

Operator

Thank you. And speakers, I'm showing no further questions in the queue at this time. I would now like to turn the call back over to Mr. Todd -- Tom Edman for any closing remarks.

Thomas Edman

Thank you. Yes, I just like to close by summarizing some of the points that I made earlier. First, we delivered non-GAAP EPS above the midpoint of guidance, and saw good year-over-year improvement on margins. Second, we announced the consolidation of our manufacturing footprint to streamline our operations to better serve our customers and lower our cost structure.

And third, we generated strong cash flow, resulting in a net leverage of 1.5 times at the low end of our target range of 1.5 to 2 times. And forth, really despite weakness in our in our commercial markets, we are seeing very strong demand in our aerospace and defense market.

In closing, I'd like to thank our employees, our customers and our investors for your continued support, as we navigate the challenges to our business. We'll continue our long-term strategic focus on diversification, differentiation and discipline. With that, I'd like to thank you again. Goodbye, everyone.

Operator

Thank you all for participating. This concludes today's program. You may now disconnect.

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