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Twin Disc, Incorporated

Fourth Quarter 2015 Fiscal Results Conference Call

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CORPORATE PARTICIPANTS

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Jeffrey Knutson, *Vice President, Finance, Chief Financial Officer, Treasurer, Corporate Controller, Secretary*

CONFERENCE CALL PARTICIPANTS

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PRESENTATION

Operator:

Good day and welcome to the Twin Disc, Incorporated Fourth Quarter Fiscal 2015 Financial Results Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Stan Berger of SM Berger. Please go ahead, sir.

Stanley Berger:

Thank you, Angela On behalf of the Management of Twin Disc, we are extremely pleased that you have taken the time to participate in our call, and thank you for joining us to discuss the Company's fiscal 2015 fourth quarter and full year financial results and business outlook. Before I introduce Management, I would like to remind everyone that certain statements made during the course of this conference call, especially those that state Management's intentions, hopes, beliefs, expectations or predictions for the future, are forward-looking statements. It is important to remember that the Company's actual results could differ materially from those projected in such forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in the Company's Annual Report on Form 10-K, copies of which may be obtained by contacting either the Company or the SEC.

By now you should have received a copy of the news release, which was issued this morning before the market opened. If you have not received a copy, please call Annette Mianecki at (262) 638-4000, and she will send a copy to you.

Hosting the call today are John Batten, Twin Disc's Chief Executive Officer, President, and Chief Operating Officer; and Jeff Knutson, the Company's Vice President of Finance, Chief Financial Officer, Treasurer, Corporate Controller, and Secretary.

At this time, I will turn the call over to John. John?

John Batten:

Thank you, Stan, and good morning, everyone. Welcome to our Fiscal 2015 Fourth Quarter Conference Call. As usual, we will begin with a short summary statement, and then Jeff and I will be happy to take your questions.

Looking at our fourth quarter results, sales for the 2015 fourth quarter were $67.3 million versus $73.6 million a year ago; down about 8%. The general conditions in our geographic markets remain unchanged from the third quarter. However, with the exception of the land-based transmission markets, all other sectors saw improved shipment levels from the third quarter, most notably in marine. Customers moving up shipments in advance of our July and August shutdowns can explain part of this increase, and I will cover that in more detail later in the call.

When we look at our broad product end markets, the growth that we saw in North America was not enough to offset lower levels of activity in Asia, nor the 6% negative impact of foreign currency translation. Our fourth quarter sales into our industrial markets improved by about 3%, with slightly higher shipments in North America. This is versus the third quarter. Most of our North American market sectors, including oil and gas, irrigation, recycling, and construction, were relatively stable versus the third quarter, but when compared to the previous year, shipments were down about 8%.

Sales into our transmission markets declined versus fiscal 2014 fourth quarter levels by about 23%; again, driven by the relatively strong shipments into our North American oil and gas markets at the end of fiscal 2014. Compared to the third quarter, our transmission shipments were down about 16%, reflecting the slowdown in oil and gas shipments into North American and continued weakness in the Chinese market. The one bright spot in the overall product markets was our marine product sales, which were up over 20% versus the third quarter and posted its highest mark in eight quarters. While sales improved in all geographic regions, part of this increase can be explained by the timing of our plant shutdowns. All of our European plants, which range from 50% marine products to 100%, take at least a two week shutdown in our first fiscal quarter. Some take three weeks plus, depending upon market conditions. This year, due to the low demand from the oil and gas sector, our largest plant based here in Wisconsin took a five week shutdown in July. Many of our customers moved planned shipments up from July and August and requested them in June. This partially explains both the bump in sequential sales versus the third quarter and the larger than expected falloff in backlog, which I'll cover again later in the call.

Gross margins for the quarter were 29% compared to 29.2% a year ago, and 31.2% the previous quarter. A good mix of product, which included a lot of aftermarket, helped offset the decline in oil and gas unit shipments.

Fourth quarter spending in marketing, engineering, and administrative, or ME&A expenses, decreased by $1.7 million versus the same period last fiscal year from $17.8 million or 24.2% of sales, to $16.2 million, or 24% of sales. The reduction year-over-year, despite the $1.1 million bonus accrual, reflected one-time items such as—one-time items related to professional services, a cash surrender value of a life insurance policy, reduced bad debt expense, lower pension expense, currency translation, and, of course, cost containment efforts.

Looking at the bottom line, the fiscal 2015 fourth quarter net earnings were $437,000 or $0.04 per diluted share versus $2.3 or $0.21 per share a year ago. The fiscal 2014 fourth quarter earnings include a pre-tax $3.3 million charge for restructuring at our North American operations, and, again, I'll have more detail later in the call. For the full fiscal year, net earnings were $11.2 million, or $0.99 per diluted share versus $3.6 million, or $0.32 per diluted share a year ago, and this is on a slight revenue increase for fiscal 2015.

EBITDA for the fourth quarter was $2.6 million compared to $6.5 million a year ago. For fiscal 2015, EBITDA finished at $26.5 million compared to $19.5 million a year ago.

Looking at the balance sheet, we ended fiscal 2015 with a total debt of $13.8 million and cash of $22.9 million for a net cash position of just over $9 million. We reduced inventory 18% from the end of fiscal 2014 to June 30, 2015, and 12% in the quarter alone, from $97.6 million at the end of fiscal 2014 to $80 million at the end of the quarter and the fiscal year.

Our six month backlog decreased from $47.8 million to $34.4 million. Products with oil and gas exposure continued to drive the decrease in backlog. The rapid decline in the price of oil in the first calendar quarter had a significant impact on net new orders for land-based and marine transmission systems that are used in the industry. As I mentioned earlier, because of the lengthy shut down here in North America, we did see positive pressure on revenue in the fourth quarter offset by negative pressure on the backlog going forward, as those shipments were not yet replaced by new orders.

Certainly the six month backlog is not a perfect indicator of the full upcoming fiscal year, but it is an indicator that the first half of fiscal 2016 will be challenging. Knowing that oil and gas may not come back for several quarters, we decided in the quarter that it was imperative that we lower our cost structure. As was mentioned in the press release, we took a $3.3 million charge that reflected actions taken at our domestic manufacturing operations to reduce headcount by almost 20%. Three-quarters of this reduction came through a voluntary separation program or early retirement, and one-quarter through involuntary actions. These actions were not taken lightly, and I'm most pleased that our employees understand the necessity of doing this, even after coming off a very good fiscal year. The annualized savings of these actions will be close to $6 million, and are split between ME&A and cost of goods sold.

As many of you can imagine, the fourth quarter was both professionally and personally taxing for many of us at Twin Disc. As all of the planning of these actions was in process and we continued to push our corporate development activities, our Chairman and Former CEO, Mike Batten, passed away unexpectedly. Jeff Knutson and I were actually on a West Coast road show when it happened, and my last conversation with him was discussing all of the investors that we met. He truly enjoyed speaking with all of you and getting your perspective on our business and the markets in general.

We have had—we've been operating the entire fiscal year without a VP of Operations, and half the year with Jeff filling both the CFO and Controller roles. I am pleased to say that we are now fully staffed. Jeff is our permanent Chief Financial Officer, and his new Controller started today. Mac Moore, the former CEO of Gehl and a former Twin Disc Board member, has agreed to resign from our Board and take the role of Executive Vice President of Operations. His extensive experience in acquisitions and global operations is a perfect fit for what we need right now. David Rayburn, our current Board member and former CEO of Modine Manufacturing here in Racine, was elected our new Chairman. Filling Mac's vacancy on the Board is Janet Giesselman, who was the former President of Dow's oil and gas division. I am extremely excited about our new lineup of Management and Board members. We are invigorated and motivated to grow our business during these interesting and trying times.

Finally, I would like to thank those of you who sent incredibly kind messages to me and the Management Team after my father's death. We truly appreciated it.

That concludes my prepared remarks, and now Jeff and I will be happy to take your questions. Angela, could you please open the line for questions.

Operator:

Thank you. If you would like to ask a question, please signal by pressing star, one, on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one, to ask a question.

We will take our first question from Josh Chan with Baird.

John Batten:

Hey, Josh. Are you there?

Operator:

Hello, Mr. Chan, if you could please check your mute function.

Josh Chan:

I'm sorry. Yes, sincere condolences to you, John. It was enjoyable working with you and Mike, for sure.

So jumping into the questions, you talked about there was some shifting of backlog from the marine orders that were shipped in the fourth quarter. Is there a way to kind of quantify how much demand you think shifted from Q1 to Q4?

John Batten:

I would say—yes, Josh, it would probably be somewhere in the $3 million to $4 million range.

Josh Chan:

Okay, so—yes, so it meaningfully affected the numbers but it wasn't a dramatic amount, I guess?

John Batten:

Yes. I would say—I mean just with the—and that was, Josh, and for everyone, that $3 plus million was primarily in North America, so there would be no currency translation. Jeff, the currency translation on the—in just the fourth quarter?

Jeffrey Knutson:

On the backlog?

John Batten:

Yes.

Jeffrey Knutson:

(Inaudible) flat.

John Batten:

Yes, yes. Okay, so really that—so that would've been the big impact, because we had just the jump here at—in the plant here in Racine after we announced the shutdown of the—you know, trying to get stuff before July.

Josh Chan:

Okay, okay, that makes…

John Batten:

They—by and large they were not replaced by new orders to replace that, so...

Josh Chan:

Right, okay. If you can kind of take a look into fiscal '16 and just kind of looking at your major end markets, maybe could you comment on kind of which markets you're seeing relative strength and stability and which markets are more worrisome?

John Batten:

Sure. I would say anything related to oil and gas is worrisome, and that's not just obviously pressure pumping, but we still have orders that we've shipped and planned orders for crew boats, the fast supply vessels, you know, both here in North America and in Asia; not as strong as a year ago, but they're still there. What's relatively stronger are anything that—pushboat activity; we call it brown water on the river system. You know, that's been relatively stronger in North America, and we have some pushboat activity in Asia, but those are kind of the—what I would say the strength.

Overall, our industrial products, the clutches and PTOs, have not seen that downward pressure that the marine oil and gas and land-based oil and gas have seen, so that is a positive. Then, of course, the aftermarket business in general for us for all of the businesses has stayed pretty stable, and that continues at a pretty good level. So—and then just quickly touching on ARF (phon) has remained fairly stable. But it continues to be the oil and gas exposure, not just land-based but kind of uncertainty in where the marine is going to go.

Josh Chan:

Okay, okay. That makes sense. So in oil and gas, I think some quarters this year it was up and then other quarters were down, so how did oil and gas revenue finish fiscal '15 kind of compared to what it was a year ago?

John Batten:

By and large up about 15%. I would say in the 15% range it was up, but we saw that—remember, fiscal '14 ended strong in oil and gas, and fiscal '15—fiscal '14 ended strong in oil and gas; fiscal '15 ended up again strong in oil and gas. So it was tough—the comparisons in oil and gas at the beginning of the year were great; we were a lot better than ‘ 14. But the comparisons—that increase shrunk during the second half of the year.

Josh Chan:

Yes, that makes sense. Is there a maintenance level of oil and gas that we should think about even if new cap ex orders are weak?

John Batten:

Yes, I…

Josh Chan:

Are we sort of at this level?

John Batten:

You know, I don't know how to answer that right now. We have customers that are doing maintenance. We also have customers that are probably, you know, going to be buying some fleets at auction. I don't know of any that are selling. So it is—it's very uneven, and we have some customers that are looking at, you know, buying new units to replace older units or competitors' units. So it is a very strange time.

Last time that we had this downdraft, everyone kind of just sat on their inventory and kept it, thinking they were going to use it. By and large they consumed a lot of their available inventory going up to last year, kind of last—you know, a year ago April. Now this downward pressure has certainly caused a lot more stress in the operators, and so some are looking to sell fleets. So I think there's going to be some opportunistic buys of fleets, but I just—I still, Josh, my sense both hearing from customers and our guys out in the field that our rigs are getting used, and I see that in the aftermarket, so I'm more optimistic that we will continue to do well on spare parts for our 8500 and 7500, just based on what I hear of what's getting used in the field. So it's hard for me to quantify right now because, you know, the last three to four months have just been–I can't give you a trend in the orders, but my overall sense is that when it balances out it's going to be okay in the spare parts area.

Josh Chan:

Okay. Thank you for all the color and best of luck for next year.

John Batten:

Thanks, Josh.

Operator:

We will now go to Walter Liptak with Global Hunter.

John Batten:

Hey, Walt.

Walter Liptak:

Hi. Thanks, guys. Yes, our condolences as well. Wanted just to follow-on to that last question. You know, I think what we saw is, you know, with oil prices picking up in the last couple of months that there was some hope that, you know, the rig counts had bottomed and that there might be some, you know, some more work out in the field. You know, so I was wondering if during the quarter if you saw any, you know, signs of hope with oil prices having picked up, and then with oil prices having come down in the last month, if that's kind of reduced the near-term outlook?

John Batten:

I would say that yes, it did. I mean, certainly discussions of, you know, buying a spread of whether it was 8 or 16, because, you know, in the last couple months when the oil was rebounding, those conversations and discussions with customers started to happen, and, you know, when could you deliver if we ordered? So we still could deliver in the first quarter if someone would place an order for units; probably even, you know, 8 to 16. We probably could do—I don't want to speak for manufacturing, but it would be more than 16 but less than 32, say.

So I think—I don't sense that the one—those projects have been affected by this blip down. I think there was some sound economical financial reasons for them to be looking at that. If this continues on and we start drifting and drifting and drifting, maybe those projects drift sideways, but I am hopeful that we're going to get, you know, new unit orders to replace older ones. Like I said, all of the—it's unbalanced where the inventory is. Some are doing much better with their excess inventory versus others. Tough question to ask, but, you know, I'm not totally doom and gloom, Walt, at all on that. I think there's definitely some opportunities; you just have to stay close to the customers.

Walter Liptak:

Okay, all right. Sounds good. So, you know, given the—where the backlog is in this tough environment, you know, the 20% cut to employment, the restructuring charge, you know, I wonder how you came about sizing it to that level and how we should think about the savings in terms of overall profitability for the next year. You know, if we get the savings in the next year, can you—you know, is there like a level of breakeven or profitability that you're shooting for?

John Batten:

Well, we certainly—you know, we didn't—what's the right—the best way to answer this. The level that we went to was based on what we saw kind of in the next three to six months, but at a level that if the market came back in, you know, not just oil and gas but it started to improve, we could react quickly. So it was a balancing point, and we erred probably going a little bit leaner than the conditions would indicate. So it wasn't an easy calculation. I don't think—certainly, what you're going to see in the first quarter, the first quarter will be by far our most challenging quarter on the top line, followed by the second quarter, and that's just really, Walt, an indication of the backlog. But this—we are much closer to breakeven in the first quarter than we would've been in certainly the second quarter. So I don't know really how to calculate the best breakeven, but it brought it down significantly, Walt; significantly.

Walter Liptak:

Okay, good. Okay, thank you.

Operator:

As a reminder, ladies and gentlemen, if you'd like to ask a question, please press star, one, at this time.

We'll take our next question from Steve McManus with Sidoti & Company, LLC.

Stephen McManus:

Hey, guys. Thanks for taking my questions, and, John, my condolences for your loss.

John Batten:

Thanks. Thank you.

Stephen McManus:

So when you mention, you know, the end market diversification, are there any new particular target areas or, you know, areas of focus that you guys are trying to capitalize on to offset the weakness?

John Batten:

Steve, I didn't hear the first part when you said the end markets—oh, diversification.

Stephen McManus:

Yes, initiatives for, you know…

John Batten:

Okay. Certainly our biggest push on product development and releases going into this fiscal year and our sales guys are on the industrial markets. So finding opportunities for our clutches, whether it's dry clutch, you know, hand-actuated or dry clutch, remote-actuated, or the hydraulic clutches, the HPTOs, finding new applications in just the very broad industrial markets, developing some OEMs, some new types of applications, whether they're blast hole drills or things in construction, we are—it's a big push to get into those markets, because we feel that there are opportunity there. We can take some customers away from some other technologies or some other of our competitors. So really that's where we're putting our push on, because there's not a whole lot we can do to change or move the needle on oil and gas, the pressure pumping right now. We certainly can stay close to the customers that don't have much inventory and are looking to replace our transmission or a competitors' transmission, but those are really the opportunities that we see, and that's globally, whether North America, Europe, or in Asia and South America. So that is where a lot of our push is, and, of course, also corporate development activities; looking in that area as well.

Stephen McManus:

Okay, and then, you know, with respect to the geographic mix, any target areas there or, you know, shifts with respect to, you know, mix abroad?

John Batten:

Yes, it's—we're certainly remaining very cautious on Asia, and China in particular, but there's still some business there. I think a lot of times we forget and everyone forgets that a lot of the ships that are built in Southeast Asia, whether there's—we sell them through our office in China or Singapore, are for international customers, whether they're going to the Mid-East, India, Europe or North America, so there's still a base business there. So we're—you know, it's hand-to-hand combat every day to get those orders and those sales, but by and large we do think that there are growth initiatives in industrial with our products in Asia. But certainly the focus where we think that we can have an effect on fiscal '16 are going to be North America and Europe for our industrial products.

Stephen McManus:

Okay. Then, you know, just looking at this year there was a bit of an uptick in cap ex and projected for next year another increase. Can you just give us a bit of an idea of what, you know, the capital spending is being directed at?

John Batten:

Sure. We've—it's been a mix of some new machine tools here in North America, a piece of equipment in Belgium, but then we also had to do a little bit of PP&E maintenance. We've been blessed with a flat roof in the Midwest, so that is an ongoing issue here in Racine, but we also had to tend to our facility in Belgium with some cap ex there on basically heating and office—just maintenance of the building in general. It was kind of, I would say, the uptick versus last year in Singapore, and we had to move into a bigger facility—well had to—we chose to move into a bigger facility in Singapore because the products that we were selling were getting bigger, so there was some cap ex involved in outfitting that new facility. But I—those were—I would say there might be some drift into some of the expenses in the first quarter, but certainly seeing the conditions going into '16, you know, we will control cap ex spending according to cash flow and debt.

Stephen McManus:

Okay. Then last one for me, just getting back to the cost savings from the headcount reductions, is that going to be relatively evenly ratable across '16, or is it going to take a couple quarters before those savings really start to materialize?

John Batten:

Yes, the first quarter you won't—a lot of the people worked into the first quarter at least a month, so the first quarter won't be the true run rate. You'll have to see the second and the third quarter to get, you know, the true run rate of savings.

Stephen McManus:

Okay, great. Thanks a lot, guys. I appreciate it and best of luck.

John Batten:

Okay, thank you.

Operator:

It appears that there are no other questions at this time. I would now like to turn the conference back over to today's presenters for any additional or closing remarks.

John Batten:

Thank you, Angela, and thank you for joining our conference call today. We appreciate your continuing interest in Twin Disc and hope that we have answered all of your questions. If not, please feel free to call Jeff or myself. We look forward to speaking with you again in October following the close of our fiscal 2016 first quarter. Angela, I'll now turn the call back to you.

Operator:

Ladies and gentlemen, this does conclude today's conference. We thank you for your participation. You may now disconnect.