Twin Disc, Inc.
Third Quarter Fiscal 2012 Financial Results Conference Call
April 24, 2012

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Twin Disc, Inc. Third Quarter Fiscal 2012 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. If you have a question, please press the star, followed by the one on your touchtone phone. Please press star, zero for Operator assistance at any time. For participants using speaker equipment, it may be necessary to pick up the handset before making your selection.

I would now like to turn the conference over to Stan Berger of SM Berger. Please go ahead.

Stan Berger: Thank you, Tideo (ph). On behalf of the management at 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 2012 third quarter and nine-month 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 (ph) at 262-638-4000 and she will send a copy to you.

Hosting the call today are Michael Batten, Twin Disc Chairman and Chief Executive Officer; John Batten, President and Chief Operating Officer; and Chris Eperjesy, the Company's Vice President of Finance, Chief Financial Officer and Treasurer. At this time, I will turn the call over to Mike Batten. Mike?

Michael Batten: Thank you, Stan, and good day, everyone, and welcome to our third quarter fiscal 2012 conference call. I will begin with a brief statement, and then John, Chris and I will be ready to take your questions.

Twin Disc had another solid quarter, with year-over-year net earnings up over 100%, and on a 25% increase in revenues, we are on track to have another record year. Looking at our results, sales for the third fiscal quarter of 2012 improved to $95 million from 76 million for the same three months a year ago. Strong demand from our oil and gas markets, along with stable or increased demand from our other end markets, including land-based industrial and transmission and marine-based military and commercial sectors, contributed to the improved performance. Pleasure craft activity remains at depressed levels. Year-to-date sales were 260 million compared to 213 million for the first nine months of fiscal 2011.

Gross margin for the 2012 third quarter was 34.6% compared to 36.3% a year ago and a 35.6% last quarter. The differences in gross margins were created by a change in the mix of sales. Year-to-date gross margin was 36% compared to 33.6% for the same period last year.

Marketing, administrative—engineering and administrative expenses as a percentage of sales were 18.6% compared to 22.3% for the same three months last year. Stock-based compensation decreased 1.4 million in the quarter, reflecting the decline in our share price. Year-to-date ME&A expenses were 20.7% compared to 23.7% for the first nine months of fiscal 2011. Stock-based compensation expense decreased by 1.3 million for the period. Movements in foreign exchange rates increased ME&A expenses by 900,000 compared to the first nine months of fiscal 2011.

Net earnings attributed to Twin Disc for the third fiscal quarter of 2012 were 9.4 million or $0.81 per diluted share compared to 4.5 million or $0.40 per diluted share for the same three months a year ago. Year-to-date net earnings were 24.8 million or $2.15 per diluted share compared to 11.2 million or $0.98 per diluted share for the equivalent period in fiscal 2011.

EBITDA was 18 million for the first—third fiscal quarter of fiscal 2012 compared to 13 million for the comparable period last year. Year-to-date EBITDA was 48 million compared to 27 million a year ago.

The 2012 third fiscal quarter was one of the best overall quarters in the Company's history. It was the best third quarter ever. Our success was driven by robust demand for our oil and gas products, and with the exception of the pleasure craft market, shipments across all of our end markets increased during the quarter. High oil prices and the resurgence of drilling in the Gulf Coast have led to increases in commercial marine activity. The demand from airport, rescue and firefighting and legacy military customers remains steady. There has also been a pickup in demand from our industrial customers.

Our six-month backlog at March 30th, 2012, was 131 million compared to 148 million at the end of the second fiscal quarter and $140 million a year ago. The sequential and year-over-year declines reflect moderating future demand from North American oil and gas customers, as well as continuing improvement in our past due order reduction, which decreased 26% from the prior quarter end and 20% since the start of this fiscal year. We remain optimistic about the long-term potential for the oil and gas market, but over the last two months, we have experienced a decline in orders from these historically high levels that we had been experiencing in fiscal 2012. Our oil and gas customers have responded to the decline in natural gas prices by slowing orders for capital expenditures related to hydraulic fracturing and pressure pumping due to the effects of the mild winter and a slower than expected U.S. economy, which has led to an oversupply of natural gas.

With one quarter remaining in fiscal 2012, we are confident we will achieve many financial and operating milestones for the year. As we look to fiscal ’13, we expect it will be another good year but down from the record levels we have experienced in fiscal 2012. While changes in the oil and gas landscape have caused our near-term outlook to be cautious, Twin Disc has never been in a stronger position. We continue to improve our product portfolios, strengthen our relationships with our customers and vendors and strategic partners. We remain optimistic about our long-term potential.

That concludes my prepared remarks, and now John, Chris and I will be happy to take your questions. Tideo, would you please open the line?

Operator: Thank you, sir. We will now begin the question and answer session. As a reminder, if you have a question, please press the star, followed by the one on your touchtone phone. If you would like to withdraw your question, press the star, followed by the two; and if you are using speaker equipment, please lift the handset before making your selection.

Our first question is from the line of Peter Lisnic with Robert W. Baird. Please go ahead.

Peter Lisnic: Morning, gentlemen.

Michael Batten: Morning, Pete.

John Batten: Morning, Pete.

Chris Eperjesy: Morning, Pete.

Peter Lisnic: I guess first question, just to kind of close the loop on the fiscal ’13 comments that you made, in terms of it not being another record year or I guess being down from ’12, can you give us a little bit more color on kind of exactly what that means? Does that mean revenue down or EPS down or just kind of how you’re thinking about preliminarily 2013 would be helpful?

John Batten: Well, Pete, it’s John. We’re pretty optimistic about most of our markets being stable or up going into next year. The one caveat is the North American pressure pumping market. It has been such a big component of our growth in ’11 and ’12 and we see that market moderating right now and into ’13; so it’d be pretty hard for us to have an increase on a record year without that market being pretty strong for our next fiscal year, and we’re going to see a little bit of a pause in the North American pressure pumping market.

Peter Lisnic: Okay, when you say a little bit of a pause, down, I guess, would be the way to read that for ’13.

John Batten: Correct.

Peter Lisnic: Yes.

John Batten: Correct.

Peter Lisnic: Okay.

John Batten: For North America. Yes, (cross talking).

Peter Lisnic: Any…

John Batten: Sorry, go ahead, Pete.

Peter Lisnic: I was going to say, I know it’s going to be hard to guess, but is there any order of magnitude that you can kind of give us given what you—you know, what your customers are telling you and what you might know about what sort of inventory’s out in the marketplace now?

John Batten: We’re not getting, I guess, that level of detail about how much there—how much of an oversupply they have. We remain optimistic. I know the international markets for us are doing very well for pressure pumping, so I think we may see a shift in some of the existing fleet or the idle fleet to markets like China and to some places in South America or Australia, so that, hopefully, will speed up, you know, any activity for new equipment in North America. As gas prices start to come—go up, supply comes down and it returns, but right now, I just—if we look at fiscal ’13 without the strong build schedule that we’ve had the last two years, it’s going to be hard for us to improve upon this year.

Peter Lisnic: Okay. All right, that's fair on that. And then the—I'm wondering if you can give us some updated commentary on the progress with EJS and CAT, just where that stands? Have you started to (cross talking) on that, and then, you know, kind of what the—at what point do you really start to fill inventory there would be helpful?

John Batten: Okay. They are working through the initial applications with their dealers and we have orders, existing orders at all of our factories that supply components, and those have started to ship. Be a pretty small impact, maybe this quarter and next quarter, but I see it begins—towards the end of the calendar year, it'll start to have a bigger impact. But the forecast that we're getting from, you know, the market from CAT and from CAT dealers and their customers is very encouraging.

Peter Lisnic: Okay, and that is factored in, into the thought that next year is, you know, down I guess from fiscal '12, correct?

John Batten: Correct, just—yes.

Peter Lisnic: Okay. Okay, that is helpful. I will jump back in queue. Thank you.

John Batten: Thanks.

Operator: Thank you. Our next question is from the line of John Braatz with Kansas City Capital. Please go ahead.

John Braatz: Good morning, gentlemen.

Male Speaker: Hi, John.

John Batten: Morning, John.

John Braatz: A couple of questions, sort of along the lines of the prior question. Your business is tailing off a little bit in the fracking area but how much is that being mitigated maybe by what you're seeing overseas in your international business and maybe the fact that you have both the 8500 and 7500 series now? How much of a mitigating factor is—do you think those two items have been?

John Batten: Well – John, it's John here – the international component is going to be a big mitigator. We said at the last call that the backlog for overseas was at about 25%.

John Braatz: Mm-hmm.

John Batten: The percentage of the backlog for overseas is bigger than that now, so that's what gives—that's a big change from this pause in the North American market versus last time. I mean, that—the backlog for China specifically was very low in the last downturn in oil and gas.

John Braatz: Mm-hmm.

John Batten: Much higher now so we're very optimistic there, and as well as some other countries. So—and then with the 7500, still not nearly as strong in the sales as the 8500 but there is opportunity there. Unfortunately in North America, we've been hit—when everything goes into a pause, everything goes into a pause, so…

John Braatz: Okay.

John Batten: That is a smaller, I guess, mitigating factor than the overseas component right now.

John Braatz: Okay. When you talk to your customers, do they have any thoughts on what price natural gas needs to return to, to unpause activity, so to speak?

John Batten: Yes, I've asked the question. The—more of the overriding factor in North America right now is just the sheer oversupply of gas.

John Braatz: Okay.

John Batten: They're running out of places to put it, so until we work through the oversupply of the gas, which I think as we do, the prices will start to come back up…

John Braatz: Mm-hmm.

John Batten: There'll be more activity in fracking, but right now, I think the single biggest factor is just the sheer amount of the gas.

John Braatz: Okay. Okay, all right. And with things slowing down a little bit, can you talk a little bit about maybe sort of a disinvestment that you need to make in your working capital? And—because I think I just read where—I think I saw where you had invested $41 million in working capital this year, but as things begin to slow down, we should return some of that to cash, should we not?

John Batten: Absolutely, and you'll see the inventory start to—as—at the end—when we have the call at the end of next quarter, certainly. But we're going to be very smart about the invested capital as it relates to oil and gas and the 8500 and the 7500.

John Braatz: Mm-hmm.

John Batten: As we saw the last time, when it comes back, it comes back quickly.

John Braatz: Right.

John Batten: But we will obviously turn some of that into cash, but we want to be ready for the return of the market too.

John Braatz: So, would that—are you suggesting that, as cash begins to build, that it would be unlikely for you to return that necessarily to shareholders in the form of a dividend or a share repurchase or anything like that?

Michael Batten: John, this is Mike. I think, on that score, we continue to be active on an acquisition front and there could be a use for that cash that's return from working capital in that area. So, in terms of the special dividend, probably not a special dividend, per se…

John Braatz: Yes, (cross talking).

Michael Batten: So our long-term policy is to increase the dividend consistent with our earnings, cash flow and outlook. With respect to cap ex, we will see some moderation of cap ex going forward but still at reasonably high levels.

John Braatz: Mm-hmm. Okay. All right, thank you very much.

Michael Batten: You're welcome, John.

Operator: Thank you. Our next question is from the line of Joe Giamichael with Global Hunter Securities. Please go ahead.

Joe Giamichael: Thank you for taking my question. In regard to backlog, you talked about the impact from past due backlog, which is not something I saw in your previous Qs or Ks but might have been something you discussed on previous calls. Could you just explain how you define past due backlog, what the dollar value of it is and whether or not that value had been included in your quarterly discussions of backlog levels?

John Batten: Joe, it's John here. We discussed it at the last call and I believe—I mean, the last quarter and then I believe the quarter previous to that. We had—just some background. We had some supplier issues in the summer of last calendar year that caused our past due backlog to rise to historically high levels. We continued to work through the first two quarters of the year, the first three quarters now, to reduce that amount significantly and it was primarily in our industrial business and our transmission business, getting the 8500s out to customers that were waiting for them. The 20—we were talking about the past due backlog. It was a—it's always reported in our backlog, whether in the—in the six-month backlog, and it is defined—the past due is defined for us as when a customer—when we accept the orders of the customer, what our published lead times are or what the agreed upon lead time is at the customer. So we were past due and made significant progress in the first six months of the year and then again, really in the third quarter, made a big dent into it. So, that was a significant component of the backlog coming down. But as we said in the press release, the other—the major component of that was just the tail-off in backlog in the last two months on oil and gas.

Joe Giamichael: Got it, thank you. That's very helpful. The way that you present your segment contribution makes it somewhat difficult to quantify the impact from frac rig demand slowing. Could you give us a little more color on the revenue contribution in the quarter or the backlog contribution—composition from an end market perspective of sort of an energy versus a more broadly defined vessel market?

Chris Eperjesy: Yes, Joe, this is Chris. As you know from prior conversations, that's not something we really give out, that level of detail by those different end markets.

Joe Giamichael: Okay. Okay, that's all the questions I've got. Thank you.

Michael Batten: Thank you.

Operator: Thank you. Our next question is from the line of Andrea Sharkey with Gabelli & Company. Please go ahead.

Andrea Sharkey: Hi, good morning.

Michael Batten: Hello, Andrea.

John Batten: Hello, Andrea.

Andrea Sharkey: I was wondering if you could give us any sense of—you know, you've done the Express Joystick and you have the agreement with Caterpillar, you've introduced the 7500 and, you know, I guess just because of the slowdown in the frac market, maybe not getting as much traction there as initially anticipated, but there—are there any new products or new things that you guys are looking into or working on maybe in, you know, different end markets or, I guess, you know, what else are you looking at doing?

Michael Batten: Andrea, this is Mike, and you're right, we have introduced the 7500 and the EJS, and in both cases, we look forward in the coming year and beyond to accelerating performance from those products. Obviously, the 7500 may be a little slower in coming because of, as you pointed out, the issue in the North American gas market. In the pleasure craft market, obviously we have a low performance level in pleasure craft, however, the EJS is expected to take share and the kinds of applications and where we're making our headway is just precisely that. We're taking share of market in a down market, and we fully expect that this will be very helpful when the pleasure craft begins to turn back up.

With respect to other products that we're looking at, we are but at this point, we're not prepared to discuss them publicly as to what products and what markets we'll be going into. But we do have significant programs underway to develop organic growth in the business, as well as acquisitive growth that we spoke to in another question earlier. So, while we would like to be responsive, specifically at this point, we can't, Andrea, but rest assured, we have got other pipelines underway bringing new product to market.

Andrea Sharkey: Okay, that's helpful and (inaudible) look forward to hearing about your new products. So—and then I guess the next question, in terms of, you know, margin impact, I know—I think you've spoken in the past about how, you know, the oil and gas end market transitions tend to be a little bit higher margin, so as that kind of tails off, I would expect to see, you know, maybe some margin decline. Maybe you can help us—walk us through, you know, what you see happening there, you know, combination of mix shift and then also maybe, you know, just overhead issues as you maybe are producing less of the frac transmissions?

Michael Batten: Again, it's Mike, Andrea, and the response to that question is we will not be specific to what we expect them to, our gross margins, but given the decline in oil and gas, we do expect to see some moderation in our gross margin, probably not down to 2008, '09 levels that one saw when the oil and gas market went totally away. We do expect that we will maintain a certain level of activity in oil and gas and that will help, from a mix point of view, keep our gross margins up, but nevertheless, the absence of volume will affect us. On the other side, management team has been working hard at improving margins in other areas to try and get much more in the way of margin expansion in our products, and we have been active through the year in looking and executing on cost reduction, especially in our fixed expenses as it relates to our European operations.

Andrea Sharkey: Okay, that's really helpful, thank you. And then one last question from me and then I'll turn it back. Any thought given or to maybe doing share repurchases?

Michael Batten: Andrea, again Mike. We have an active authorization from the Board, and we deliberate on that subject periodically. We won't rule them out and it will be a question of do we have a lot of excess cash to use. If we are not in a situation where we have an acquisition or a capital expenditure plan, I don't see us, as I mentioned earlier, doing a special dividend. I don't—all the counsel that I've received over the years is that the market really doesn't reward for special dividends; so I think, yes, it's an option that's on the table that is looked at and it could be something that we could do in terms of a share repurchase.

Andrea Sharkey: Okay. Thanks a lot.

Michael Batten: You're welcome.

John Batten: Thanks, Andrea.

Operator: Thank you. Our next question is from the line of Greg Garner with Singular Research. Please go ahead.

Greg Garner: Thank you for taking my question. Good morning, gentlemen.

Michael Batten: Good morning.

John Batten: Morning, Greg.

Greg Garner: A couple of items. On the backlog, is there any contribution from the 7500? Can you give us any kind of detail, is it ramping up a little bit or a level of interest there or maybe there's more interest from international versus domestic? Can you give us some flavor?

John Batten: Yes, Greg, it's John. There is—the 7500 does have, as far as it's one product, a very good representation in our backlog, but it was not immune to kind of the oil and gas effect, the North American oil and gas effect of the last two months. Having said that, we do have opportunities overseas for the 7500, just like the 8500. It's a little bit more work for us because we're going—you know, each application is a new one and we have repeat applications in China for the 8500, so it's a little bit more investment for us and time and people to bring those applications online, but we do have applications overseas for the 7500.

Greg Garner: So, safe to say that, without the 7500, the backlog would be weaker?

John Batten: Correct. Without the 7500, the existing backlog would be weaker.

Greg Garner: Okay. And do you still see the 7500 really fulfills a unique niche, a need there that competitive transmissions or even the 8500 can't meet due to the size and (inaudible) still see getting that response?

John Batten: Yes. The market still sees the need for the 7500 as a competitive product to the existing players, absolutely.

Greg Garner: Okay. And regarding the backlog, I'll (inaudible) one last question there. I know you've talked about how it's changing, but is there any sense can you provide on what the oil and gas business is declining, like 20%, is it declining more like 30, 40%? It seems like it's probably more in that 15 to 25% range. Is that about right, or…

John Batten: I would say, Greg, hard to answer specifically. It depends upon the timeline. I would say, yes, looking forward into next year, that's probably correct, but there could be quarters here and there where the impact is different. But this is, again, a very different situation than three or four years ago, when the shock was driven by something other than the dynamics in the oil and gas market, so I don't see it being as dramatic as it was, you know, back in 2008, 2009.

Greg Garner: Are you seeing more interest overseas? I mean, they don't have the natural gas pricing issues that we have here in the States, and so it seems as if that market may improve (ph).

John Batten: Absolutely. The offshore market—I mean, offshore—not offshore oil but the—China, the international markets are going to improve for us in the next 12 months, no question about it.

Greg Garner: And are you seeing that your percentage revenue from offshore, as you describe it, in the oil and gas is going to be greater than in the next year or two?

John Batten: Yes.

Greg Garner: (Cross talking).

John Batten: Correct. Absolutely. Our percentage of sales and backlog for international markets is going to increase in the next 12 months.

Greg Garner: And…

Michael Batten: As well as in real terms.

John Batten: In real terms, yes, in real terms, not just percentage.

Greg Garner: Okay. And I presume that it wasn't that great of a contributor, the international market, for the oil and gas prior to the 7500 being introduced. Is that correct?

John Batten: Well, it was—I would say—if we go back to the last ramp up in 2006, '07 and '08, the international markets were hardly a component at all. They are a significant component now, primarily driven as the rest of the markets as of late with the 8500 but the 7500 is going to be a player in that market as well.

Greg Garner: Okay. All right, well, that helps give me flavor on that. The pleasure craft market, in the prior quarters, you mentioned how there's been an—it has been improving and I'm not seeing that in your characterization of it for this third quarter. Is there some—is it becoming—is it getting a little flatter now? And I thought that might—because I had thought it might continue to improve in anticipation of, you know, the summer season.

John Batten: It's a tough one. Overall, I would say the market, the pleasure craft market bounces around and some regions do better than others. In the last year or so, Australia has been a little bit better than North America and Europe. The Italian yards continue to struggle. There's optimism, a little bit in Australia and North America. Having said that, our percentage of—I mean, we are gaining market share in the pleasure craft market. We are doing—our sales in the pleasure craft with the EJS components and our transmissions continues to increase at very small levels, but the market is so depressed that it's not having a big impact yet. I remain optimistic that once CAT and their 360 product comes on full stream, that will have, you know, a bigger impact in our overall shipment into the market.

Greg Garner: And the timing for that?

John Batten: Probably starting the second half of this calendar year, you know, the first couple of quarters of fiscal '13.

Greg Garner: Okay, that's why you say towards the end of the calendar (cross talking).

John Batten: Correct.

Greg Garner: When you think (cross talking).

Michael Batten: Yes.

Greg Garner: Okay. Great. And given the—as I remember, first of all, cap ex was increasing to double the production capacity for the oil and gas and 8500 and the 7500 in the past year or two, and does that mean you're going to scale back on some of that production capacity in (cross talking).

John Batten: Well, the same machines that we were adding to double our oil and gas capacity also work to increase our capacity for commercial marine transmissions, and we're seeing a very big ramp up in demand for those, so the same assets are going to be used for our commercial marine product.

Greg Garner: Okay. And is there anything meaningful in the backlog beyond six months at this point? I know (inaudible).

John Batten: Sorry, Greg, you tapered out a little bit. I didn't hear the last part of your question.

Greg Garner: Well, you've always focused on the backlog for six months. I'm just wondering, is there anything that you can see beyond six months that has some meaningful value in the backlog?

Michael Batten: It's typically—Greg, this is Mike. It's typically transmission, a longer lead time product that is out beyond six months, so—and some marine, so our industrial products tend to have shorter lead times and certain marine products have shorter lead times. So, the segment you're looking at beyond six months is definitely filled with transmission product, so that would be oil and gas, it would be ARFF vehicles, airport, rescue and firefighting vehicles and the like. So, there what we have reported with respect to oil and gas in the six-month backlog is consistent out in the—beyond six months, okay? That's your question, is there a similar decline in backlog out beyond six months? And the answer is, yes.

Greg Garner: Okay. All right, well thank you very much.

Michael Batten: Yes.

John Batten: Thanks, Greg.

Operator: Thank you. Ladies and gentlemen, if there are any additional questions, please press the star, followed by the one. As a reminder, if you are using speaker equipment, please lift the handset before making your selection.

Our next question is from the line of Shawn Boyd with Westcliff Capital Management. Please go ahead.

Shawn Boyd: Morning, gentlemen. How are you doing?

John Batten: Hi, Shawn.

Chris Eperjesy: Hi, Shawn.

Michael Batten: Fine, thank you.

Shawn Boyd: Just a couple here. Stock-based comp I know was down, I believe you said almost 1.4 million. Does that get it below about 500,000 for the quarter? What's the absolute level in the quarter?

Chris Eperjesy: It was actually, I guess you could call it income of about—just under 400,000.

Shawn Boyd: Okay, great. And going on—back to the past due backlog, so we've got a pretty good drop now quarter-to-quarter, two quarters in a row so it would really help us just to understand a little bit more on that. So, if we look at the backlog down, let's call it $33 million since September '11 quarter, you know, over the two-quarter period, just roughly how much of that is a past due backlog?

Chris Eperjesy: From the 165 to the 131?

Shawn Boyd: Yes.

Chris Eperjesy: It's probably a third.

Shawn Boyd: Okay, and so two thirds is the drop in oil and gas?

Chris Eperjesy: Is other stuff because there'd be—there's—yes, it would be other stuff, but it would include oil—oil and gas would be a big component of it, correct.

Shawn Boyd: Okay, that's helpful. And would you say that past due backlog is kind of normalized at this point? Are you at a level that—you know, I would assume people are getting—you know, lead times are probably down now (cross talking).

John Batten: Yes, we're…

Shawn Boyd: Getting what they need.

John Batten: We're about at normalized levels, correct.

Shawn Boyd: Okay. And on the gross margin impact, with oil and gas—a mix shift away from oil and gas as we go forward here a little bit, and I know it's just a pause, but you know, running 35% gross margins, we've had a—we've had quite a fluctuation. The '08/'09 lows were 27, 28%. Here we are at 35. We expect them to moderate but, you know, would you—I would assume we're probably talking several percentage points, you know, even if we just go to halfway back to the lows. Is that the way to think about it, or is that more just, no, it's, you know, 50 to 100 bips again like the last quarter?

Michael Batten: I admire your analysis – this is Mike – and I don't think we're going to be in a position to quantify what you would like to hear us quantify, but I—we're going to see some moderation. A lot depends upon what happens in our mix, so it's not something that we have an awful lot of control over ourselves. So, I'm sorry to put it this way but we're going to have to wait and see as to what happens with our gross margins. We're doing everything we can possible do to expand other margins and to get them up to levels that we would like to continue at or even beyond, but at this point, for us to try and make a prediction for your model, that's difficult for us to do.

Shawn Boyd: And—fair enough. I appreciate that. And maybe just one other thought, and this could be just directional only. When we think about gross margin within oil and gas, would—I would think that we are probably—is the gross margin on new business booked now lower than two quarters ago? Maybe that's the question I'm trying to ask.

Michael Batten: I (cross talking).

Shawn Boyd: (Cross talking) within oil and gas, so take—you know, forgetting about mix shift for a second.

John Batten: Could you repeat the question again? I don't—I'm not sure that we caught the question in its entirety.

Shawn Boyd: If we get away from the mix shift issue and we think about just within oil and gas…

John Batten: Mm-hmm.

Shawn Boyd: Gross margin on new business you're booking today, is that at a lower margin than what we were seeing a couple of quarters ago (cross talking).

Michael Batten: No.

Shawn Boyd: Okay.

Michael Batten: No.

John Batten: No.

Shawn Boyd: So that stays fairly constant.

John Batten: Yes.

Michael Batten: Yes, right.

Shawn Boyd: Okay.

Michael Batten: We don't see—just so we understand the question, we don't see a modulating price structure on our transmission equipment. It's a constant, more or less constant margin, but it doesn't fluctuate with the demand cycle.

Shawn Boyd: Got it. So the issue is really, are they booking orders or not?

John Batten: Correct.

Michael Batten: That's right.

Shawn Boyd: Okay, great. And just last thing, in terms of capacity utilization, we haven't talked about that in a little while and we—we're off peak a couple of quarters now, so what's going on there? Are you—just, can you give us roughly what your percentage capacity utilization is now? Are you still increasing shifts, decreasing? How does that—just give us anything you can in terms of color on where you stand on your manufacturing.

John Batten: Sure, I would say—and it's—we're going to go by a facility but I'm not going to drag you through all that, but just—you know, we are still shifting at extremely high levels so the capacity that we've added with our Meccino (ph) centers to increase oil and gas, which is going to play into commercial marine, we are still operating, primarily here in Racine, at very high levels. You know, we're still three shifts six days a week and we see that continuing because of the demand of commercial marine. At some point, you know, if the oil and gas continues at depressed levels for North America, we have flexibility. We have temps so we can modulate, you know, our cost structure depending upon the demand, but we're still at, in North America, very high capacity utilization, lower in Europe. The European markets are not nearly as strong as North America so we have capacity there. And we still have additional capacity opportunity in Racine but it's going to be based more on outsourcing and working with our partners here in the Midwest.

Shawn Boyd: Okay. Okay, very good. Thank you so much.

John Batten: Thanks, Shawn.

Michael Batten: You're welcome.

Operator: Thank you. Our next question is a follow-up from the line of Joe Giamichael with Global Hunter Securities. Please go ahead.

Joe, your line is open.

Joe Giamichael: Sorry about that. Could you just share with us how you view leverage? You talked about using the cash, the anticipated cash flows to reduce debt but sort of, you know, given cost of capital, is there an ability to use the cash flow or use additional leverage to augment shareholder value around these prices?

Michael Batten: Joe, we're a Midwestern company that's more or less averse to a great deal of leverage, primarily because we're in a cyclical business. We think that we use leverage well. We're not opposed to using financial leverage, but we don't see us leveraging ourselves up with a lot of bank debt and then going into a downturn—you put it, whether it's a 2008, '09 kind of downturn or whether it's a 1983 kind of downturn. The fact that we're 93 years old attests to the fact that we use leverage when we feel it's important to use it, and then, in certain instances, we will cut back on it. So, I don't know if that answers your question, but we use it but we are not—we're not going to go overboard on it.

Joe Giamichael: No, that's great, thank you. I just wanted a better sense of sort of how you view it, so that was a good answer. Thank you.

Michael Batten: Yes, okay.

Operator: Thank you. And our next question is also a follow-up from the line of John Braatz with Kansas City Capital. Please go ahead.

John Braatz: Thanks. We talk quite a bit about the oil and gas market but usually it centers around gas. How much exposure does—do you have to the oil markets?

John Batten: Well, the—in the—the frac rigs, including our transmissions, can be used in dry gas, wet gas and pure oil but the sliding scale is it's much more intensive, you need more horsepower for dry gas and shale, a little bit less in wet gas and not nearly as much in oil, so that's what's happening. The rigs are being redeployed to wet gas and then into oil, but you just need less horsepower, therefore, fewer rigs, so…

John Braatz: Okay.

John Batten: That's where—like, you know, that's kind of been the shift in most of the fleets.

John Braatz: Okay. Any mix that you—proportions that you can give us in terms of where your transmissions are going?

John Batten: I would—it differ—each company is different, each operator, but if I had to guess, I think most of the 3000 horsepower rigs are probably still in wet gas, where they're drilling for oil and there's a natural gas component or vice versa.

John Braatz: Yes.

John Batten: But the problem is, is that even in wet gas right now, the gender (ph), you know, there's no place to put the gas.

John Braatz: Yes, right.

John Batten: So, that's why we're thinking that, you know, some of these fleets—some of the rigs could be headed offshore.

John Braatz: Okay.

John Batten: To other markets.

John Braatz: Okay, all right. Going back to cash flow, what would you, at this point maybe, think about your cap ex plans for next year?

Michael Batten: We're actually in the process of putting together our business plans and so they haven't been finalized, but we're looking at basically a cap ex program down slightly from where we were this past year.

John Braatz: Okay, and this year is—what are we at, going to be at this year?

Chris Eperjesy: We said we were going to be in the 15 to 20 million range (ph). We'll probably be closer to the 15.

John Braatz: Okay. All right, thank you very much.

Michael Batten: Okay.

John Batten: Thanks.

Operator: Thank you. Our next question is a follow-up from the line of Shawn Boyd with Westcliff Capital Management. Please go ahead.

Shawn Boyd: Hi, just one more and it's kind of following off that last call—or that last question. Not just cap ex but overall operating expenses, if we come in—we're probably going to be fairly flat for this fiscal year, in the low 70s, 73, 72 million for the year. I know it's real early here but just a preliminary look out on fiscal 2013 directionally, would you expect to be bringing those down a little or increasing for further growth?

Chris Eperjesy: I'm not sure—the number you're quoting here, are you talking about our ME&A?

Shawn Boyd: I am, exactly.

Chris Eperjesy: With the caveat that, of course, there's the stock-based comp component that's always in there, certainly there could be some opportunity for it to come down just given overall incentive comp next year, but I wouldn't expect a significant change.

Shawn Boyd: Okay. Okay, thank you.

Michael Batten: Yes.

Operator: Thank you. And I'm showing no additional questions. Please continue with any closing remarks.

Michael Batten: Fine, Tideo, thank you. Thank you again, everyone, 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 you have any follow-on questions, please feel free to call Chris or John or me. We look forward to speaking with you again in August, following the close of our fiscal year and fourth quarter. Thank you, Tideo.

Operator: Thank you. And, ladies and gentlemen, that does conclude our conference for today. Thank you for your participation. You may now disconnect.