Twin Disc Incorporated

Fiscal Third Quarter Investor Call

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CORPORATE PARTICIPANTS

Stan Berger, *Investor Relations*

John Batten, President *& Chief Executive Officer*

Jeff Knutson, *Vice President of Finance, Chief Financial Officer, Treasurer & Secretary*

CONFERENCE CALL PARTICIPANTS

Josh Chan, *Robert W. Baird*

Walter Liptak, *Seaport Global Securities*

PRESENTATION

Operator:

Good day, everyone, and welcome to the Twin Disc Incorporated Fiscal Third Quarter 2016 Investor Conference Call. Today's conference is being recorded.

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

Stan Berger:

Thank you, Dana. On behalf of the Management at Twin Disc, we're 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 2016 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 are 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 President and Chief Executive Officer; and Jeff Knutson, the Company's Vice President of Finance, Chief Financial Officer, Treasurer and Secretary.

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

John Batten:

Thank you, Stan, and good morning, everyone. Welcome to our fiscal 2016 third 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 third quarter results. Sales for the 2016 fiscal third quarter were $41.4 million versus $60.9 million a year ago, a decrease of about 32%. Year-to-date sales were $123.6 million which were 38% lower than $198.5 million in fiscal 2015. Cap ex had a negative impact on sales of about $1 million and $7.8 million on the quarter and year-to-date numbers, respectively.

Looking at our product end-markets, there were no significant improvements in the Marine, Transmission or Industrial sectors. Aftermarket and service continue be the drivers as owner-operators continue to delay purchases of new capital goods. During the quarter, there were no new unit shipments into the oil and gas markets; nor were there any new orders. We did have service work done on units in the field and are happy to report that those units have achieved 16,000 hours before their first overhaul. Compared to the prior fiscal year, our transmission products continue to have the worst comparables because of oil and gas, followed by marine and then industrial.

When looking at our sales geographically, Asia continues to be the hardest hit when comparing to prior year. All markets are down significantly due to the economic slowdown in China and we do not see this improving until the later stages of this calendar year. We have started to see some uptick in the construction numbers and while this is not necessarily a bellwether sign for all of their markets, it is a good start.

In North America, the markets are in relatively better shape, with the exception of those closely tied to energy and we are the most optimistic about improving trends here in our industrial markets.

Our European markets have fared the best when compared to fiscal 2015. Obviously, little exposure to oil and gas helps, but the traditional Marine and Industrial market sectors have been a lot more stable from year to year. I would note, though, that these markets in general did not see the recovery from 2009 to 2015 that we have experienced in Asia and North America.

Gross margins for the quarter were 23.2%, compared to 31.2% a year ago and 25.9% the previous quarter. Mix and volume continues to be two big factors. As we focused on inventory reduction and production only after firm orders, our lot sizes decreased significantly which had a negative impact on the number of setups that we were doing.

The net effect was to drive efficiency and gross margins down, but to improve inventory and cash flow. Third quarter spending in marketing, engineering and administrative or ME&A expenses decreased by $1.6 million versus the same period last year from $15.6 million to $14 million and by $4.2 million compared with the first nine months of fiscal 2016 to fiscal 2015. Headcount reductions, reduced bonus expense and continued cost reduction efforts were partially offset by pension increases, legal fees with respect to the new banking agreement and some other corporate development spending. Looking at the bottom line, we reported a loss of $963,000 or $0.09 per diluted share, compared to $2.9 million in earnings or $0.26 per diluted share, in the third quarter of fiscal 2015.

Our third quarter earnings benefited from a favorable impact of $2.4 million in cash repatriation and we will comment on that a little later in the call. Year-to-date net earnings are a loss of $7.6 million or $0.68 per share, versus $10.7 million a year ago. Looking at our balance sheet, we continue to focus on actions that will keep it as healthy as possible through this cycle. In the quarter, we reduced inventory by another $3.7 million and this brings the total reduction from the 2015 fiscal year-end to $10.7 million or 13.8%. During the quarter, we were able to repatriate $9.7 million of cash from our European operations in a tax-effective manner, generating a $2.4 million tax benefit. This allowed us to reduce debt by 32% or $5.6 million in the quarter.

Adjusting for the one-time tax benefit of the cash repatriation, our tax rate was 34.3% and 36% for the quarter and year to date March 25, 2016. While free cash flow remains negative at $1.5 million, it has improved significantly from the negative $4.7 million quarterly run rate to the second fiscal quarter. We continue to focus on achieving positive free cash flow through operational improvements, capital conservation and working capital optimization.

Our six-month backlog increased from $34.6 million at the end of the second quarter to $39.9 million and is now about $4.5 million higher than it was at the end of fiscal 2015. About $1 million of this increase can be attributed to one-off suppliers that we experienced with one of our larger foundries.

Most of the increase in activity in our backlog came in the aftermarket and industrial areas. While the slight increase in backlog is cause for some optimism, we still remain very cautious about a recovery in Asia in our energy markets. During the quarter, we finalized our new $40 million revolving credit agreement with the Bank of Montreal and we feel that this will give us the flexibility not only to weather this cycle but to help us address both growth opportunities and our current global cost structure.

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

Operator:

Thank you. If you would like to signal for a question, please press star, one on your touchtone phone. Please make sure your mute function is turned off to allow your signal to reach our equipment. Again, that's star one for any questions.

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

Josh Chan:

Hi, good morning, John and Jeff.

John Batten:

Morning Josh.

Jeff Knutson:

Hi, Josh.

Josh Chan:

Hi. It was good to see the backlog number going up. But John, you still seem to be not as optimistic. Could you just go through the different end-markets and kind of describe what has changed from your perspective over the last few months, if anything?

John Batten:

The only thing that is unfortunately I don't have—nothing has really changed in energy other than we are getting some calls about rebuilds in oil and gas on some of the transmissions. So I see some of that activity going on. I see some of the existing frac fleets out there being purchased and consolidated. So that is also a good sign, but not much has changed, really, on the order board. So, those are all signs that you have to see before the order board starts to increase but we haven't seen that there. But we have seen good activity on aftermarket parts, Industrial which are shorter lead time items. They are not the longer lead time ones. So it's optimistic and, again primarily North America-driven in the increase in backlog.

So that just points more to the strength of the markets here domestically than internationally. So, really with respect to at the end of last quarter, I think it is still going to be tougher a few quarters on the Transmission and Marine Transmission units that are going into the oil and gas markets.

Josh Chan:

All right, that makes sense. Do you think this is near the bottom of the industrial and/or Marine order rates or are you not as sure about that quite yet?

John Batten:

Not as sure. It would be hard for them to get lower, and I think a lot of the backlog on boats that were intended for, you know, oil and gas fast supplier—I think a lot of the fluff in the schedules at shipyards around the world has been shaken out now. I do believe we're at or very close to the bottom and that we should see growth in the second half of the year, maybe closer towards the end of the calendar year.

Josh Chan:

Okay, okay. You mentioned a little bit about the oil and gas side, about some of the consolidation of inventory, and what are you seeing in terms of overall demand and maintenance related revenue right now?

John Batten:

Well, it's good and bad that we see our units coming in with 16,000 hours for the first overhaul. It's great to see that they are living that long, but there is still a lot of surface work to be done. So, what we're seeing is that the frac fleets are beginning to consolidate, and I think there are people waiting for the next up cycle. So, I'm confident that our units are going to be used significantly when that uptick comes and be purchased new. So, I'm very confident in our position in this market. It is just trying to time when it's going to come back is very hard, and when our units are not necessarily being used in shale gas, they're being used in oil and wet gas, they are lasting a lot longer, and so that rebuild activity is taking longer and longer to get to us.

Josh Chan:

Yes, that makes sense. Do you anticipate there being kind of an inventory bubble that needs to be resolved in the upcoming cycle before you see any new orders? Or how do you expect that to turn around?

John Batten:

Depends how quickly the up cycle comes. If it comes quickly, it's probably quicker to build some new rigs than try to figure out the service work on what you have. So it's going to be different by each operator, but what we have seen is you get a blip in a lot of spare parts ordering and then units follow soon after that. So when you start to see a big increase in aftermarket parts to rebuild the existing fleet, that is soon followed by new orders for units.

Josh Chan:

Okay. Is there a trigger price in terms of oil that your customers look at before being serious about discussions on new orders?

John Batten:

Well, I read everything that you read and I have no crystal ball. Theoretically, the price keeps coming down, and a lot of that can be that people are buying some assets for a fraction of what they cost. So the operational cost is down, but I still think the number needs to start with a five and probably be in the high 50s or 60s before you see a fundamental change. So, we're still quite a ways off Josh, I think, on the price. But I would also look at inventory, the number of wells, number of the rig count because at some point we're headed into the summer, and if there is not a steady supply of oil, that could drive the spike quicker than we thought.

Josh Chan:

Okay, and lastly, you mentioned in your prepared remarks about addressing the global cost structure. Is there any initiative that you have planned in the horizon to kind of improve the gross margin without a potential oil and gas recovery over the next year?

John Batten:

Yes, typically, we have done restructuring actions in the fourth quarter. This year, to be honest, has been different because the Team here has spent a considerable amount of time getting this new banking agreement in place. So what we have typically done in the fourth quarter may not be the fourth quarter. It may be sometime soon after that, but to answer your question, the answer is yes. We're planning additional levers. If the volume levels were to stay the same, we cannot maintain this cost structure.

Josh Chan:

Great. Best of luck in the coming months. Thanks for your time.

John Batten:

All right. Thanks, Josh.

Operator:

Once again if you'd like to ask a question. Please press star, one.

We will go next to Walter Liptak with Seaport Global.

Walter Liptak:

Hi, good morning, guys.

John Batten:

Good morning, Walt.

Jeff Knutson:

Hi, Walt.

Walter Liptak:

I wanted to go back to the backlog question, and you called out that there were delays related to a supplier or some kind of supply problem. So the question is how much revenue shifts from this quarter into next quarter, and was the backlog up primarily because of that supply issue?

John Batten:

No, it was part of it. It was about a million of it. So, there really is a true uptick in the backlog. It was a foundry supplier, and it took the better part of most of the third quarter to get the patterns and tooling to other suppliers so we could get into production. I would expect most of that volume will go in the fourth quarter. There may be an exception or two, but most will ship this quarter.

Walter Liptak:

Okay. All right. Good. You talked about the gross margin and the change in lot sizes and that having an impact on the gross margin. So I guess I'm wondering do we continue or do you continue with these smaller lot sizes, so should we think about a lower gross margin, you know, short-term until we see some of your end-markets come back a little bit more?

John Batten:

Yes, I would anticipate that. Typically, it's not a rocket science on how you do it. If we're running batches and we're going to put, say, a Marine Transmission and we have some in the third quarter and some are in the fourth quarter. They're a couple months out, a few months out. We will try to optimize the efficiency on the machine and run everything and then have the other items just sit and wait a few months. We're not doing that right now because we're focused on cash, and so we're really running the machines just to produce what is on order that month or that quarter. So, this is not a forever thing. But right now, as we're focusing on cash in the balance sheet, it just makes sense as we try to get inventory out and really focus on just-in-time.

Walter Liptak:

Okay, and is that the primary factor impacting the gross margin or is it also—you talked about price a little bit. I'm sure volume going through the plants is a little bit lower, too.

John Batten:

It's primarily—I would say the biggest factor—the change from the prior two quarters really is running the lower lot sizes, volume and mix. We do have a lot of cost that's coming out. So, as volume even starts to come back a little bit, I think you'll see a better rebound on gross margin as the volume starts to come back.

Walter Liptak:

Okay, and I wanted to ask about the normalized tax rate. I think you talked about Adjusted at 34%. Is that what we should use, I guess, as a go-forward tax rate?

Jeff Knutson:

Walt, I would use 35.5%, 36%, something like that. The quarter even without the $2.4 million had some smaller one-off benefit, provision return type of benefit. So I think a go-forward at, like 35%—between 35% and 36% makes sense.

Walter Liptak:

Okay. Great and you called out pension costs and BMO credit agreement fees. Were those material? Can you size those for us?

Jeff Knutson:

The pension, I think, was around $0.5 million year-over-year in the quarter and the BMO fees, well not really BMO fees, the fees in the quarter related to the amendment that we did at the beginning of our third quarter—the amendment to the Wells Fargo-Prudential agreement that was about $200,000 to $250,000 in the quarter. So that does not include the fees related to the BMO agreement which we just completed, will be a fourth quarter item.

Walter Liptak:

Okay. Do you have an idea—those will run through the P&L, I imagine.

Jeff Knutson:

Yes.

Walter Liptak:

Do you have an idea of what the BMO fees are going to be?

Jeff Knutson:

Well, I would say that just based upon the level of work that we did on the two, it will probably be a little bit more than the $250,000.

Walter Liptak:

Okay, fair enough and the pension, does this recur, the higher pension costs or was that just a one quarter…

Jeff Knutson:

No. That's a recurring item quarter-to-quarter, it's really based upon the actuarial valuation done last year, and it carries through the year.

Walter Liptak:

Okay. Okay got it. Thank you, guys.

Operator:

Gentlemen we have no further questions. As one final reminder, I'd like to tell everybody, it is star, one if you'd like to ask a question.

John Batten:

Okay, Dana.

Operator:

Yes, sir. We have no further questions in the queue.

John Batten:

All right. Thank you, Dana. 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 July following the close of our fiscal 2016 fourth quarter. Dana, now I will turn the call back to you.

Operator:

Thank you, sir. That does conclude today's conference. Thank you everybody for your participation.