Twin Disc, Inc.
Second Quarter Fiscal 2012 Financial Results Conference Call
January 23, 2012

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Twin Disc, Inc. Second Quarter Fiscal 2012 Financial Results conference call. During today's presentation, all participants will be in a listen-only mode. Following the presentation, the conference will be open for questions. If you do have a question, please press star, one on your touchtone telephone. If you're using speaker equipment today, please lift the handset before making your selection. This conference is being recorded today, Monday, January 23rd, 2012.

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

Stan Berger: Thank you, Vince (ph). 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 2012 second quarter and first half 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 forward-looking statements as 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 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. Welcome to our second quarter fiscal 2012 conference call. I will begin with a brief summary statement, and then John, Chris and I will be ready to take your

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questions. As you have already seen from our press release, Twin Disc had another solid three months, with second quarter earnings up 45% year-over-year on a 10% improvement in sales. Our backlog remains strong and we expect fiscal 2012 to be another good year for the Company.

Looking at the results for the quarter, net sales increased to 83 million from 75 million for the same period a year ago. Our oil and gas markets continued to be the main driver of demand; however, stable to slightly increased sales continued to—in a majority of our other markets, including our aftermarket, industrial, our airport rescue and fire fighting market, land and marine-based military, commercial marine and pleasure craft markets. Year-to-date sales were 164 million compared to 137 million for the first half of fiscal 2011.

Gross margin for the fiscal 2012 second quarter was 35.6% compared to 31.6% in the same quarter last year. The significant year-over-year improvement resulted from higher sales, improved manufacturing efficiencies and absorption and a more profitable mix of business. On a sequential basis, gross margin was down from an all-time fiscal high of 2012 first quarter performance of 37.8% due to an anticipated shift in the business mix. Year-to-date, gross margin was 36.7% compared to 32.1% for the first half from fiscal 2011.

Our ME&A expenses as a percentage of sales were 24.2% for the current second quarter compared to 24.8% for the same period a year ago. ME&A expenses increased 1.5 million versus the same period last year, with 1.2 million of the increase due to stock-based compensation associated with the rise of the Company's stock price during the second quarter. Year-to-date, ME&A expense as a percentage of sales was 21.9% compared to 24.5% for the first half of last fiscal year. Stock-based compensation for the first half of the current year increased $100,000 compared to the same period last year. Year-to-date movements in foreign exchange rates increased ME&A expenses by 1 million for the first half compared to a year ago, and the net remaining increase of 1.5 million was primarily related to increased R&D activities and higher salary and wages.

Net earnings attributed to Twin Disc for the second quarter were 5.9 million or $0.51 per diluted share compared to 4 million or $0.35 per diluted share for the fiscal 2011 second quarter. Year-to-date, net earnings were 15.4 million or $1.34 per diluted share compared to 6.7 million or $0.59 per diluted share for the first half of fiscal 2011. EBITDA for the current second quarter was 12.3 million compared to 7.3 million for the same period last year. EBITDA for the current first half was 30.1 million compared to 14.3 million a year ago.

We continue to see strong demand for our products, which is reflected in our fiscal second—2012 second quarter results. While profitability in the second quarter was down from an exceptionally strong first

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quarter, the second quarter results represents the strongest second quarter in sales, gross margin and net income the Company has ever achieved. Our results continue to be driven by outstanding demand for our 8500 Series of oil and gas transmission systems, and we are pleased that, after thorough field testing and product refinement, our orders for the 7500 Series transmissions have grown in our six-month backlog.

Our six-month backlog at December 30th of 2011 were 149 million compared to 165 million at September 30th, 2011, and 147 million at the end of June 2011. While our backlog is down from the record high level in the first quarter, this is not an indication of slowing demand across our businesses. Our two main manufacturing operations made a considerable reduction in our past due backlog during the quarter, and we are optimistic that we will continue to demonstrate solid year-over-year financial and operating growth as we enter the seasonally strong second half of our fiscal year. With two quarters remaining, we anticipate that fiscal 2012 will be another good year.

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

Operator: Thank you, sir. Ladies and gentlemen, we will now begin the question and answer session. As a reminder, if you'd like to ask a question at this time, please press star, one on your touchtone telephone. If you'd like to withdraw that question at any time, please press star, two; and if you're using speaker equipment today, please lift the handset before making your selection.

Our first question's from the line of Pete Lisnic with Robert W. Baird. Please go ahead.

Pete Lisnic: Good afternoon, gentlemen.

Michael Batten: Hello, Pete.

Pete Lisnic: I guess first question, if we could just explore backlog a little bit more, down sequentially. Can you give us maybe some of the moving parts? It sounds like you clearly focused on getting some of the extended backlog out, but I'm just wondering if you can give us some end market color, oil and gas, marine, some of the other end markets and what backlog was like?

Michael Batten: John, do you want to handle that?

John Batten: Sure. I guess, some of the past due backlog as we were making up, primarily out of the Racine and Belgian (ph) operations were in the industrial and marine markets. And I can say that the second quarter as far as order intake improved month-over-month, so October was the weakest,

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December was by far the strongest and improved across the board in all of our markets, including transmission and oil and gas. So, you know, as far as the backlog, we knew it would be coming down as we worked through some of the past due and it did improve through—within the quarter.

Pete Lisnic: Okay, but it's—I'm sorry. Order has actually accelerated through the quarter across end markets, correct?

Michael Batten: Yes.

John Batten: Correct.

Pete Lisnic: Okay. And if you bifurcated the oil and gas piece into 7500 and (inaudible) 7500 is, can you give us a little color on what the (inaudible) were, one versus the other?

John Batten: I would—well, the orders were stronger for the 8500. It was a much bigger market. But I—you know, there were some good orders for the 7500.

Pete Lisnic: Okay. And then just in the context, I guess, of what we're hearing out of some of the bigger oil service guys, you know, like we did today, maybe potentially flat North American rig count, how do you square sort of that order strength that you're seeing in the oil and gas business relative to the outlooks that we're getting from, you know, from the Haliburtons or the Schlumbergers of the world?

John Batten: I would say that, you know, we are still seeing a pretty stable demand for the next 12 months, but it is not as feverishly crazy as it has been the past 18 to 24 months. Like, I think we've done a pretty good job and we got some good feedback from our customers. Their lead times now, we've been able to bring them back down slightly and the demand is more stable. I certainly would say that there is, not pause but it's—you know, there's some good demand but it's not crazy and let's bring it in whenever we can get it type attitude.

Pete Lisnic: Okay, but…

John Batten: If that answers the question.

Pete Lisnic: It does. It sounds as though maybe the—you're still growing but slowing growth, would be the way that (cross talking).

John Batten: That's probably a good way to phrase it.

Pete Lisnic: Okay.

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Michael Batten: Then you might want to—excuse me, Pete, for interrupting, but John, you might want to comment on the international order intake in that regard.

John Batten: Yes, that's—again, we mentioned it the last quarter of the conference call and, you know, orders for our oil and gas transmissions are in—in Asia and in particular are increasing outside of North America, so there is a chance and the opportunity to continue to grow the order board even if North America slows.

Pete Lisnic: Okay, and is there—can you give us a sense as to how much of the business is skewed towards international versus North America currently?

John Batten: About a quarter now.

Pete Lisnic: About a quarter international, okay. And then maybe, how about onshore versus offshore?

John Batten: Well, on—offshore, excuse me, continues to improve, but that is—it's primarily driven by North America—for North America and they—a lot of the builders serviced (ph) West Africa but it's also improving in Asia. And if I had to say which one grew more in the quarter, the offshore probably grew a little bit more than the on—than onshore.

Pete Lisnic: Okay. And then, Chris, if I could, just the inventory increase in the quarter, a little color there?

Chris Eperjesy: Yes. I mean, it continues to be a similar story that we said in the first quarter in terms of it really inventory that's building to support this demand, first and foremost in oil and gas but also as we're starting to see some increased activity in the other markets as well.

Pete Lisnic: Okay. That is helpful. I will—I'll jump back in queue. Thanks for your time.

Chris Eperjesy: Thank you.

Michael Batten: Thanks, Pete.

Male Speaker: Thanks, Pete.

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

Andrea Sharkey: Hi, good afternoon.

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Michael Batten: Hi, Andrea.

Male Speaker: Hi, Andrea.

Andrea Sharkey: So, let's talk about the gross margin a little bit. Sequentially it declined, which I think was expected and you guys had guided towards that. One of the comments in your commentary was that it was mix shift, so I was just wondering if you could give us a better sense of maybe what was increasing to shift away? I think oil and gas typically has higher margins, so I would think maybe some other end market products that were coming through stronger?

Chris Eperjesy: Yes, this is Chris, and that's correct. You know, as you—as we've talked about in the past, in the first quarter, our European operations tend to be shut down for a month, either in July or August. In the second quarter, they would have been on for three months so, you know, on average, oil and gas does have a higher margin. So, while it may have been relatively flat, there would have been a higher mix in terms of the European operation, but I think we still feel comfortable with our comments from the first quarter that, you know, mid-30s gross margin rates are sustainable.

Andrea Sharkey: Okay, so maybe where we were this quarter would be kind of fair to expect for the rest of the year?

Chris Eperjesy: That's probably a good guess, yes.

Andrea Sharkey: Okay. And then just on the ME&A, you know, you went through where the increases came from. Would you expect that 20 million a quarter level to kind of continue going forward? Are there—is there something coming through that would continue to increase that, or are there things that you could do to bring that in a little bit?

Chris Eperjesy: With the caveat that, of course, the stock-based comp was the biggest factor in terms of the increase, I wouldn't expect any significant things that would create that—you know, cause that to go higher. You know, stock-based comp is really the biggest driver of what the increase was in the current quarter, so if not for that increase, you know, we would have been below the 20 million mark, which I think is more historically where we've been at. So I guess that's how I would answer your question.

Andrea Sharkey: Okay, great. And then you said that 7500, it's increasing in the backlog. Can you give us any sense of—you know, quantify that at all, you know, as a percentage of your backlog or as a percentage of your oil and gas backlog, just so we can get a sense of, you know, I guess what kind of traction you guys are getting with that?

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Chris Eperjesy: It's not something we generally disclose, either for the 8500 or the 7500, but I will say it is becoming a more significant portion of the backlog. No (ph), in the second quarter in a row that has seen, you know, a relative increase in it, but we don't generally disclose those specific numbers.

Andrea Sharkey: Okay. Thanks a lot. That's it for me.

Chris Eperjesy: Thank you.

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

Jon Braatz: Good afternoon, gentlemen.

John Batten: Hi, Jon.

Michael Batten: Hi, Jon.

Jon Braatz: Looking at the order rates, looked like the order rates in the quarter were—was down 32% sequentially and maybe 29% year-over-year and you had mentioned that they improved monthly as the quarter progressed. What—does that—did the drop off in the order rates maybe in October surprise you? I mean, I don't know what the number was but presumably it was more than 32%. Was there a drop off in orders that just completely took you by surprise early on in the quarter?

Chris Eperjesy: Jon, this is Chris. I think there's probably a flaw in your math…

Jon Braatz: Okay.

Chris Eperjesy: Because those numbers don't even sound vaguely familiar. December year-over-year was a significant increase in order activity, I can tell you, and I think in the quarter as a whole, so you may be mixing manufacturing backlog, which is what we report, somehow with what's going on in distribution (cross talking).

Jon Braatz: Okay, and I probably—okay.

Chris Eperjesy: But, yes, I can tell you year-over-year, and particular the momentum as it builds through the quarter, in December and then continuing into January, the order activity is up year-over-year significantly.

Jon Braatz: Okay, okay. All right. Then…

Chris Eperjesy: I think part of the missing piece there is going to be the inventory that's been built for, you know, some of the demand that's coming.

Jon Braatz: Okay. I think also in the—maybe in the first quarter call – and I may be wrong; and maybe it was in a conversation I had – I think there were two large firms that you really don't do much business with in the transmission area and you had suggested that maybe some of their arrangements with other providers were being terminated or coming up for renewal, or whatever; the exclusivity was going to end. Anything on that front that you can talk about?

John Batten: No, not right now. But those firms remain a target but I would say we will—obviously, we could—they continue to be targets and we're going to spend more energy on them in the second half of the year here.

Jon Braatz: Okay.

John Batten: That's about all the update I can give you on that.

Jon Braatz: Okay, all right. Thank you very much.

John Batten: Thanks, Jon.

Male Speaker: Thank you.

Operator: Thank you. Our next question comes from the line of Matthew Dodson with Edmunds White Partners. Please go ahead.

Matthew Dodson: Can you just help me walk through the SG&A? So, last quarter, I think you had a hit of, like, 1, 2, 1.2 million – is that right – because of stock comp, it was less, and then this quarter, it was up 1.8 million? Is that correct?

Chris Eperjesy: I guess, to take the different pieces, you said—in the first quarter, we actually had a benefit from the fact that (inaudible) stock price down in the first quarter.

Matthew Dodson: And it was 1.2 million, is that correct?

Chris Eperjesy: I recall 1.4 million but it's (cross talking).

Matthew Dodson: Okay.

Chris Eperjesy: And then in the second quarter, we had the opposite occur, where the stock price went up, so if you compare the year-to-date—well, if you compare the second quarter figure, basically we had an increase of about 1.2 year-over-year but—and if you compare to the first quarter, it's almost a $2.8 million swing.

Matthew Dodson: Right, but I guess—the question I have for you is, if you put the 1.4 million into Q1, that means your base was, like, 17.3, right?

Chris Eperjesy: Okay, and then you'd have to back off a similar amount from Q2 because it's a net swing of 2.8 million.

Matthew Dodson: Okay, so you're saying—the—I guess, apples-to-apples, what did you spend more in dollars in Q2 versus—without stock comp?

Chris Eperjesy: Right. We assume that 1.4 number. You would have been comparing—you would have—you would also deduct, so there would have been a slight increase of—I think that would take you from just under 16 to just over 18, and part of the answer to that question is we do see a seasonal increase in the second quarter; and also, as I mentioned, our European operations are all shut down for a quarter in the—for a month in the first quarter, so that would result in lower ME&A expense. So, you know, historically, if you back out stock-based comp in that 17.5 to 18.5 million, you know, recent historic levels is where ME&A generally falls.

Matthew Dodson: Got it. And then you said that you increased R&D spending, I guess. Is that for new products, or is that for your new 7500?

John Batten: Both. Spending on the 7500 and also spending on new projects.

Matthew Dodson: Okay. And then I guess the last question, I know last quarter you talked about your gross margin and that it was perfect; you know, you just had a perfect quarter, et cetera. But you grew sequentially, I guess; I would assume that you would absorb more fixed cost, so can you help us—and did you have more marine this time? Was it more—what caused the difference? What was the bad mix?

John Batten: Well, the difference just on the product level is some of our marine markets and other transmission markets within the transmission business all saw increasing sales in the second quarter, so—and then coupled with that, we had some of the European operations that don't have as a general mix the same gross margin as oil and gas, so you had expanding business in marine and other transmission segments and you also had the European operations basically three months on nine with a slightly lower gross margin, so all of that had the effect of bringing the gross margin slightly down.

Matthew Dodson: Got it. And then just the last question, though, are you finding any pricing in your energy business? I mean, is pricing starting to deteriorate there?

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John Batten: No—I would say, after a couple of quarters of increasing surcharge, we saw the—this past quarter slightly tick down on surcharges, so it did not continue the trend of increasing surcharges.

Matthew Dodson: Okay. So, I mean is there any way to quantify how important these surcharges were to your gross margin or overinflated your gross margin?

John Batten: Not—they weren't substantial at all.

Chris Eperjesy: They wouldn't have been inflating them. They would have been some pressure downwards.

Matthew Dodson: Yes.

Chris Eperjesy: But they weren't significant.

Matthew Dodson: Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Elliott Blonde with Royal Bank of Canada. Please go ahead.

Elliott Blonde: Good morning. Can you put a little more color on the translation of the currency?

Chris Eperjesy: Currency didn't have a significant impact in the quarter. So, there was only a minor impact there that related to just transactional exchange, in this particular case, gains, but it was small. If you're talking about translation, it was very small.

Elliott Blonde: Okay. And the last question, is there any way to quantify the rigs that are using your equipment, their percent to oil and the percent to gas with the stacking of gas rigs?

John Batten: It's information typically we don't give out, but if you name—if you go with the major players that build pressure pumping rigs, both in Canada and the U.S., those would be our—the major players who are our customers.

Elliott Blonde: Okay. Thank you.

John Batten: Thank you, mm-hmm.

Operator: Thank you. If there are any additional questions at this time, please press star, one. And as a reminder, if you're using speaker equipment, please lift the handset before making your selection.

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We have a follow-up question from the line of Jon Braatz with Kansas City Capital. Please go ahead.

Jon Braatz: Can you provide us with any new developments on the Caterpillar relationship and maybe refresh us, you know, the timing and so on of when we might see some revenue?

John Batten: Revenue, okay, let me—well, the two parts here are, one is the agreement to sell our joystick system under the CAT label to CAT and their dealers, and that program will commence—really, their sales program through their dealers starting in June 1, maybe July 1, and so we'll start to see the effects on our backlog a little bit this quarter and then improving into the fourth quarter. We're also working on some control system designs for their pod system, and that is still a couple of years out because the design efforts have just kicked off. So, as far as a revenue impact, that's probably two full years out, maybe two and a half.

Jon Braatz: Okay.

John Batten: But as far as revenue for the joystick, we'll start to see the revenue taking place in the first quarter of fiscal '13 for us, but you'll see some backlog impact in the next two quarters.

Jon Braatz: Okay. I know it's a ways away, but in terms of the impact on the margin, how would you look at the gross margin on that—on the joystick?

John Batten: This will help our gross margin for our joystick products.

Jon Braatz: But I mean for overall corporate margin.

John Batten: Overall corporate margin should be pretty close to not having much effect on it right now at all.

Jon Braatz: Okay. And then last question, I should know this, but you incurred some stock compensation expense in the first half. Given what's happened today, can that—would that be reversed? Is there a reversal possible?

Chris Eperjesy: Yes.

Chris Eperjesy: Yes, if the stock price stayed where it is today, yes, there would be a pickup in the third quarter.

Jon Braatz: Okay.

John Batten: So an income.

Jon Braatz: Right, right. Okay. Okay, thank you a bunch.

John Batten: Thanks, Jon.

Chris Eperjesy: Thank you, Jon.

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

Andrea Sharkey: Hi. I just had one quick follow-up. I believe Cummins had put out a press release a while ago saying that they were going to be introducing a transmission for the oil and gas market I think in the first quarter of 2012, and I know it's probably pretty early, but I was just curious if you guys had heard anything about it, had you, you know, seen—are you seeing anything from your customers related to it, or any color that you can give on whether they actually introduced it? Is it being adopted? Anything you can tell us would be helpful.

John Batten: Hi, Andrea, I have—I know the press release you're referring to, and I know they have one in design and under test, but I don't think there's been any news on that as of late. So, I—really, I don't have any specific knowledge of it in the market or how it's doing; haven't heard anything.

Andrea Sharkey: Okay. Great. Thanks a lot.

John Batten: Thank you.

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

Shawn Boyd: Hi. I just needed to calibrate here on the stock-based comp, if I could. From the comments earlier, it looks like we're at about 3.5 to 4 million in terms of that expense this quarter that's within the ME&A.

Chris Eperjesy: That's incorrect. I think it is, for the quarter – and I'm just trying to look here real quick – in the quarter, the actual expense that was booked – just bear with me for a second; I apologize – the actual expense that was booked was 2.6 million.

Shawn Boyd: Two point six, okay.

Chris Eperjesy: The swing versus the first quarter was 2.8 million because of the adjustment that was booked in the first quarter was actually—resulted in stock-based comp income.

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Shawn Boyd: A few hundred thousand.

Chris Eperjesy: Correct.

John Batten: Yes.

Shawn Boyd: Okay. And the year ago quarter, just while we're at it?

Chris Eperjesy: The year ago quarter, we're about 1.2 million higher this year versus last year second quarter, so last year would have been 1.4.

Shawn Boyd: Got it. Okay. Thank you.

Chris Eperjesy: You're welcome.

Operator: Thank you. Our next question's from the line of Michael Fomook with Wolverine Asset Management. Please go ahead.

Michael Fomook: Hi. Hi, thanks for taking my question. A couple of questions. You know, back to the O&G transmission and the frac spreads, can you talk about any opportunities to pick up any remand business as the industry takes a little breather and, you know…

John Batten: Sure.

Michael Fomook: And possible idles some equipment?

John Batten: That's going to be an increasing component of the overall business in the next 12 to 36 months. We know that the rig manufacturers, unlike the last spikes, are going to do much more of a planned rebuild program within their fleets, so that will be an ongoing activity for the foreseeable future.

Michael Fomook: Can you talk about relative margins?

John Batten: They're as good or better as the existing oil and gas margins, so we like those margins.

Michael Fomook: And then secondly, you talked about an uptick in the marine. Can you differentiate between the—you know, what you're seeing in commercial versus leaser (ph)?

John Batten: Sure, pleasure craft has improved but, you know, from a very, very low level, historically low. Most of the improvement has come, you know, from the inland waterways in North America, offshore oil and gas in North America, Asia, and then just the general work boat markets in Asia as well

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have improved, so—you know, a lot more substantially than pleasure craft, which has improved but really off of a big hit that they took a couple of years ago.

Michael Fomook: And on the commercial side, especially in the oilfield services space, the order book has picked up quite a bit for new builds.

John Batten: Yes.

Michael Fomook: You know, what's your RFP activity look like there? You can—getting some increased visibility?

John Batten: Yes. Yes, it looks like—you know, the requests for proposals had improved in the last—you know, in this past quarter, which usually bodes well for increased shipments, probably six to nine months out from that. So, you know, certainly we're strengthening the second part of this year and it's looking good for our fiscal '13.

Michael Fomook: Thanks a lot.

John Batten: Thank you.

Operator: Thank you. Gentlemen, I'm showing no further questions at this time. I turn it back to you for any closing comments.

Michael Batten: Okay, thank you, Vince. Thank you, everyone, again for joining our conference call today. We appreciate your continuing interest in Twin Disc and hope that you've—we've answered all of your questions. If you have any follow-on questions, please feel free to call Chris, John or me. We look forward to speaking with you again in April following the close of our third quarter.

Vince, we return it back to for you to terminate the call.

Operator: Thank you, sir. Ladies and gentlemen, that does conclude our conference for today. Thank you very much for your participation and you may now disconnect.

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