Twin Disc, Inc.
First Quarter Fiscal 2013 Financial Results Conference Call
October 23, 2012

Operator: Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the Twin Disc, Incorporated First Quarter Fiscal 2013 Financial Results Conference Call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be opened for questions. If you have a question, please press the star, followed by the one on your touch-tone phone. Please press the zero for Operator assistance at any time. For participants using speaker equipment, it may be necessary to lift your handset before making your selection. This conference is being recorded today, October 23rd, 2012.

I would now like to turn the conference over to our host, Stan Berger, with SM Berger. Please go ahead.

Stan Berger: Thank you, Ian (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 2013 first quarter 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 Michael Batten, Twin Disc Chairman and Chief Executive Officer; John Batten, President and Chief Operating Officer; and Christopher 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 fiscal 2013 first quarter conference call. As usual, I will begin with a brief summary statement, and then John, Chris and I will be ready to take your questions.

Our first quarter results were significantly impacted by a challenging North American pressure pumping market, as rig operators continued to adjust to North American natural gas supply overhang and lower prices. We remain cautious about this sector through the balance of fiscal 2013.

Sales for the first quarter of fiscal 2013, seasonally the weakest quarter of the fiscal year, declined to 68 million from a record performance of 81 million last year. The decrease in sales was primarily the result of lower demand from customers in the pressure pumping sector of the North American oil and gas market. The shortfall was partially offset by a higher demand from customers in the North American and Asian commercial marine markets, while demand remained steady for equipment used in the industrial, airport, rescue and firefighting and military markets. Sales to the global megayacht market remained at historic lows in the quarter.

Gross margin for the quarter was 28.2% of sales compared to a record of 37.8% for the same three months a year ago. The anticipated year-over-year decline in margin reflected lower sales volumes and a less profitable mix of business.

ME&A expenses, our marketing, engineering and administrative expenses, were 24.2% of sales compared to 19.6% last year. ME&A expenses increased 711,000 versus the same three months last year, primarily the result of the decreased product development activities, wage inflation, and additional headcount.

The effective tax rate for the first quarter of fiscal 2013 was 45.6%, significantly higher than the previous year rate of 35.3%. The current year rate was unfavorably impacted by an existing valuation allowance in certain foreign jurisdictions during the quarter. The remaining increase relates to the expiration of a credit, the research and development, a reduced domestic production activities credit, and a change in the mixture of domestic and foreign earnings.

Net earnings attributable to Twin Disc for the first quarter of 2013 were 1.3 million or $0.11 per diluted share compared to record earnings of 9.6 million or $0.83 per diluted share for the same period last year.

EBITDA for the first quarter was 5.3 million compared to 17.8 million for the same quarter a year ago. Total debt net of cash was 18 million at the end of the quarter compared with 16 million last year. With a debt to capitalization ratio of 21.9%, our balance sheet provides us with the flexibility to withstand any near-term volatility, and we continue to invest in forward business opportunities.

Looking at our outlook, our six month backlog at the end of the first quarter was 82 million compared to 98 million at June 30, 2012, and 165 million at this time a year ago. The backlog reflects continued weakness in demand from the North American oil and gas market that we anticipate will continue for the majority if fiscal 2013. While the decline in demand from this sector will have an obvious near-term impact on our business, we are well-positioned to grow when the market rebounds.

Further, interest in our oil and gas transmissions is improving in other areas, mainly Asia, as producers are beginning to develop shale formations in their own countries. And finally, while demand from oil and gas has an influence on the Company, our business today is far more diversified in terms of products and markets and geography than at any other time in our history. As the year progresses, we anticipate a slow recovery in oil and gas, with more robust demand coming from our traditional sectors, such as commercial marine, legacy military, and our ARFF market.

That concludes my prepared remarks, and now John, Chris and I will be happy to take your questions. Ian, please open the lines for questions if you will.

Operator: Absolutely. As a reminder, if you'd like to ask a question today, it is star, followed by the one on your touch-tone phone. If you'd like to withdraw your question, please press the star, followed by the two. And if you're using speaker equipment, please lift the handset before making your selection.

And our first question is from the line of Peter Lisnic from R.W. Baird. Please go ahead.

Michael Batten: Pete, are you there?

Peter Lisnic: Can you hear me?

Michael Batten: Yes, now we can.

Operator: (Cross talking) go ahead.

Michael Batten: Now we can.

Peter Lisnic: Yes, good morning. Sorry about that. I guess the first question if we could talk a little bit about the oil and gas market and your market assumptions there. It sounds like 1Q very difficult obviously, but maybe some visibility that things get better in the, you know, call it the back half of the year, maybe fourth quarter. Can you give us a sense of a couple things? One, just how you're thinking about the North American piece. Does that effectively get better here in the, you know, in the later part of the year, and then international as well? And then just kind of if you can maybe give us an order of magnitude of what we might be seeing near-term and intermediate-term, that would be very helpful as well.

John Batten: Okay, Pete, it's John. North America has slowed down dramatically. Most of what we've seen year-to-date is driven by Asia, and will probably be the same in Q2. I would say that we are hopeful and expect North American demand to pick up in the second half, but it's going to be probably a lot closer to the Q4 and maybe even the later stages of Q4. There's quite a bit of inventory of rigs—finished rigs, and then also of inventory at some of the OEMs to build the rigs; transmissions and engines.

So I know your next follow-up question is how many months of inventory? I would say it's probably, you know, four to six months, but that's at current rates. But if you go back to the peak, you know, there's a month and a half of inventory sitting out there, so if it ramps up quickly, the inventory will get used up pretty quickly. But I mean we could see a very slow second half of the year in North American oil and gas.

Having said that, going back to Asia, Asia was still and still is very good for us, but I see the Chinese market maybe developing a little bit slower than we'd anticipated. They have trouble doing the horizontal drilling. Their soil has a lot more clay in it than in North America, so while that's going to be the main market for us in the next few quarters, it's not going to be the rocket that we had anticipated.

Peter Lisnic: Okay. And then if—maybe Chris will be willing to answer this one. If we look at the backlog, and, you know, 50% decline I guess year-over-year and down 16 or 17% sequentially, can you give us a flavor for how much of that deterioration was oil and gas and maybe color commentary on what the other markets were doing in terms of that backlog?

Christopher Eperjesy: Yes, Pete, is it Chris. The majority of it, so more than half of it is going to be driven by—the decline in year-over-year is going to be driven by oil and gas in terms of reduction in the backlog; you know, more than that. The other piece of it is going to relate to, you know, we had talked about the past two backlogs last year at this time at our European operation particularly for marine transmissions. That has worked its way through, so that's going to be another portion of the decline year-over-year. And then as you know versus sequentially, it's not untypical from the first quarter for the backlog to come down. But clearly the biggest piece of it is going to be the oil and gas.

Peter Lisnic: Okay. All right. And then as we see this volume decline, Chris, how should we think about the ME&A rate? The first quarter looked like it was a little bit higher at least than what we had modeled, but I'm just wondering how that piece of the cost structure should delever as we see the volume come down?

Christopher Eperjesy: Right. Pete, one part of it, you know, if you remember last year in the first quarter there was a significant adjustment to stock-based compensation because of the stock price movement in Q1 of '12.

Peter Lisnic: Right.

Christopher Eperjesy: So actually essentially there was stock-based, I'll call it income, but there was a negative number in the first quarter of last year. This year it was more normalized, so you did have a negative effect there that would've played out in the first quarter. Somewhat offsetting that, obviously given that this would be a down year, the incentive compensation was lower in the first quarter—significantly lower. I guess the answer to your question is obviously there is a base level of ME&A that will be there as we continue to invest in research and development and growing some of our activities around the world, geographically in particular, so there will be a base level that as volume goes down obviously that percentage will go up. But it is something, you know, that we monitor closely, and certainly as the results, you know, would indicate, that we would look at cost cutting opportunities everywhere that we can.

Peter Lisnic: Okay. Is the first quarter sort of a fair base run rate for that ME&A level on an absolute dollar basis?

Christopher Eperjesy: It's not far off of what I would expect to be typical, but with the caveat of, you know, movement in stock-based compensation is difficult to predict.

Peter Lisnic: Okay, yes. I understand that. All right, and then the last question. John, balance sheet in good shape, it sounds like you're relatively comfortable that things maybe get a little bit better here in the later part of the year and into fiscal '14 I guess. What's the thought process behind potential buyback activity with the stock obviously coming off a bit here, and how do you think about capital allocation given those—that backdrop, I should say?

Michael Batten: Pete, it's Mike. I'm jump in here if I may. And with respect to buybacks, you see that we increased our ability to buyback shares at the July board meeting up to 500,000, so we have that dry powder. And quite frankly, we see the stock prices where it is today as a buying opportunity. So we're bullish on the Company long-term, and we will be prepared, without being specific, to buy into the market at these levels.

Peter Lisnic: Okay, and then I guess the natural follow-up is is there anything in the acquisition pipeline that would maybe preempt that from, you know, the buyback activity from happening?

Michael Batten: Nothing that is immediate, such as the buyback opportunity. Our acquisition work or conclusion of any acquisition work would be a little bit further down the line.

Peter Lisnic: Okay. All right, that is very helpful. Thank you all for your help.

Michael Batten: Thanks.

John Batten: Thank you, Pete.

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: Good morning, Andrea.

Andrea Sharkey: I guess maybe talking about the margin a little bit, can you give me a sense of how much of the degradation either sequentially or year-over-year was due to the mix shift away from the oil and gas transmissions because they have the higher margins?

Chris Eperjesy: The majority of it is going to be mix and volume related to oil and gas, Andrea, so the majority of it will be driven by that.

John Batten: Yes, the rest—Andrea, we have—it's John. In—usually in the first quarter we have shutdowns at all of our manufacturing facilities, in which case the first quarter is typically the lowest gross margin quarter of the year. Last year was a complete anomaly because we had a record shipment of 8500s in that quarter that were—that we could not get out in the fourth quarter. And customers were still clamoring, so we did everything we could to pull them in from the second quarter. But typically having the operations on shutdown both here in North America and Europe drives the gross margin down for the quarter.

Andrea Sharkey: And actually I guess last quarter we—I know you guys actually talked about that that the Q1 shutdowns would have an impact, but that overall you thought a good target for the year, maybe kind of ex-Q1 with the 30% gross margin. Do you think that that's still feasible, or has that changed a bit given the maybe greater decline in the oil and gas transmission demand?

John Batten: If the north—if the oil and gas does not improve, we're probably looking at high 20s.

Andrea Sharkey: Okay.

John Batten: But if the oil and gas comes back, obviously we would change our target.

Andrea Sharkey: Okay, sounds good. And then maybe just to give us some sense of you mentioned, you know, the other end market's going to be bigger drivers now this year. Can you refresh our memory on the military end market; what you're selling into there, and is there anything that we should be concerned about with potential sequestration that may happen, you know, January 1st?

John Batten: Sure. Kind of two areas. In the U.S., our primary military business is the legacy military. The transmissions that we sell to BAE and TACOM for the M88 and the Hercules M98 (ph), that is very steady business. We have not heard anything affecting that from sequestration, but I'm going to have to look into that how that would be. But we have orders out to 2016. Not saying that couldn't change in January given what happens in Congress.

The other part on a more global basis is the patrol boat and military, mostly marine-type activities. And that business is going very well. The only caveat there is the timing from quarter to quarter, because building boats can sometimes be unpredictable on when they finish and when they need our product. But both of those markets as of right now are going very well for us.

Andrea Sharkey: Okay, great. And then last question for me on cap ex. Do you think your budget—I think last quarter you said 15 to 20 million for this year. Q1 seemed very light, so I was just curious if that was just a timing issue, or if maybe you're retrenching a bit on your cap ex plans?

Christopher Eperjesy: It's actually—the answer is both. I mean it was a timing issue. It's not a typical debt (ph). The first quarter tends to be low from a cap ex standpoint for some of the reasons John talked about; the plant shutdowns, but other logistics of getting it approved and getting it, you know, ordered and received. But also given, you know, the earlier comments, we're probably looking more in the 10 to 15 million range as opposed to the 15 to 20.

Andrea Sharkey: Okay, great. Thanks a lot. That was really helpful.

Michael Batten: Thank you, Andrea.

John Batten: Thank you, Andrea.

Operator: Thank you. Once again, if you'd like to ask a question today, it's star, one on your phone. Star, one if you have a question.

And our next question is from Brian Uhlmer with Global Hunter. Please go ahead.

Brian Uhlmer: Hi, good morning. How are you?

Michael Batten: Hi, Brian.

Brian Uhlmer: I had a question for you on the product development that you spoke about; you spent some money last year on that. I was curious if you had anything in the pipeline that was somewhat new, smaller, and maybe working with gas turbines for pressure pumping, or anything such as that that will help us out on the order front as we move through what is going to be a relatively tough year for North America in the oil and gas side?

John Batten: Brian, it's John. We have looked at the gas turbines as far as how it relates to the frac market. I don't have any updates there other than it is an option that we have considered, because we've heard from several different sources that this is a consideration. As far as other product development, you know, we're investing all the time and looking at a lot of different products and technologies, but it's too soon to announce anything at this point.

Brian Uhlmer: Okay. Now staying in that market, you know, calendar Q2 basically the orders dropped out at the end of that calendar quarter, so your—you know—our fiscal Q1 we just finished, would you see that as the trough in orders, or do you think that there was still some excess inventory that was being bought, or, you know, can we go down from here or was that pretty much the bottom in your view this quarter?

John Batten: It's John again. If I had to guess, it would be—potentially it's going to be the first quarter—looking at our fiscal year, Q1, Q2, or Q3 is going to be the bottom. It's hard to say, and it'll happen sometime, you know, in those months. But I expect that it will start to come up in the next quarter or two. And the backlog—here's the problem, the backlog—the components in the backlog are changing with a lot of oil and gas transmissions out which are 12 month lead time type items, they obviously are very good for the backlog, but once you get into our aftermarket and clutch business PTO, those are three week lead times items, and so they're in and out of the backlog before it can be reported, so that's why there's a caveat. Certainly our aftermarket business, industrial business and marine business look very good going forward, it's just hard to predict when the backlog is going to bottom out and start to come back up.

Brian Uhlmer: Okay, that makes perfect sense. And one final question. Were there any—did you experience at any point in time any cancellations in the quarter?

John Batten: Very small, but most of it was push-outs. Customers do not want to lose line for the transmissions that they had on order when the market comes back. Everyone is very sensitive that when the ramp-up occurs again, they want to be able to deliver.

Christopher Eperjesy: So those wouldn't—this is Chris. Those wouldn't be in the six month backlog. They would be beyond that.

Brian Uhlmer: Okay, perfect. Thanks for your help. Appreciate it.

Operator: Thank you. Our next question is from the line of Kevin Leary with Spitfire Capital. Please go ahead.

Kevin Leary: Hi. Good morning, guys.

Michael Batten: Good morning, Kevin.

Kevin Leary: First question. On ME&A, just thinking about maybe scenarios for the rest of the year. You know, under what scenario might you dial back your dollar spend on ME&A? Let's say that demand sort of stays down, you know, down 15% range, would you look at dialing back or would things have to get incrementally worse from here?

John Batten: Well, we're already looking at our ME&A spending, you know, kind of operational spending, both cost of goods sold and ME&A, and obviously given what's happened in the first quarter and the outlook of North American oil and gas, we're being very prudent in how we spend. I neglected to chime in, you know, some of the ME&A adds that we've had, obviously we're investing in people in Asia as our business is expanding there, and we have a larger Company-owned distribution territory now. We have some additional people in the Mid-Atlantic region, so that's kind of, you know, the year-over-year increase in people. Certainly if things were to change, we would be very aggressive, as we've shown in the past, at controlling and reducing costs. If it comes to that, that's certainly not out of the realm of possibility.

Kevin Leary: Thanks, that's helpful. And then just one cleanup. On the free cash—on the statement of cash flows there's a $1.7 million of other cash outflow. What is that?

Christopher Eperjesy: It's a good question, and I believe it was the stock buyback.

Kevin Leary: Okay. Do you guys have a number in front of you in terms of buybacks in the quarter?

Christopher Eperjesy: You know, Kevin, and I apologize, I don't.

Kevin Leary: Okay. Okay, we can follow-up. Great, that's all I had.

Michael Batten: All right. Okay, thanks, Kevin.

Operator: Thank you. And we have no further questions at this time.

Michael Batten: Okay, thank you, Ian. Thank you all again for joining the conference call today. We appreciate your continuing interest in Twin Disc, and hope that we've answered all of your questions. If not, please feel free to call Chris, John or me. We look forward to speaking with you again in January following the close of our third quarter. Ian, I'll turn it back to you now for the close.

Operator: Ladies and gentlemen, this does conclude the Twin Disc, Incorporated First Quarter Fiscal 2013 Financial Results Conference Call. Thank you for your participation. You may now disconnect.