

## Q1 2020 Twin Disc Inc Earnings Call

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### CORPORATE PARTICIPANTS

Jeffrey S. Knutson, Twin Disc, Incorporated - VP of Finance, CFO, Treasurer & Secretary

John H. Batten, Twin Disc, Incorporated - CEO & Director

Stanley Berger, SM Berger & Company, Inc. - President

### CONFERENCE CALL PARTICIPANTS

Noah Duke Kaye, Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst

## PRESENTATION

### Operator

Good Day, ladies and gentlemen, and welcome to the Twin Disc, Inc. Fiscal First Quarter 2020 Earnings Conference Call and Webcast. Please note, today's conference is being recorded. At this time, I will turn the conference over to Mr. Stanley Berger. Please go ahead, sir. .

**Stanley Berger**, SM Berger & Company, Inc. - President

Thank you, Molly. 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 2020 first quarter financial results and business outlook. Before I introduce management, I would like to remind everyone that certain statements made during 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 Miannecki at (262) 638-4000, and she will send a copy to you. Hosting the call today are John Batten, Twin Disc's Chief Executive Officer; 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 H. Batten**, Twin Disc, Incorporated - CEO & Director

Thank you, Stan, and good morning, everyone. Welcome to our fiscal 2020 First 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. Before Jeff goes over the quarter results, I'll touch on some of the operational highlights from the quarter. As we previously mentioned in the prior call, we faced several supply challenges in the run-up of the 8,500 in fiscal 2018 and 2019. And in order to meet demand on other products, we had to move supply to other vendors and not always at the lower cost, availability and quality were a primary concern because our customers could not wait. This, coupled with some key suppliers who went out of business resulted in quick decisions just to maintain supply and resulted in higher prices on some key components for our Marine transmission, RF transmissions and newer oil and gas models. I'm happy to report that between a combination of pricing and component cost reduction, we are just beginning to see the effects of our cost reduction efforts. While many of the wins have come from finding new suppliers. Other wins have come from the improved efficiency of our new CapEx equipment recently installed in our plant here in Wisconsin, assuming a static mix and volume going forward, as an example, we would expect to see improved margins going forward over the next 4 to 8 quarters as we bring the new supply sources online. We will also address other cost drivers, such as overhead and make the necessary adjustments.

Now I'll turn to a couple of our key strategic objectives for a moment. We continue to drive actions and strategies that will limit our exposure to deep oil and gas cycles and prepare us for the electrification evolution of our markets. One of the biggest challenges we face at the top of an oil and gas cycle is physical capacity, which is why we took action to free up space in our main plant here in Racine, Wisconsin. As we stated in the fiscal 2019 fourth quarter call, we have moved our aftermarket facility out of the main production plant to a more efficient warehouse facility along I-94. And the new layout and better organization of parts, including a VLM storage system has almost doubled our efficiency with respect to picks per hour. More importantly, the move has freed up valuable space in our plant. So that we could be more efficient with staging inventory closer to our assembly locations.

During the quarter, we made significant progress on our Lufkin facility after a summer of heavy rain, we should be operational at the 50,000 square foot facility by the fourth quarter, and we are beginning to hire employees for the operations so that they can train in our processes here in Racine. We've held several Kaizen events to optimize the layouts of what we will need in Lufkin, having a facility dedicated to our industrial products will improve efficiency, both with direct labor, but also greatly reduce the amount of indirect labor needed. With respect to growth and diversification, our best acquisition has provided us with \$60 million of non-oil and gas business and the opportunity to grow that outside of Europe. We could not be happier with the progress with that proposal. We continue to develop projects here in North America and in Asia and the synergy between the 2 teams could not be better, especially in terms of hybrid development. Best experience to date is having significant impact on our electrification and hybrid efforts, we see opportunity in all of our markets and have applications in our marine and transmission areas and are looking for industrial ones as well.

With that, I'll turn it over to Jeff for some comments on the financials.

**Jeffrey S. Knutson**, Twin Disc, Incorporated - VP of Finance, CFO, Treasurer & Secretary

Thanks, John, and good morning, everyone. I'll briefly run through the fiscal '20 first quarter numbers. Sales of \$59.3 million for the quarter were down \$15.4 million or 20.6% for the prior year first quarter. The quarter decline is the result of a significant reduction in new build activity in the North American fracking market, along with the related reduction in aftermarket activity. This accounted for \$14.8 million of the first quarter reduction in sales and is the continuation of the slowdown we saw in the fourth quarter of fiscal '19. While this important market is in a temporary pause, we continue to see solid growth in our industrial markets.

Global Industrial volume was up 5.9% over the prior year first quarter, following 10% growth in fiscal '19. Global sales of Marine Propulsion products were down 3.5% from the prior year first quarter, primarily on project timing. We continue to see strong project and quoting activity in the global commercial marine market and anticipate increasing volumes as we work through fiscal '20. The first quarter margin percent was 16.3% compared to 32.1% in the prior year first quarter. Our gross margin performance for the quarter was severely impacted by a continuation of the unfavorable product mix experienced in the fiscal '19 fourth quarter with lower fracking demand for new rig construction and reduced aftermarket demand being the primary drivers.

In addition, we recorded a \$3.9 million charge to address a product performance issue on our high horsepower fracking transmission associated with the unique set of application characteristics. This charge is intended to cover the entire population of impacted units, and we estimate that \$2.6 million of the cost will be addressed with existing inventory, resulting in a net cash impact of approximately \$1.3 million. Excluding this charge, gross profit would have been 22.8% for the first quarter, slightly higher than the 22.7% reported in the fourth quarter of fiscal '19 on reduced first quarter sales level. As we discussed in the year-end earnings call, we anticipated a continuation of this difficult sales mix and have been focusing on cost reduction and pricing actions to drive margin improvement. We have started to see the initial benefits of these actions and anticipate improving margins through fiscal '20.

Spending on marketing, engineering and administrative costs for the fiscal '20 first quarter decreased \$2.6 million or nearly 14% compared to fiscal '19. The decrease is a result of reduced bonus, marketing spending, stock-based compensation and professional fees, along with the impact of the mill log sale. With reduced first quarter volume, challenging product mix and product performance charge, we reported an operating loss of \$6.8 million in the quarter compared to a \$4.8 million operating profit in the fiscal '19 first quarter. The effective tax rate for the fiscal '20 first quarter was 20.5%, slightly lower than the prior year rate of 23.4% due to the jurisdictional mix of earnings.

The net loss for the first quarter of fiscal '20 was \$6.3 million or \$0.48 per diluted share compared to a net profit of \$2.9 million or \$0.24 per diluted share in the prior year first quarter. Negative EBITDA of \$4.6 million for the quarter, down from a positive \$8 million in the prior year first quarter.

Balance sheet remains healthy with \$33 million of debt, debt to total capital of 22.3% and a debt-to-EBITDA ratio of 2.38%. Inventory was up slightly in the quarter as reduction efforts were hampered by reduced volume and vendor commitment. 6-month backlog finished the quarter at \$97 million, which is down slightly from \$100 million at the end of fiscal '19. Operating cash flow was positive \$1.5 million, which is \$700,000 better than the prior year first quarter despite significantly reduced earnings and limited inventory improvement. Free cash flow was negative \$2.6 million in the quarter with significant CapEx of \$4 million in the quarter. We expect to spend between \$12 million and \$14 million this year as we invest in modern machining and quality technology to drive productivity and cost improvement.

And with that, I'll turn it back to John for some final comments.

**John H. Batten**, Twin Disc, Incorporated - CEO & Director

Thanks, Jeff. Now I'll spend a quick moment on our outlook. We know the main question on everyone's mind is the timing or return of new rig construction in North America. And what, if any, affects political promises, the band fracking will have? Both are good questions. I do believe that the effective horsepower is much lower than most people believe, and it could go lower. If prices and demand improve, I think you could see a rebound in mid-2020. Some of

that growth, 10% to 15% potentially, maybe efrac solutions, and we are ready for those types of applications. With respect to political promises to ban fracking, I don't see how that can be universally implemented beyond federal lands. If somehow it were, the net cost of energy for everyone with SAAR. And I don't think people realize how widespread pressure pumping is for oil and gas production and completion.

Finally, we want to convey the message that management continues to focus on diversification and growth even as we address the short-term margin challenges ahead of us, and these should begin to improve going forward in the next few quarters. We continue to explore further opportunities to grow our industrial business and enhance our hybrid development.

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

## QUESTIONS AND ANSWERS

**Answer – Operator:** (Operator Instructions) Our first question today will come from Noah Kaye with Oppenheimer.

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**Analyst:** Noah Duke Kaye, Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst

**Question – Noah Duke Kaye:** I guess, maybe just to start with the discrete product issue that drove the charge you mentioned, that was a function of your customer-specific application. Can you give us just a bit more color on the application and really what drives your confidence that the issue is kind of confined here and buttoned up?

**Answer – John H. Batten:** Well, it's -- Noah, I'll give you some details. I can't give you all the details because there are other components involved but it really is, I would say, an extreme application, highest horsepower, highest pressure and the highest usage rate per day. So generating the most hours in the shortest amount of time. And just the application in general, where there's other things like original vibration alignment, things that there are multiple people, multiple suppliers involved in. And it really is sitting down and addressing how could this overall rig last longer, and then it has. It is, in many cases, well exceeding our warranty period, but it is not living up to the expected life of our transmission and some other components. So it really -- to Jeff's comments, it covers almost every potential unit out there. So we're being conservative in our estimate. And we're in it. It is something that we can address on a rig without having to pull our transmission.

**Question – Noah Duke Kaye:** Okay. And then just on the sort of the strategic actions to improve margin, you kind of listed a number of different items here. I guess, if we just sort of add this all up, any way to think about that order of magnitude in the static demand environment? And maybe what really are kind of the biggest driver here of margin improvement?

**Answer – John H. Batten:** So just to answer -- how to answer it first. I would -- the goal Noah is to exit the year in the high 20% gross margin. I don't know if we'll get to 30 %. But there's a very good chance we'll get to 28%. And a lot of that has to do is -- so we've had and I mentioned in the call in the ramp-up of oil and gas in the 8500, we did not, very honest, make the best sourcing decisions with respect to costs. We were looking for quality and availability and a lot of time, we've obviously clearly brought in too much 8500 inventory for the moment. That -- so moving other products for our Marine transmission and RF to other suppliers to free up capacity for 8500 and resulted in net cost increase. We had a couple of key suppliers, primarily for castings that went out of business. And there, we were scrambling just to find some shops that had availability. Oftentimes, in significant cost increases. I'm happy to report that, that's where we found the first impact because we never removed the castings, but we didn't stop. We immediately were looking for new sources because we knew the costs have gone up significantly. We're just now seeing production volume of these castings at a much lower price coming through the door. So you're going to see steady improvement over the next few quarters with cost decreases based on components that we found newer sources for or that we brought back inside, and we can do it less expensive. That's one driver.

Second driver, our cost increase -- price increases on some of our RF transmission models and lower horsepower oil and gas models, those are going into effect, I would say, starting this quarter, late this quarter and early next quarter. So we'll have pricing improvement, cost improvement those would be the -- I would say, no, those are the 2 main drivers. You'll see some -- we have aftermarket is operating more efficiently. Once we get the industrial product out, this will greatly improve efficiency at our plant here in Racine, and we'll be able to adjust overhead accordingly. The rates, -- particularly the ratio of direct to indirect, we have, I would say, we still have a lot of indirect temps. I would say the plant here is still very full, and we spend too much time moving inventory around. So it's going to be a combination of all 3 of those. But the immediate effect that you'll see will be roughly 50/50 on margin improvement due to lower cost of components, and higher prices.

**Question – Noah Duke Kaye:** Great. I appreciate that. I guess, on the demand environment, you obviously are seeing stability now in the backlog. And I think with respect to marine, you commented on kind of continued positive direction for quoting and demand, just kind of wondering because as we continue to hear about macro uncertainty impacting CapEx broadly, right? This is a global theme for industrial? Just how would you characterize marine

spending trajectory? And can you give any color on how the portion of your backlog, specifically relating to the marine end markets has been trend there?

**Answer – John H. Batten:** Sure. I would -- the new dimension for us is that because they typically are -- to put in perspective, a small order of several hundred thousand dollars, a big one is over \$1 million, a project for a vessel. So when you have a \$60 million business, each order is a big chunk. And that seems that activity has remained constant is actually because in Europe, but we're getting more and more interest and more and more project development in Asia and North America. So that's what I think gives us confidence that even in a stagnant market, we have the chance or a declining market of or decline, we have a chance to remain flat or increase our sales. It's a little bit tougher to say on just our traditional business, particularly here out of Racine, which is definitely more, particularly in North America and in Asia actually is more tied to the overall economy. So as long as the economy is doing well, and people are confident, I expect the marine trends -- our domestic marine transmission market, where it is right now to remain -- to reflect the trends. If were to -- if things were to decline in the macroeconomic environment, I think you'd see a slight decline in our marine transmission backlog.

**Question – Noah Duke Kaye:** Okay, great. And if I could just squeeze one more in before turning it over. IMO 2020 implementation beginning on January 1, are you seeing any impact on demand or mix, really, any shift to battery electric or any other alternative marine fuels? Or is there any color you can give on how maybe this is having an impact on what would normally be business as usual?

**Answer – John H. Batten:** I would have to get back -- I will dig into more details. But at every month, or every quarter, there are more and more hybrid applications coming up, what is both good and bad in marine, for us at least, is it's not a Toyota or a Honda or a GM, where they can design one solution and throw it across 3 or 4 platforms and sell millions of vehicles. You're dealing with a design for each boat builder, each owner. So it's a lot more work for each application. But absolutely, any customer of any size in any market is exploring, particularly in marine, a hybrid solution, not or diesel electric solution. And it's absolutely being driven by environmental concerns, emissions, in many cases, there are tax incentives to do it. So part of it is economic. But it's -- it is a -- it's hard to design one solution that fits all. So it's -- we're doing -- I think we're doing a very good job with Veth on designing a control system that can go across multiple models, and we're designing each one of our marine transmissions to be able to simplify the plug and play. We want to be able to react to a multitude of hybrid diesel electric solutions in the marine market or any of our markets. So that's a lot of where our product development and thinking is, is we know particularly, it's going to go hybrid. And we want to be ready. We also want to be ready if it goes purely electric, but in a lot of our marine markets, purely electric is difficult to achieve.

**Question – Noah Duke Kaye:** Yes. Yes, understood. I'm sorry, just one quick housekeeping one, I apologize. Is any chance, Jeff, you could provide the revenue breakdown for manufacturing and distribution and eliminations in the quarter?

**Answer – Jeffrey S. Knutson:** I don't -- yes, one second. I do have that information certainly. So it was -- for the quarter, round numbers, \$55 million manufacturing, \$22 million distribution and about \$18 million in eliminations.

**Answer – Operator:** (Operator Instructions) Our next question will come from Josh Chan with Baird.

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**Analyst:** Unidentified Analyst,

**Question – Unidentified Analyst:** I guess, my first question is on the backlog. Would it be fair to think of your kind of backlog right now is predominantly marine and industrial? And if you were to get any improvement in oil and gas that would be kind of on top of what the number is right now?

**Answer – John H. Batten:** Yes, yes, absolutely.

**Question – Unidentified Analyst:** Okay. And so then, I guess, on the oil and gas potential improvement? I mean, you guys mentioned that you're continuing to projects. So what are you hearing from your customers in terms of how they're thinking about timing and what that is dictated by, I suppose, over the next couple of quarters?

**Answer – John H. Batten:** Josh, it's John. We still have a small, well call it, small of what the overall peak was in Asia. So we have continued projects going on in Asia. I would say in North America, it's -- the capacity, I think the pipeline issue out of the Permian is being addressed. I think, honestly, it's, again, different for each person I talk to each company. But it's price stability and cost and cash flow. I think -- I do think you're going to see the effective horsepower continues to decline in the North American fleet. So if there's any improved demand and pricing, I think, sustained, I think you'll see the faucet turned back on on new rig construction. But it's not something I see in the next quarter, maybe 2 quarters out, middle of 2020. But again, the problem is, is that if we get there, we get closer to a general election. So we'll see, Josh, but I don't see it getting much worse than it is right now on new rig construction in North America. But the rigs, again, everything that can -- everything that all of our equipment is being used almost every single day.

**Question – Unidentified Analyst:** Right. Okay. Yes. And on the charge, I just wanted to make sure that -- is it the expectation that there wouldn't be a similar charge in next quarter? And then also, just the mechanics of it. If you kind of took it against the inventory, would that mean that when you sell that inventory, you would have lower gross margin? Just kind of how would that kind of flow through?

**Answer – Jeffrey S. Knutson:** Yes. So no, we wouldn't be selling the inventory, we'd be taking -- we would be taking inventory out to replace the components that need to be replaced in the rigs. So it would be a reduction in inventory and an offsetting reduction to the accrual that we made. That accrual was intended to cover the population of impacted units. So yes, based on what we know today, we don't anticipate an additional charge.

**Answer – John H. Batten:** Josh, I think we would be covered under our normal warranty spending warranty accrual. If something else that we don't know about today. But that would -- that would be it.

**Question – Unidentified Analyst:** Okay, that's great. And then last question is, is this still the expectation that you might be able to generate positive free cash flow this year based on how the first quarter has gone? What are your thoughts there, Jeff?

**Answer – Jeffrey S. Knutson:** Yes. It's going to be tight, right? I mean, we had a little bit of, I would say, accelerated timing in CapEx just in terms of timing of deliveries of machines. So that should ease somewhat on average over the rest of the year. I'm confident we're going to see some inventory reduction, but a lot of that depends on what the market does. So I think we have a good chance of being positive free cash flow. I would say, for the rest of the year and for the full year, breakeven, I think, is...

**Answer – John H. Batten:** I would say if we weren't bringing Lufkin online, we would be. But that's that is a strategic imperative for us to get that up and running.

**Answer – Operator:** And at this time, we have no further questions in our queue. We'll turn the conference back over to our speakers for any additional or closing remarks.

**Answer – John H. Batten:** Okay. Thank you, Holly, and thank you for joining our conference call today. We appreciate your continuing interest in Twin disc and hope that we have answered all of your questions. If not, please feel free to call Jeff or myself. And we look forward to speaking with you again following the close of our fiscal 2020 second quarter. Holly, I'll now turn it back to you.

**Answer – Operator:** Thank you. And ladies and gentlemen, that does conclude our conference for today. We thank you for your participation.

