Twin Disc, Inc.

Fiscal Third Quarter 2018 Investor Conference Call

May 7, 2018

CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Joshua Chan, *Robert W. Baird & Co.*

James Dowling, *Jefferies Capital Partners*

Simon Wong, *Gabelli & Company*

PRESENTATION

Operator:

Good day, everyone, and welcome to the Twin Disc, Incorporated Fiscal Third Quarter 2018 Conference Call. Today's call is being recorded. Now, your host for today's conference, Mr. Stan Berger of SM Berger. Mr. Berger, please go ahead, sir.

Stan Berger:

Thank you, Rufus. On behalf of the Management of Twin Disc, we are extremely pleased that you have taken the time to participate on our call, and thank you for joining us to discuss the Company's fiscal 2018 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, 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:

Thank you, Stan, and good morning, everyone. Welcome to our Fiscal 2018 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. Before Jeff goes over the quarter results, I will touch on some of the operational highlights from the quarter.

Sales for the quarter rose 45% year-over-year. Compared to third quarter sales a year ago, demand was up in most of our markets. Obviously the most dramatic increase year-over-year was in our land-based oil and gas transmission sector, but we also saw rising tides in many of our other markets as well. Demand was strong across our marine market, and we have seen a nice industrial demand increase across both our forward and aftermarket businesses.

As we mentioned in prior calls, this is putting a lot of pressure on our supply chain. A lot of our Management time has been spent on securing the parts and processes needed to meet this ramp-up. The overall situation improved throughout the quarter, but we still have work to do. Many of our key suppliers are at full capacity, and we are adding additional capacity through new suppliers to new internal cap ex.

Sales for the quarter could easily have been $7 million higher if we were able to get all of the components necessary to meet the demand. Currently, we have about $6 million in cap ex on order, which will increase our internal capacity, primarily in gear production in anticipation of assembly and test expansion.

As part of our cost rationalization process the past two years, we have moved some of our distribution people functions back to Racine when we divested our distribution entity in the southeastern part of the U.S. To improve our manufacturing throughput, we will be moving this activity out of the shop area to a new location and using this free space for a new machine.

Our productivity slipped a bit in the quarter due to a lot of new hires coming online after January 1, but the trend should reverse as the productivity of the new employees improves, and the new cap ex is installed.

Our gross margin for the quarter could have been 130 basis points higher, except for a one-off warranty expense related to some marine transmissions and 10 fast supply vessels. While the marine gears were well past the standard warranty time, there were 20 that we felt were not meeting our internal threshold and we decided to update them in this low-activity period.

With that, I'll turn it over to Jeff for some comments on the financials, and then I'll be back for an outlook at the end.

Jeffrey S. Knutson:

Thanks, John, and good morning everyone. I'll briefly run through the third quarter numbers in a little more detail.

Sales of $55.3 million for the quarter were up $20.3 million or nearly 45% from the prior year third quarter. This represents the fifth consecutive quarter of year-over-year growth, demonstrating a sustained and accelerating growth trend. The primary driver, as John mentioned, for the improved revenue in the quarter, remains the improved shipments of oil and gas transmission units into North America, along with improved North American aftermarket demand which was also led by oilfield activity.

In addition, we've seen increasing signs of growth to varying degrees in nearly all of our markets, including European and North American commercial marine, global patrol craft, pleasure craft, global industrial and Asian commercial marine. The global offshore supply vessel market, however, remains depressed.

For the first nine months, sales are now up $52.4 million or 46% to $167 million. Our gross margin percent for the quarter improved by 220 basis points to 31.7%, compared to 29.5% in the prior year third quarter. This improvement is primarily volume driven, but also reflects improved operating efficiencies and a global reduction in fixed cost.

As John mentioned, margin performance for the quarter was somewhat hampered by an isolated warranty issue, resulting in an $800,000 charge in the quarter. Year-to-date, gross margin through March was 31.6% compared to 27.4% for the fiscal 2017 nine months.

Spending on marketing, engineering and administrative costs for the fiscal 2018 third quarter increased $1 million or roughly 7% compared to fiscal 2017, but decreased as a percent of sales from 30.5% in the fiscal 2017 third quarter, to 22.6% in the current quarter. The increase in spending was primarily related to $600,000 increase in the global bonus expense, as well as a $400,000 currency impact.

Similarly, year-to-date spending has increased $4.9 million or 13%, but has declined as a percent of sales, from 33.8% to 26.2% in the fiscal 2018 first nine months.

We invested another $0.5 million in the quarter, and now at $2.5 million for the first nine months related to the restructuring actions to drive additional cost reductions and efficiencies primarily at our European operations.

With the improved volume and margin performance, our operating results improved by $8.9 million from a $3.4 million operating loss in the prior year third quarter, to a $5.5 million operating profit in fiscal '18. For the first three quarters, operating results have improved by $17.9 million compared to the prior year, to an operating profit of $6.6 million.

The effective tax rate for the third fiscal quarter was 20.7%, reflecting the impact of the new tax legislation, along with some smaller favorable discrete items.

Net profit for the quarter of $4.3 million or $0.37 per diluted share reflects a $6.2 million improvement over the prior year fiscal third quarter, resulting in a year-to-date profit of $3.6 million compared to a prior-year nine-month loss of $7.5 million. Positive EBITDA of $7.2 million for the quarter reflects an $8.9 million improvement over the fiscal 2017 third quarter. On a trailing 12-months basis, we are now at $14.5 million of EBITDA, which includes the restructuring charges of $3.1 million over that period.

The balance sheet remains in a very strong position with $7.5 million of net cash, debt to total capital of 5.3% and $27 million of availability on our revolving credit facility. While inventory has increased $13.8 million since the end of fiscal 2017, this reflects growing demand as inventory turns have increased 23% over the prior year results. This increase is supported by the continuing growth of our six-month backlog, which reached $116.3 million in the quarter, a 150% increase over the prior year-end, and a 37% increase over the second quarter. The inventory increase also includes the positive exchange of tax of $2.4 million.

Free cash flow was negative $4.2 million in the third quarter, hampered by the growth in inventory and timing of sales within the quarter. Through the first nine months, we've reported $3.4 million in negative free cash flow compared to negative free cash flow of $2.7 million in the first nine months of fiscal 2017.

Cash flow performance has been impacted by volume driven increases in working capital. The $15 million increase in working capital compared to the prior year's third quarter represents 24% of the increase in trailing 12 month sales volumes. In addition, we've started to ramp up cap ex, as John noted, after an extended pause. We anticipate capital spending could fall on the $6 million to $8 million range for fiscal 2018 as we invest in modern equipment, global sourcing programs and new products.

Now I'll turn it back to John for some final comments.

John H. Batten:

Thanks, Jeff, and I'll just spend a quick moment on the outlook.

Our six-month backlog increased, as Jeff mentioned, 37% in the last three months, and is 130% higher than a year ago. I would say that the biggest change since our last call is the market improvements in areas outside of North American pressure pumping, particularly Asia. In short, it's a better mix of backlog.

We have seen a lot of new order activity in Asia, both in marine and oil and gas, with continued aftermarket demand across all of our product lines, signaling that the markets are coming to life. Our industrial marine shipments are up almost 10% year-over-year, and with respect to land-based oil and gas, the market is very active and we expect it to be for some time to come.

The attendance at last week's OTC Show in Houston was extremely busy, and many of our customers had a very positive outlook through 2019 and into 2020. We share that optimism, but it is our goal to use this opportunity to invest in new products and technologies to diversify our business.

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

Operator:

Thank you, sir. Ladies and gentlemen, if you would like to ask a question, please firmly press the star key, followed by the digit one on your telephone keypad. If you're using a speakerphone, please make sure that your mute button is disengaged so that your signal can reach our equipment. We will pause for just a moment to allow everyone the opportunity to signal.

Again, that is star, one to ask a question.

For our first question, we go to Josh Chan with Baird.

Joshua Chan:

Hey, good morning, John and Jeff.

John H. Batten:

Hey Josh.

Jeffrey S. Knutson:

Hey Josh.

Joshua Chan:

Yes, if I can start on North American oil and gas, obviously that drove the quarter for you guys. Could you talk about the conversations that you're having with the customers and the lead times, and whether you think the market is under-supplied and will be for some time, or whether you think it's sort of balanced with the capacity that's coming on?

John H. Batten:

My sense, Josh, is—well, we've had very positive conversations down in Houston. I'd say we're in that phase where a lot of the orders that we currently—a lot of our production bills for our customers are kind of in mid-stream and we're already in discussions for the follow-on orders. My sense, and I think the sense of our entire team that was down there is that we're still in a state of under-supply. I think there's more investments to come; I don't know how long it's going to last, but it certainly seems that there's a lot more runway. We're talking multiple orders.

I think the overall sense is that the market's healthy. There's still a lot of regional activity going on, a lot of new equipment being added. We're looking out—deliveries for us are eight to nine months out, so everything that we would be scheduling now would probably be at the very end—or not very end, but it would be in the first calendar quarter of 2019, so our third fiscal quarter of fiscal '19.

Overall, the best OTC in many years for many reasons.

Joshua Chan:

Right, right. That's good to hear that there's some visibility on that. I guess, on the backlog, could you talk about the amount of concentration or diversity in terms of—did you get one large order that drove the growth, or was there a number of orders that contributed to the very strong backlog this quarter?

John H. Batten:

I probably should have been a little clearer. It was multiple orders from different customers, different regions. I would say the thing that made us the most optimistic was Asia coming to life in a couple markets, commercial marine and oil and gas orders that we hadn't seen with that type of significance in two or three years. That's why I say a better mix of backlog; it wasn't just all driven by North American oil and gas—certainly a big part of it, but it wasn't the only part.

Joshua Chan:

Right, no, that's encouraging. Then, following up on some of your comments about—it sounds like there's a lot going on in terms of hiring, in terms of adding capacity. Could you talk about whether you're having trouble finding people, and how are you managing the moving pieces between that and equipment coming in and all that?

John H. Batten:

Sure. It's a mix of finding additional suppliers, dual and triple sourcing certain components, hiring and adding cap ex. Certainly, I would say the two most challenging, just as far as time, is finding additional suppliers and new employees that you can bring in and train and get them up to speed. Certainly, the cap ex, it's going to come in, we have guys that know how to run those machines, guys and gals, and that's going to be rolled out over the next few quarters.

But we made a big—a lot of headway was made in the third quarter. A lot more to do, but I feel a lot better right now than I did three months ago. Certainly, hiring, it's for everybody; but finding people here that want to work in manufacturing has always been a challenge, but the guys that are coming out of trade school are going to fit nicely with the machines that we have coming in.

Joshua Chan:

Okay, thanks for the color on that. I guess the last question that I have is on free cash flow. Given the increase in demand and I guess the working capital investment, should we think of free cash flow as more of an investment year this year in '18, and how would cash flow look potentially into next year when you take into account working capital and cap ex and all that?

Jeffrey S. Knutson:

Yes, I think that's fair, Josh, to look at this year as an investment year. I don't know how sustainable 45% year-over-year revenue growth is going to be, so I think we'll see some leveling off of working capital when we get into next fiscal year, but I think we'll see more cap ex. I think those two might balance a little bit, but we're certainly looking to see positive cash flow generation when we turn into fiscal '19.

Joshua Chan:

Great. Thanks for your time, and congrats on the good quarter.

John H. Batten:

Thanks, Josh.

Operator:

For our next question, we go to Jim Dowling with Jefferies Company.

James Dowling:

Yes, you've specifically referenced streamlining the operation and you're talking about cap ex and getting new equipment in, basically to make the business more profitable. I didn't go back and look, but if you went back in your history, the last time you were in a very strong up trend, where would you categorize the potential for future margin versus your past peak margins?

John H. Batten:

I would say we're—the potential peak is higher, I don't want to say if it's 300 basis points higher, 500 basis points, but it's higher, Jim, and it's going to be a combination of new cap ex and a lower fixed cost. Basically, our last peak, this rough number, we had 250 hourly employees here in Racine where the demand was. The trade-off this time, when we get to those peak levels, is we'll have more cap ex with fewer heads, and fewer facilities around the world.

I would say that if we do everything right, at a minimum, I could see 300 basis points higher end of peak.

James Dowling:

Thank you.

John H. Batten:

Thanks, Jim.

Operator:

As a final reminder, that is star, one to ask a question. Again, if you are on a speakerphone, please make sure that your mute button is disengaged so that your signal could reach our equipment. Once again, that is star, one to ask a question.

For our next question, we go to Simon Wong with Gabelli & Company.

Simon Wong:

Good morning.

John H. Batten:

Morning, Simon.

Simon Wong:

Morning. Just looking at the backlog, can you quantify how much that is related to oil and gas versus your other new businesses that came in during the quarter?

John H. Batten:

Sure. Simon, it is roughly half, is what we consider land-based oil and gas, and the rest is—I guess the rest is every other market. The rest is the rest.

That's why I say it's a much better mix of backlog, because if you go back 12 months, 18 months, two years, the half of our backlog is significantly better than it was at the bottom, just a year or two years ago.

Simon Wong:

Okay, and again, for the—again, staying on the backlog, are you able to identify how much that is new builds versus replacements?

John H. Batten:

Sure. If I'm just going to look at the unit, I would say—I might be off by 10%—I'm going to say at least three quarters is new builds, a quarter is for replacements, and then certainly the aftermarket component of it all is the 100% replacement. But if it's significantly different than that, we'll let you know, but that would be the rough order of magnitude.

Simon Wong:

But when you say new build, you're lumping in a rebuild to it… (inaudible).

John H. Batten:

Yes, I'm saying that 75% of what we have on order, roughly, is for new rig construction, ground up. They're building the new trailer, new engine. Probably a quarter of our units are going into replacement for units that they're not going to rebuild again but they're going to keep the rig going.

Simon Wong:

Right.

John H. Batten:

Then, obviously 100% of the aftermarket business is for the rebuild activity.

Simon Wong:

Okay. Now, in terms of your incremental, is the higher warranty expense the main driver of the low incremental margin for the quarter? How should I think about that going forward?

Jeffrey S. Knutson:

Yes, that's exactly right, Simon. Without that, we would have been about 130 basis points higher in the quarter, and that was a one-time. That issue is very discrete and accounted for within the quarter, so we would expect the margin performance to follow what the Q3 pro forma would have been without that.

Simon Wong:

Okay. Just my rough calculation, I'm looking at 45% incremental without the higher warranty expense. Is that what I should be looking for going forward?

Jeffrey S. Knutson:

In that 40% to 45%. I think as we get—as we compare—as the comps go forward, we're comparing to very favorable mix quarters over the past, say, two or three quarters, so we won't necessarily see the 45%, maybe it's drifting more towards 40%.

Simon Wong:

Okay. Then finally, DSL. Is there anything driving the jump in the quarter?

Jeffrey S. Knutson:

Yes, there is. As John noted, we had a lot of operational supplier issues that caused shipments to be more heavily weighted right towards the end of the quarter. Obviously those last three weeks of the quarter were not collectible within the quarter, which drove days up significantly.

Simon Wong:

Okay, great. Thank you.

Jeffrey S. Knutson:

Yes.

Operator:

With that, ladies and gentlemen, we have no further questions on our roster. Therefore, I will turn the conference over to you, Mr. Batten, for any closing remarks.

John H. Batten:

Thank you, Rufus, 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. We look forward to speaking with you again in August, following the close of our fiscal 2018 fourth quarter and year-end.

Rufus, I'll now turn the call back to you.

Operator:

Thank you, sir. Ladies and gentlemen, this will conclude today's conference. Thank you for your participation. You may now disconnect.