Twin Disc, Inc.
Fourth Quarter Fiscal 2012 Financial Results Conference Call
July 31, 2012

Operator: Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Twin Disc, Inc. Fourth Quarter Fiscal 2012 Financial Results Conference Call. At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question and answer session and instructions will be provided at that time. If anyone has any difficulty hearing the conference, please press star, followed by zero for Operator assistance at any time.

I would now like to turn the conference over to Mr. Stan Berger of SM Berger. Please go ahead, sir.

Stan Berger: Thank you, Ron. 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 fourth quarter and full-year 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 Mainaki (ph) at (262) 638-4000 and she will send a copy to you.

Hosting the call today are Mike 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 time the call over to Mike Batten. Mike?

Michael Batten: Thank you, Stan, and good day, everyone. Welcome to our fiscal 2012 fourth quarter and year-end conference call. I will begin with a brief summary statement and then John, Chris and I will be ready to take your questions.

As we noted in our press release issued earlier today, fiscal year 2012 was a record year in terms of sales and earnings that was driven by an exceptionally strong first nine months of the year, reflecting high oil and gas demand. However, softening demand from that sector produced moderating sales in the fourth quarter, but still ranked as our second best in history.

Turning to our results, for the fiscal year 2012, Twin Disc reported record sales of 356 million, compared to 310 million for fiscal year 2011. Gross margin for fiscal '12 was 34.2%, compared to 34.7% for the previous year. Marketing, engineering and administrative expenses held steady at 73 million for both fiscal '12 and '11. Net earnings attributable to Twin Disc for the fiscal year were 25.8 million, or $2.24 per diluted share, compared to 18.8 million, or $1.64 per diluted share, for fiscal 2011.

Sales for the fiscal fourth quarter of 2012 declined modestly to 96.1 million from 97.4 million for the same period a year ago. The anticipated decline in fiscal '12 fourth quarter sales was from softening demand in oil and gas products. Shipments to the aftermarket and industrial products markets, land- and marine-based military, airport, rescue and firefighting, and commercial marine markets were good, while the yacht market continued to be challenging.

Gross margin for the fiscal '12 fourth quarter declined to 29.4%, compared to 37.1% for the fiscal '11 fourth quarter and 34.6% for the fiscal '12 third quarter. The year-over-year and sequential decline in gross margin reflected a change in the mix of sales, primarily due to the impact of lower oil and gas transmission sales, as well as the unfavorable absorption impact due to the significant inventory reductions realized in the fourth fiscal quarter.

Spending on marketing, engineering and administrative expense declined 3.2 million to 19.3 million in fiscal '12 fourth quarter, compared to 22.5 million for the same three months of fiscal '11, primarily due to a reduction in stock-based compensations, the details of which are set out in the press release.

In preparing our financial statements for fiscal '12, we concluded that we were required to take an impairment charge amounting to $3.7 million, or $0.32 per diluted share, in the fourth quarter of fiscal '12 for the write-down of goodwill for our China operation, due to softness in the Italian mega-yacht market.

The net effective tax rate for the fourth quarter was 81.1%, significantly higher than the prior year fourth quarter rate of 41.4%. The primary factor increasing the current year rate was the impact of the nondeductible impairment charge of 3.7 million that increased the effective rate by approximately 32 percentage points. The remaining rate increase was due to a combination of reduced foreign tax credits, elimination of the R&D tax credit, and additional impact of the valuation allowance related to the Company's Belgian facility.

Net earnings attributable to Twin Disc for the fiscal year 2012 fourth quarter were $1 million, or $0.09 per diluted share, compared to 7.6 million, or $0.66 per diluted share, for the fiscal 2011 fourth quarter.

EBITDA for the current quarter was 8.8 million, compared to 16.3 million for the same period last year.

Working capital improvements during the three months enhanced our operating cash flows that were used to reduce debt, invest in our facilities and buy back our common stock. During the fourth quarter, the Company repurchased 125,000 shares of stock for $2.4 million at an average price of $19.40 per share.

Our six-month backlog at June 30th 2012 was 99 million, compared to 131 million at March 30th, 2012, and a record 147 million at the end of fiscal year 2011.

While our business is demonstrating improving trends, especially to customers in our industrial and commercial marine markets, changes to the oil and gas market are impacting our near-term outlook. We anticipate a challenging North American pressure pumping market to remain for at least the first half of fiscal 2013, as rig operators adjust to lower pricing. Sales to our Asian customers, including the sale of oil and gas transmissions, continue to be strong, with the result that Asia became our second largest end market, surpassing Europe. Sales of marine products into the US Gulf region have improved and our development programs, including our collaboration agreements with Caterpillar for our QuickShift® and Joystick technology solutions, are on track. Our commitment to innovation and quality has never been greater. The slowdown in oil and gas markets will impact sales and profitability and we remain cautious about the outlook for fiscal year 2013; nevertheless, we will continue to make strategic investments that will improve our balance sheet, develop new products and capabilities, as well as great new markets.

That concludes my prepared remarks for today and now John, Chris and I will be happy to take your questions. Ron, you may now open the line for questions.

Operator: Thank you. Ladies and gentlemen, we will now conduct a question and answer session. If you have a question, please press the star, followed by the one on your touchtone phone. You will hear a tone acknowledging your request. Your questions will be polled in the order they're received. Please ensure you lift the headset if you're using a speaker phone before pressing any keys. One moment for your first question.

Your first question comes from Peter Lisnic from Robert W. Baird. Please go ahead.

Josh Chan: Hi, good morning. This is Josh Chan filling in for Pete.

Michael Batten: Hi, Josh.

Josh Chan: Hi, good morning. Going to your outlook on the oil and gas market, you talked about it being challenging through calendar 2012. I guess that's where the cap ex cuts are taking place, but given all the parked fleets that are out there, you know, would you expect that could meaningfully slow down a recovery for your equipment, even if the industry somehow finds a balance in 2013?

John Batten: Josh, it's John. Absolutely. I mean the rig manufacturers and the operators need to work through the inventory of their fleet, and, obviously, our recovery is dependent upon utilization and where those rigs are being utilized, is it in oil, is it in wet gas or is it in dry gas, so that is something that we are watching.

Josh Chan: Okay. Then, kind of on a similar note, how would you characterize the useful life of your transmission products at current utilization rates?

John Batten: Well, depending upon—I mean, we're still looking at 6,000 plus hours, so it's how are they utilizing it, are they utilizing that in a year-and-a-half or over, you know, multiple years. The utilization hours are much higher in dry gas and lower in pure oil, so it all depends upon the mix of where they're using the rigs, but we're continually pushing to expand the effective hours of our rigs before overhaul.

Josh Chan: Right, makes sense. How would you characterize the rate of growth that you're seeing in the international market? You talked about shipments being higher there in oil and gas.

John Batten: Yes, particularly in Asia for us, it's been growing steadily throughout fiscal '12. I think we've reached a pretty good point where it's a very active market for us. I think before we see the next jump of growth we need to see some more infrastructure, you know, just in the oil and gas industry in China.

Josh Chan: Right, okay. Then, switching over to your gross margin, you talked about mix being an issue, but it sounds like manufacturing absorption impacted you this quarter, as well. Is there a way you can ballpark, you know, what kind of impact the under-absorption component had on your gross margin?

Chris Eperjesy: It's difficult, Josh—this is Chris—just because there's so many moving parts, but I would say between mix, under-absorption and then some impact of pricing, they were all relatively equal and important.

Josh Chan: Okay, all right. Thank you.

Chris Eperjesy: As you probably saw, there's a significant inventory reduction, I think almost 15 million in the fourth quarter.

Josh Chan: Yes, yes, absolutely, so that all makes sense. So, thank you for your time.

Operator: Your next question comes from John Braatz from Kansas City Capital. Please go ahead.

John Braatz: Good morning, gentlemen.

Michael Batten: Hi, John.

John Batten: Good morning, John.

John Braatz: A couple of questions. Oil and gas slowdown, there seems to be another issue that is developing, and that is because of the drought and lack of water. Are you hearing about any delays, postponements and cancellations of drilling work because of the lack of water out here in the Midwest?

John Batten: John, this is John. I have not, but that's something I will look into, but nothing that we have heard of yet.

John Braatz: Okay, okay. Secondly, Chris, your inventory position, you brought down rather significantly sequentially, but how do you view your inventory position relative to the current production rates and are you where you want to be or are we going to see additional cutbacks in the inventory position? Then, correspondingly, when you look at the full year, maybe for this year, how much working capital disinvestment might we see this year?

Chris Eperjesy: I guess I can kind of answer both together. We see more room for additional improvement, and that'll be one of the focuses for us this year, to continue to work on working capital improvement. I'm not going to give you a number, but, certainly, we think there's more opportunity.

John Braatz: Okay. One of the issues in your gross margin this quarter was the under-absorption. Do you think that will ease a little bit as we go forward? Will there be a little bit less under-absorption, so to speak?

Chris Eperjesy: Yes, I don't think you're going to see what you saw in the fourth quarter in terms of that significant of a fall-off. I think there'll be a more balanced approach for fiscal '13, so you won't see that significant of an impact.

John Braatz: Okay. Then, lastly, any new thoughts on the Caterpillar relationship and when we might see some of that begin to hit the P&L?

John Batten: John, it's John again. I would see that probably will have a little bit of impact on product being ordered and shipped to the CAT dealers the first half of the fiscal year, but it seems like they're targeting the real launch would be calendar 2013, the fall boat shows in particular, then Miami in February. That's kind of the launch cycle that we're on.

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

Chris Eperjesy: Thanks, John.

Operator: Your next question comes from Andrea Sharkey from Gabelli & Company. Please go ahead.

Andrea Sharkey: Hi, good morning.

Michael Batten: Good morning, Andrea.

John Batten: Good morning, Andrea.

Andrea Sharkey: One thing that I think was positive for you guys is that the revenue really kind of held up a lot better than I thought, given the weakening oil and gas markets. You guys were pretty much—you were pretty flat year-over-year sequentially. Can you talk about that? Is it because you're still pushing oil and gas out of inventory and out of backlog and so we haven't really seen that drop yet, or are there other end markets that are really offsetting the supply and demand?

John Batten: Yes, it's a little bit of both, Andrea. The North American oil and gas was down compared to last year, but making up for that we've improved commercial marine shipments to the US Gulf Coast and to Asia.

We also had some oil and gas shipments to Asia. And in general, industrial, our industrial products were a much better quarter compared to last year. So, what we saw as a drop-off in oil and gas, we made up for at the shipment level in marine and industrial.

Andrea Sharkey: Okay, great, and, I guess, how do you see that maybe going forward, do you expect to see a continued drop-off in oil and gas, and then is there enough demand in the other end markets to see that kind of continue to offset or do you think we'll see a bigger drop next year, next fiscal … (cross talking).

John Batten: Yes, I think we'll see some moderating levels. I think that marine and industrial will continue to improve, but I don't think they're going to make up at the top line for oil and gas coming down.

Andrea Sharkey: Okay, that's helpful. Then, on the impact of the mix on margins, is there anything that you can do—I know you guys have added a lot of capacity for the higher oil and gas demand that you saw—is there anything you can do to rebalance your manufacturing to sort of accommodate that decline, or are there other, you know, product lines that you can run through there? And, I guess, how should we think about margins going forward, are we going to continue to drop to high 20% percentage gross margins or is it more low/mid 20%? I know it's hard to be precise, but just to give us a sort of an idea.

John Batten: Sure. I think we're going to see a more traditional fiscal year for Twin Disc where the lowest margins are going to be in the first quarter, because we have a shutdown here in Racine, and we have longer shutdowns both in Belgium and Italy, so we're going to see more traditional. Last year was an anomaly, we had a late quarter. That's not going to be the case this year. We're going to have, probably, you know, the weakest top line and the weakest gross margins and then it'll build through the year, but as we have capacity or over-capacity in Europe, we're still going to take advantage of the chômage and (inaudible) grazioni (ph) programs, which are basically governed-sponsored layoffs in Europe. We have more than enough business in North America with commercial marine where we're going to be still working a solid six days a week here to get all the shipments out. So, we will be able to improve gross margins in Q2 through Q4, but the first quarter is going to be—it'll be a challenging quarter for gross margins, but it shouldn't be the indicator for the rest of the year.

Chris Eperjesy: This is Chris, Andrea. That is the typical kind of historical trend. Last year's first quarter was unusual.

Andrea Sharkey: Okay, great. Then, one last question and I'll let somebody else have a chance. Any idea on cap ex plans for 2013?

Chris Eperjesy: It'll be relatively—this is Chris again—it'll be relatively consistent with this year, in the $15-20 million range.

Andrea Sharkey: Okay, great. Thanks a lot.

John Batten: Thanks, Andrea.

Operator: Your next question comes from Joe Giamichael from Global Hunter. Please go ahead.

Joe Giamichael: Thank you. I realize we've sort of beaten the margin question to death at this point, but just to follow up on it, it sounds like you're discussing the quarter as sort of a trough for gross margins, with Q1 being a seasonal softness because of the shutdown. Is it possible to maintain these levels as the mix shift continues to shift away from the oil and gas products?

John Batten: Joe, it's John. I think, when we had the high oil and gas we kind of set the new norm of mid to high 30s. I think we're looking at, with this mix, you know, low 30s, but I'd qualify that, that it's going to be a tough first quarter to achieve that just because of the shutdown, but we still think that we should be targeting above 30% gross margin, but, obviously, oil and gas is going to have an impact of whether it's high 30s or low 30s.

Joe Giamichael: Got it, that's fair. You mentioned a pick-up in the industrial products side. Could you just give us a bit more color on the improvement there, sort of on either an end market demand or geographic basis, just to get a sense of sort of what's happening in the world?

John Batten: Yes, we're having—well, North America has just really at this point kind of eight quarters of steady improvement after the recession, and it's in all markets. A lot of it is in road construction, a lot of rock crushers aggregate type business; biomass growing, we have a lot of shredders, large wood chippers, where we're selling our PTOs. It really is the industrial market in Europe is the one bright spot for us, it's the one market that is holding its own and has shown some growth, and then we have a lot—we spend a lot of time in our distribution organization, both in Asia and South America, would have been traditionally marine focused, are now getting more into industrial product. So, we have improved shipments into Asia and South America. So, it's a balanced solid growth from the depths of the recession.

Joe Giamichael: Okay, great. Thank you very much.

Operator: Your next question comes from Greg Garner from Singular Research. Please go ahead.

Greg Garner: Yes, thanks for taking my question. Good morning, gentlemen.

Michael Batten: Hi, Greg.

John Batten: Good morning, Greg.

Greg Garner: Just one last item on that gross margin. You mentioned it was about an even mix between pricing, the absorption and product mix. Would the total magnitude be about 5 million? It seems like that would put gross margin at your mid 35% range. Is that about the right dollar amount I should look at for the aggregate effect of these items?

Chris Eperjesy: That's in the ballpark.

Greg Garner: Okay, and, again, about equal mix, nothing more towards absorption versus pricing?

Chris Eperjesy: Mix was big, but, I mean, so was the absorption impact as a result of the significant inventory reduction, but, yes, mix may have been slightly more, but they were both significant contributors.

Greg Garner: Okay. Can you tell us anything about the 7500? Is that at least maintaining the level of oil and gas revenues that wouldn't have occurred had that not been introduced, or a level of interest or new projects with it?

John Batten: It definitely contributed in the fourth quarter, because we didn't have it in the fourth quarter of fiscal '11, but it suffered the same as 8500 and everybody else with just the rapid slowdown, but we do have a couple of significant projects with the 7500 where it could be a much bigger contributor this year.

Greg Garner: Would that be in North America or would those projects be more Asia or Europe?

John Batten: There'll be one in North America and one in Asia.

Greg Garner: Is it gaining much traction in Asia? You were talking about the Asia oil and gas doing better?

John Batten: We've just started working the project in Asia. We wanted to do most of the initial production units in North America, but we have now opened it up to customers in Asia, as well.

Greg Garner: Okay. The impairment charge for Italy, the yacht business there, does that mean that your outlook for how that may recover has declined? Could you give us more color on how your outlook for the European yacht market, how it has changed?

John Batten: Well, the problem is that it really hasn't changed, the overall macro market, the pleasure craft yacht market is going to be very challenged for the next few years. However, we feel that our opportunity with Caterpillar and the CAT 360 and EJS, that our outlook is better. Unfortunately, you know, we have to look at the macro economic trends and when you look at that and you read the publications, you know, they're not showing great growth. So, that is where we had to base our decision upon, was what are outside publications and people saying versus just what our internal forecasts are.

Greg Garner: Okay. In the Caterpillar market, the assistance through Caterpillar would be on a worldwide basis, right?

John Batten: It's going to be worldwide through their CAT dealers, their marine dealers.

Greg Garner: All right, great. Thank you.

Michael Batten: Thanks, Greg.

John Batten: Thanks, Greg.

Operator: Ladies and gentlemen, if there are any additional questions at this time, please press the star, followed by the one. As a reminder, if you're using a speaker phone today, please lift the handset before pressing the keys. One moment, please.

There are no further questions at this time. Please continue.

Michael Batten: Thank you, Ron. Everyone, thank you again for joining our conference call today, we appreciate your continuing interest and support of Twin Disc, and we hope that we've answered all of your questions, and if not, please feel free to give Chris, John or me a call. We look forward to speaking with you again in October following the close of our first quarter.

Ron, you can turn it back to you now.

Operator: Ladies and gentlemen, this concludes the conference call for today. Thank you for your participation. You may now disconnect your lines.