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Twin Disc, Inc.

Fiscal First Quarter 2018 Investor Conference Call

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CORPORATE PARTICIPANTS

Stan Berger, *SM Berger*

John H. Batten, *President, Chief Executive Officer & Director*

Jeffrey S. Knutson, *VP of Finance, CFO, Treasurer & Secretary*

CONFERENCE CALL PARTICIPANTS

Kai Shun Chan, *Robert W. Baird & Co.*

Rand Gesing, *Neuberger Berman*

Mario Joseph Gabelli, *GAMCO Investors, Inc.*

PRESENTATION

Operator:

Good day, and welcome to the Twin Disc, Inc. Fiscal First Quarter 2018 Investor Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Stan Berger of SM Berger. Please go ahead, sir.

Stan Berger:

Thank you, Brian. 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 2018 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 states 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 President and 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 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 first quarter results, I'd just like to take a few moments to go over some of the operational and market highlights from the quarter.

As the increased year-over-year shipment levels and backlog numbers increased, it is obvious that conditions have improved in some of our product end markets. The North American pressure pumping fleet continued to add horsepower, both through new rig construction and overhauls of idle equipment. But we also saw widespread demand in aftermarket parts for all of our products. Also in the quarter, we saw a nice year-over-year increase for the demand of our higher horsepower hydraulic power takeoffs, which serve our broader industrial markets. Our marine markets remain mixed in the quarter, with our global patrol boat and North American inland river markets remaining active, while our global offshore markets, with at least 25% of the fast supply vessels and offshore vessels taken out of service, and most of our marine market—Asian marine markets remaining soft.

We also saw a continued success in the Eastern Canada fishing markets, where the higher commodity prices and lower fuel costs drove more demand for our marine transmissions. Besides the obvious benefit of a six-month backlog growing 35% sequentially and about 90% versus a year ago, Management feels the most significant milestone this quarter was achieving a 30% gross margin level on $45 million in sales. While we know that there's more work to do on our cost structure, and our first quarter restructuring costs reflect our determination to address these costs globally, hitting 30% of $45 million shows that the restructuring work we have done here in our domestic operations, coupled with the efficiency improvement programs we have enacted in the last 12 months, are working and beginning to pay off.

Jeff will have more of an explanation on the restructuring costs and the reversal of the tax evaluation allowance, but both of these reflect our efforts to have the most efficient global manufacturing and operational organizations going forward. Much of our focus over the last two years has been on our domestic operations, which saw the brunt of the demand drop. But we feel that this activity has stabilized and the charges this quarter reflect our efforts in Europe, where we are striving for more shared services, both backroom and operational, among our European plants. There will be more work to come. With that, I'll turn it over to Jeff for some comments on the financials.

Jeffrey S. Knutson:

Thanks, John, and good morning, everyone. I'll briefly run through the first quarter numbers in a little more detail. Sales of $45.1 million for the quarter were up $9.2 million or nearly 26% from the prior year first quarter. This represents the third consecutive quarter of year-over-year growth, demonstrating now a nice sustained growth trend. The primary driver for improved revenue in the quarter was improved shipments of oil and gas transmission units into North America, along with North American aftermarket demand also led by oilfield activities. While we've had encouraging signs in our European and North American marine markets and global patrol craft market, global industrial demand in Asian and commercial marine remain flat through the first quarter.

Our gross margin percent for the quarter improved by 520 basis points to 30.8% compared to 25.6% in the prior year first quarter. As John noted, a significant improvement, certainly volume-driven with a positive mix impact as well, but also reflects the improved operating efficiencies and a global reduction in fixed costs. This marks the first time in the history of the Company that we achieved a 30% margin result on sales less than $50 million, demonstrating that reduced cost structure and improved productivity we've been creating with the many actions we've taken over the past several quarters.

Spending on marketing, engineering and administrative costs for fiscal 2018 first quarter increased $1.2 million or roughly 10% compared to the prior year first quarter. But decreased as a percent of sales from 34.8% in the fiscal 2017 first quarter to 30.3% in the current quarter. The increase in spending was related to increases in the global bonus expense, stock compensation and volume-driven salary expense. We invested $1.2 million in the quarter related to restructuring actions to drive additional cost reductions and efficiencies, primarily in our European operations. With the improved volume and margin performance, our operating loss improved by $2.6 million compared to the prior year despite $1 million increase in the restructuring expense. The significant tax benefit for the quarter was primarily related to the reversal of a $3.8 million valuation allowance in a foreign jurisdiction, driven by improved recent operating results and execution of certain tax planning opportunities.

Excluding this significant item, the first quarter effective rate was 68.2%. This rate also benefited from a reduction in the reserve for uncertain tax positions following the successful conclusion of an IRS audit, which had a magnified impact on the effect of tax rate due to the near breakeven pretax results. Net income for the quarter of $3.4 million or $0.29 per diluted share marks the second consecutive profitable quarter following seven negative quarters. Positive EBITDA of $442,000 for the quarter reflects a $2.2 million improvement over the fiscal 2017 first quarter, despite the incremental $1 million in restructuring charges. On a trailing 12-month basis, we are now essentially at breakeven EBITDA after now two positive quarters in a row. Balance sheet remains in a strong position with $7.2 million of net cash, debt-to-total capital of 6% and over $18 million of availability in our revolving credit facility.

While inventory has increased 3.8 million since the end of fiscal 2017, this reflects growing demand along with the positive exchange impact of $1.7 million. Free cash flow was negative $2.9 million in the first quarter, hampered by the fiscal 2017 global bonus payments and the increase to inventory. But this reflects an improvement over the prior year negative free cash flow of $3.2 million. We have spent $1.5 million on capital improvements during the first quarter of fiscal 2018, and we anticipate spending in the $7 million to $9 million range for the fiscal—for the full fiscal 2018 as we invest in modern equipment, global sourcing programs and new products.

With that, I'll now turn it back to John for some final comments.

John H. Batten:

Looking at our outlook for fiscal 2018, there's no doubt that we feel we're in a much better place than we were a year ago, even six months ago. The North American pressure pumping fleet is finally addressing their horsepower gap in a big way. Our industrial markets appear to be improving and we see a lot of marine projects ahead of us. Only offshore marine remains a question mark for us. How much we improve in fiscal 2018 will depend on the collective efforts of our internal operations, coupled with our supply chain. We have tried to anticipate this increase in demand but it will take a lot of hard work to ensure that our suppliers can keep up with us. This is turning into a global effort as more and more pressure's put on our supply chain, with increased demands from a lot of entities, not just Twin Disc.

With that, Brian, I will turn it over for questions.

Operator:

Thank you. If you would like to ask a question please signal by pressing star, one on your telephone keypad. If you're using a speakerphone please make sure your mute function is turned off to allow your signal to reach our equipment. Again, that is star, one to ask a question.

We'll now take our first question from Josh Chan with Baird.

Kai Shun Chan:

Hi good morning and congrats on getting the gross margin and backlog improvement. On the gross margin, obviously, you've got over 30% this quarter, typically, Q1 is the softest margin quarter, if I remember right. Do you expect basically to stay above that level for the rest of the year?

John H. Batten:

I think if nothing changes in the mix dramatically, yes. I think that this—again, historically, seasonally, the lowest in revenue level and the lowest in gross margin. Yes, I think this is a steppingstone for quarters to come.

Kai Shun Chan:

Okay, great. Yes, that's good to hear. On the oil and gas business, are you—can you still book and ship if you get an order today? Or does that fall in the backlog given kind of production schedules and things like that?

John H. Batten:

We are still—any orders that we're taking today, we can still—these will show up in our six-month backlog. We are actually still probably able to deliver on some models in that four to five-month timeframe. But right now, we are scheduling out in the calendar 2018. That is somewhat based on our internal constrictions. But it's also based on customers. What they are able to build at their facility. Most of what we're booking right now really is for, I would say, a calendar 2018 Q1 delivery.

Kai Shun Chan:

Okay, okay. Then how do you see this demand shaping kind of maybe a little bit beyond? Are you having at least initial discussions with customers about kind of the pacing after the beginning of '18?

John H. Batten:

Yes, I mean, we are talking about potential builds beyond what they have. Again, as seen from other calls, it tends to be different at each customer. But I would say, even if the price of oil stays the same, gas stays the same, and the fracking activity stays the same, there's a growing horsepower gap coming.

What we've all seen in calendar 2017, again, pressure pumping hours stays the same, oil stays the same, everything is pointing towards a growing gap as more and more equipment, existing equipment has to be taken off-line. We've see a balance of rebuilding equipment, rebuilding our current equipment that hasn't been—and not maintained but hasn't been rebuilt for a long time. We see new construction of rigs and we've also seen our models being purchased and taking out a different transmission.

There's a mix of that at—across the market. But I think the broader theme is, if price stays the same, the number of hours for pumping for oil and gas stays the same, there is a growing horsepower gap coming in the next couple of years. It remains—and it's encouraging I, mean, I can't point to orders being placed for the fourth quarter of calendar 2018 or into 2019. But certainly, the conversations we're having with our customers, it's pointing to—I think, most people are recognizing that there's a horsepower gap coming and it's just the economics of how does each customer—what do they have to do to address that horsepower gap.

Kai Shun Chan:

All right. On the marine side of the business, you talked about maybe some improvement ahead. When do you think that might happen and what areas are you referring to?

John H. Batten:

Well, certainly the inland, what we consider our kind of the traditional core business of the deep case transmissions along the river and some tug activity in North America. That seems to be going well, certainly, activity in similar types of vessels in Europe. That seems to be getting better. The area that again still seems to be—not soft, we have some—I mean, it's soft, we still see some construction activity. But the biggest concern in marine still is the offshore. I think that is tied to, obviously, the confidence level on future and growing exploration in the Gulf of Mexico, in Southeast Asia.

If there's one market specific globally that it still remains a question mark, it's the offshore market. If there's one market geographically that still is soft, I would say it's most of the Asian marine markets. But orders, I would say, in the market have improved year-over-year. But it's still coming off a very low level. Then as I mentioned, the industrial markets for us, driven really by North America and Europe seem to be doing better, certainly in the new products that we've released, the higher horsepower hydraulic power take-offs. We're doing much better than we were a year ago. Just in general, the new units seemed better this quarter versus a year ago.

Kai Shun Chan:

All right. That's great. Then lastly for me, do you expect any further restructuring charges in the upcoming quarters?

John H. Batten:

I would say, Josh, yes. They're going to be—again, addressing how we operate in Europe, streamlining that organization we have. I would say one medium-sized plant and three smaller ones. Certainly, what we did in this course, just addressing, streamlining, I would say the shared services and how we're going to operate going forward.

Kai Shun Chan:

Okay. Any way to kind of bucket the size of those future charges, are they going to be smaller than what you did this quarter?

John H. Batten:

Josh, I would say it's hard to say. It certainly will be, I would say—let's just say manageable actions. I wouldn't look for anything larger than we've ever done in the past, not trying to telegraph anything like that. But just continued actions that makes sense, really, the right size, our cost structure but also streamline where we do each type of product to each type of operation. It also really reflects where we're finding the best sources of raw material and machine components. We're just trying to make the European organization much more streamlined.

Kai Shun Chan:

Okay, great I'll jump back in the queue. Thanks for your time.

Operator:

Once again as a reminder it is star, one to ask a question on today's conference.

We will now take our next question from Rand Gesing with Neuberger Berman.

Rand Gesing:

Hey guys it's been awhile.

John H. Batten:

Hi Rand.

Rand Gesing:

How's it going? Good?

John H. Batten:

It feels better this quarter Rand, thank you.

Rand Gesing:

I guess the question I have, given this building visibility into, perhaps, horsepower gap. Do you think that could make this oil and gas experience for you, guys, this cycle a bit different, a bit more sustainable? Or if we have—if it does come to sort of come to fruition, is it just sort of continue what we've had the last two times? It's been sort of a short term, relatively short-term period where activity has been very strong and then a drop off. I'm just wondering if you do get this horsepower gap thesis to sort of come to fruition, if it's a little bit different for 26 (phon)?

John H. Batten:

I think—I do think that what's similar to the last time, I'll kind of go back to that 2011, 2012, is I do think that the actual horsepower gap is probably very similar. But what is different this time is, I think, the experience of five years ago is still very fresh, five, six years ago, still very fresh in everyone's mind about the overbuild. I think we, too soon, too quickly added too much horsepower. The other thing that I think is going to make this one different is, when you go back to 2011, 2012, everybody had a lot of cash and their balance sheets were very clean and they could afford to buy too much, too soon, too quickly. I think what's different this time is those economics just aren't there. I think that is—what potentially could make this a more sane buildout is that, it's going to literally be limited by each customer—each Company is in a different situation, some are similar, some are different, for the overbuild.

I think that is going to add, I hope, some sanity to—if the gap turns out to be as big as we think it is and other people think it is, you just can't have everyone overbuilding at once. I am hopeful that this one will be more metered and more measured out. That's certainly my hope. But a lot of times, we've seen that history does repeat itself.

Rand Gesing:

Yes. You guys have done pretty well from a share perspective. The last couple of times have been an upcycle. How you feel about this particular moment in time as it relates to share?

John H. Batten:

We still—I still think it's a good deal, the stock. I think that the performance...

Rand Gesing:

No, no. I'm talking about your market share.

John H. Batten:

Market share?

Rand Gesing:

Yes, in pressure pumping.

John H. Batten:

I am feeling pretty good, Rand. I'm feeling pretty good when I look at the projects that have been out there, the ones that—we haven't won all of them, but we're certainly losing a lot fewer than we used to. Again, yes, I'm feeling pretty good about seeing us rebuild our stuff in—that's already out in people's fleet. I'm seeing new orders for new construction. I certainly love seeing our stuff being purchased to replace other equipment in the field. All in all, I'm feeling very good about it.

Rand Gesing:

Are you seeing enough of that? Because I think there's sort of a tendency to use the all Allison or you guys or what have you. Are you seeing a little bit more of that conversion? Or is just the guys that are typical (inaudible) those guys are the ones ordering you?

John H. Batten:

No, I'm seeing more conversion.

Rand Gesing:

Yes good. Alright well best of luck and we'll talk soon.

John H. Batten:

Thanks Rand.

Operator:

Once again as a reminder it is star, one to ask a question on today's conference.

We'll now take our next question from Mario Gabelli with GAMCO Investors, Inc.

Mario Joseph Gabelli:

I'll look forward to seeing you John, you and Jeff and questions that I couldn't ask in private I'll ask in public.

John H. Batten:

Yes.

Mario Joseph Gabelli:

Everyone is saying companies like the ones we are involved in, that have a $0.5 billion of market cap are too small and need to scale up. I'm looking at the way you handle your inventory. Inventories were down in the fourth quarter, but your receivables—let me just make sure of the first quarter. Your receivables were just surprising with a big flush of sales. Inventories were up and, I mean, receivables down, which is unusual. But look–scale. How do you think about how you handled the corporate overhead and corporate costs of being public and in an environment where when you had $250 million market cap, it's kind of tiny? Do you look at partnering up with other organizations, do you look at joint ventures, do you look at taking your cash flow and using it to make acquisitions? Kind of just 30-second observations.

John H. Batten:

Sure, Mario. It's John. We look at all of it. Certainly, some of the things that we've done in the corporate structure and the cost of being public, we—for the first time in 100 years, we changed our audit firm. And again, realizing that a Company, of course, $250 million may not—having a big four accounting firm may not the right fit for us. So that process...

Mario Joseph Gabelli:

That saved you $150,000 but you're spending it on (inaudible) so you're doing a lot of things that you don't need to do. I got it.

John H. Batten:

I'm happy to report it saved a lot more than that. But no, certainly on—say, the biggest impact on being public would be growing. Certainly, what you mentioned on acquisition, partnering up with people are all things that we are actively looking at to grow the top line because you're absolutely right. Staying at these levels, yes, is...

Mario Joseph Gabelli:

You guys have launched the product, you're going to have cyclical recovery in a lot of your markets. We talked to all the pressure pumping companies that we've got a good handle on all of that. The market share with Allison, we know that you might—aside from sharing, with the rest of those on the call, but independent of all that, what else have you worked on in the technology area or in your R&D that we haven't seen in public form yet that we should think about? What areas and what sectors and what products, if any, that you've…?

John H. Batten:

Sure. I would think that the one area that we can, I would say, combine both organic growth and then also in corporate development would be the shift in—hybrid has been very, I would say, not quick at all and not slow, but it has begun to trickle into the marine markets. You can have diesel electric and you can have pure hybrid. Certainly, it's been very fragmented.

For us to look at expanding our content and sales organically and adding key components through acquisition, it's if the marine market transitions into more and more hybrid forms, it's an area where we can double, maybe triple our content per vessel. We certainly have a lot of pieces of the puzzle to design and put that whole system together. But the key things that we need to add and certainly the many components, it's not just the marine transmissions anymore or controls, they're electric motors, they're inverters, they're different type of control systems. As we going forward and being—we were just a clutch and then just a gearbox Company, we've added controls, certainly moving into that space for us provides a huge opportunity to accelerate growth.

Mario Joseph Gabelli:

Yes, when I see you, I'll talk about taking that technology on land—on marine-based into a land-based opportunity because we had a Company called Sevcon, which (inaudible) just bought, doing something similar.

Look forward to seeing you both take care. Thanks very much. Unfortunately, I've got four calls at one time. Take care, bye.

John H. Batten:

Alright, thank you Mario.

Operator:

Once again that is star, one to ask a question on today's conference.

It appears there are no further questions at this time. Mr. John Batten, I'd like to turn the conference back over to you for any additional or closing remarks.

John H. Batten:

Thank you, Brian. 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 February following the close of our fiscal 2018 second quarter. Brian, now I'll turn the call back to you.

Operator:

Thank you. Ladies and gentlemen, that concludes today's conference call. We thank you for your participation.