Twin Disc, Inc.
Third Quarter Fiscal 2013 Financial Results
April 23, 2013

Operator: Ladies and gentlemen, thank you or standing by. Welcome to the Twin Disc Third Quarter Fiscal 2013 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. Instructions will be provided at that time. If anyone has any difficulties during the conference please press star, followed by zero for Operator assistance at any time.

I will now turn the conference over to Stan Berger. Please go ahead, sir.

Stan Berger: Thank you, Angel. On behalf of the Management of Twin Disc we are extremely pleased that you have taken the time to participate in our call, and thank you for joining us to discuss the Company's fiscal 2013 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 is contained in the Company's annual report on Form 10-K, copies of which may be obtained by contacting either the Company or the SEC.

By now, you should have received a copy of the news release which was issued this morning before the market opened. If you have not received a copy, please call Annette Mianecki at 262-638-4000, and she will send the copy to you.

Hosting the call today are Michael Batten, Twin Disc Chairman and Chief Executive Officer; John Batten, President and Chief Operating Officer; and Chris Eperjesy, the Company's Vice President of Finance, Chief Financial Officer and Treasurer.

At this time, I will turn the call over to Michael Batten. Mike?

Michael Batten: Thank you, Stan, and good day, everyone. Welcome to our Fiscal 2013 Third Quarter Conference Call. I will begin with a brief summary statement and then John, Chris, and I will be ready to take your questions.

As previously forecast, our third quarter results reflect continuing weakness from the oil and gas industries in North America, and general market demand in Europe. These soft markets have been offset somewhat by improving conditions for pressure pumping applications in Asia and continuing demand in the global commercial marine markets. Our near-term outlook remains challenging as we work through the bottom of the energy cycle, although we anticipate that demand will resume for fiscal 2014.

Sales for the third fiscal quarter of 2013 were 68 million, down from a record $95 million for the same period a year ago. Sales for the first nine months were 209 million, compared to a record 260 million in the prior year. The decrease in sales was primarily the result of lower demand from customers in the Pressure Pumping sector of the North American oil and gas market. Offsetting weakness in this market was higher demand for Pressure Pumping transmissions from China, as well as continuing demand from customers in the North American and Asian commercial marine markets.

Sales to customers serving the global mega-yacht market remained at historic lows for the quarter, while demand remained steady for equipment used in airport, rescue, and firefighting and the legacy military markets.

As previously forecast, gross margins for the third fiscal quarter was lower at 25.9%, compared to 34.6% in the same three months last fiscal year, and 30.8% in the fiscal 2013 fiscal second quarter. The anticipated decline in gross margin was the result of lower sales volumes and a less profitable mix of business.

Year-to-date gross margin was 28.4%, compared to 36.0% for the first nine months of fiscal 2012. ME&A expenses, marketing engineering and administrative expenses, for the third quarter of fiscal 2013 were 25.5% of sales, compared to 18.6% of sales for the same period a year ago. ME&A expenses decreased 341,000 in the quarter compared to last year.

Year-to-date ME&A expenses were 24.3% of sales compared to 20.7% for the first nine months of fiscal 2012. ME&A expenses decreased $3 million for the nine months versus the same period last fiscal year. The net decline in ME&A expenses reflected increased stock compensations, reduced incentive bonus accruals, tighter expense controls, and reduced R&D activities, wage inflation, and headcount additions.

The Company reported a net loss attributable to Twin Disc for the fiscal 2013 third quarter of $750,000, or $0.07 per diluted share, compared to net earnings of 10 million, or $0.86 per diluted share, for the record fiscal 2012 third quarter.

Year-to-date net earnings attributable to Twin Disc were 3.8 million, or $0.34 per diluted share, compared to 25.5 million, or $2.20 per diluted share, for the fiscal 2012 nine-month period.

EBITDA for the third quarter was 2.9 million, compared to 17.9 million for the same period a year ago. For the first nine months, EBITDA was 16.4 million, compared to 48 million reported last year.

While we continue to invest in inventory to support the growth and demand we are seeing from customers in Asia for our Pressure Pumping and Commercial and Marine products, we are also working on reducing inventories to reflect the overall demand and anticipate levels to decrease sequentially.

Our balance sheet and liquidity remains strong and sufficient to fund Corporate initiatives. Capital expenditures through the first nine months totaled 5.1 million, and we anticipate investing slightly less than $10 million in capital expenditures for the year.

Turning to our outlook, as we indicated last quarter, our fiscal 2013 results continue to be challenged by a decline in market activity in North America for our Pressure Pumping transmissions, as well as soft market conditions in Europe. Fortunately, our product market and our geographic diversity are helping to limit the impact on our results.

Our six-month backlog as of March 29th, 2013 was 65 million, compared to 68 million at the end of the second quarter, and 131 million a year ago. The backlog is in the process of bottoming and reflects the difficult situation encountered in the trough of the cycle where some markets continue to sputter, while others begin to gain traction for a recovery.

While the near-term outlook for oil and gas will remain challenging for the North American market, demand from China is encouraging. Per (ph) Commercial Marine activity in North America, the Pacific Basin, and Brazil continues to improve. Our Legacy Military and Arms (ph) demand is holding steady, however Uric (ph) and Pleasure Craft Marine continues to suffer from low demand.

While the near-term outlook will continue to be somewhat challenging, we anticipate a recovery in the 7500 and 8500 Pressure Pumping Transmission sales in fiscal 2014 that will be augmented by growing demand from customers in the Commercial, Marine, Industrial, Legacy, Military, and Arms markets. We are optimistic that we are well-positioned to capitalize under longer-term trends in all of our end markets.

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

Operator: Yes, thank you. Ladies and gentlemen if you have a question please press the star, followed by the one on your touchtone phone. Please ensure you lift the handset if you are using a speakerphone before pressing any keys. Once again, if you would like to ask a question you can press star, one at this time.

And your first question will come from the line of Mr. Peter Lisnic from Robert W. Baird. Please go ahead.

Peter Lisnic: Good morning, gentlemen.

Male Speaker: Good morning.

Male Speaker: Morning, Pete.

Male Speaker: Morning, Pete.

Peter Lisnic: First question just on gross margin, if we look at the year-over-year decline or sequential—however you want to do it—just wondering if you'd give us a feel or a flavor for how much of that decline was mix versus volume. I think year-over-year you're down almost 900 (ph) basis points so just put a little bit of color on mix versus volume.

Christopher Eperjesy: It's going to be—this is Chris, Pete—it's going to be equal parts of both. I mean both will have a significant impact. The volume decline—I would say they were probably roughly equal.

Peter Lisnic: Okay. All right, and should we expect the mix to kind of be, you know, a weight (ph) as we go into the fourth quarter and to fiscal '14, or are we kind of troughed-out on the mix impact?

Christopher Eperjesy: I think we've troughed-out of the mix impact. You should be—you know, I think in the release and in Mike's comments we talked a little bit about what's going on in Asia for oil and gas, so you may start to see the benefit of that in the fourth quarter. So I think the answer is we've troughed-out in (ph) March.

Peter Lisnic: Okay, all right. And then when you talk about the 7500 and 8500 recovery, I guess, in fiscal '14 and in those, you know, last bit of prepared comments, can you give us a sense as to how much of that potential recovery that you're talking about or seeing could be just a function of replacement demand—i.e. things wearing out and needing to be replaced—versus what I'd describe as new fleet or new rigs?

John Batten: Pete, it's John. I would say any demand in the first half of our fiscal '14, so the second half of calendar '13, will be more replacement, and I don't anticipate new rig demand until calendar 2014.

Peter Lisnic: Okay.

John Batten: But having said that, where we are—we have seen improved orders for China for those transmissions.

Peter Lisnic: For…okay.

John Batten: Which are new builds (ph) for China. Yes, so North America replacement, I think, will be kind of the next six months. I don't see any new solid rig activity, you know, frack rig construction, until calendar 2014.

Peter Lisnic: Okay, so North America replacement, China new fleet is kind of the way to—

John Batten: Yes, correct.

Peter Lisnic: Summarize that. Okay, and then just, can you give us a little flavor for Europe, exactly where the end market weakness there is exactly?

John Batten: Pete, it's John, again. With the exception of some of the industrial markets, you know, the small construction equipment, I would say most of our markets in Europe are very weak, and it's across the board. Most of the commercial marine activity that we're seeing is North America, South America, and Asia. Certainly a lot of our market in Europe, historically, has been pleasure crafts and, you know, fishing vessels, and government vessels, and a lot of that activity has slowed down to a complete trickle. So Europe, as a whole, with the exception of some of our industrial markets, is not doing very well.

Peter Lisnic: Okay. All right, I will get back in my line. Thanks for the call.

Male Speaker: Thanks, Pete.

Male Speaker: Thanks, Pete.

Operator: And your next question comes from the line of Mr. Brian Uhlmer from Global Hunter. Please go ahead.

Brian Uhlmer: Hey, good morning.

Male Speaker: Good morning.

Male Speaker: Good morning, Brian.

Male Speaker: Good morning, Brian.

Brian Uhlmer: I had a couple of quick follow-ups, but I got a lot of good stuff out of the way just now with those questions, but was curious on to what extent, when you talk about replacement, what extent of your work was kind of aftermarket repair business in the North American oil and gas business versus new, kind of, worn-out replacement transmissions?

John Batten: It's John. I believe as a percentage it hasn't really changed this fiscal year. So about 25% of what we've done this year in North American oil and gas has been, you know, repair and replacement and that was all in primarily the first four months of the fiscal year. So we have not seen a lot of aftermarket activity and rebuilds in the last four months. We know our rigs are working; we just haven't had a whole lot of issues.

Brian Uhlmer: Okay.

Michael Batten: And, Brian, this is Mike, and that's a good news, bad news situation.

Brian Uhlmer: Yes, you're building them too well.

Michael Batten: And, well, we like to hear that and that, I think, is the key takeaway here is that our product is lasting longer than what the oilfield, historically, is used to seeing, and so that's good news for our reputation and for follow-on new business, but we aren't seeing the same rate of aftermarket parts of supplies that maybe some others would see in this similar market.

Brian Uhlmer: Yes, perfect, perfect. And I guess the thesis is that, you know, a couple of the big guys came out in the last couple of days and said substantially more stuff around 24-hour operations, so that should accelerate somewhat in the next few months. Have you started seeing more indications of interest or discussions as those start to peak-up a little bit here or it's still too early for that?

John Batten: It's still too early, but I think there has been some utilization of inventory on the floor, so that is good, and I'm sure that's been going into replacing other rigs in the field. But I just don't see—I guess I should clarify—I don't see new orders on us for new units until calendar 2014. I think some of the big guys are going to be putting new rigs out in the field, but it's going to be inventory of completed rigs that they have sitting idle, or engines, transmissions, and inventory they have that they will (ph) assemble to put out in the field.

Brian Uhlmer: Right, okay.

John Batten: To clarify what I said before, I don't see new orders on shipments, until calendar 2014.

Brian Uhlmer: Okay, calendar 2014?

John Batten: Yes.

Michael Batten: For shipments, for shipments.

Brian Uhlmer: For shipments? Okay.

Michael Batten: The orders could be coming in between now and then.

John Batten: Yes.

Brian Uhlmer: Perfect. Now, can we talk a little bit about China? Who are you selling—are you selling those transmissions to existing customers from North America, or is it a new customer base over there that, local Chinese companies that you're selling?

John Batten: They're local Chinese companies. We're selling to the SJ Petros in China. We're also selling to some of the Chinese companies that have offices here in the U.S. and then they're shipping products back over to China. So it's going, you know, the sale is happening in two ways, but they're all Chinese rig manufacturers operating for the Chinese oil companies, the same oil companies.

Brian Uhlmer: Okay, and based on what you're—excuse me—based on what you're seeing in the field, I don't think that your product is really, that there's a proclivity for reverse engineering and manufacturing by a local Chinese party.

John Batten: No.

Brian Uhlmer: Is that how you feel, as well?

John Batten: Brian, of course I'm tapping on wood here, but I just—our volume is so low that I just don't think it would be worth the effort. You know, the economies of scale aren't there to reverse engineer.

Brian Uhlmer: Perfect, thank you very much. I'll turn it over.

Operator: And our next question comes from the line of Ms. Andrea Sharkey from Gabelli & Company. Please go ahead.

Andrea Sharkey: Hi, good morning.

Male Speaker: Good morning, Andrea.

Male Speaker: Morning.

Male Speaker: Good morning, Andrea.

Andrea Sharkey: So I just was curious. With the cap ex spending you've spent about 5 million already this year. You said you're going to spend a little bit less than 10 million for the full-year, but you only have one quarter left. So just curious, you know, what the big spend in Q4 is going to be for; and then maybe if you have any preliminary thoughts about spending for fiscal 2014.

Christopher Eperjesy: Andrea, this is Chris. I guess the caveat in fourth quarter spending always is whether we're able to get the equipment in before the end of the quarter. So to answer your question is, you know, it could be closer to the 7.5, $8 million range if we don't get everything in. So that's the answer to the first question; if we get everything in, it could be closer to the 10 million.

Regarding next year, I think it'll be, you know, more back in that $15 million-plus range is what we have in our plans for next year, but as we always do, you know, we'll react to kind of the environment we're in at the time.

Andrea Sharkey: Okay. And when you say, you know, what you get in in the quarter, I mean what does that go into? Are you expanding capacity in a particular product line or is it just, you know, replacement equipment in your facilities? I guess, you know, what is that, what are you using (ph) it for?

John Batten: Andrea, it's John. It's some of both. It's new equipment to replace older equipment for hobbing (ph) and stuff in our Industrial and Marine product lines so it's really a lot of it is fundamentally when the machines come in and when we get them up and running.

Andrea Sharkey: Okay, great. That's helpful. And then was just curious, you know, what happened? The backlog, you know, appears to be bottoming, but it did come down a little bit sequentially and I think in the last quarter call you guys thought that I had already bottomed because, you know, it had started to come back up. Was there another leg (ph) down in March and I guess how is April trending in terms of, you know, orders and what you think your backlog is going to look like?

John Batten: Andrea, it's John. I'm the one that said that, so I'll take the question now. We did. The backlog kind of see-sawed through the second quarter, and I had thought that we had potentially hit the bottom, but it see-sawed again in the third quarter, and came up with March. The best months of orders have been February, March, and April, and overall our backlog held very steady. It was just the six-months that fell; and that was a combination of I didn't foresee some of the shipments from—our facility shifted a little bit more than I had forecast. The European backlog came down a little bit more than I thought, but the backlog for North American and Asian customers did come up quite nicely. So I feel pretty good where we are today.

Andrea Sharkey: Great. That's good news. I'll turn it back. Thank you.

John Batten: Thanks, Andrea.

Operator: And your next question comes from the line of Rand Gesing from Neuberger Berman. Please go ahead.

Rand Gesing: Hey, guys. How are you?

Male Speaker: Hey, Rand.

Male Speaker: Hey, Rand.

Male Speaker: Hey, Rand.

Rand Gesing: I guess I wanted to talk about your trying to reduce some inventories. I'm assuming that's in Pressure Pumping or maybe not, but just what are the areas where you're trying--you have inventories where you're a bit high?

John Batten: Well, I guess the inventories where we're high are on, not necessarily oil and gas. I mean we do, we'd like to reduce this by shipping more and getting the orders. We really can't do much with that until we get new orders. Where we are reducing are in some of our more standard product lines, from some of our Marine transmissions; Industrial. Where we had had supplier issues last fiscal year and into this fiscal year where we had a little bit too much safety stock, we're working that through. We don't necessarily want to push out our oil and gas. We haven't been adding to it. You'll notice that our inventory has come down in the last quarter, but we want to be ready for the next surge in North American oil and gas.

Rand Gesing: Right.

John Batten: And we're in a very good position this time around.

Rand Gesing: Yes, I was just trying to get a feel for like, you know, the extent that you're underutilizing capacity and the impact that, I mean, the impact that's had on the last quarter and the next couple. I mean maybe it's a modest reduction of inventories, and so the capacity isn't being, you know, underutilized at first as current demands it by that much, but…

Christopher Eperjesy: Right. And maybe just to add to the inventory question, so, you know, right now Asia is the market that continues to be growing at record levels, so some of that inventory is either in production, on a boat, or arriving there, you know, that will ship in the fourth quarter and beyond. So that's part of the natural reduction of inventory. Regarding your question, you know, the third quarter, just looking at the volume year-over-year clearly was down significantly versus last year, so there is some, you know, impact on the absorption if that's what you're referring to.

Rand Gesing: Yes.

Christopher Eperjesy: That then starts to ramp up and orders come in. You're right; there'll be some benefits (ph).

Rand Gesing: Okay, okay. So, but you sort of view this as still continuing in Q4, and then as we move into the new fiscal year, that this will be less of an issue? In other ways—

Christopher Eperjesy: Yes, yes.

John Batten: Yes.

Rand Gesing: Okay. The free cash flow for the first three quarters sort of $6 million or something like that, will you guys—in the fourth quarter with taking inventory out of it will you grow that level of free cash flow, or how should I think about the fourth quarter in terms of how free cash flow might look for the year?

Christopher Eperjesy: That's our expectation, Rand, yes.

Rand Gesing: Okay, okay. And then so if I understand Europe, it sounds like it's been a weak market for you, but it's still sort of ticking down in terms of level activity.

John Batten: Yes, and actually to clarify—thanks for bringing that up again—you know, our European factories don't just ship to Europe.

Rand Gesing: Right.

John Batten: So what's keeping them going is, you know, their export markets back here to North America, South America and Asia, and we just have to keep focusing on, you know, export for them and not relying on their traditional home market, because it's going to be a long recovery for the European markets.

Rand Gesing: Right. Do you have to, at some point, start thinking about restructuring there, which is difficult to do, but…?

John Batten: You know, you're always thinking about that, Rand.

Rand Gesing: Yes. Okay. All right, thanks for the time.

John Batten: Thanks, Rand.

Operator: And our next question comes from the line of Ben Mackovak from Cavalier Capital. Please go ahead.

Benjamin Mackovak: Hi, guys. Thanks for taking my call.

Male Speaker: Hi, Ben.

Male Speaker: Hi, Ben.

Male Speaker: Hi Ben.

Benjamin Mackovak: So should we expect a sequential increase in the backlog next quarter?

John Batten: Ben, that is the million-dollar question. If I look at the incoming order rigs I would say yes, but traditionally the fourth quarter is this also the strongest shipping month so it's going to be a factor of how much comes in and can be shipped in the fourth quarter. But I think, you know, I think it's not going to get significantly worse or any worse, but, you know, we ship quite a bit in the fourth order; it's historically our best quarter. But I see the demand in, you know, in Asia and North America improving. It's just, it's more of a function of how much are the factories going to ship.

Benjamin Mackovak: Okay, great.

John Batten: And that is (ph) hard to predict.

Benjamin Mackovak: Of course, of course. I appreciate the color. Can you comment on any potential new customers out there, and just how the pipeline looks for that?

John Batten: Yes. I would say in, you know, for new customers, really, the success story has been the Chinese rig manufacturers, you know, that are servicing SJ Petro, Sinopec and the state oil companies in China. And then we're always working on—you know, those are kind of like the homeruns and the grand slams—but our sales guys have been hitting some singles in the U.S., getting new industrial customers, and that's really where we're focusing. Yes, and, you know, in China it's been getting the 7500s and the 8500 in, getting them accepted at the beginning of the market.

You know, that is, you know, that's a very good question, because that's how we're challenging our sales guys now, is finding the new customers, because a lot of the customers, particularly the ones in Europe, we've seen, you know, the market shrink and, you know, through consolidation, but we've also seen some of the customers disappear, and so we're having to find more customers everywhere.

Benjamin Mackovak: Okay, great. Thanks a lot.

Operator: And, gentlemen, there are no further questions at this time. Please continue.

Michael Batten: Well, good (ph). Well thank you, again, for joining our conference call today. We appreciate your continuing interest in Twin Disc and hope that we've answered all of your questions; if not, please feel free to call Chris and John, or me. We look forward to speaking with you again in July following the close of our fourth quarter.

Angel, you can turn it back to you, now.

Operator: Okay. Ladies and gentlemen, this does conclude the conference call for today. Thank you for your participation and please disconnect your lines.