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Twin Disc, Inc.

Third Quarter Fiscal 2015 Financial Results

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CORPORATE PARTICIPANTS

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Stephen McManus, *Sidoti & Company, LLC*

Walter Liptak, *Global Hunter Securities, LLC*

Doug Dyer, *Heartland Advisors*

PRESENTATION

Operator:

Good day and welcome to the Twin Disc, Inc. Third Quarter Fiscal 2015 Financial Results Conference Call. Today's conference is being recorded. At this time I would like to turn the conference over to Mr. Andy Berger of SM Berger. Please go ahead, sir.

Andrew Berger:

Thanks, Amber (phon). 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 2015 third quarter and nine months 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 a copy to you.

Hosting the call today are John Batten, Twin Disc's Chief Executive Officer, President, and Chief Operating Officer; and Jeff Knutson, Vice President, Finance, Interim Chief Financial Officer, Corporate Controller, Interim Treasurer, and Secretary.

At this time, I'll turn the call over to John Batten. John?

John Batten:

Thank you, Andy, and good morning, everyone. Welcome to our Fiscal 2015 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.

Looking at our third quarter results, sales for the 2015 fiscal third quarter were essentially flat at 60.9 million versus 60.7 million a year ago. The general conditions in our geographic markets remain unchanged. When compared to the previous year levels, our North American manufacturing and distribution operation showed good growth in the quarter in most product end markets, but that growth was offset by moderating markets in Asia and continued low demand from Europe.

When we look at our broader product end markets, the growth that we saw in North America was not enough to offset the lower levels of activity in Asia, nor the 5% or 3.2 million negative impact of foreign currency translation primarily from Europe.

Our third quarter sales into our industrial markets were essentially flat year-over-year with slightly higher shipments in North America offset by currency translations at our European operation. Most of our North American market sectors, including oil and gas, irrigation, recycling, and construction were relatively stable during the quarter. With the exception of oil and gas, we anticipate this trend continuing throughout the fiscal year.

Sales into our transmission markets improved versus fiscal 2014 third quarter levels, again, driven by the relatively strong shipments into our North American oil and gas end markets. Compared to the previous quarter and sequential quarter, our transmission shipments were down primarily driven by a lower level of shipments to Asia. After second quarter shipments rebounded nicely from a relatively weak first quarter, our global marine markets declined when compared both to the second quarter and previous year quarter levels.

Negative currency translation had the biggest impact in our marine markets due to the high percentage of marine activity at our European operations. While revenues did come down and the outlook is cautious due to the moderating day rates and rig counts, we're optimistic that any down cycle will not be nearly as severe as what we have seen in the pressure pumping area.

Gross margins for the quarter were 31.2% compared to 27.2% a year ago and 30.4% the previous quarter. A strong mix of product, which included both oil and gas units, service and parts, drove the gross margin improvement. Year-to-date, our gross margins are 32% versus 29.3% last year.

Third quarter spending in marketing, engineering, and administrative or ME&A expenses decreased by 210 basis points, or 1.2 million versus the same period last fiscal year, from 16.9 million or 27.8% of sales to 15.7 or 25.7% of sales. Reductions due to currency translation, pension expenses, reversal of stock compensation, and general spending controls were partially offset by an increased bonus accrual and general inflationary expenses. Year-to-date, ME&A spending is 48 million or 24.2% of sales versus 49.6 or 26% of sales a year ago.

Turning to the bottom line, the fiscal 2015 third quarter net earnings were 2.9 million or $0.26 per share versus a loss of half a million or $0.05 cents a share a year ago. For the first nine months of the year, net earnings of 10.7 million or $0.95 per share compared to 1.3 or $0.12 per share a year ago. EBITDA for the third quarter was 6.2 million compared to 2.3 million a year ago, and year-to-date EBITDA is at 23.9 million compared to 12.9 million a year ago.

Looking at the balance sheet, we ended the 2015 third quarter with a total debt of 12.4 million compared to 18.4 million at the 2014 fiscal year end, and we also had cash in the books of 23.6 million. Working capital declined almost 13 million since the beginning of the fiscal year and 17 million from a year ago.

Our balance sheet remains strong with debt to capital still below 10% and a positive net cash position of over $11 million. Our six-month backlog decreased from 58.3 million to 47.8 million in the quarter, products with oil and gas exposure drove the decrease in backlog. The rapid decline in the price of oil had a significant impact on net new orders for land-based and marine transmission systems that are used in the industry.

While we are pleased with our results in the first three quarters of the year, the confidence and optimism that we had this time a year ago has changed to one of cautiousness. While the drop in oil prices, day rates, and rig count has certainly curtailed a lot of new equipment purchases, North American oil production remains at historically high levels. Equipment is being used and will need to be serviced and eventually to be replaced.

Looking specifically at the North American pressure pumping market, we've felt that, as of last fall, we were very close to the 100% utilization of the fleet after having an excess capacity of almost 25%. With a dramatic drop in new drilling activity we may be headed to that level of excess capacity until the rig count begins to rise again.

Looking at the longer term, we still feel that our overall energy markets are a good place to be, and we will continue to develop new products for these markets and to look for new acquisition opportunities to enhance our position within these markets.

That concludes my prepared remarks and now Jeff and I will be happy to take your questions. Amber, please open the line 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, press star, one to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal for questions.

We will go to Tim Wojs with Robert Baird.

Timothy Wojs:

Hey, guys. Good morning.

John Batten:

Good morning, Tim.

Jeff Knutson:

Good morning.

Timothy Wojs:

I guess first question, just on—I was wondering if you can just maybe add a little bit of color around just the oil and gas order activity, how that trended through the quarter, maybe how it looks in April; and then maybe just add on how the aftermarket also kind of trended through the quarter.

John Batten:

I would say the order activity for units, particularly for North America, was very quiet in the quarter. Not—thankfully as far as spare parts, that continued, but not at the level that we saw in the second quarter. So the service activity for North America will, I think, slow down because through the—we're in the fourth quarter right now, that will slow down. Still some work to do that we have on the books, but with the excess capacity, I think we're going to see a lot of the operators rotating rigs if—and not repairing right away if they don't have to.

Timothy Wojs:

Mm-hmm.

John Batten:

So anything as far as order activity, we've seen a switch from past years where primarily North American shipping, then that trended kind of in '13 and '14 where a lot of it was to Asia, and this year it was primarily back to North America, but I think going forward we'll see a higher percentage going back to Asia for the time being.

Timothy Wojs:

Okay. Okay, and I guess just on Asia, how has that kind of played out through the quarter? Has that continued to weaken or has there been a little bit of strengthening in that market?

John Batten:

It depends. I would say the marine got—as far as where we restarted in the beginning of the year, the marine part's gotten slightly better, but oil and gas has kind of stayed at a, I would say a relatively weak position compared to where it was a year ago. So that really hasn't improved very much. But it's it doesn't—while it's down, it's not down as significantly as North America looks to be for the next couple of quarters.

Timothy Wojs:

Okay. Okay, that's helpful. Then, I guess just on the outlook, I guess we're closer to fiscal '16 now, should we think about revenue and I guess EBIT being flat to downish next year; is that probably the best view at this point?

John Batten:

Yes. I would say that certainly our toughest quarter of this fiscal year is going to be the fourth quarter and that usually has a mirror going into—coming out. So certainly the toughest quarters for us for fiscal '16 are going to be the first couple of quarters.

Timothy Wojs:

Okay.

John Batten:

They're just–it's going to take some recovery in the price of oil and the number of rigs to at least stabilize, stop reducing and...

Timothy Wojs:

Sure.

John Batten:

Then I think we'll see some improving trends.

Timothy Wojs:

Okay. Then you highlighted a balance sheet in your prepared remarks, and I know the end markets have kind of been choppy. I guess today versus maybe three or six months ago, are you more willing to do an acquisition now or would you rather wait to see visibility improve a bit?

John Batten:

If it's strategic I definitely have the capacity and the desire to do one. Because—I mean, I think our balance sheet can handle an acquisition and some choppy markets.

Timothy Wojs:

Okay, great. Well, I appreciate...

John Batten:

If it's the right one.

Timothy Wojs:

Sure, sure. I appreciate that. Well thanks, guys.

John Batten:

Thanks.

Operator:

We will go next to Steve McManus with Sidoti Company, LLC.

Stephen McManus:

Hey, guys. How you doing?

John Batten:

Hi, Steve.

Jeff Knutson:

Hi, Steve.

Stephen McManus:

I guess just staying on the topic of the aftermarket and kind of new rig activity, what has the mix been, I guess, at the end of this quarter versus the last couple, and where do you see that moving forward?

John Batten:

Well, I would say I believe that as far as aftermarket as a percentage of the sales will start the highest in the third quarter, driven by aftermarket kind of staying at its similar levels throughout the fiscal year, but the unit sales being down, and I see that general activity still being very good for the next few quarters. The trends look good in all, not just oil and gas, but marine, industrial, just general activity.

As I—a lot of the rigs are still being used, so there's going to be some repair work and a lot of our equipment out there is still being used, there's going to be repair work. So that part I'm pretty confident in. We tend to balance the right—we can be as low as 30% and as high as 40% and right now we're kind of in that just touching close to that 40% range as aftermarket and service as a percentage of sales.

Stephen McManus:

Okay, great. Then there's been, I guess, a bit of a ramp up in cap ex. Can you, I guess, discuss the allocation a bit and do you think the spending levels are going to remain at this level through fiscal '16.

John Batten:

That depends. We've had some projects, some plant activity here working on the facilities here, and we have a project in the fourth quarter at one of our European operations for some general facilities. So from the outside, that'll look like the spending will probably be up, but we're going to be mindful of what's happening in the markets and certainly mindful of any acquisition opportunity and spend where is needed, but be cautious.

Stephen McManus:

Okay, great. Then the last for me, I know the effective tax rate was impacted by a series of adjustments. Do you guys have like a fair run rate moving forward that we can expect?

Jeff Knutson:

Yes. This is Jeff, Steve. I think the rate is going to stay in that 35%, 36% range given where earnings look to be coming from. I think the phase of the P&L is always going to be a little bit challenging just because of the adjustments and, like, we call out the—some of our entities at the valuation allowance, but I think as a run rate you would look at that 35% to 36%.

Stephen McManus:

Okay, great. Thanks a lot, guys. I appreciate it.

John Batten:

You're welcome.

Operator:

We will go next to Walter Liptak with Global Hunter.

Walter Liptak:

Hi. Thanks. Good morning, guys.

John Batten:

Good morning, Walt.

Jeff Knutson:

Good morning.

Walter Liptak:

I wanted to ask one the pressure pumping business. I think you said that the units were down during the quarter, but it sounds like you are still getting some orders; is that right in North America?

John Batten:

I would say the units were down versus the second quarter, but up versus the third quarter of last year. The orders, I would say it's trimming up of the scheduling in Asia. There really haven't been any net new orders for North America in the quarter for units.

Walter Liptak:

Okay.

John Batten:

Any orders have been for aftermarket.

Walter Liptak:

Yes, okay. Kind of along those lines, the delta and backlog from December through March is about 10 million.

John Batten:

Yes.

Walter Liptak:
I wonder if we can get a little bit more description. I think you went through some of it already, but—and we can imagine where some of it is coming down.

John Batten:

Yes.

Walter Liptak:

But I wondered could you give some more detail.

John Batten:

Besides the FX translation, I think there was about a million. It is pretty much—Walt, it's going to be in the oil and gas story, just a drop of—for every, yes, six (ph) of it oil and gas, which will be the pressure pumping, about a million I think was translation, and the balance is probably weighted mostly in marine and again, trending towards what would be offshore oil and gas. So, I mean, 10% currency translation, 90% oil and gas related, and primarily, obviously, yes—just the obvious extreme cautiousness over the price of oil.

Walter Liptak:

Right, right. Okay. You didn’t mention that pricing at all and I think a theme that we've been hearing throughout the quarter was just the pricing pressure. I wonder if you're getting any of that on either units or remands or parts for the pressure pumping.

John Batten:

I would say we're starting to see certainly at the distribution level there's pressure on pricing as far as service, it's and repair work and we're feeling that too. Certainly on new—any new quoting activity as far as new units, particularly on—so far we've seen it mostly on the marine side. Not to say that there wouldn't be a little bit of pressure on oil and gas. It's just that in this quarter there hasn't been a lot of quoting activity for new equipment.

Walter Liptak:

Okay.

John Batten:

But you've seen, Walt, you've seen what the oil services companies have been able to do just as far as efficiency on labor. I mean, they are producing as much oil right now with dramatically fewer rigs and so a lot of the efficiency gains have been, you know, how they're servicing and staging the fracking and other activities. So, I do think that frack operators have gotten significantly more, let's say, cost competitive, have brought the cost down in the whole scheme of things.

Walter Liptak:

Okay. Got it. Okay. You mentioned that marine might—I want to make sure I get this right. It sounded like it's trending a little bit better than it was when your comments last quarter, and if that's right, is it either workboats or is it Coast Guard or something? Where is it getting better?

John Batten:

General workboat activity, push-boats along the river moving commerce, whether it's in North America or Asia, with the exception of kind of the coal barges in Indonesia for China, that is doing okay. It's really the offshore where we see if the crew boat is delivered, there's not necessarily one coming in behind it, or if someone drops out and a big guy takes that spot, again, that the slack behind him is not being filled for the moment. So it's just generally cautious right now, very cautious.

Walter Liptak:

Okay. In Europe, the pleasure craft, is there anything improving there?

John Batten:

Actually, I would say in different parts of the market, yes. I would say something that we don't' serve the trailer boat market; that's definitely getting better, but we are seeing some improved activity in North America with our Joystick System, certainly new orders; Australia as well. So that is actually in the backlog but I think some of it is outside the backlog with their schedules. So that is one area in marine that's been a benefit of a highlight.

Walter Liptak:

Okay, great. Then I—just a last one for me on industrial, and how are you seeing the industrial parts of the business I guess early in 2015?

John Batten:

Thankfully very stable. Good in North America, not as good in Asia or Europe right now, but, hopefully that's a trend that's can continue and doesn't suffer a little decline like we're seeing in oil and gas. But overall, those markets have been, for us at least, pretty good, pretty stable and we're optimistic. We have some new products coming out. So that is one area that heading into next fiscal year that there's at least a ray of optimism.

Walter Liptak:

Okay, great. Thank you.

Operator:

As a reminder to our phone audience, that is star, one at this time to ask a question. Once again, star, one. We will go next to Doug Dyer with Heartland Advisors.

Doug Dyer:

Hi, good morning, gentlemen. With some of the pressure pumping equipment that has been stacked, does any of that idle equipment ever become competition for your parts business or is that—since you're stacking the least productive equipment, that doesn't enter into the equation?

John Batten:

Good question and that is one that's going to change. The answer, I mean, is going to change depending upon who the fleet operator is. Most likely if there's a problem on a rig they'll swap it out with a new rig and just park the rig, and then rebuild the rig at some later date. We don't see or hear as much of them cannibalizing parts from a transmission unless it's something—or of the system—the whole frack—unless it's something that they can get at easily. So it's going to depend by operator, but by and large they'll swap out. If the rig's not—if the frack rig's not working, they'll just replace it with a different frack rig and then attend to the problem either immediately or some time down the line. But to answer your question, yes, it can provide a competitor because it delays either a replacement or a rebuild.

Doug Dyer:

All right. Thank you.

Operator:

It appears there are no further questions. At this time, I'd like to turn the conference back over to Management for any additional or closing remarks.

John Batten:

Thank you, Amber. Thank you for joining us on the 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 fourth quarter and end of fiscal year 2015.

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

Operator:

Thank you. That does conclude our conference. Thank you for your participation.