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Twin Disc, Inc.

Fourth Quarter 2019 Earnings Conference Call

August 9, 2019

C O R P O R A T E P A R T I C I P A N T S

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Timothy Wojs, *Robert W. Baird & Co.*

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Christina Bronec, *Campo GAMCO Investors*

P R E S E N T A T I O N

Operator:

Good day, and welcome to the Twin Disc, Inc. Fiscal Fourth Quarter 2019 Earnings Conference Call and Webcast. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Stanley Berger of SM Berger. Please go ahead, sir.

Stanley Berger:

Thank you, Ian. 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 2019, 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 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—I'm sorry, 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 you—a copy to you.

Hosting the call today are John Batten, Twin Disc's 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 Batten:

Thank you, Stan, and good morning, everyone. Welcome to our Fiscal 2019 fourth quarter and year-end conference call. As usual, we'll begin with a short summary statement, and then Jeff and I will be happy to take your questions.

Before Jeff goes over the quarter results, I will touch on some of the operational highlights and issues from the quarter. We continued to face several challenges in the fourth quarter that are reflected in our results. Jeff will provide more color on the details, but supply chain and internal capacity continued to affect our ability to keep up with demand.

In the run-up of the 8500s, we caused a lot of strain on our supply base. In order to meet demand on other products, we had to move supply to other vendors and not always at the lower cost. Availability and quality were our primary concern because our customers could not wait. We also faced some suppliers who went out of business or shifted focus away from our markets. We have been working hard to resource these parts to a lower cost supply and are on our way to achieving this, but we'll have to work through some existing inventory.

Additionally, our newer products like the 4001 and ARFF transmission, the 7600 with the planetary output in many of our new industrial products are still working through inventory at prototype and preproduction pricing. Q4 had a higher than normal percentage of new products.

We should see improving trends throughout Fiscal 2020 due to lower cost supply, improved efficiency and pricing actions. As we mentioned on the last call, we did have oil and gas pushouts from Q3 and Q4 into the first half of Fiscal 2020, which obviously affected the mix.

Internal capacity was affected by declining efficiency, partially driven by newer employees and increased training and a dramatic shift in mix in the second half of the year. We continue to get better by the month and reacting to the new demands and our new employees are coming up to speed.

Almost all of the inventory increase with the exception of Veth came from an increase in oil and gas demand on two transmission models, the 8500 and 7600. The 8500 is almost purely for new rig construction or for a direct 8500 replacement on an existing rig.

The 7600 has been used widely in China and for—and in North America for a swap out of a competitive model. This is where most of our demand remains at the moment, but we do have an excess of inventory that we plan on—that we plan to bring down to meet the near-term demand. Operational and functional changes have been made to make sure this happens.

Looking at more positive developments in the year. Both our global, industrial and marine markets saw growth, and we maintained a healthy backlog heading into Fiscal 2020.

Now I'll turn to a couple of our strategic objectives for a moment. As we finish our first year with Veth, we could not be more pleased with our progress of integration into the Twin Disc family. Most of the efforts in year one were in finance, HR, marketing and engineering.

Our finance team did a great job bringing the team up to SEC speed, and we delivered a coherent and unified approach at the major global trade shows. And our engineering teams came together to forge a collective path forward, especially on the hybrid front. There is no doubt that Veth will greatly help us in our path of diversification going forward.

Our response in the North American and Asian markets has been extremely positive, and we expect good sales growth in the coming years. Our facility in Lufkin is under construction, and we expect to be operational in our fiscal fourth quarter with all of our North American produced industrial products. We will have a dedicated team solely focused on growing our industrial business. Developing and adding new products to our portfolio is a top priority for us in Fiscal 2020 and beyond.

With that, I'll turn it over to Jeff for some comments on the financials.

Jeffrey Knutson:

Thanks, John, and good morning, everyone. I'll briefly run through the fourth quarter numbers. Sales of $72.4 million for the quarter were down $1.3 million or 1.8% from the prior year fourth quarter. The quarter decline is the result of a significant reduction in new build activity in North American fracking market along with a related reduction in aftermarket activity. This decrease was partially offset by the addition of Veth propulsion activity and increased activity in our marine and industrial market. The quarter was also impacted by continued supply chain challenges, resulting in some delayed shipments and excess inventory.

We continue to see strength and positive momentum in nearly all of our markets including the global, industrial, commercial, marine and patrol craft markets. For the full year, sales finished up $61.9 million or 26%. Adjusting for the Veth acquisition, the organic increase is approximately 3%. This year-over-year growth was driven by oil and gas demand primarily in the first half of the Fiscal Year, along with improving sales of industrial product, which grew over 10% from the prior year.

Our gross margin performance for the quarter was severely impacted by an unfavorable product mix with lower fracking demand for new rig construction and reduced aftermarket demand being the primary drivers. The fourth quarter margin percent was 22.7% compared to 37.4% in the prior year fourth quarter. In addition to the mix impact, we were forced to move some production, as John mentioned, to higher cost suppliers in order to meet the growing demand of some of our land-based transmission systems. We are already pursuing alternative vendors for improved pricing to address this issue. The fourth quarter result includes the impact of the Veth acquisition and related purchase accounting amortization.

Excluding the Veth noncash purchase accounting amortization, gross profit was approximately 24.2% for the fourth quarter. For the full year, gross profit finished at 29.6% compared to 33.5% in Fiscal '18. Again, adjusting for the write-up amortization on the Veth acquisition, Fiscal '19 gross profit would have been 31%.

With the challenging product mix in the second half of the year, we are focused on driving cost reduction and pricing actions to improve margin performance. Spending on marketing, engineering and administrative costs for the Fiscal '19 fourth quarter decreased $1.8 million or 10% compared to Fiscal '18. The decrease is a result of reduced bonus and professional fees, along with the impact of the Mill Log sale, partially offset by the addition of Veth Propulsion and related purchase accounting amortization. For the full year, ME&A expenses fell to 23.6% of revenue compared to 25.4% for Fiscal '18.

Included in the Fiscal '19 results are two other operating items totaling $1.6 million. These relate to an $800,000 gain on the sale of the Mill Log business and assets and an $800,000 adjustment to an accrual associated with the Veth Propulsion acquisition. While the fourth quarter operating results were essentially breakeven on the challenging margin performance, the full year operating income was $2.4 million or 15% higher than Fiscal '18.

Effective tax rate for Fiscal '19 was 25.6% compared to 33.1% for the prior year. The current year rate reflects the benefit of a full year impact of the new tax legislation, which was enacted midyear in Fiscal '18. The prior year rate was also negatively impacted by discrete adjustments related to rate changes and related remeasurement of deferred tax, assets and liabilities. The Fiscal '19 bottom line has improved by $1.1 million to a profit of $10.7 million or $0.83 per diluted share compared to a profit of $9.5 million or $0.82 per share in the prior year.

Positive EBITDA of $6.1 million for the quarter reflects the $3.8 million decline from the prior Fiscal '19 fourth quarter, but brings the full year results to $29.9 million and $8.9 million improvement over the prior full year. The balance sheet remains healthy as we closed our Fiscal '19 with the impact of the $61 million Veth acquisition and subsequent $32 million equity offering remaining the headlines for the year. We finished the fourth quarter with $30.1 million of net debt, debt to total capital of 18.9% and debt to EBITDA ratio of 1.26.

While inventory did come down $2.3 million in the quarter, inventory reduction efforts were hampered by customer-driven delays in delivery into Fiscal 2020. Six-month backlog finished the quarter at $100 million, which is down $14 million from the Q3 level. Operating cash flow was positive $6.7 million and free cash flow was positive $3.6 million in the fourth Fiscal quarter with improving working capital numbers contributing to the positive results for the quarter.

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

John Batten:

Thanks, Jeff. Now I'll spend a quick moment on our outlook. A lot of management time was spent on the integration of Veth in Fiscal 2019. Many of the actions that we were looking at to consolidate back-office functions, particularly in Europe, were put on hold as we did the acquisition and then the integration. Moving forward, we will continue our efforts to reduce fixed cost in conjunction with our efforts on variable material cost. Veth provides us the critical mass and access to talent we need to build a European team. We are already using their experience to develop our marine hybrid line, and we look to expand these electrification efforts into our industrial and transmission lines.

There has been a lot of talk about electric frack rigs. And while the current number is relatively small, we see this as a growing trend in the future. We will be ready with solutions for our customers who wish to pursue this option. Many of you also probably saw our press release in May that Jim Feiertag has rejoined Twin Disc as our President and Chief Operating Officer after spending four years as Chief Executive Officer of Bemis Manufacturing. Jim's intimate knowledge of our people, products and facilities will be very beneficial in the coming years as we rationalize our global footprint and product portfolio.

Finally, we want to convey the message that Management continues to focus on diversification and growth. Even as we address the short-term margin challenges in front of us, we will continue to explore further opportunities to grow our industrial business and to enhance our hybrid development. That concludes my prepared remarks.

And now Jeff and I will be happy to take your questions. Ian, 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 use a speaker phone please make sure your mute function is turned off to allow your signal to reach our equipment. Again that's star, one to ask a question.

We'll take our first question that comes from Noah Kaye of Oppenheimer. Please go ahead.

Noah Kaye:

Good morning, gentlemen. Thanks for taking the questions. First, if we can touch on the margins. You pointed to a number of factors to your mix, supply based challenges. Can you give us a little bit more granularity on this? How much did mix weigh on margins in the quarter? And then any detail you can give on some of the other factors.

Jeffrey Knutson:

Yes. I can jump on that one, Noah. Mix was—they're kind of related, I guess, in some way. So the mix—the low margin on the products that drove the negative mix is really a result of the sourcing issues that John described. So we've got the lower margin products, the newer transmission products. That drove, if we're comparing Q4 to Q4, almost $9 million of unfavorable impact on the margin line. So that really was the driver, and that's why we're focused on the cost profile of those products that are driving that negative mix as well as pricing on those products.

Noah Kaye:

Right. The—this is the legacy business, really—the Veth margin, I think you previously commented. That is kind of around Twin's typical margin in the low to mid-30s. So Veth was not—if I understand right, that was not a drag on margin?

Jeffrey Knutson:

That was a little bit of a drag. They finished the year—and I'm excluding the amortization piece, right? So the amortization was about $4 million—$4.1 million for the quarter—for the year. Excluding that, they were around 28% for the full year. And it—they've got a little bit of mix as well in their project. So Q4, in particular, was a challenging margin quarter for Veth.

Noah Kaye:

Okay. And then...

John Batten:

Noah, if I could add a little bit of color. If I look at the transmission products where we had to shift suppliers, I guess with the full year looking back, those units in general were probably—and I don't have the exact numbers in front of me. But their margin went down by about 5% based on shifting to—having to shift to different suppliers, if that makes sense. So the gross margin on them probably deteriorated over the year with that supply about 5%, which we are working to reverse right now.

Noah Kaye:

Right. Right. And then you commented to expectations that margins should improve sequentially over the coming quarters as you take action. Just roughly, how should we think about that? Can we kind of get back to the margin levels that we would typically expect with sort of more for a stable run rate?

John Batten:

Absolutely. I mean, we are looking to get back to, at a bare minimum, kind of being where we were for our year-end gross margin during a down cycle at high 20%s, approaching 30%. It's a combination of—and we have already begun shift—finding different supplies who're being able to go back to other suppliers that were lower cost and pricing. So typically though, our first quarter is usually our lowest margin quarter because of the shutdowns in the U.S. and in Europe. So I expect—most of our pricing actions start in September and October. So I think the real improvement that you'll see will probably be in the second quarter, but we should...

Noah Kaye:

Okay. That's really helpful. And then just on the development front, in your prepared remarks, you mentioned your development of the marine hybrid line of products that you might be looking to take that into some of your other end markets. Just can you maybe update us a little bit on what kind of adoption you're seeing or expecting to see for the hybrid products on the marine side? And then kind of how we should think about that entering the portfolio for some of your...

John Batten:

Yes. We're seeing—it's fragmented. Certainly, we're seeing in a lot of urban areas in Europe demand for hybrid tugs. So being able to operate in low-speed mode on—from the genset or batteries. And particularly, in marine, what we're seeing, hybrid in the sense of not diesel electric for these types of tugs. But running off the genset or running off of propulsion engines. We're seeing that for passenger ferries. And then a lot of the canal boats, river traffic in Europe, and we're seeing that for tugs in the U.S. and in Asia. So it's—but it's—I wanted to say it's not a tidal wave. It's happening application by application. And we're seeing it both for the Veth Z-drives and for our current marine transmission product line. So it is—we are working as one team to develop the controls logic to be able to do this across all of our products.

Noah Kaye:

And then just on how quickly you could introduce a new fracking product?

John Batten:

We are working on current projects right now. I can't say when they're going to be in the field, but they're in development right now with end customers. So—and I would say this, we probably won't have one single solution. It will be different solutions tailored to different customers. But what I'd like to say, you'd see something this Fiscal Year, but I can't bank on that, Noah. But it's sooner rather than later.

Noah Kaye:

Okay, thank you very much for the color. I'll jump back.

John Batten:

Okay, thanks.

Operator:

And we'll take our next question from Tim Wojs of Baird. Please go ahead.

Timothy Wojs:

Hi, gentlemen. Good morning.

John Batten:

Good morning.

Jeffrey Knutson:

Good morning, Tim.

Timothy Wojs:

So I guess, just first question on the gross profit cadence. I just want to make sure I kind of get it in the right ballpark here. Were you thinking kind of high 20%s, low 30%s gross margin for the year or do you think that's more the run rate that you can exit the kind of back half of next year at?

John Batten:

Tim, I'll answer first. That's what I think. For this year, that's where we're going to exit the year.

Timothy Wojs:

Okay. Got you. That's helpful. Okay. And then you would expect it to be probably down in Q1 relative to what we saw in the fourth quarter? And then kind of build, much more of a step-up in Q2 and then building it to the back half of the year?

John Batten:

Correct.

Timothy Wojs:

Okay. Got you. Great. And then just a housekeeping question. How big was the North American oil and gas business in the quarter, if you're able to say that?

John Batten:

I'll let Jeff give you the numbers. But most of—almost all of our activity was aftermarket or rigs—units going into rigs that were taking out—replacing competitive product in existing rigs in the North American market. I think that was almost all of it. I think we had maybe a handful of units that went into new rigs in the quarter. Very few.

Timothy Wojs:

Okay. Okay. Got you. And then when we think about just free cash flow for next year, Jeff, how should we think about—if you kind of look at working capital and kind of the—it sounds like you'll release some working capital maybe in the first half of the year with inventory. How should we think about just kind of a ballpark estimate of what free cash flow could look like in 2020?

Jeffrey Knutson:

It's always a tough one to answer, and I know it's an important point. Yes, we're certainly focused on bringing inventory down. We have inventory—as John pointed out, a big part of our inventory growth is in that oil and gas market. So a lot depends on the market dynamics there and how much we're able to move through, but we're certainly—we expect to be positive free cash flow quarter by quarter and certainly for the full year. I would say something on the order of what we did in Q4.

Timothy Wojs:

For a quarterly number you're saying?

Jeffrey Knutson:

Yes.

Timothy Wojs:

Okay. Got you. Okay. And then I guess, last question here that I had, when we think through how you're thinking about kind of the oil and gas market in 2020, John, should we expect—do you think this is kind of the bottom quarter, I guess? Q4, did you think you start to see some more rebuild activity in the first quarter and then kind of building into the year? How would you kind of frame where we are in terms of—and when you think new could actually start to shift in a more meaningful way?

John Batten:

I don't—I'll start with your last question first. I don't see new rig construction happening in any meaningful way until Calendar 2020. And I do think—well, our first quarter be like our fourth quarter? I expected—I personally am driving for and expected the first quarter will be a little bit better for our shipments of oil and gas for replacement. So I think that should be better in the first quarter. But it could easily be the same quarter as the fourth quarter. I mean it's—because the activity requires some rework on the rigs, we're beholden to how they're doing on getting the rigs ready for the transmission. So—but yes, it's going to be—my hope is that it's a little bit better, but it could be the same as the fourth quarter. But certainly, we have the demand there for that growing replacement market.

Timothy Wojs:

Okay. Thanks guys. Good luck. Look on next Fiscal Year.

John Batten:

Thank you. Thanks, Tim.

Operator:

And we'll take our next question that comes from Rand Gesing of Neuberger. Please go ahead.

Rand Gesing:

Hi, guys.

John Batten:

Hi, Rand.

Jeffrey Knutson:

Hi, Rand.

Rand Gesing:

On the e-transmission, are the—are you guys sort of like the third player to the market there? What's sort of currently available?

John Batten:

There are a whole bunch of—well, there's two ways of looking at. You can do it with variable frequency drives or you can do it with a DC motor and a transmission. Obviously, we are—again, e-frack is—when compared to diesel engine for a frack, it's very expensive, high maintenance, but it is a growing option. So we are pursuing all avenues, but I would say our primary avenue is DC motor and using a transmission to control the shaft into the pump.

So I don't think anything changes with the main players of the kind of the three transmissions that are in the market. But again, it's—we're building a team and expertise that we have at Veth on providing the best solution for our customers, and we think the most cost-effective. We think—when we hash this out in a few years that we will have a very compelling product portfolio solution for those who are looking to do e-frack.

Rand Gesing:

Okay. As it relates to—it looks like the gross profit was down almost a little over $10 million quarter-on-quarter, Q4. You mentioned $9 million was for the mix issue. Just wanted to sort of confirm that, that's I guess the bulk of the down gross profit?

John Batten:

Yes. Fourth quarter of last year. I'll let Jeff do the numbers, but it was probably the height of new rig construction shipments for us and aftermarket rebuild. It was a—fourth quarter of last year was an incredible quarter.

Jeffrey Knutson:

Yes. We knew that was going to be a different comp when we printed it. So yes, that's—mix is the big story.

Rand Gesing:

Okay. And what—if—I just think of sort of like your fort walls, where we're having inefficiencies. Can you just sort of—is it—how meaningful is it, I guess, I'm trying to understand. Obviously, you're getting in boarded from suppliers...

John Batten:

It's a combination. So Rand, it's—the internal efficiency is—it's twofold. Obviously, there are external factors and internal factors. Supply base not knowing what parts you're going to get in and we're trying to build what we can in each month because we're hand to mouth with few suppliers is one issue. So it drives inefficiency if you're building one product and then you realize you're not going to get all the parts, and you have to pivot.

Secondly, and a big factor, we—in the prior 18 months, I don't—you have to go back to the early '70s or kind of post-World War II or when Twin Disc started, the amount of new people that we added and we are seeing is the most I've seen in my career. And I know when I started, we hadn't had a hiring ramp-up like that since probably the late '60s, early '70s. It just took a while to get people trained and up to speed, particularly on some of our newer products that are a lot more technical and more complicated to build. So I see that improving. All the employees have had six months to 12 months under their belt, have been trained. So I see that efficiency—employee efficiency improving. But as we find alternate suppliers and get a more steady streaming where we can bank on it, you'll see our efficiency improve, output improve and inventory start to come down. So I do believe we've turned the corner, and then we'll see some improvement throughout the next four quarters.

Rand Gesing:

Okay. Last question I had was—if we think about your slice, I think you called it out in the press release sort of 48% is marine. How do you feel like that—I'm hoping it's a grower as we head into '20. So we sort of think like that apples-to-apples for the acquisition. Is that sort of a mid-single-digit grower you think as we look to '20?

John Batten:

I think our traditional product line, the marine transmission product line and propellers and surface drives, I think that is a mid-single-digit grower. I think we have the opportunity to beat that with the Veth product line. Provided that the markets in Europe remain stable, I see good growth opportunities in North America and Asia in the coming years. So I think we can beat that with the Veth product line.

Rand Gesing:

Okay. And I guess, I do have another question, just popped up. Do you guys see in the next 18 months doing another sort of non-oil and gas add-on to your pipeline? You could do that or—obviously, you got some manufacturing things going on too, so maybe...

John Batten:

That is the goal. I mean, we do want to bring—we do not want to take the eye off the ball on our Lufkin facility. I personally believe and Management does believe that this facility can have as much of an impact to Twin Disc as the Veth acquisition. Getting the industrial products out of our 21st Street operation into a dedicated facility with a dedicated team, I think it's going to be—when we look back a few years from now, it will be as impactful to Twin Disc as the Veth acquisition was.

Rand Gesing:

Okay. All right. Great, thanks for the update, guys. Good luck.

John Batten:

Thanks Rand.

Operator:

We'll now take our next question from Mario Gabelli of GAMCO Investors. Please go ahead.

Christina Bronec:

Hi, Mr. Bailey actually had to step into a meeting. It's Christina Bronec from GAMCO Investors with Mr. Gabelli's question. What is different this cycle from previous cycles? I know a couple of dynamics have been touched on, but if you just sort of summarize that would be great.

John Batten:

Really—Christina, are you talking about the oil and gas cycle?

Christina Bronec:

Yes.

John Batten:

Okay. Well, I think the difference this time—the easy one is the price of oil is a lot higher. The last cycle we saw volume disappear because of pricing in Asia and North America. There wasn't a lot of the rebuild activity. We weren't replacing a competitive product with our 7600, but that is changed this cycle. We still see the price of oil remaining strong. We see a lot of activity. The equipment is being used and used hard. So we see continued rebuild activity on the horizon and our order board for units to replace competitive product has never been higher. So that gives us a little bit of optimism that this cycle will be better than that 2015, 2016 cycle.

Christina Bronec:

Great, thanks so much.

John Batten:

Okay. Thank you, Christina.

Operator:

Thank you. Again if you would like to ask a question at this time it's star, one. At this time, we have no further questions. A final call for questions, that's star, one. It looks like we have no further questions. So Mr. Batten, I'd like to hand the call back to you.

John Batten:

All right. Thank you, Ian. 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. And we look forward to speaking with you again following the close of our Fiscal 2020 first quarter. Ian, now I'll turn the call back to you.

Operator:

This concludes today's call. Thanks all for your participation. You may now disconnect.