VIAVID
communications simplified.

Twin Disc, Inc.

Fiscal Fourth Quarter 2017 Investor Conference Call

August 4, 2017

CORPORATE PARTICIPANTS

Stan Berger, *SM Berger & Company, Moderator*

John Batten, *President and Chief Executive Officer*

Jeff Knutson, *Vice President of Finance, Chief Financial Officer, Treasurer and Secretary*

CONFERENCE CALL PARTICIPANTS

Tim Wojs, *Robert W. Baird*

Steve, *Seaport Global Securities, LLC*

George Gaspar, *Private Investor*

PRESENTATION

Operator:

Good day, and welcome to the Twin Disc Incorporated Fiscal Fourth Quarter 2017 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, Jim. 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 2017 fourth quarter and full-year financial results and business outlook.

Before I introduce Management, I would like to remind everyone that certain statements made during the course of this conference call, especially those that states Management's intentions, hopes, beliefs, expectations, or predictions for the future, are forward-looking statements. It's 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 2017 fourth quarter and year-end 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 fourth quarter and year-end results, I'd like to just take a few moments to go over some of the operational highlights from the quarter and Fiscal year.

No doubt many of you have seen the improved results already reported by other industrial and energy companies for the latest quarter, which is a good indication that some of our markets are headed in the right direction. The main drivers for Twin continue to be an increased demand for our oilfield power transmissions, our marine products for the Global Patrol Boat Market, and a general surge in demand for our aftermarket parts.

While the global offshore market remains at depressed levels, with at least 25% of the SSVs and OSVs taken out of service, we did see some increased quoting activity for new build. Globally, our industrial markets continued with steady, but depressed, demand for units, but a strong surge in demand for the aftermarket parts.

As we discussed in the third quarter call, we have finally begun to see new build and replacement activity in the North American pressure pumping fleet. A broad, generalized statement would be this: this was absolutely needed. Available, usable horsepower was at a critical level, with nothing left in reserve for any increase in activity. Demand for both units and parts for oilfield transmissions continued at a very strong level in the quarter, and the demand spread to more of our customer base.

Operationally, our Fiscal fourth quarter was the best that we have seen in many quarters; over $50 million in sales, gross margins above 30%, and positive net earnings. The results of the quarter began two years ago with a lot of hard decisions on our cost structure, new ideas of how to operate differently, and continued close cooperation with our distributors and customers to take advantage of new market opportunities.

At the beginning of the downturn two years ago, our goal was to be profitable at $200 million. We feel that this latest quarter is a good marker that this is achievable. With only a 1% increase in sales in Fiscal 2017 versus Fiscal 2016, our operating margin, without in structuring or impairment charges, improved by $12 million.

During the past six months, we have added key operational talent, both in our European and domestic facilities that will help lead our teams to a new level of operating efficiency. I would particularly like to highlight of the work done by our employees here in Racine over the past two years. Our domestic operations took the brunt of the demand drop, went through the most thorough of the restructuring, had salaries and wages reduced, and quite often had to fill multiple roles as we redesigned how we operated. They never complained once, and worked harder than ever to get to a quarter like the one we reported today. If you ask any of them, I think you will find that they believe that there is more to come.

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

Jeff S. Knutson:

Thanks, John, and good morning, everyone. I'll run through the numbers in a little more detail for what's turned out to be a very nice ending to our fiscal year.

Sales of $53.6 million for the fourth fiscal quarter were up almost $11 million, or approximately 26% from the prior-year fourth quarter, and $8.5 million, or nearly 19% sequentially. This follows 9% growth in the third fiscal quarter, giving us two consecutive growth quarters for the first time since fiscal 2012. Fourth quarter sales represented the highest quarterly sales level since the fourth quarter of fiscal 2015. A primary driver, as John stated, for improved revenue in the quarter, was continuing shipments of oil and gas transmissions into North America, along with improved North American aftermarket demand, also led by oilfield activity.

Full-year sales finished $1.9 million, or just 1% ahead of fiscal 2016, reflecting a nice second half volume recovery. Through the first half, we were 15% below the fiscal 2016 sales level, but exceeded the second half by 17% to edge over the prior full year. Year-over-year results reflect a second half recovery in North American oil and gas demand, offsetting reduced activity in the Asian market for the Company's commercial marine products, and general softness in the global industrial market.

Our gross margin percent for the fourth quarter improved by 520 basis points to 31.4%, compared to 26.2% in the prior year fourth quarter. This is the first time in the history of the Company that we achieved a 30% margin result on sales less than $60 million, reflecting the reduced cost structure and improve productivity we've been creating with the many actions we've taken over the past several quarters. For the full year, our margin percent has improved by 430 basis points to 28.7%, compared to 24.4% for the prior year. This positive result, again, is reflective of the Company's aggressive cost reduction initiatives over the past several quarters, a response to very difficult market conditions in many of our end markets, along with the favorable margin impact of the increased oil and gas and aftermarket shipments in the second half.

Spending on marketing, engineering, and administrative costs for fiscal 2017 declined $4.3 million, or 8%, compared to fiscal 2016. This decline was a result of previously announced cost reduction actions, and our global focus on managing costs, along with reduced expense—pension expense, and lower spending on corporate development activities in the current year. These savings were partially offset by an increase to global incentive compensation expense, based upon successful progress the Company made towards margin improvement and fixed cost reduction goals.

We invested an additional $424,000 in the quarter and now $1.8 million for the year in restructuring actions to drive additional cost reductions and efficiencies in our domestic and European operations. These actions are expected to generate annualized savings in excess of $2.4 million.

With the improved margin performance and reduced MD&A spending, along with the impact of significant prior year impairment charge, our operating loss improved by $15.6 million compared to the prior year on relatively flat sales. Approximately $3.6 million of that improvement relates to the decline in impairment of restructuring charges compared to the prior year.

Our effective tax rate was 35.8% for fiscal 2017, lower than the prior year rate of 48.6%, which was favorably impacted by $2.4 million of foreign tax credits associated with the repatriation of cash from certain foreign entities. Adjusting for this non-recurring benefit, the fiscal 2016 rate would have been a more consistent 39.1%.

Net income for the quarter of $1.2 million, or $0.10 per diluted share, marked a return to profitability after seven negative quarters. For the year, the net loss has improved to $6.3 million, or $0.56 per share, compared to $13.1 million, or $1.17 per share in the prior year.

EBITDA for the fourth quarter was positive $3.4 million, and EBITDA for the full year, a negative $2.4 million, an improvement of $13.7 million compared to the prior year.

Our balance sheet remains in a very strong position with net cash of just over $10 million, debt-to-capital of 4.9%, and over $21 million of availability in our revolving credit facility. After reducing inventory 17% in fiscal 2016, inventory remained relatively flat through fiscal '17, with recovering demand of oil and gas products in the second half of the fiscal year.

We achieved positive free cash flow of over $2.8 million in the quarter, resulting in neutral free cash flow for the year, as we continue to focus on cash generation. This represents a $2.8 million improvement over the prior fiscal year. We remain committed to optimizing free cash flow, including close management, prioritization of capital spending on key new products, global sourcing, and process improvements.

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

John H. Batten:

Thanks, Jeff. I just have a quick comment on the outlook. While our six-month backlog did drop about $2.5 million from our third quarter, it is up 30% from year ago levels, and we feel that, overall, we are in a much better position with our markets than we were at the end of fiscal 2016. Orders in July continued the strong trend that we saw in the first half of calendar 2016. Our two biggest market concerns going forward remain in the global offshore market and the overall Asian marine market. While there has been steady aftermarket demand from both areas, it is too soon to try to anticipate a growing demand for any new build.

That concludes my prepared remarks, and Jeff's. Now, Jeff and I will be happy to take your questions. Jim, could you please open the line for questions?

Operator:

Certainly. For the phone audience, if you'd 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, and we'll pause for a moment to allow everyone an opportunity to signal for questions.

We'll take our first question from Tim Wojs from Baird.

Tim Wojs:

Hey, guys. Good morning. Nice job on returning the profitability.

John H. Batten:

Thanks, Tim.

Jeff S. Knutson:

Yes. Thanks, Tim.

Tim Wojs:

I guess the first question I had was just on backlog. I know you had booked a pretty large order in the third quarter, and so I'm just curious how much of that order has—have you kind of blown through in backlog, and I'm just trying to understand what the underlying backlog number might look like, just ex that order, because you did mention in your previous—or in your prepared remarks that you were seeing broader order activity from your customer base.

John H. Batten:

We're, I would say, about two thirds of the way through that initial order, the two main orders, and I would say that we shipped more 8500s in the fourth quarter then we took orders for, that's for sure, so that's going to result in almost all of the decline. Aftermarket was still strong. Other orders helped offset that, but this is going to be kind of a numbers game in some of the quarters, because these—the orders come in chunks, obviously, for the 8500. We can take an order for more in a week then we can deliver in a week, so it's going to be kind of up and down, but I would just say, Tim, that the demand going forward for the 8500 is as strong as the orders that we took in the third quarter and fourth quarter, so I don't—I suspect that you might see that backlog number reverse fairly quickly here coming out of the first quarter if everything goes well, so I'm not overly concerned about that $2.5 million job. That's why I mentioned in my comments a much—I feel much better about the 30% improvement over last year, and I still think that we have growth. Now, our operational guys will tell you they don't want the backlog number to grow. As soon as they get an order, they want to be able to ship it.

Tim Wojs:

Sure.

John H. Batten:

I would say that $2.5 million drop was not a reflection on anything in our markets weakening, particularly in oil and gas.

Tim Wojs:

Yes. No. Yes, that's why was trying to ask that question, because I know some of it's just that order may be normalizing a little bit, so okay. Got you. Then, on the—maybe just on fiscal '18, I mean is it, from a guidance perspective—I'm not sure if you want to comment on it, but do you expect that 2018 should be a year of positive EBITDA contribution for the whole year, and then kind of on that, I think the cap ex is kind of up ticking next year. How should we think of free cash flow in Fiscal '18?

John H. Batten:

Well, I'll let Jeff answer the second one, but the first one, if—I would say, clearly, we're starting Fiscal '18 in a much better position than '17. A lot's going to have to do with continued—this isn't, I'd say, a boon demand from oil and gas, but it's a nice uptick. We've had good aftermarket spare parts growth, and we've seen, again, some quoting activity in marine that we didn't see kind of for the last six months, so if we have sales levels near that $50 million mark, quarter, quarter, quarter, then yes, I think you can safely say that's what we're shooting for, is to be profitable for all of fiscal '18, and to be profitable, quite frankly, in each quarter. Now, historically, the first quarter's the hardest, just because we have shut—every plant has a shutdown during the first quarter, so we just struggle with the number of shipping days, so—but yes, Tim, we're shooting for profitability, and profitability in each quarter, and really, the key metric is how close to $50 million are we in each quarter of—on the top line, and I'll let Jeff answer the second one.

Jeff S. Knutson:

Yes, Tim. On the free cash flow, I think it's—I think we'll try to be positive. I wouldn't predict a full year that's a significant positive free cash flow. I think we might find ourselves investing in a little more capital this year. I think there's a little bit of pent-up demand, in particular as volume comes back. We have some capital that we'll need to spend, and I think we might find a little more working capital landing on the balance sheet as it bounces back, but I think we're in a good position right now, generating cash in the quarter and I think we've got a good case and a good pace, and we feel good about how our, in particular, inventory is set up for this coming year with the volume that's in front of us, so I think a good goal for us is just to stay positive quarter-to-quarter and for the full year.

John H. Batten:

Yes. The other thing I would add is, on the topic of MD&A-wise, structurally, I mean, as far as headcount, a lot of that we're going to try to hold, again, at the levels that we've achieved, but we are beginning our hundredth year, so in September of 2018 it will be our hundredth anniversary, so we have some marketing spend that we'll do in calendar 2018 that'll kind of spill between fiscal '18 and fiscal '19. Over the past couple of years we've maybe done half of the distributor meetings that we've done in the past, and as our distributors look to cut costs, then we're cutting costs, but it kind of all comes back together where we're going to have a global distribution meeting here in Racine, and some other activities that we're going to try to also put into a marketing campaign just on general awareness, so those are some costs that'll be in next calendar year, 2018, but that'll be kind of straddled on fiscal '18 and '19.

Tim Wojs:

Okay. Okay. That actually was going to be my next question, just as revenue comes back, how much of the MD&A you can kind of keep compressed versus how much it's going to grow, so okay, and then the last question for me, just on the gross margin in the quarter, any way to kind of parse out how much was volume mix and structural cost improvement?

Jeff S. Knutson:

That's a tough one.

Tim Wojs:

I know. It's probably not an easy question.

Jeff S. Knutson:
I guess the answer is, it's kind of a relatively even split. I mean, the mix was very good, clearly, with aftermarket in oil and gas, but we're seeing productivity levels that we haven't seen in a long time in our Racine operation, so.

John H. Batten:

I would just say, just visually, Tim, the—again, most of the volume—as I mentioned, most of the hit came in our domestic operations here in Racine, so a lot of the recovery you've been able to see has been there, because that's where the downdraft was, but what they delivered in the fourth quarter and the third quarter, and I look at the number of people that they did it with. They're at their—the lowest level of employees. You'd have to go back three, four years when they had 25%, 30% more employees, and so they're delivering a top line with—and they're just operating more efficiently, so yes, a lot of it was the market coming back and having the demand, so you're able to produce the transmissions, but they're doing it more efficiently and with fewer people, so a lot of it is, really, with efficiency improvements and the cost structure here in Racine.

Tim Wojs:

Okay. Let me ask it a different way. I think the incremental gross margins in the quarter were 50%. Does that kind of tail off a little bit in ‘18, or do you think that that's an appropriate number, kind of mix neutral?

Jeff S. Knutson:

I think that would be, probably something we might target through the first half...

Tim Wojs:

Okay.

Jeff S. Knutson:

...but again, with mix theoretically improving through the first half year-over-year, I think when we get to the second half, that tails off.

Tim Wojs:

Okay. Great. I'll hop back in queue, but great job on the year and look forward to ‘18.

Jeff S. Knutson:

All right.

John H. Batten:

Thanks, Tim.

Operator:

Moving on, we'll take our next question from Walter Liptak from Seaport Global.

Steve:

Hi. This is Steve. I’m on for Walt.

John H. Batten:

Oh, hi, Steve.

Steve:

Hey, so we've seen some of the data out of the U.S. stocks, and many of the PDS employers are complaining about frac equipment shortages. Are you guys seeing increased quotes and orders for the 8500 unit, and also, how long does the process take from an older unit to go through the field and produce?

John H. Batten:

The answer, Steve, is yes, we're seeing a broadening of the inquiries, so the number of customers coming in requesting quotes on new units and aftermarket parts, and the orders are increasing from the number of customers. We absolutely see that there is a shortage, and right now I would say we're kind of in that 14, 16 week lead time to get new units, maybe a little bit shorter, and then there is a—certainly, I think there's a rush—there's a tier change, and if you can get Tier 2 engines before the end of the calendar year and you can get everything bolted up and assembled, you can use Tier 4 engines—sorry, Tier 2 engines as opposed to Tier 4, so I think there's a push to get as many of the Tier 2—they're less expensive to build—before the end of the year, so right now we can certainly deliver units to those wanting to build before the end of the year, but I would—yes, I would use about 16 weeks for us right now.

Steve:

Okay, thanks, and just one more. Do you guys discuss the volatility around oil prices when adding new frac capacity?

John H. Batten:

Yes. We talked about it in the last few calls. I think there was—certainly when we were down in the 20s and low 30s, the cash flow was severely constrained, even though the equipment needed to be upgraded, overhauled, or replaced. I think you're seeing that even in the 40s, there is enough cash flow that people are rebuilding their equipment and overhauling it and replacing really old units with new units, so I think that we're in a pretty good spot for the frac fleet, at least as we add the horsepower that we need to. Certainly, $50 and higher would help maybe spur more activity. Really, where we're seeing the price of oil kind of have the most sobering effect is really on the offshore fleet, and that's with the number of OSVs and SSVs that are docked, and just total constraint on new construction, so if we see the price of oil affecting anything right now, it's the global offshore fleet, not the North American pressure pumping fleet.

Steve:

Okay, thanks, and just one more before I let you guys go. A lot of material costs have gone up, and I was seeing if you could discuss the pricing around the 8500 unit, and do you guys plan on increased prices in the future? What is the outlook with that?

John H. Batten:

Steve, it's pretty competitive pricing. I mean, we're—each order that we're getting, we're being pitted against the competition. We have, again, started to see material prices increase, which is going to everyone equally, so I would just say that each order and each quote is a competition, and it hasn't—I would say that the price pressure has not been as great as you would think, so really, what's winning the day more often than not right now is your reputation on reliability. Can they get access to spare parts, and when can you deliver, so if you can deliver quickly, you stand a much better chance of holding your current pricing and pricing that you had back in 2012 and '13.

Steve:

Okay, thanks.

John H. Batten:

Thanks, Steve.

Operator:

Again, as a reminder, that is star, one if you'd like to ask a question, and again, we'll pause for a moment.

Gentlemen, at this time, it appears there are no further questions. My apologies, we did have a question from George Gaspar, a Private Investor.

George Gaspar:

Yes. Thank you. Good morning.

John H. Batten:

Morning, George.

George Gaspar:

A quick one on the 8500 outlook. I assume that that 8500 push that you've had recently is due to the more extensive horizontals and—that are going out further on a well-to-well basis, and do you see that continuing? I assume that you keep trying to sense the market, and if you listen to the sand producer reports, they're all pretty bullish about the amount of sand going in, and I keep thinking of Twin Disc when I hear that sort of thing, that there should be a pretty good market out there, so is this—is there something that is beyond the 8500 that could evolve in the marketplace or not?

John H. Batten:

Thanks for the question, George. Yes, it is a—so you're absolutely right. The correlation of the amount of sand being used is a fantastic predictor of, hopefully, the capital spend. It's a predictor that the equipment is being used and that there is pressure pumping going on, and the amount of sand being used certainly tells you that the laterals are a lot longer, and that leads you to higher pressure, higher horse powers, so the 8500 is extremely well-positioned for that. There have been a lot of—not a lot—there's been, over the years, looking at what's the next level—is there a three—go from 3000 to 3500, 4000 horsepower? So far, the weight of those engines and the size, just making it moving over the road, just impractical, so as of right now, when you take the size and weight, we're kind of at the Cat Cummins MTU engines that are in that 3000 horsepower range, so this is where we are today, and then they'll answer that demand with just multiple engines, but certainly we see the trend continuing at that higher horsepower level where the 8500 is well-positioned.

George Gaspar:

Right. Right. Okay, and just—because just what you're saying kind of was highlighted this morning with the Chesapeake Energy report. They've made tremendous progress in the first six months here, and their well count in Eagle Ford and Permian, they're all moving up pretty good, so it looks like there's a lot more opportunity for you.

John H. Batten:

I think you will—we will see the number of customers and operators start to redo their fleet, for sure. As I said—I mentioned in the beginning, people were very judicious with their maintenance spend and their cap ex spend over the last two to three years, and just at continued—this continued activity level, there needs to be a lot of maintenance and replacement in the fleet.

George Gaspar:

Right. Okay, well thanks for your comments.

John H. Batten:

All right. Thanks, George.

Operator:

At this time, I'll give one final reminder that it is star, one to ask a question.

Again, gentlemen, there are no further questions in the queue.

John H. Batten:

All right. Thank you, Jim, and everyone. 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 in October at the close of our fiscal 2018 first quarter.

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

Operator:

Certainly. At this time, this will conclude today's conference. I do thank everyone for their participation. You may now disconnect.