VIAVID
communications simplified.

Twin Disc, Inc.

Second Quarter Fiscal 2015 Financial Results

February 3, 2015

CORPORATE PARTICIPANTS

Stan Berger, *Investor Relations*

John Batten, *President, Chief Executive Officer*

Christopher Eperjesy, *Vice President - Finance, Chief Financial Officer and Treasurer*

CONFERENCE CALL PARTICIPANTS

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

Walter Liptak, *Global Hunter*

Brian Sponheimer, *Gabelli & Company*

PRESENTATION

Operator:

Good day and welcome to the Twin Disc, Inc. Second Quarter Fiscal 2015 Financial Results Conference Call. Today's conference is being recorded. At this time I'd 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 2015 second quarter and first half financial results and business outlook. Before I introduce Management, I would like to remind everyone that certain statements made during the course of this conference call, especially those that states Management's intentions, hopes, beliefs, expectations or predictions for the future are forward-looking statements. It is important to remember that the Company's actual results could differ materially from those projected in such forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements 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 and President; Christopher Eperjesy, the Company's Vice President of Finance and Chief Financial Officer and Treasurer.

Now 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 2015 Second Quarter Conference Call. As usual, we will begin with a short summary statement and then Chris and I will be happy to take your questions.

Looking at our second quarter results, sales for the 2015 fiscal second quarter were 72.7 million, up 15% from 63.2 million for the same period a year ago. The increase in sales year-over-year came primarily from our North American manufacturing and distribution operations where we saw improved demand in most of our end product markets. Slightly moderating demand from our Asian commercial marine and oil and gas customers partially offset the increase. Overall demand from our European market remains weak.

Looking at our broader product markets, the North American sales increase was driven by improved oil and gas shipment including a strong aftermarket component, continued strength in the commercial marine markets, and improved sales in our industrial products. Continuing the improvement trend, our second quarter sales into our industrial markets increased when compared to last year. The majority of this improvement was again driven by an increase in demand from the North American market sectors including oil and gas, irrigation, recycling and construction. We anticipate this trend continuing throughout the fiscal year. Sales into our transmission markets improved versus the Fiscal 2014 second quarter levels, again, driven by the strong shipments into our North American oil and gas markets. Shipments into our global marine markets in the second quarter improved year-over-year and the—as a result of the higher demand from our North American customers. The increase in the second quarter was enough to offset the decline we saw in the first quarter and we are now essentially flat to Fiscal 2014 levels year-to-date.

Gross margins for the quarter were 30.4% compared to 29.3% a year ago, and 34.5% the previous quarter. A better mix of products specifically within our transmission products primarily drove the gross margin improvement over last year. Year-to-date our gross margins are 32.4% compared to 30.2% last year.

Second quarter spending in marketing, engineering and administrative expenses, or ME&A, decreased by 3.9% or 678,000 versus the same period last fiscal year, from 17.2 million or 27.2% of sales, to 16.5 million or 22.7% of sales. Currency translation of 491,000 is a primary driver to reduced ME&A expenses, but also lower pension expenses, corporate expenses, as well as continued controlled spending at global operations also accounted for the decrease. Partially offsetting these decreases were slight inflationary increases in salaries, benefits and a bonus expense accrual.

Turning to the bottom line, the Fiscal 2015 second quarter net earnings were 3.7 million, $0.33 per share, versus 0.5 million or $0.05 a share a year ago. EBITDA for the second quarter was 8.3 million compared to 4 million a year ago and year-to-date EBITDA is 17.7 million compared to 10.6 million a year ago.

Looking at the balance sheet, we ended Fiscal 2014 (ph) second quarter with total debt of 16.7 million compared to 18.4 at the prior fiscal year-end. Inventory in the quarter declined 6.7 million from 97.5 million to 90.8 million. Over half of this decrease was driven by currency translation but we also saw true inventory decrease at our North American operations.

Our balance sheet remains strong with debt-to-capital still low at 10% and a positive net cash position.

Our six-month backlog decreased 9% from 63.4 million to 58.3 million. The decrease in our six-month backlog was driven primarily by our non-oil and gas transmission systems and our marine products. Year-over-year we are heading into the second half of the fiscal year with a higher backlog of oil and gas products, both unit and aftermarket, than we had at this time last year.

Looking at our outlook, certainly our first half result, especially on earnings and margins, were a good start to the fiscal year, but the slowdown that we saw in Asia in the first quarter coupled with the rapid decline of oil prices in the second quarter make us cautious for the remainder of the year and we continue to monitor our global markets for any signs of further weakening.

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

That concludes my prepared remarks and now Chris and I will be happy to take your questions. Jim, please open up the line for questions.

Operator:

Certainly. 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, and we'll pause for just a moment to allow everyone an opportunity to signal for questions.

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

Tim Wojs:

Yes, hey guys. Nice job on the quarter.

Christopher Eperjesy:

Thank you.

John Batten:

Thanks, Tim.

Tim Wojs:

I guess I just had—I wanted to start a little bit with just the outlook. I guess, you know, maybe just a little color on maybe some of the discussions you've had with your customers. Is there a way to put a percentage on, you know, how much of your customer base has communicated their cap ex budgets with you at this point?

John Batten:

No. This is John. I know there's—I would say most of the conversations have been probably very similar to what you've experienced other places, is, you know, what's going on? Is this really temporary? Is this a six-month, you know, a quarter, two quarter phenomenon, or is it a 12-month to—you know, or beyond? As you've seen in the press, it is pretty split but from what our customers are saying, my gut is telling me that it's more of a shorter-term phenomenon than a longer-term phenomenon. So, I honestly think that it's kind of where are the prices of oil going in the next—I would say next six months. I think if we start to see some strengthening, there'll be more investment in new equipment. Certainly, as I said in the first quarter and it continued to the second quarter, the amount of rigs that we're seeing being rebuilt, you know, on units that we supplied back in 2011 and 2012 and actually earlier, the '08 run-up, the rigs are getting used, certainly the big guys. They're getting used and they're getting rebuilt so that is a good sign. That's continuing, but there's definitely been a pause and a hesitation on cap ex, because when you go, you know, a hundred dollars down to 50, that's $50 a barrel of oil that you don't have to invest in equipment.

So, overall, I'm still very bullish on the whole market. It's just—it looks like there's been a pause and thankfully the next cap ex run-up, most of the budgets start in the fall so there's still time, but there's definitely a wait and see attitude right now.

Tim Wojs:

Okay.

John Batten:

Hard to put a percentage on it.

Tim Wojs:

Yes. No, I understand. It's not—I mean it's not fully—I mean you're kind of a victim in the market too, so.

John Batten:

Yes, and the—what I would add is, you know, is as non-receptive as Washington is to oil and gas extraction, they've been less receptive to do anything for coal. So, I mean the underlying demand, you know, for energy for the power plant is still—it's still natural gas, so it's still very positive in that respect.

Tim Wojs:

Okay. Then I guess just on the backlog, you know, what drove the decline in some of the non-oil and gas and marine markets? Is that something that was one-off or is there some incremental deterioration in some of those markets to be aware of?

John Batten:

Part of it I think is, really in that second quarter, in that timeframe of oil coming down, I think it just made a lot of the industrial markets, you know, certainly a lot of the marine market, crew boat (ph), a little bit hesitant on—and ARF. We have some ARF projects that were a lot lower than last year, but those have been cyclical. But I think in general if I had to say a trend kind of in the second half of the second quarter is people thought—and really in, you know, December, end of November, definitely a pause in some ordering trends just to wait and see what happens.

Tim Wojs:

Okay. Then as we think about—I know you expressed some optimism in the press release around, you know, revenue and EPS being up for the year, but as we look at the back half of the year, just so—just from a modeling perspective, can revenue and earnings be up in the second half of the year in Fiscal 2015 versus Fiscal 2014, the back half of that year?

John Batten:

Versus? Yes.

Tim Wojs:

Yes.

John Batten:

I think sitting here today, Chris and I feel for sure that we are in a better position entering the second half of the fiscal year than we were last year. Certainly at this time last year, we didn't predict the exact timing of that little spike in North American oil and gas for the fourth quarter.

Tim Wojs:

Right.

John Batten:

That was still three to four months away from when that happened. Today we are in a much better position heading into the second half of the year than we were last year.

Tim Wojs:

Okay. Great. Thanks guys.

Christopher Eperjesy:

Thank you.

Operator:

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

Walter Liptak:

Hi, good morning guys.

John Batten:

Walter.

Christopher Eperjesy:

Hey Walt.

Walter Liptak:

Wanted to try and dig a little bit further into, you know, the O&G. You know, you mentioned that the backlog is up year-over-year for O&G but if—you know, if I'm remembering this right, in your December quarter last year, North America was basically at zero orders and it was all China, and I wonder if you can provide some color on, you know, the kind of order activity you had during the quarter in North America and in China, too. Was China up year-over-year?

John Batten:

Yes, (inaudible) on the backlog it slipped again so now it's—the majority of it is North America, to a lesser extent China but I believe China is up actually year-over-year too on backlog for oil and gas, and North America obviously—you know, when you come off something that's almost zero, any increase is significant, but it's good. You know it's a combination of units and aftermarket and I just—again, the aftermarket component in North America has not been something that we have seen sustained for quite a long time, so we're finally getting into some rebuild activity, so we know, you know, everything is being used.

China has been cyclical but it's not the boom or bust. So, you know, the backlog goes up, orders go up and they come down a little bit. It seems that they're maintaining their slow and steady development of, you know, the capital for their market.

You know, again, feel much better here in—well, it's February. It was January last year but feel much better right now heading into the second half last year because there is that North American component and a good sign that stuff is being used.

Walter Liptak:

Okay. You know, kind of along those lines, you mentioned that there were no cancellations, but are you seeing—you know, with this pause are you seeing any delays in shipments for the O&G backlog or are the customers taking the product?

John Batten:

No. What we've—I mean everything that we've—there haven't been any firm orders cancelled but, I mean, we've definitely heard discussion about, you know, projects that hadn't been ordered yet moving out a little bit, kind of a wait and see.

Christopher Eperjesy:

Yes. Walt, this is Chris. I mean typically what we see is that type of activity happens beyond the six-month backlog that we report. So there may be orders that were out there at seven, eight, nine months that got pushed out, but typically the six-month backlog you don't see that. Usually when those orders are within six months, they tend to be pretty high likelihood that they're going to ship.

Walter Liptak:

Okay, and the—you know, the unit orders that you're getting in aftermarket, how's pricing looking on those incoming orders? Are you able to maintain price in this environment? I imagine the aftermarket is—it's better margin on the rebuilds.

John Batten:

Yes. So far on that side we have been able to maintain margin. You know it's—we'll wait and see if anything, you know—where it starts is, you know, with the operators and the day rates and it begins to work its way back, so, but we have not seen that here yet at the Company.

Walter Liptak:

Okay and, you know, I guess on the industrial side, you know, the pause that you saw in November and December, was that on marine, or was that industrial, or was that both?

John Batten:

For the most…

Walter Liptak:

I guess in January, is it picking up again as we, you know—as we move forward.

John Batten:

Yes, it's—mostly it's been in some of the marine units. Industrial is I would say, you know, on comparables to last year and the previous years is doing better, and so those order rates are better. Marine was the one that took a little bit of a pause, and again, a lot of that is driven in Asia, just kind of the slowdown in China. They need less coal so there's, you know, less marine transmission going into the coal tugs coming up from Indonesia, so that's a bit of a wait and see. I'm hoping that, you know, that trend starts to reverse here in the next couple of quarters.

Walter Liptak:

Okay. Maybe a last one on foreign currency. You know, what kind of headwind? It doesn't seem like it was that big of a negative for you, the million and a half dollars, but, you know, are you hedged or can you hedge anything? You know, what are you doing to try and offset something to the foreign currency, or what do you think the impacts will be?

Christopher Eperjesy:

Yes, I mean from—this is Chris. From a margin standpoint, we didn't really have a significant impact on profitability because it's—we're somewhat naturally hedged. You know, as an example, our Belgian operation which has euro costs ships into North America and sells into the US in dollars, so that would be a good guy. In other cases, from a translation standpoint it's negative, so when you mix that all up, you know, margin had a relatively small impact year-to-date. So from a margin—the answer to your question is yes, we look at hedging various currencies, but typically these movements don't have a significant impact other than translation on the top line.

Walter Liptak:

Okay, got it. Okay, thank you.

John Batten:

Thanks Walt.

Operator:

As a reminder, that is star, one, if you'd like to ask a question. Moving on we'll take our next question from Brian Sponheimer from Gabelli & Company.

Brian Sponheimer:

Hi. Good morning guys.

John Batten:

Hi Brian.

Brian Sponheimer:

Just, I guess, a conceptual question. When in the past have you seen your orders that are more related to the oil and gas market come off and what would make you get more concerned as we're looking into that—the next, you know, the next six to 12 months?

John Batten:

Boy, it's—I guess, you know, what conditions would make us more concerned?

Brian Sponheimer:

Yes.

John Batten:

I guess if there were some more macroeconomic events with the overall economy coming, you know, way down globally all through all regions. The concerns that we have, certainly China is not performing how they have in the recent past. Europe continues to be weak, at least—and I'm speaking for our markets, and really what's been driving I'd say the last four quarters has been an improving North American economy and market. I think we would have had a lot more orders, you know, all of us in the equipment industry, had there not been the huge ramp up and let's just say over-purchase of oil and gas equipment and the 28% over capacity. But fundamentally, I still feel that natural gas and our ability as a North American continent to produce our own energy is important and that—those fleets are going to be maintained.

I just think that if the oil price stays low, you know, in the 40s, 50s, even 60s, it is going to slow the investment but those who are making money are going to continue to operate and it'll just be more of a rebuild activity and it will just delay the new unit, the new rig purchases into the future and what it's going to cause—it typically does—is it's going to cause a ramp up where everyone has delayed cap ex spending and everyone tries to do it at the same time. What's nice about right now though is we are getting that aftermarket component before any ramp up in new builds. When we go back to 2010 and '11, everybody tried to rebuild everything at the same time and add new equipment, and it just created havoc on the lead times and went—you know, everything went from six months to 12 to 15 months very quickly.

So I guess, Brian, my number one concern would be is it—there's a global recession something like 2008 and '09 which just slows activity and the demand for oil reduces sharply, then that would be a concern, but if we stay at stable demand I think we can weather through this pretty well.

Brian Sponheimer:

Okay (inaudible) thank you—that's very helpful. If you're thinking about the six-month backlog within your energy markets, what's first versus aftermarket, just from a split perspective, and where was that six months ago, say?

John Batten:

You know, that is a good—I would say it's slightly more shifted towards units than aftermarket, but I will preface that that, you know, a lot of the after—the new units have a six-month lead time, four, you know—four- to six-month lead time and they're ordering aftermarket parts within, you know, three weeks. So I would—roughly it's not quite 50/50 but it's not that far off.

Brian Sponheimer:

Just relative to maybe where it is in times where we've probably had $90 oil?

John Batten:

Yes, I would say at that point you're down more in, like the 20 to 25% aftermarket and the balance in new units.

Brian Sponheimer:

Okay.

Christopher Eperjesy:

Brian, this is Chris. Just to give you kind of a number, you know, with sales being up 15% year-over-year, service and parts business this quarter was about 37%, give or take 0.5%, 37% of overall revenue. Last year it was slightly less than 34. So even on that higher revenue, it represented a larger percentage, obviously a larger—much larger dollar but larger percentage of overall, and that's on a consolidated across all markets.

John Batten:

Yes, and I would—certainly we've had, Brian, in the last couple of years, maybe going back to Fiscal 2013 and I would say most of Fiscal 2014, the aftermarket component in oil and gas was extremely low and that was, you know, saying directly to us that we're using the excess capacity in the field before we're going to spend money on rebuilding, and when you go from almost nothing, 5%, 10%, up to that high 30s to 40%, it tells you that they're—that excess capacity is not out there anymore and they need to rebuild units that they're using. So that in itself is a good indicator for the North American market.

Brian Sponheimer:

Got you, and just one last one from me, just on the inventory side. How comfortable are you with the balance sheet and, you know, are there any adjustments you think you need to make as the—we go into the next three to six months?

John Batten:

No. I think we're in a good position for, you know, any scenario that…

Christopher Eperjesy:

I think—this is Chris. If you mean in terms of any potential issues with excess inventory or obsolete inventory or anything like that, the answer is no. No, the answer is no.

John Batten:

No, I would…

Christopher Eperjesy:

I don't see anything like that. I mean if anything, you know, as John had mentioned in his introductory comments and in the press release is our balance sheet obviously is well positioned to do things which can include potential acquisitions.

John Batten:

Yes. I would like to be here, Brian, saying—Chris and I both would that, you know, our debt is higher and that we've made an acquisition. So we continue to focus on that for sure and want to make sure that we have the ability to do it.

Brian Sponheimer:

Yes. No, I'm not worried about the leverage at all. I'm just curious and to confirm as always in markets that could go off a cliff, you know, that you're left with a strand of working capital, but it's—that's not—(inaudible) that's not the case.

Christopher Eperjesy:

(Cross talking).

John Batten:

Brian, at least, now we have people that have been here for 10 years of experience when there's course (ph) events and there's still people that have been here for 40 years and they've experienced a couple of them. So…

Brian Sponheimer:

Sure.

John Batten:

We will be ready for that.

Brian Sponheimer:

All right, well congratulations and best of luck.

John Batten:

Thanks Brian.

Christopher Eperjesy:

Thanks Brian.

Operator:

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

John Batten:

Thank you, Jim, and thank you 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 or myself.

We look forward to speaking with you again in April following the close of our fiscal third quarter. Jim, now I'll turn the call back to you.

Operator:

Thank you, and again, that will conclude today's conference. We thank everyone for their participation. You may now disconnect.