Twin Disc, Incorporated

Fiscal Fourth Quarter 2016 Investor Conference Call

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CORPORATE PARTICIPANTS

Stan Berger, *SM Berger & Company, Moderator*

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Jeffrey S. Knutson, *Vice President of Finance, Chief Financial officer, Treasurer and Secretary*

CONFERENCE CALL PARTICIPANTS

Josh Chan, *Robert W. Baird & Co.*

Walter Liptak, *Seaport Global Securities, LLC*

PRESENTATION

Operator:

Good day and welcome to the Twin Disc Fiscal Fourth Quarter 2016 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, Brian. On behalf of the Management at 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 2016 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 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 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'll send you a copy.

Hosting the call today are John Batten, Twin Disc's 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 2016 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 I begin, both Jeff and I would like to apologize for the slight delay in announcing our fiscal 2016 fourth quarter and year-end results. We would like to reassure all of you on the call that this was not due to an accounting irregularity or anything of that nature, but rather, the lengthy second round analysis for goodwill impairment. It should come as no surprise to anyone that the continued sluggish markets and declining comparables to previous years made this year's analysis more rigorous, especially with the backlog that continues to bounce around the bottom.

Of the $13.2 million of goodwill that we had on the books, it was decided to take a non-cash charge of $7.6 million and to write down assets with respect to our Domestic Industrial business and European Propulsion business. We can get into more details of this later in the call.

Looking at our fourth quarter results, sales for the 2016 fiscal fourth quarter were $42.6 million versus $67.3 million a year ago, a decrease of about 37%. Full-year sales were $166.3 million, which were also 37% lower than the year-ago levels of $265.8 million. FX had a negligible impact in the quarter-over-quarter sales comparison but a negative $7.8 million impact on the full fiscal 2016 to 2015 comparison.

As with previous quarters in fiscal 2016, we saw no recovery in our Domestic Oil and Gas markets or Asian Marine markets. European demand for our Marine Industrial products remained weak but stable throughout the year when compared to fiscal 2015. Aftermarket Industrial and non-Oil and Gas Marine Transmission products were relatively stable in the quarter throughout fiscal 2016 in our North American markets. The one market highlight of the year would have to be our sales into Australia where our subsidiary had another good year of Marine sales, both in the Pleasure Craft and Commercial markets, spearheaded by our Electronic Joystick Technology.

Gross margins for the quarter were 26.2% compared to 29% a year ago and 23.2% in the previous quarter. While not at year-ago levels, the 26.2% represents the highest gross margin percentage of the year and is more representative of the annual run rate resulting from the cost reductions taken earlier in the year. Fiscal 2016 gross margins were 24.4% versus 31.2% a year ago.

Fourth quarter spending in marketing, engineering, and administrative expenses decreased by $3 million versus the same period last year, from $16.2 million to $13.2 million. For the year, ME&A spending was $7.2 million less than in 2015.

Looking at the bottom line, we reported a loss of $5.5 million or $0.48 per diluted share compared to a net earnings of $476,000 or 4% per share in the fourth quarter of fiscal 2015. Our fourth quarter earnings were affected by the $7.6 million goodwill impairment on our Domestic Industrial and European Propulsion business. Year-to-date net earnings were at a loss of $13.1 million or $1.17 per share versus a net earnings gain of $11.4 million or $1.01 per share a year ago.

EBITDA for the fourth quarter was a negative $7.6 million and a negative $16.1 million for the full fiscal year. Without the goodwill impairment, the fourth quarter EBITDA would have been the first positive quarter since fiscal 2015.

Our inventory rationalization efforts continued on the $1 million per month trend and we are now $14 million lower, or 17%, than we were at the fiscal year-end of 2015. Again, looking further into the balance sheet, we had a strong cash generation quarter and delivered $8.7 million of operating cash flow which allowed us to increase our cash position to $18.3 million while making the final payment on our senior note.

Our six-month backlog decreased from $39.9 million at the end of the third quarter to $35.7 million, which is—at the end of the fourth quarter, but still $1.3 million higher than at the end of fiscal 2015. Clearly, we have not yet seen an overall recovery in our broader end markets and our customers, both direct OEMs and distributors, are only ordering what they absolutely need and when they absolutely need it.

Looking at the outlook, given the vacillation in our six-month backlog and oil's retreat from $50, we are not expecting the next couple of quarters to be any different from the previous four on the demand front. We have put a lot of effort into expanding our Industrial markets with the release of new products with more to come this fiscal year; calls to potential new customers, both in existing and new markets; and extensive cost reduction efforts. We remain optimistic that we could see some oil and gas volume this fiscal year in terms of both unit rebuild activity and transmission replacement activity. Our 8500 units that have been rebuilt this year have hit the 16,000 hour mark, which is a staggering number, and some of our 7500 units have hit the 3,000 plus hours of just pumping activity.

With the exception of our Australian market, we expect Fiscal 2016 to remain challenging for our Global Marine products, as the global new ship (phon) build has declined dramatically in calendar 2016. Despite the weakened markets and the continued low oil prices, Management remains very positive on the medium- and long-term prospects of the Company. We will continue to manage our balance sheet so that we are in a position to make a strategic acquisition when the opportunity arises or to further our global restructuring efforts in order to become more efficient in these difficult market conditions, or both.

We are also actively looking at ways to apply our Controls Technology into new markets and applications and to bundle a variety of mechanical components into a system managed by our Controls Technology.

Finally, on the behalf of the Management and the Board, Jeff and I would like to thank all of you for your continued interest, your questions, and support of the Company.

That concludes my prepared remarks and now Jeff and I will be happy to take your questions. Brian, 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'll take our first question from Josh Chan with Baird.

Josh Chan:

Hi. Good morning, John and Jeff. Great job on the cost control and the cash flow.

John H. Batten:

Thanks, Josh.

Jeffrey S. Knutson:

Thanks, Josh.

Josh Chan:

My first question is on the oil and gas conversations with the customers. I assume they're not placing orders at this point, but just what is the tone like and when are customers talking about potentially seeing any type of improvement there?

John H. Batten:

I think—we've had conversations on rebuild activity. There's a small amount of that still going on, but we're getting into more conversations about replacing some of our competitors' transmissions in the field. So, whether that's in the next quarter or two, there's still a good chunk of the fleet, both of our transmissions and others' that are working and are doing work. So, I think finally our story's getting out on how long our units are lasting in the fields, so we're getting more interest in replacing maybe someone's older—another—a competitor's older transmission with a new one of ours.

So, as long as oil is not above $50, I think that's going to be our opportunity, particularly in North America in the next 12 months.

Josh Chan:

Okay. Okay. Well, that's good that you're—

John H. Batten:

And—

Josh Chan:

Go ahead.

John H. Batten:

I would just say, yes, if—again, I used to think it was in the high $50s, closer to $60, but I think if we can sustain oil above $50 for any length of time, I think we could see that activity might increase a little bit.

Josh Chan:

Okay. Sounds good. It sounds like you may also have some share opportunity there if (inaudible) through.

John H. Batten:

Yes.

Josh Chan:

Okay. Just, so then in terms of the year-over-year comps, is there still a lot of oil and gas activities to cycle through in Fiscal '16 as we look at—

John H. Batten:

No. I think we're going to start Fiscal '17 to Fiscal '16 comparisons pretty clean of oil and gas.

Jeffrey S. Knutson:

Right. We had a few units shipped (phon) in Q2 of last year, but that was about it, yes.

Josh Chan:

Okay. Okay. So then kind of looking at some of the other end markets, do you anticipate those markets potentially growing in Fiscal '17; and, I guess, one that I was particularly interested in was the Asia Marine. It seems like weakness there is a little bit more persistent than maybe previously thought.

John H. Batten:

Yes. It has been a very, very slow year for the Asian Marine markets, so any new activity, I think, we could say would be some growth. So, it's going to be challenging. I see any growth in Asia or Europe might be offset a little bit by a slight slowdown in North America because we have seen the build activity in the Gulf Coast start to slow down; that's with respect to offshore oil and gas. We'll see what happens in more of the Commercial—the river traffic, the barge activity push boat. But I just think overall it's going to be stable where we've been running. I'm just not that optimistic the next two quarters are going to see any significant growth in Marine.

Josh Chan:

Okay. Okay. Then I saw the pension line on the balance sheet kind of move higher. So, is there going to be, like, a pension expense headwind as we look into Fiscal 17?

Jeffrey S. Knutson:

There will be a little bit, not as significant as you see in the—that's the result of our valuation exercise, so that has a tendency to move in big amounts depending on what the discount rate does and what the asset returns do during the course of the year. It doesn't always translate into that significant of an impact on the expense or a cash contribution in that next year.

Josh Chan:

Okay. Great. Those are all my questions. Thanks for the time.

John H. Batten:

Thanks, Josh.

Operator:

As a reminder, star, one for questions. We'll go next to Walter Liptak with Seaport Global.

Walter Liptak:

Hi, guys. Good morning.

John H. Batten:

Hey, Walter.

Walter Liptak:

Congratulations on the adjusted profits today too with the cost down.

John H. Batten:

Thanks.

Walter Liptak:

I wanted to ask you, the comment that you made about the hours worked on some of your OMG transmissions, the frack equipment. I wonder if you can just provide some color on the equipment that's out there, how it's being used, if you're getting calls on equipment breaking down. In the past, we've talked about kind of that shadow inventory out there and cannibalized equipment. Any update that you might've gotten that kind of led to that 1,600 hour work or hours on the machines would be helpful.

John H. Batten:

Yes. The 16,000 hours are coming from the Canadian fleet, and clearly, I doubt that those 16 hours—the 16,000 hours were in hard shale formations, so it's probably more in pure oil and wet gas. So slightly easier on the unit, but 16,000 hours is a lot of hours and they have been putting off—they don't have to do anything to the transmission as far as maintenance. They haven't been doing it. They have done some of the preventative maintenance, so they've gotten a lot more life out of these than I think they thought. So we've seen the transmissions—most of our rigs right now are in fleets that are doing pure oil and oil and gas, and not a whole lot of pure gas. So, the application, the demand on the unit has been a little bit less.

I'm still looking for the increase in usage in gas because we've just seen coal has been beaten up to a point where I don't know if that is going to recover. I believe it was April where there was a tipping point where natural gas was the primary fuel for electricity generation for the first time, so that demand is good for gas, and then as export, demand builds up. I'm optimistic or—I don't know if I should say optimistic or hopeful that that could be a trend that will help us not so much the oil part of oil and gas, but gas, in that the demand for gas drilling will increase some activity both on the rebuild side, but on the new unit side.

As far as what fleets are out there in inventory, I don't have a real update, but it just seems like from our customers, there hasn't been—other than Trican selling their North American fleet a few quarters ago, I haven't seen a whole lot of movement of our units with our equipment in it moving or changing hands.

Walter Liptak:

Okay. Has there been any—when you're talking to the customers about replacing transmissions, is there any description of, like, the sizes? Is it the 7500 or is it a larger one that are being used in this environment?

John H. Batten:

It's a combination of both. I think primarily just from the size of the actual—the whole rig, it'll probably be more applications for the 7500, and that's not to say that we can't modify the 7500 more to make that transition a lot easier, so you don't have to do as much work on the rig to make that happen. But there certainly will be some of that demand for the 8500, but we see more of it on the 7500 side, and we're working to address—to make that easier so it's not as much work on the rig to put in the 7500 if another transmission is already there.

Walter Liptak:

Okay. As you're having these conversations with customers on the rebuild opportunity, I think a lot of it is their investment is return based and there's a lot of price focus by the service providers. Are they hitting you guys up for lower prices or trying to put it out to bid or something, or are you able to get a return on what you're making?

John H. Batten:

Yes. Absolutely still able to get a return. We haven't—

Walter Liptak:

(Inaudible). Maybe that was the wrong way to ask the question, sorry. I guess the question is just on pricing pressure, are they trying to work down price?

John H. Batten:

There is some pricing pressure for sure, but, I mean, there hasn't been these big contracts or bids for spreads, so a lot of it has been on sharpening your tool on hourly rate, sharpening your pencil, make sure that you're competitive on what your labor rates are to help with the refit and doing the rebuild activity. What we're still—you pick a model, we're less expensive than one of our competitors.

Walter Liptak:

Yes, right.

John H. Batten:

They don't seem to sharpen their pencil that much. So we're—that helps.

Walter Liptak:

Okay. I hear that. I wanted to ask you about the comments about the—Jeff, on the annual run rate and gross margin with the 700—or $7.5 million of costs down. Is this gross margin level? You say it's the run rate, so that's maybe, like, the average that we would see for 2017 or is—do you think the gross margin still has some benefits from cost cutting in 2017?

Jeffrey S. Knutson:

I think the fourth quarter really saw the full run rate of all of the actions we've taken to date, so I think movement, going forward, will be based upon future actions we might take and then further efficiencies that we continue to push for in all of our plants, and then mix. So it's hard to give an expectation. I think we were pretty happy with where Q4 came in.

John H. Batten:

Walt, I would just caution you and everyone that the first quarter is—now that oil and gas is out, is historically our lowest on both the sales and the margin because of the shutdown. We have a one-week shutdown here in the US, but also up to a three-week one at the plants in Europe. So the third—sorry, the first fiscal quarter for us is historically the lowest, both on sales and particularly on the margin level.

Walter Liptak:

Okay. Okay. Well, thank you (inaudible).

John H. Batten:

Yes.

Walter Liptak:

Maybe just a last one for me is just: sequentially in the Industrial exposure that you have, did you see any changes during the quarter, anything getting better or worse from month-to-month?

John H. Batten:

I would say only that we're making a lot more calls, and so it didn't really change that much quarter-to-quarter. It's just that—in what (phon) you look at the pure numbers, but I would say our opportunity now to grow is a lot better than it was even in the third quarter. We made a lot of more contacts and a lot of more single unit sales to new customers.

Jeffrey S. Knutson:

The growth from Q3 to Q4, which is about a million dollars on the top line was pretty much all Industrial, so some of that showing in the result there.

Walter Liptak:

Okay. Great. Okay. All right. Thanks, guys.

Operator:

Once again, that is star, one to ask a question on today's conference.

John H. Batten:

Okay, Brian. I think that's it. No. There's Josh.

Operator:

We do have another question in the queue. We'll take our next question from Josh Chan with Baird.

Josh Chan:

Hi. Just two follow-ups. First one is: is there going to be an opportunity to generate further working capital reductions in terms of the cash flow basis in the next year?

John H. Batten:

It becomes more challenging, Josh. Obviously we've done a lot with inventory. We expect volume to—as we've been bouncing along the bottom in terms of backlog, so I don't think we anticipate significant declines. I think as we hopefully see volumes start to improve, there will be some investment in working capital. So I think it's going to be more challenging. I don't think we'll see a quarter like we saw in the fourth quarter, which was—had a lot of good movements on our balance sheet. We'll obviously continue to manage it as well as we always have.

Josh Chan:

Okay. Then last one for me: you alluded to some new product development. Could you kind of, like, elaborate on where you're focusing your efforts there and what are you looking at?

John H. Batten:

Yes. I would say a lot of it has been on the new Industrial products, both extending the horsepower range of our hydraulic PTOs which can go into big rock crushers, wood chippers, but also bringing that hydraulic clutch technology down the horsepower range. Then we also have been releasing—a lot of our PTOs out in the field are mechanical. There's a lever, so you have to engage it and disengage it by hand, and we've been working on both electronic and hydraulic clutches for those so you can retrofit existing PTOs with—you know, so you don't have to engage it by hand; you can do it either electrically or hydraulically. So, those models are starting to rollout.

Then we've been looking at Controls Technology on how do we control our products, our components, but other people's as well, and offer systems and capabilities to customers. Then in the Oil and Gas area with respect to the Pressure Pumping Transmission, is seeing the new fleet activity and new builds is key (phon) to being pushed out a couple quarters, a couple quarters. What can we do to make our transmissions and the configuration easier to swap out if someone wants to replace someone else's transmission with ours? So, right now, that is kind of where the activity is focused.

Josh Chan:

Okay. Great. Yes. Thanks for the color—the update.

Operator:

There are no further questions in the queue at this time.

John H. Batten:

Okay. All right. Thank you, Brian, and thank you all 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. We look forward to speaking with you again in October following the close of our Fiscal 2017 first quarter.

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

Operator:

Ladies and gentlemen, that concludes today's conference call. We thank you for your participation.