Twin Disc, Inc.

Fiscal Third Quarter 2017 Investor Conference Call

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CORPORATE PARTICIPANTS

Stan Berger, *SM Berger & Company, Moderator*

John H. Batten, *President, Chief Executive Officer*

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

CONFERENCE CALL PARTICIPANTS

Josh Chan, *Robert W. Baird & Company*

Walter Liptak, *Seaport Global Securities, LLC*

Brian Sponheimer, *Gabelli & Company, Inc.*

PRESENTATION

Operator:

Good day and welcome to the Twin Disc Incorporated Fiscal Third 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, Jessica. 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 third quarter and nine-month 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 will send a copy to you.

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Hosting the call today are John Batten, Twin Disc President and Chief Executive Officer, and Jeff Knutson, the Company's Vice President, 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 third quarter 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 third quarter results, I'd just like to take a few moments to go over some of the key take-aways from the third quarter and year-to-date results.

As other industrial companies have been reporting, our fiscal 2017 third quarter, or the first calendar quarter of 2017, was our first quarter-over-quarter improvement in some time for both shipments and incoming orders. The main drivers are an increased demand for oil field power transmissions, our aftermarket parts business across the entire spectrum of our products, and a nice increase in orders for our global patrol boat projects.

While the global offshore market remained weak, with many fast supply vessels and offshore supply vessels taken out of service, we did see some bright spots with patrol boats in Asia, fishing vessels in the Canadian Maritimes, and the steady inland and work boat market in North America and Europe. Our industrial market saw some slight softness in the quarter for units, but a strong demand for aftermarket parts.

Jeff will cover the goodwill impairment, which relates more to our domestic markets not showing accelerated forward market growth.

As I mentioned at the beginning, the first real demand in three years from North America for our oil and gas transmissions led the way in the quarter. The amount of useable excess capacity in North America may be at a historic low. While we are not anticipating the huge bounce we saw in 2009 to 2011, constant usage should equate to a steadier demand going forward.

A lot of the gross margin improvement we saw can be attributed to increased sales, but we have to give credit to our operations group, who has taken a significant amount of cost out of the operation, reorganized and implemented new lean initiatives, both in the office and on the shop floor, to keep us on an improved performance track. After our restructuring and early retirement two years ago, we have been running lean, no pun intended, in certain parts of the organization, especially operations. Our newer hires, with some very valuable outside experience, have begun to help us move forward with these new lean initiatives. Jeff will have more of the margin detail, but we will continue to expand this effort throughout our operations to keep us better prepared for all parts of the cycle, not just the downturn.

We set a target to be profitable at $200 million, with a smaller share of that being oil and gas, and we believe we are ahead of that target.

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. Sales for the third fiscal quarter of $45.1 million were up $3.7 million or approximately 9% from the prior year third quarter, and $11.4 million or nearly 34% sequentially. Third quarter sales represented the highest quarterly sales levels since the fourth quarter of fiscal 2015. As John mentioned, the primarily driver for

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improved revenue in the quarter was the initial shipments of oil and gas units into North America, along with improved North American aftermarket demand, which was also led by oilfield activity.

Year-to-date, sales are down $9 million or 7% below prior year levels. The year-over-year decline is largely due to reduced activity in the Asian market or the Company's commercial marine products, delayed shipment due to a supplier transition issue we've mentioned on previous calls, and general softness in the industrial market.

FX had a small positive impact on sales through the first three quarters compared to the prior year of approximately $600,000.

Despite the $9 million decline in sales, gross profit is actually ahead of last year by $2 million through three quarters. Our gross margin percent for the third quarter improved by 630 basis points to 29.5% compared to 23.2% in the prior-year third quarter. For the three quarters ended March, our margin has improved by 360 basis points to 27.4% compared to 23.8% for the prior year. The positive result is reflective of the Company's aggressive cost reduction initiatives over the past several quarters in response to 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 fiscal third quarter.

Spending on marketing, engineering, and administrative costs for the first three quarters of $38.8 million declined $5.1 million or 12% compared to the prior year. This decline was also a result of previously announced cost reduction actions and a global focus on managing costs, along with reduced pension expense and lower spending on corporate development activities in the current year. Those decreases are partially offset by an increase to global incentive compensation expense based upon successful progress towards margin improvement and fixed cost reduction goals, some of those things that John mentioned are driving our margin improvement through the first three quarters.

As part of our third quarter close, we identified impairment indicators with respect to our domestic industrial business units, primarily related to the absence of significant market recovery for these products. The result of the full impairment test was a complete write-off of the remaining $2.6 million of goodwill related to this business unit. You might recall that we recorded a partial impairment of $6.4 million related to this business unit in the fourth quarter of last fiscal year.

We invested an additional $300,000 in the quarter and now $1.4 million through the first nine months in restructuring actions to drive additional cost reductions and efficiencies at our domestic and European operations. These actions are expected to generate annualized savings of approximately $2.4 million.

With the improved margin performance and reduced M&A spending, our operating loss improved by $3.5 million compared to the prior year, on lower sales volume, despite the $2.6 million impairment charge noted and incremental restructuring charges of $600,000.

Our effective tax rate was 34.8% through the first three quarters, lower than the prior year rate of 51.5%. In the prior year, you might recall, was favorably impacted by $2.4 million of foreign tax credits associated with the repatriation of cash from certain foreign entities.

Net loss for the quarter of $1.8 million or $0.16 per diluted share was greater than the prior year loss of $1 million or $0.09 per diluted share, primarily due to the pre-tax asset impairment of $2.6 million and the $2.4 million positive impact of foreign tax credit. Operationally, before those adjustments, I think significant improvement at which you can see us at the operating income level. Through the first three quarters the net loss is down slightly to $7.5 million or $0.66 per share compared to $7.6 million or $0.68 per share in the prior year.

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EBITDA for the first three quarters was negative $5.7 million, an improvement of nearly $3 million compared to the prior year to date.

Our balance sheet remains in a very strong position, with net cash of $6 million, debt to total capital of 7.6%, and nearly $16 million of availability in our revolving credit facility.

After reducing inventory 17% in the prior year, inventory has remained relatively flat through this fiscal year, balanced somewhat by the fact that we've got improving demand through the third quarter driving some additional purchasing activity.

We achieved positive free cash flow of over $800,000 in the quarter, as we continue to focus on cash generation. This represents a $2.4 million improvement over the third quarter of the prior fiscal year. For the three quarters ended March, we are now $6.2 million ahead of the prior year free cash flow result. We remained committed to optimizing free cash flow including close management and prioritization of our capital spending on key new products, global sourcing, and process improvements.

With that, I will turn it back to John for some final comments.

John H. Batten:

Thanks Jeff. I'll just spend a quick moment on the outlook.

Certainly the 31% improvement in the backlog, up to almost $50 million, gives us some wind in our sails. As I mentioned earlier, oil and gas, global patrol boat projects, and aftermarket were the key drivers in improving that backlog. It's hard to predict the timing of any new oil and gas orders, so there is a chance that the backlog could fluctuate going forward. But we believe that we'll bouncing around at a level that is certainly higher than in the recent past. If our recent order trends continue, we feel confident that only offshore oil and gas face potential further negative headwinds in the coming quarters, and that we will see profitable quarters in the very near future.

That concludes our prepared remarks, and now Jeff and I'll be happy to take your questions. Jessica, please open the line for questions.

Operator:

Absolutely. If you'd like to ask a question today, please do so by pressing the star key followed by the digit one on your touch-tone telephone. If you're using a speaker phone, please make sure your mute function is turned off, to allow your signal to reach our equipment. Once again that is star, one on your touch-tone telephone. We will pause for just one moment.

We will go to Josh Chan from Baird.

Josh Chan:

Hi, good morning, John and Jeff.

John H. Batten:

Good morning, Josh.

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Jeff S. Knutson:

Morning Josh.

Josh Chan:

Morning. Just a question on your thoughts about the oil and gas market, obviously, you have that large order, so, can you remind us, the timing of shipping those units, where does it last till, and then, based on your comments, can we assume that maybe the order trends in oil and gas have not yet been that much broad-based relative to (inaudible)?

John Batten:

Yes, Josh, we received the order kind of in the middle of the third quarter, and we got some units out in the third quarter. But most of that shipment of that hundred is throughout the fourth quarter and into the first quarter of our fiscal '18. We have had other orders, so that order of 100 wasn't the only one, but yes, the bulk of what's in the backlog right now is going to ship in the fourth quarter and the first quarter of next fiscal year.

I would say that the order rate for the entire industry certainly hasn't peaked, I would say it's just begun. Having travelled around the oil patch in the last few months, and to echo my comments from earlier, I do think that the usable excess inventory is at a historic—at a very recent historic low. So, even with constant production, the assets need to be overhauled or replaced, and that's widespread.

Josh Chan:

Okay, okay. So, based on kind of like your conversation with customers, it's reasonable to expect that orders come in maybe on a more steady basis, you just maybe haven't quite seen it at this point yet?

John H. Batten:

Correct. I don't expect just the pop that we saw back in calendar 2009, '10 and '11, but I do see that there will be increased orders. Predicting the timing of it is hard, and that's why I think that, if we don't get anything this quarter, our backlog easily could go down a little bit, only to go back up at the end of the first quarter. But I do think that we're going to be—certainly what's in the average backlog for the prior two or three quarters, that level's going up. Definitely an increase in parts and in units in oil and gas going forward.

Josh Chan:

Understood, okay. Then, switching over to your comments about the strength in the aftermarket businesses, do you think that is kind of an early sign that maybe the OE side of the business can improve too in some of the non-oil and gas businesses, or how are you thinking about this in aftermarket?

John H. Batten:

Yes, it's—historically, an increase in aftermarket has always been a prelude to new unit order and markets recovering. We would hope that this would be the same, no different than any other cycle. It's just that a lot of the forward market activity, particularly the industrial markets, it's just not as clear, you don't get as many verbal commitments or forecasts from OEM customers and our distributors are not getting the same type of forecasts in their customers, so. But the aftermarket activity certainly makes us all feel better about the upcoming forward market activity.

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Josh Chan:

Right. Then on the marine business, you mentioned strength in the patrol boats, what about the other marine businesses that you have, commercial marine and things of that nature?

John H. Batten:

I would say, when we think about work boat, inland waterway, harbors, that's been good. It's been—it hasn't been on fire, like the recent oil and gas, to the aftermarket with nice increases, but it's been steady. On the concerning market, where we see a lot of excess capacity, really is in the offshore area. So, the crew boats down on the Gulf Coast, crew boats in Asia, the offshore supply vessels, there's just right now a big excess capacity there. So, if there's one, I would say, market that can say, as I mentioned, continues to concern us for this calendar year, it's that offshore market.

Josh Chan:

I see, and then on the $2.4 million of savings, have you started realizing that already, or is that something that expects to come through next year?

Jeff S. Knutson:

It's hard to give you a good feel for exactly how much we've realized, but yes, we start—have started realizing those savings. We've had action sort of on an ongoing basis over the last six quarters, and certainly so the spending this year over the three quarters we've already had savings from the actions taken in the first two quarters. It's an immediate impact.

Josh Chan:

All right. All right, that makes sense. All right, great, yes, thanks for your time and congrats on the improved backlog there.

John H. Batten:

Thanks Josh.

Operator:

We'll now go to Walter Liptak from Seaport Global.

Walter Liptak:

Hi, thanks, good morning, guys.

John H. Batten:

Hello.

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Jeff S. Knutson:

Hello.

Walter Liptak:

If I could just follow on from the last question, about the cost savings, and you made a comment that the $200 million of profitable that you're ahead of target, I wonder how you like us to look at kind of your break-even level now, and then, as you get beyond the $200 million mark, what kind of operating leverage are you thinking about, going forward?

Jeff S. Knutson:

Walt, it's Jeff. We feel like, going into this downturn, we wanted to be profitable at $200 million. I think, as John said, we're pretty confident. Obviously, it depends on mix, and how much aftermarket in oil and gas makes up of that volume, but I think we are pretty confident at—even at $190 million that we're at that break-even level, given a reasonable mix. Along with that, the reductions that we've put in place, the structure changes that we've made, the operating efficacies that have been implemented over the last year and a half, I think, will certainly create some favorable operating leverage coming out. We look at sort of our standard target is to convert at 40%, as we increase volume, that we're dropping around 40% to the operating margin line, so that's kind of our target, given again that sort of reasonable mix.

Walter Liptak:

Okay, so that 40%, is that target kind of like over a long-term period, where you would see better leverage early on in the recovery, or is it kind of the recovery operating leverage you think you'll get?

Jeff S. Knutson:

Yes, I mean again, it's going to depend a lot on mix, and—but I think 40% is kind of a standard at any point in the cycle, based upon what we've done with costs to this point.

Walter Liptak:

Okay, fair enough. I wonder if you could talk about—a little bit about the backlog and the increase sequentially. Looks like about $17 million or so of backlog improvement. How much of that is the oil and gas, as a percentage, and maybe how much is industrial or marine?

Jeff S. Knutson:

Well, yes, seeing that the backlog—you can pick the sequential quarter just before it or the one a year ago, the backlog for oil and gas would have been zero. So, by far the biggest movement in dollars and percentage is going to be the oil and gas, when you stick in a hundred units. But that's certainly not everything. Really, I mean, there is a noticeable increase in aftermarket in the patrol boat products. So, those alone would have been a good story, just the offshore oil and gas, I mean not the off shore, sorry, the pressure pumping transmissions, I mean, obviously stole the dollar amount in the percentage because it was coming from zero.

Walter Liptak:

Okay. All right, and the—how are you feeling about the pricing of the product, I guess, as gets to the mix that you brought up, Jeff, the—how we should think about the pricing of what's in backlog? Were these

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real competitive orders to take in? Or, you have talked in the past about the competitiveness of the 8,500. Are you able to get a captive customer base with that product?

John H. Batten:

It's competitive, certainly, it's more competitive than it was, but it's still the mix of price, quality, and availability. We feel we compete very well on all of them, but we're very happy that we made some decisions two years ago, going into the down, to keep some inventory to be able to react. So, that—all three are still very important. But yes, it's not—I'd be lying if I said it wasn't more competitive now, just given that it had been a barren desert for new units for over two years.

Walter Liptak:

Right, everyone wants to sell something. Okay, great, and then the—you kind of talked about or alluded to the diversity of the oil and gas market that there may be more bids out there, and I wonder if there's a way of quantifying that? Like if you look at it three or six months ago, the quote activity versus now, are you seeing more customers that are active in the market and…?

John H. Batten:

It's—I don't—I mean—I would have—given everything that I had seen, heard, witnessed, and read, I would have predicted, the orders that we got, that we would have gotten them sooner. So, I still think, and I know a lot of other people, our competitors, I believe, see this as well, is that the equipment has been used and used hard, and it needs overhaul, and in many cases, it needs replacement. So, if they're out on a site and something happens where you need to service a rig, there's not necessarily a swing unit, there's not a rig there available to come in. So, I just think, in general, everyone is going to see an increase in demand. It's just—I'm continually wrong when I think (inaudible) when I think it's going to be, because I think it should be sooner. But, it's nice to see that we've gotten orders from multiple customers, I know that there are other customers out there, and I'm sure our competitors are going to get some orders, so I do—I think it's the start of an improving trend. I just think everyone is still very very cautious about outlaying cash in, I would say, uncertain macroeconomic times, and you're still dealing with OPEC who you never know what they're going to do so. But I don't think, whether it's $50 a barrel or $60 a barrel, it really doesn't matter, because the assets need to be replaced.

Walter Liptak:

Okay. All right, great, well thank you very much.

John H. Batten:

Okay.

Jeff S. Knutson:

Thanks Walt.

Operator:

As a reminder that is star, one on your touch-tone telephone. We'll now go to Brian Sponheimer from Gabelli and Company.

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Brian Sponheimer:

Good morning everyone.

John H. Batten:

Hey Brian.

Jeff S. Knutson:

Hey Brian.

Brian Sponheimer:

Just to hang on your last statement there, you mentioned you don't expect an uptick like we saw in 2009 to 2011, and certainly we'd agree, but your conversations with your customers about break-even then versus break-even now, you mentioned $50 to $60 oil really doesn't matter. When you're talking to your customers who really need this equipment, what do they think they're all-in cost to get the oil out of the ground is right now?

John H. Batten:

Brian, I wish—I wish I could answer—I have probably a couple more one-on-one conversations with operators than some, but not—it's hard—it is different for every company. Certainly, when you're running with equipment that is fully depreciated, and you're not doing a lot on expense to maintain it, it's going to be a lot lower than if you replaced it with new equipment. But I would say that the overall efficiency on how they're doing it, staying at sites longer, doing longer laterals, it's down significantly. It's hard for me say that there's a general average, but I would—I think that most people are making money at $50 a barrel.

Brian Sponheimer:

Okay. So, and it's a reasonable expectation that we stay around these levels, that there's no reason why what you're seeing should continue.

John H. Batten:

Yes. Yes.

Brian Sponheimer:

(Inaudible).

John H. Batten:

Correct, that there—more equipment needs to be—have major overhauls or replaced, yes.

Brian Sponheimer:

All right. Terrific. Well, best wishes and great job.

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John H. Batten:

Thanks Brian.

Jeff S. Knutson:

Thanks Brian.

Operator:

It appears there are no further questions. I'll turn the conference back over to our presenters for any additional or closing remarks.

John H. Batten:

Thank you, Jessica. 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. We look forward to speaking with you again in August, following the close of our 2017 fourth quarter and year end.

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

Operator:

This does conclude our presentation for today. Thank you for your participation.

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