Twin Disc, Inc.

Fiscal Second Quarter 2019 Investor Conference Call and Webcast

February 1, 2019

CORPORATE PARTICIPANTS

Stan Berger, *President and Managing Director, SM Berger & Company*

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

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

CONFERENCE CALL PARTICIPANTS

Noah Kaye, *Oppenheimer*

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

PRESENTATION

Operator:

Good day, and welcome to the Twin Disc Incorporated Fiscal Second Quarter 2019 Investor Conference Call and Webcast. 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, Christian (phon). On behalf of the Management of Twin Disc, we are extremely pleased that you have taken the time to participate in our call, and thank you for joining us to discuss the Company's Fiscal 2019 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 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.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

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 2019 Second Quarter 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 quarterly results, I'll touch on some of the operational results of the quarter.

Obviously, sales, you've seen, for Twin Disc business were up 13% year-over-year, and as Jeff mentioned, demand was up in all of our markets. Gross margins and operating margins were up year-over-year. Having said that, while our results have improved from a year ago, we continued to face significant supply chain challenges in the quarter, mainly in the area of machine components, gears, castings, forgings and other subcontracted components. The capacity strain, mainly due to labor shortages at our suppliers and internally, is our number one focus operationally.

The slowing growth in the domestic onshore oil and gas market should help alleviate some of these constraints, but we see this slowing growth only as a temporary pause. As we have mentioned in our prior calls, we are investing a significant amount of cap ex in our plants to improve throughput and capacity. Additionally, we are moving our North American aftermarket spare parts business to a facility closer to the I-94 Corridor between Milwaukee and Chicago, and we are breaking ground this month on our facility in Lufkin, Texas, where we plan to move all of our North American industrial business and depot activities for the North American market.

With this freed-up space at our Racine facility, we are adding new gear-cutting equipment, five access (phon) machining centers and automated test dams, all with the focus of leveraging the improved efficiency of the newer machine and improving our output in the face of a very tight labor market in Southeastern Wisconsin. Additionally, we are looking at bringing in some heat treat processes so that we can improve our lead times and improve our delivery commitments.

In the quarter, we also spent a significant amount of time with our new acquisition, Veth. Obviously, a lot of time has been spent on SEC reporting with the Finance team, but our Sales, Marketing and Engineering teams have all gotten together, and I'll have some comments on my outlook with the Veth hybrid technology, and coupled with the Twin Disc marine transmission.

After Jeff goes over the financials, I'll go over the outlook for the second half of the year and cover, in more detail, our outlook on the onshore oil and gas market specifically.

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

Jeffrey S. Knutson:

Thanks, John. Good morning everyone. As John said, I'll briefly run through the second quarter numbers. Sales of just over $78 million for the quarter are up $21.6 million or 38% from the prior year second quarter. The quarter obviously includes the impact of the Veth acquisition. Excluding the impact of Veth, sales were up 13%, as John mentioned, compared to the prior year second quarter, which now represents the eighth consecutive quarter of year-over-year growth, demonstrating the sustained growth trend we've been enjoying since the middle of Fiscal '17.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

The primary driver for improved revenue remains the improved shipments of oil and gas transmission units into North America, along with the improved North American aftermarket demand, also led by oilfield activity. In addition, we continue to see improving trends in nearly all of our markets, including the global industrial, commercial marine and patrol craft markets.

Through the first half, sales are now up $51.2 million, or just over 50% compared to the prior year. Adjusting for the Veth acquisition, the organic increase is over 23%. Again, while much of this was driven by oil and gas demand, industrial product sales have increased over 9%, and marine and propulsion sales over 6% compared to the prior year first half.

Gross margin performance for the quarter was strong, with a margin percent of 33.4%, an improvement of 120 basis points from the prior year second quarter, and 130 basis points from the first quarter. This result included the impact of the Veth acquisition and the related purchase accounting amortization, which, again, is a one-year phenomenon. Excluding that non-cash purchase accounting amortization, gross profit would have been approximately 34.7%. The improvement is primarily volume-driven, but also continues to reflect the strong mix related to oil and gas and aftermarket.

Spending on marketing, engineering and administrative costs for the Fiscal 2018 second quarter increased $3.8 million, or roughly 25% compared to Fiscal 2018. The bulk of the increase represents the addition of the Veth entity and their related spending, and the related amortization of the acquired intangibles. In addition to that, we had some increased spending on professional fees—salaries, travel and marketing costs, compared to the prior year second quarter.

As a percent of revenue for the Fiscal 2019 second quarter, ME&A declined to 24.2% compared to 26.7% in the prior year, and through the first half, down to 24.8% compared to 28% in the first half of Fiscal ’18. With the improved volume and margin performance and reduced restructuring spending, our operating results improved by $4.4 million in the quarter from a $2.3 million operating profit in the prior year, to $6.7 million in the current year—and through the first half, an improvement of $9.9 million to an operating income of $11.6 million this year compared to $1.7 million in the first half of Fiscal ’18.

The effective tax rate for the second quarter was 26.2%, which reflects the continuing impact of the new tax legislation. The prior year rate looks quite strange and reflects the significant impact of the implementation of the U.S. Tax Cuts and Jobs Act in the prior year, which resulted in a non-cash tax charge of $4.6 million due to a re-measurement of deferred tax assets and liabilities due to that revised rate structure.

Net profit for the quarter of $4.1 million or $0.31 per diluted share reflects a significant increase from the prior year; fiscal second quarter net loss of $4.1 million or $0.36 per share. Through the first half, the bottom line has improved by $7.6 million to a profit of $6.9 million or $0.56 per share compared to a loss of $700,000 or $0.06 per share in the prior year first half.

Positive EBITDA of $9.1 million for the quarter reflects a $5.6 million improvement over the Fiscal 2018 second quarter. On a trailing 12-month basis, we are now at $34.2 million of EBITDA, which includes restructuring charges of $2 million.

The balance sheet remains healthy as we close out the first half of Fiscal ’19, with the impact of the $61 million Veth acquisition and subsequent $32 million follow-on equity offering being the headline for the year so far. We finished the second quarter with $28 million of net debt, a debt to capital ratio of 20.4% and debt-to-EBITDA ratio of 1.4 times. The increase in inventory from the prior year-end is partially explained by the Veth acquisition, along with an increase at our U.S. operations for current orders and future demand. We anticipate inventory will improve by fiscal year-end.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

Backlog finished the quarter at $138 million, which is relatively flat with fiscal year-end, and up 35% from the prior year second quarter, excluding the impact of the Veth acquisition.

Operating cash flow was negative $4.6 million and free cash flow was negative $7.7 million in the quarter, impacted by a ramp-up in capital spending, as anticipated, and increased inventory in the quarter. We look for an improved cash flow result through the second half.

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

John H. Batten:

Thanks, Jeff. Just looking at the outlook here and the backlog, obviously it dropped about 6% from Q1 to Q2, and late in the second quarter, just before the Christmas shutdown, we saw some cancellations in oil and gas (inaudible) new orders for frac transmissions. This trend continued into Q3. Again, I want to emphasize that we are driving this activity to make sure that all the transmissions in our backlog have a specific project to be in, and we're not just driving a forecast which is then driving the inventory.

Just as a side, we did receive the second or third largest aftermarket order in oil and gas in January, so the activity continues. But, a lot of this restructuring of our backlog is to make sure that our demand is driving an appropriate inventory level. We are well-positioned for the next few quarters on inventory for oil and gas.

We do see demand in the frac market flattening for the next few quarters, but we do not see it disappearing. Again, we have several projects for retrofits of existing fleets, and the aftermarket demand continues for all of our product in the field.

I would like to finish just covering, specifically, the Veth acquisition. I would say, for the first six months, it has exceeded our expectations in almost every way. Obviously, day-to-day activity has been spent on bringing it up to SEC reporting. We've had meetings and developments between our Sales team, our Marketing team and our Engineering team, and I can't overstate how excited we are to have them as part of the Twin Disc team, and specifically their knowledge in the hybrid area and diesel/electric area of the marine market and what that means for our marine transmissions, and bringing a single technology type solution in the marine hybrid space. I do firmly believe that the Veth and Twin Disc combination pushes us to the front in this space in our market area.

Additionally, in a tight labor market, access to high quality marine engineering talent in the Rotterdam area is also a huge benefit for us. Look to hear more about the Veth acquisition in the coming quarters, and seeing the development of the products that go into the marine hybrid area.

Christian, with that, that concludes our comments, and we'll turn it over to questions at this point.

Operator:

Thank you, sir. Ladies and gentlemen, if you wish to ask a question at this time, please press star, one on your telephone keypad. Please ensure that the mute function is switched off to allow your signal to reach our equipment, and if you find that your question has already been answered, you may remove yourself from the queue by pressing star, two. Once again, it's star, one to ask a question. We'll pause for just a moment.

We will now take our first question from Noah Kaye from Oppenheimer. Please go ahead, sir, your line is open.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

Noah Kaye:

Thanks, good morning and good to be with you. In the release and in your comments, you commented on expectations to decrease inventory throughout the year and pay down debt. Is it possible to give us an order of magnitude on how much you're expecting debt repayment to be, and how far you think you can work down those inventory levels?

Jeffrey S. Knutson:

That's a challenging one, Noah. I think we're really trying to balance what we need to bring in to satisfy customers and be prepared for the demand we're expecting. I think we would like to recover what we—at a minimum, what we—(inaudible) what we experienced through the first half. I think in our minds, we would like to get to—at a minimum, to breakeven free cash for the year.

Noah Kaye:

Okay, that is very helpful. You talked about Lufkin breaking ground and relocating the aftermarket. Can you comment on, once you have this additional capacity, what kind of revenue levels do you think that could support it, and then also, how do we think about the efficiency gains and the impact on margin from this reconfiguration?

John H. Batten:

Well, Noah, I would say freeing up the square footage in our plant here in Racine and moving industrial to Lufkin, aftermarket out, I would say that we have the square footage and the freed-up space to put the capital in that would get us leaving all other pieces equal. This would get us—potentially get to a $500 million run rate, given that we add the necessary capital and we have the right employees. But, as far as the walls and the building, I think we are set to get to that $500 million mark.

Looking at gross margin, it's probably going to be as we bring facilities online, my goal, I'll be honest, Noah, is to maintain gross margin as we're putting a little bit of cost before the payback.

Noah Kaye:

Mm-hmm.

John H. Batten:

The goal is that, as our gross margins cycle through different cycles, that we're at least 200 to 300 basis points higher in the cycle. Does that make sense?

Noah Kaye:

Yes.

John H. Batten:

That we're able to maintain a higher level of efficiency throughout the cycle that's about 200+ basis points higher.

Noah Kaye:

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

As a result of the reconfiguration, or as the result of…

John H. Batten:

Yes.

Noah Kaye:

…kind of the recent cost actions—okay, all right. No, that's very helpful.

Maybe one last one from me. You've commented on the work you're doing with Veth, and just wondering, what are the conversations like you're having with customers around the hybrid drive offering, the synergy with your own transmission; what's the response been, and do you think that this may start to pick up more of the market?

John H. Batten:

I think so. I haven't been at every meeting, but I've been at several shows. In my 23 years at Twin Disc, nothing—and this is true—nothing has been more electric at any tradeshow, and when I'm out with customers, than this acquisition.

We have—I put our global distribution network and service—I mean, they are the cream of the crop. This opens doors outside of Europe for the Veth product. We've already set up some of our distributors to be their dealer. We've set up new ones, independently new ones. We're working with traditional Twin Disc product through some of their agents. The Z-Peller, as a product, was more conducive to diesel/electric—dual input, or an electric motor input. We have already begun a path to hybrid technology with our traditional marine transmissions, and it was nice to see that we, independent of what Veth was doing, we were using some of the same software, same hardware, same processors.

They were much farther along, but getting our two teams together has been fantastic as far as the quality of the hybrid product that we're going to continue to develop for their product line, but also what it's going to mean to a hybrid application with the traditional marine transmission.

Noah Kaye:

(Inaudible). I'm sorry, yes, go ahead.

John H. Batten:

No, go ahead. (Inaudible).

Noah Kaye:

Presumably—yes, just as a last point, that presumably—that those sort of synergies and development improve your time to market. How should we think about kind of a product—yes.

John H. Batten:

We have—I would say we're at a handful of initial hybrid activity; projects, orders, for our traditional marine transmission. I don't know if I can give you a number would this double our growth, but it certainly grows—it improves the growth rate of our applications in hybrid for all of our product lines, if that makes sense. It's going to fast-forward it significantly.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

Noah Kaye:

Okay. Thank you very much.

John H. Batten:

Thanks to the software and the hardware to help us, yes.

Noah Kaye:

Excellent. Thank you.

Operator:

Thanks. We will now—as a reminder, if you wish to ask a question, it's star, one on your telephone keypad.

We will now move on to our next question from Josh Chan from Baird. Please go ahead, your line…

Joshua Chan:

Hi, good morning, John and Jeff.

John H. Batten:

Hey Josh.

Jeffrey S. Knutson:

Hey Josh.

Joshua Chan:

Good morning. Just was wondering if you could talk a little bit about the oil and gas market. You talked about—I think you were proactively trying to firm up your order book, I guess. Then I guess you talked about, also, the belief that the activity is stabilizing, sort of in January. Can you talk a little bit about what's going on there, I guess?

John H. Batten:

Sure. I guess late in December, kind of just before the Christmas shutdown, the end of everyone's quarter, we did receive some cancellations for units that were from our customers but didn't necessarily have a home yet. As I mentioned, we also had new orders in the quarter; it's just that the cancellations outpaced the new orders.

In January, we've continued that, to shakedown what everyone has on order with us to make sure that people aren't chasing the same business, and that we aren't driving more inventory than is necessary for the next two to three quarters. We led that activity; we kind of forced the issue—what do you believe your chance of getting this business, and then here, trying to talk about, are we all chasing—do we have multiple customers chasing the same business? Our goal is to make sure that our backlog, the number of

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

units that we have on order at the factory matches as closely as possible the number of units that are actually needed in the field, if that makes sense, Josh.

Joshua Chan:

Okay, yes.

John H. Batten:

We do see a flattening demand. I mean, the growth rate that we saw for the prior four quarters was not sustainable, so we knew that there would be a flattening. But, we have—we had a very good order book for oil and gas transmissions going out in the next few quarters.

We do see—we all read the same articles, we see all the same information about the Permian. There's definitely been a lot of slowdown in the growth rate, for sure, but we still see building activity. As I mentioned, we had one of our largest spare parts orders for oil and gas transmissions ever, in January. It's not that the activity is grinding to a halt, but it's definitely flattened out.

Joshua Chan:

Okay. Would you say that spares or overhaul, would that comprise the majority of your activity going forward, as opposed to new units being added to the field? How do you think about that composition?

John H. Batten:

Spare parts and overhaul is not the majority, but it's definitely a bigger percentage of the ongoing business, especially if you include new units just to swap out a unit at a rig. I would foresee that the spare parts business, and we'll call it a retrofit, is going to be—for the next three to four quarters, will be a much bigger part of our business than new rig construction.

Joshua Chan:

Okay. Just so that maybe we're not surprised, or no one is surprised, because you were trying to firm up your order book in January, would you be surprised if the backlog at the end of March was a little bit lower than the December one, or how should we think about that?

John H. Batten:

I would not be surprised at all if we saw a drop of—what, 6%, 6% to 10% again in the third quarter.

Joshua Chan:

Okay.

John H. Batten:

I wouldn't be surprised. It's still a healthy backlog and it doesn't change the fact of what we have to deliver. Our order book for the next two to three quarters is pretty firm.

Joshua Chan:

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Okay, that's good to hear. Then on gross margin, usually it builds over the course of the year as you get more seasonal volume. Do you expect that to be the case this year as well, given the strong start in the year?

Jeffrey S. Knutson:

Yes, Josh, you're right, typically that is the case. I think what's different this year is, we're sort of at the level of the high margin product that we're going to ship, so what's going to be incremental is more of our lower margin business that's in backlog today. I don't anticipate that we'll see improving margins through the second half; still very good margins, but I don't think we should anticipate a jump on improving margin percent through the second half.

Joshua Chan:

Okay, and then my last question, just housekeeping. Should we expect any kind of one-time type costs or a disruption with respect to the facility moves this coming quarter, or do you expect that to kind of go pretty smoothly?

John H. Batten:

No, I would say—I don't anticipate any one-time big thing for Lufkin, and our lease on the aftermarket facility begins in April, so we'll kind of have half of a quarter—so no. Nothing significant.

Joshua Chan:

All right. Great. Good quarter, guys, and good luck with the second half of the year.

John H. Batten:

Thank you.

Operator:

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

John H. Batten:

Okay. Well, thank you, Christian, and thank you for joining our conference call today. We appreciate your continued interest in Twin Disc and hope that we've answered all of your questions. If not, please feel free to call Jeff or myself. We look forward to speaking with you again in May following the close of our 2019 third quarter.

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

Operator:

Thank you. This will conclude today's conference call. Thank you all for your participation. You may now disconnect.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com