Twin Disc, Inc.

Fiscal Second Quarter 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

Stanley Berger, *President, SM Berger & Company*

John Batten, *Chief Executive Officer & Director*

Jeffrey Knutson, *Vice President of Finance, Chief Financial Officer, Treasurer & Secretary*

CONFERENCE CALL PARTICIPANTS

Noah Kaye, *Oppenheimer*

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

Rand Gesing, *Neuberger Berman Group*

Timothy Chatard, *Meros Investment Management*

PRESENTATION

Operator

Good day, and welcome to the Twin Disc, Inc. Fiscal Second Quarter 2021 Earnings Conference Call.

Today's conference is being recorded.

At this time, I'd like to turn the conference over to Stan Berger. Please go ahead, sir.

Stanley Berger

Thank you, James.

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 2021 second quarter and first half financial results and business outlook.

Before introducing Management, I would like to remind everyone that certain statements made during 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.

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

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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 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 Batten

Thank you, Stan, and good morning, everyone. Welcome to our Fiscal '21 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 highlights or headwinds that we faced in the quarter. Again, in the fall timeframe, our second quarter, we faced, again, a lot of our distributors and end customers working down inventory that was in the pipeline. And we've seen that come and the trends start to reverse, and orders and the backlog improved in the quarter.

I thought our team did an excellent job navigating the continuing COVID pandemic and ongoing staffing issues due to quarantines. Obviously, having people out in the plants here, and we're seeing 15% to 20% of the staff, but there are a lot of increased efficiencies and some extra overtime on people who were not on quarantine.

Half of the topline miss that we faced in the second quarter was due to aftermarket, and obviously, aftermarket parts come at a higher margin, and a lot of that miss was due to a lot of decreased activity, the ability to do rebuild out in the market. And we've seen that trend reverse as of late as far as incoming orders in the quarter, and that continued into January.

Our facility in Lufkin did come online in late November, early December, and we started producing and shipping some of our mechanical clutch lines. And all of the—the rest of the mechanical clutches and PTOs were transferred there over the holiday shutdown.

Orders in the quarter did show some improvement, and our backlog, as you've seen in the press release, did increase during the quarter. We saw strong orders at our Veth subsidiary. We saw good orders in Asia and Australia and a lot of the U.S. and European core markets. Obviously, activity in North American oil and gas remained extremely low, but we did see some aftermarket demand in orders at the end of the quarter. We are seeing some rebuild activity at some of our customers starting in January.

We did have a nice increase again in projects for hybrid and electrification, and our application and engineering teams are very busy with projects in most of our core markets, whether it's industrial, marine or oil and gas. And we are expecting to get more orders as these projects come to completion.

With that, I'll turn it over to Jeff for some comments on the financials before I come back for an outlook.

Jeffrey Knutson

Thanks, John, and good morning, everyone.

I'll briefly run through the Fiscal '21 second quarter numbers.

Sales of $48.4 million for the quarter down $11.1 million or 18.6% from the prior year second quarter. The quarter decline from the prior year was the result of a continuation of a generally weak global economy due to the ongoing effects of the COVID-19 pandemic. Compared to the prior year second quarter,

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transmission sales were down 28.7%, industrial sales down 8.2%, and marine and propulsion down 18.1%.

By region, sales in North America were down 35%, sales into Europe were down 17%, and sales into Asia Pacific were actually up 11% on improving Australian market demand and relatively stable demand for oil and gas transmissions in China. Foreign currency exchange was a net positive $2.1 million impact to sales in the quarter.

For the first half, sales were down $24.2 million or 20.4%, with currency translation contributing a positive impact of $3.6 million compared to the prior year first half. Second quarter margin percent was 19.6% compared to 26.4% in the prior year second quarter. The decline in margin percent was primarily a function of the reduced volume and a very unfavorable product mix with significant declines in aftermarket volume and shipments in the North American oil and gas market. Gross profit for the first half finished at 20.9% compared to 21.3% for the Fiscal '20 first half.

Spending on marketing, engineering, and administrative costs for the Fiscal '21 second quarter decreased $2.4 million or 15% compared to Fiscal '20. The decrease is primarily the result of reduced payroll costs, bonus expense, corporate travel, amortization expense and marketing activities.

Along with the reduction in all North American wages, we continue to aggressively pursue cost reduction opportunities to compensate for the decline in gross profit. As a percent of revenue for the second quarter, ME&A expense was 28.8% compared to 27.6% in the prior year second quarter. For the first half, ME&A spending is down $5.8 million or 17.6%, finishing at 28.5% of revenue compared to 27.6% in the Fiscal '20 first half.

A restructuring charge of $120,000 was recorded in the second fiscal quarter, primarily related to actions to adjust cost structure at our domestic operation, and ongoing cost reduction and productivity actions at our European operations.

With the reduced second quarter volume and challenging product mix, we reported an operating loss of $4.6 million in the quarter compared to a loss of $5 million in the prior year quarter. The slight improvement is the function of the prior year impairment charge, partially offset by the volume decline and unfavorable mix impact.

For the first half, operating loss of $7.8 million reflects a $4 million improvement over the Fiscal '20 first half. Significant other expense of $1.7 million for the quarter and $2.9 million for the first half is primarily due to translation losses on euro-denominated liabilities due to the weakening of the U.S. dollar.

The effective tax rate for the Fiscal '21 second quarter was 38.1% compared to a negative 19.2% for the same period last fiscal year. The current year rate benefited from newly enacted regulations related to the GILTI provision of the Tax Cuts and Jobs Act.

Net loss for the second quarter of Fiscal '21 was $4.3 million or $0.33 per diluted share compared to a net loss of $6.5 million or $0.49 per diluted share in the prior year second quarter. Through the first half, we reported a net loss of $8.3 million or $0.63 per share compared to $12.8 million or $0.98 per diluted share in the prior year first half.

EBITDA of negative $3.6 million for the quarter was reduced from negative $2 million in the prior year second quarter. For the first half, EBITDA of negative $5.2 million is $1.5 million better than the prior year first half.

As we work through the second quarter with little market improvement, we determined there was a high likelihood that we would not meet the minimum cumulative EBITDA covenant for the quarter. As a result, we have entered into a forbearance agreement with BMO, which relieves us of the EBITDA covenant

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through September 30, 2021. This agreement also reduces our maximum capacity to $42.5 million from the current $45 million for the forbearance period, and includes some additional reporting requirements, which are described in more detail in the 8-K filed earlier today.

Turning to the balance sheet. Inventory was up $1.6 million due to a $4.9 million currency translation driven increase, partially offset by a significant reduction at the North American operations. With a focus on liquidity and cash flow, we were able to generate $3.5 million of operating cash flow in the quarter, bringing free cash flow to essentially break even through the first half.

Capital spending at $1.4 million for the quarter was focused on the new Lufkin facility and modern machine tools and testing equipment. As we remain in a very challenging market environment, we will continue to defer all nonessential capital spending and continue to expect to invest $5 million to $7 million during the fiscal year.

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

John Batten

Thanks, Jeff. And I have just a few comments on outlook.

As we've mentioned, orders and backlog improved in the second quarter, and we saw that across most markets, including oil and gas and some spare parts orders, and we expect our markets, the core markets to improve throughout the year. Obviously, oil and gas may improve a little bit towards the latter half of the year. But we are seeing, as I mentioned, much better demand in our aftermarket spare parts orders. The order rates in January were double what they were throughout the summer. So that gives us a lot of optimism heading into Calendar 2021.

Our focus remains diversification through the growth of our other markets outside of oil and gas, primarily industrial, with our new products coming out, whether it's the HPTOs or the RO PTO line that are going to be produced at the Lufkin facility. And again, our focus on how we participate, whether supplying the complete system in hybrid and electrification or how we provide the key components that work in the general systems.

We will continue with those product development efforts throughout the year and continue to rationalize our investment in bricks and mortars, whether it's in North America or in Europe.

That concludes our prepared remarks. And with that, now, James, I'll turn it over for questions.

Operator

Thank you, sir. If you would like to ask a question please signal by pressing star, one on your telephone keypad. If you're using a speaker phone 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 take our first question today from Noah Kaye with Oppenheimer.

Noah Kaye

Hi. Good morning, John and Jeff.

Can we start with the transition and ramp at Lufkin? So first, I want to understand, maybe you talk a little bit about how the transition is going. How you see kind of revenue capacity ramping at Lufkin in a little period of time. If you can remind us of the revenue you think that can support, and how much of that is

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incremental. And then just to clarify, did you have any sort of production slowdowns or any lost revenue in the quarter from the transition? Or do you expect any?

John Batten

Noah, it's John.

Lufkin will probably be for the first 12-plus months about 1 million to 1.5 million of shipments a month as we transition the units that were being produced here in Racine. And that facility, we easily—that facility, depending upon what units go there, we have—the bricks and mortar there, Phase I, 50,000 square feet. We easily could go to 30 million to 50 million, depending upon the value of the units that are produced there. So we have considerable room for growth there.

The incremental, I wouldn't say there is much incremental business there. It's moving business from Racine, but given the extra—the room and the capacity there and the team focused, we are determined to grow our industrial business, and grow it in a way that we could not have done it in Racine, given the constraints here.

Part of the plan with Lufkin is to move, obviously, the industrial production there. We move the inventory. We free up room here in Racine. We have three facilities currently in Racine County. We have corporate headquarters, 21st Street, which is our main manufacturing plant, and then we have an aftermarket warehouse out on the interstate.

The plan is once Lufkin is up and running we can consolidate some of the facilities that we have in Racine here for further savings. So the long-term plan is growth of our industrial business in Lufkin, which will then allow us to consolidate some of our facilities here in Racine.

Noah Kaye

Yes. And obviously, at that run rate, there is a lot of untapped markets you could play in. But can you talk a little bit about your strategy for growing industrial sales, end markets, applications, regions where you think you have relatively more promise?

John Batten

Our biggest potential for growth is in the industrial markets, and it's with the clutches in the PTO lines. We're doing a lot of projects and a lot of development on being able to plug-and-play into hybrid and electrification efforts, many of which require motors—I mean, which require gearboxes with motors and control systems. So whether it's expanding our hydraulic PTO, which typically are larger horsepower than the mechanical PTOs, or remote control activated mechanical PTO lines for pump drives and gearboxes. So a pump drive or an AM line basically in a hybrid application connects behind the diesel engine and provide inputs, whether it's a hydraulic pump or an electric motor. So as more and more applications shift to hybrid and electrification, we have pieces that plug in very nicely to that.

It's growing the core, the existing, just the purely internal combustion engine part of industrial, but then we see a lot of the growth in the hybridization and electrification area.

It's across all markets. It could be recycling, construction, biomass; it's some oil and gas applications. So we're really looking to grow and have the focus and the capacity of a facility that is not on different cycles. So the Lufkin facility will be solely dedicated to the industrial business.

Noah Kaye

Great. Thanks so much.

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Operator

Next, we'll hear from Josh Chan with Baird.

Josh Chan

Hi. Good morning, John and Jeff.

I guess, dove tailing on the prior question about the sort of the strategy to grow industrial. I guess, will those efforts kind of require you to work with newer OEMs that you haven't worked within the past? Or are these usually with OEMs that you already have a relationship with? And kind of how are you going about those types of customs, I guess?

John Batten

Yes. It's—Josh, it's both and all of the above. It is working with our existing customers as they venture into hybridization and electrification, and it's working with new OEMs that we haven't worked with before. And then a lot of it is working with partners, because, as I've mentioned in previous calls, it's rare that one company can provide all of the components in the solution. So we find ourselves working with electric motor manufacturers, people who do the inverters, other controls companies. And so it is a—it's not a one-size-fits-all solution.

What we're trying to do is look at our traditional customer base and other customers that we don't have, work with them on solutions that they need, and then try to put together the solution for them. And we can provide all of that or we can provide part of it; or that we have the products that plug into a hybrid solution or an electrification solution that someone else is providing. So it is all of the above.

Our main effort, my effort, and the Management team is to focus in on the solutions that are going to provide the best return in the near term. So we can't—obviously, we can't focus on everything. We have to sharpen our focus, and that's what we've been concentrating on the last year, is working with key customers that have been long-term customers and then exciting stuff for us working with some new customers.

Josh Chan

Okay. That's good to hear.

I guess my next question is on the oil and gas business. Does the backlog improvement currently include some of the improvement that you expect to see over the next couple of quarters? And then, I guess, broadly, with respect to the replacement cycle, how do you expect the pace of that to come through? I know that in the past, new build cycles have been sort of all at once, but does replacement kind of come at a more gradual pace?

John Batten

Yes. Josh, the improvement in the backlog, I would say, there is unit demand improvement for Asia, some spare parts demand improvement here in North America; seeing a little bit stronger demand on some of our distributors, so they've had some inventory that they're able to get out of their inventory, and hopefully, we'll soon see being replacement orders on us.

Yes, I don't see a new unit demand for new construction like we saw in 2017/2018 or 2011/2012. We'll see one maybe at the end of second half of this calendar year, but I think you'll see a steady improvement of some rebuild activity. Again, what we're waiting to see is transportation demand to get back to even

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what it was before the COVID pandemic. Get demand on oil up, and that will drive production and make people more comfortable about investing in rebuild activity.

Josh Chan

That makes sense. And then I guess last question is, how should we think about your ability to leverage the ME&A line as you, I guess, presumably grow next year? Can we expect to see some leverage there? Or will some expenses kind of come back? How should we think about that?

Jeffrey Knutson

Yes. This is Jeff, Josh.

Yes, I think as we recover to sort of more normal market conditions, some ME&A expense will come back. We've obviously done a lot of reduction in some of those permanent, some of those—the wage reduction, for instance, eliminating the bonus program, all that kind of stuff, would come back in normal times. But I think we have done a good job of really making sustainable reductions in our cost structure on the ME&A side.

Josh Chan

That's great. Thank you both for your time.

Operator

We'll move on to Rand Gesing with Neuberger Berman.

Rand Gesing

Hi, guys.

I guess it sounds like we have a bit of a healing over the next couple of quarters from a top line perspective. Apologies my daughters are playing. Some noise in the background, can't avoid them. So I'm just wondering about sort of the free cash neutrality environment, metric as the working capital will kickback in. We just talked about expenses maybe a little bit on the graph. What's your position that you can sort of keep out of a cash burn in the second half?

Jeffrey Knutson

Yes. As we've talked about the first couple of quarters, that's our focus. So we're happy with where we are. I think we have the ability to continue to sort of stay neutral. I think, obviously, any activity in North American oil and gas is only going to help us. We have inventory to support that demand, and that can turn into cash very quickly. And as John pointed out, we're starting to see some of that aftermarket demand. So we're still—in my mind, we're still focused on staying neutral and not losing cash in this fiscal year.

Rand Gesing

Most of the orders you're seeing most recently, are those sort of book and ship? (Inaudible) lead times outside the year, fiscal year?

Jeffrey Knutson

Okay. Book and ship and then...

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John Batten

Book and ship.

Jeffrey Knutson

Yes. Yes, essentially, book and ship in the aftermarket segment.

Rand Gesing

Okay. Good. Any update on the sale of the Racine headquarters?

John Batten

No. It's been, I would say, relatively quiet. We've had one interested party, but nothing to report.

Rand Gesing

Okay. And what's been on the market for?

Jeffrey Knutson

I think the list price is four point three (phon).

Rand Gesing

Okay. Okay. Go ahead.

John Batten

Rand, do you need the Racine office? You're welcome.

Rand Gesing

Nice view of the lake?

Okay, good. Well, obviously, that will bring in a little bit of liquidity if that monetizes. Okay. I just want to check on those items.

Operator

We have a question from Tim Chatard with Meros Investment.

Timothy Chatard

Good morning.

The liabilities that you referred to that are euro-based that translated negatively to dollars, can you give any more detail as to what that is?

Jeffrey Knutson

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Sure. We have—part of our revolver is euro-based liability. It was debt that we took on when we acquired the Veth subsidiary about a year and a half ago. So that's denominated in euro. That's the biggest piece of it.

Timothy Chatard

Got it. And just for my edification, on the land transmission segment, how much of that is oil and gas, specifically?

Jeffrey Knutson

Yes. I mean, obviously, that's our most cyclical piece. So right now, it's probably 20% oil and gas, all Asia, essentially all Asia right now, but it can be over 50% oil and gas when it's at it's peak.

Timothy Chatard

And to what extent do you think progress on gross margin for you going forward relies on North American natural gas recovering? Sort of looking-around-the-corner type question a little bit, but your gross margins here kind of sub-20%, I think you hit on mix being a problem in the quarter. But I'm just curious, is North American natural gas a—or northern oil and gas a higher gross margin piece in that segment that really is a driver for gross margin? Or is that not the case?

Jeffrey Knutson

It is. It is a driver. And I think that's—when you go back to some of our past quarters, when we were in the mid-30s, that's really high North American oil and gas activity. I think we can get improved margins certainly without a significant move in oil and gas, but to get to where we all want to be, which is back around 30%, is going to require some in North American oil and gas, at least in the near term. We're working on a lot of things to drive improvement in both our cost structure and new products to improve margins. But right now, yes, that North American oil and gas and the aftermarket component of that is a big driver of our mix impact and margin performance.

Timothy Chatard

Yes. From a big-picture perspective, do you think this oil and gas cycle is any different from prior cycles? Or do you—or are you under the assumption that activity will come back as it always has?

John Batten

It's—this is John, Tim.

It will come. I do not think the next wave will be as big as the one five years—three years ago. I think the people will be more tempered on investment. I think the long-term outlook is still good. We still need to generate electricity, and natural gas, as you point out, is the primary source of electricity. Renewables are coming online and increasing their percentage every year. But I still think there is a huge role for natural gas in that mix for electricity. And honestly, that plays into our strong suites because that's typically the higher horsepower fracturing rigs and that tends to—our 8500 transmission fits in perfectly there.

So, long term, optimistic that we still have a very strong market. I think everyone who's in the market, ourselves included, would like it to be more balanced and steady state than binary of either being all on or all off. So that's our hope. We would take years of a lower demand per year over more years than all or nothing in a year and a half or two years, and then the cycle turn off again. But we're optimistic there—there will be some new rig construction. We're also—some retrofits and rebuild activity. Again, I think we

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would have seen more of that in Calendar 2020, if it were not for the pandemic. That put a lot of capital spending plans on hold as demand plummeted and the price of oil plummeted.

We see a reversal of that trend, and I think a lot of it has to do—it will be complete—not completely, but very much tied to the general economy improving post-COVID, post-vaccine. And if I had to guess, if I had a crystal ball, once we get to a widespread activity where people feel comfortable moving in and around the economy and traveling again, you'd see a noticeable increase in rebuild, retrofit, new construction a quarter or two after that, would be my best guess.

If we have something late spring, summer, where a more normal economy is moving, people are moving around, and there is a better demand for oil, I think it would be—within a quarter or so, you see—you would notice that across the board on some equipment manufacturers.

Timothy Chatard

Not to belabor the point here, but I think—is there a way to think about maybe oil? The U.S. went through sort of a five-, six-, seven-year cycle where it became this tremendous growth engine of global oil. It went from 4 million, 5 million barrels a day to 11 million, 12 million, 13 million, I think it's were peaked out in 2019. And I think with all of the OPEC Plus countries having to cut their production substantially to support oil last year, is there really going to be a—are we not on a slow decline in the U.S. production for the next several years as a result of that dynamic change?

That would be kind of the framework that I would be working under where you wouldn't be looking at a recovery in domestic oil production so much as just sort of a steady decline because OPEC Plus is really the supply control at this point. It's not—we're on a completely different path from where we were from 2010 to 2018. It is that not something that, I guess, ties in with your view of the world?

John Batten

I wouldn't disagree, but I would say that it's still on the base production, if I take your assumption that North American oil and gas—or North American oil production, it will have a steady state decline. That is certainly—that is a scenario. That's one of the most likely scenarios. But again, there is still production and the equipment needs to be replaced, and a pressure pumping is an integral part of that. We see more—we've seen less investment offshore and deepwater. So more and more of the swing production and demand, I think, is going to be onshore. So the market may not be as big or growing, but the equipment absolutely has to be replaced, rebuilt and maintained.

And again, we're not—Tim, I guess, nothing surprises me in oil and gas; meaning that any little event or hiccup in the Mideast could change OPEC's plans. And we can't forget that OPEC—as nations, they need oil prices to be a lot higher just to fund their budgets, which is not the case here in the U.S. As I've said in the past, it's an asymmetrical battle or war, if you want, where U.S. producers and Canadian producers are basically competing with nations. And Russia and OPEC, they need—I mean, realistically, for their fiscal budgets, they need oil around $100 to pay for all of their social programs. This country doesn't. Canada doesn't. So all that's doing is driving Canadian and American producers to be more efficient.

Again, Tim, nothing surprises me, but certainly, in our planning, and that's one of the reasons we want to diversify. We still want to get everything we can in oil and gas, in North America on onshore because we've seen the pressures that it puts offshore, and again, why we want to grow our business outside of that because we'll take the bubble, provided our base business is growing other places.

Timothy Chatard

That’s really helpful to hear your thoughts on the plan and the aspects of that. I appreciate it.

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John Batten

Thanks, Tim.

Operator

That will conclude today's question-and-answer session. I will now turn the conference over to Mr. Batten for any additional or closing remarks.

John Batten

Thank you, James, and thank you, everyone, for joining our conference call today. As always, we always appreciate your continuing interest in Twin Disc, and hope that we've answered all of your questions. If not, please feel free to contact Jeff or myself, and we'll try to get back to you as quickly as we can. And we look forward to speaking with you again following the close of our Fiscal '21 third quarter.

And with that, James, I'll turn the call back to you.

Operator

Thank you, sir. That will conclude today's conference. Thank you for your participation. You may now disconnect.

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