Twin Disc, Inc.
Fourth Quarter Fiscal 2014 Financial Results
August 5, 2014

Operator: Good day and welcome to the Twin Disc, Inc. Fourth Quarter Fiscal 2014 Financial Results conference call. Today's presentation is being recorded.

At this time, I would like to turn the call over to Mr. Stan Berger of SM Berger. Please go ahead, sir.

Stan Berger: Thank you. On behalf of the Management of Twin Disc, we are extremely pleased that you've taken the time to participate (audio interference) call and thank you for joining us to discuss the Company's 2014 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 states Management's intentions, hopes, beliefs, expectations, or predictions for the future, are forward-looking statements. It is important to remember that the Company's actual results could differ materially from those projected in such forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in the Company's Annual Report on Form 10-K, copies of which may be obtained by contacting either the Company or the SEC.

By now you should have received a copy of the news release which was issued this morning before the market opened. If you have not received a copy, please call Annette Mianecki at 262-638-4000, and she will send the copy to you.

Hosting the call today are John Batten, Twin Disc's Chief Executive Officer, President, and Chief Operating Officer; and Chris Eperjesy, the Company's Vice President of Finance, Chief Financial Officer, and Treasurer. 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 2014 fourth quarter conference call. As usual, we will begin with a short summary statement, and then Chris and I will be happy to take your questions.

Looking at our fourth quarter results, sales for the 2014 fiscal fourth quarter were 73.6 million, down 3% from 75.9 million for the same period a year ago, but up 21% from the fiscal third quarter. The sequential improvement over the third quarter was driven largely by the increase in shipping for the Asian and North American oil and gas markets. For the full fiscal year, fiscal 2014 sales were 263.9 million, down 7.5% from a year ago.

Looking at our broader product markets, this decrease in sales in part can be contributed to a slight falloff in record levels in some of our commercial marine markets, primarily in the lower horsepower ranges. However, crew boat demand in Asia and the US Gulf Coast remained strong for a high horsepower marine transmission.

Sales for our propulsion products also suffered during the fiscal year as many of the global controllable projects had fallen behind schedule. In what should surprise no one, the global pleasure craft market continued to struggle, although we did see some pockets of promise in the Australian yacht market and the North American custom sport fish market, where builders used our Express Joystick System and CAT360 for certain control systems as differentiation against the competition.

While our marine shipments were lower than a year ago levels, demand remains high at the offshore oil and gas markets, especially in the US Gulf Coast and Southeast Asia, and the second half of the year shipments were stronger than in the first half of the year.

Sales into our industrial markets declined when compared both for the prior fourth quarter and full fiscal year. The majority of the impact was driven by the slowdown in our North American and European sectors, including oil and gas at (ph) air clutches, but also in irrigation and construction. On a positive note, our industrial products sales improved sequentially throughout the fiscal year and order rates improved in the fourth quarter.

While sales into our transmission markets were essentially flat compared to last year, both when comparing the fourth quarter and full fiscal year, the momentum that we have seen in the North American oil and gas market in the last few months was a welcome addition to our backlog. As we anticipated, the new order rates have not duplicated what we saw in 2010 and 2011, but we believe that these trends will hold and could even improve as we move through the balance of fiscal 2015. The main difference between 2014 and 2010 is that four years ago everybody needed product, a lot of product. Today the situation is different and each customer is—they're all in their own unique recovery and utilization of inventory. But clearly, the broad momentum has changed from the last 12 months, or even six months ago.

As we discussed in prior calls, the global arc (ph) market remained flat year-over-year, but sales into our legacy military products declined as vehicle utilization in Iraq and Afghanistan declined with the planned troop drawdown. New order trends also improved throughout the quarter, specifically in North America and driven by oil and gas. This is the third quarter in a row where our six-month backlog increased and now stands at 66.1 million, up sequentially 15% from the previous quarter.

Gross margins for the quarter were 29.3% compared to 27.2% a year ago and 27.2% for the previous quarter. A better mix of products specifically within our transmission range, primarily drove the gross margin improvement over last year and the sequential improvement versus the third quarter. We also saw improvement in all product areas when comparing to the third quarter. Year-to-date gross margins were 29.3% versus 28.1% a year ago.

Fourth quarter spending in ME&A, marketing, engineering, and administrative expenses, increased by 4.3%, or 730,000, versus the same period last fiscal year, and 17.1 million, or 22.5% of sales, to 17.8 million, or 24.2% of sales. There were several one-off items that contributed to the negative in variance, including $572,000 relating to the cash surrender value of a split-dollar life insurance policy; 567,000 related to the investigation which includes audit, legal, and severance costs of a previously announced accounting irregularity at our Belgian operation. That investigation did not uncover any other matters that required us to amend our financial statements. Additionally in the fourth quarter, we reported a $320,000 charge related to a Nexus (ph) study on sales and use tax at our North American distribution operations. Year-to-date ME&A spending decreased 0.7%, or 490,000, over year ago levels, from 67.9 million, or 23.8% of sales, to 67.4 million, or 25.5% of sales.

As I've mentioned in the last few calls, we continue to rationalize our resources in both the European and North American operations. Even with the opening of the plant in Chennai, the add that we have made in Asia, our net employment is down again year-over-year.

Looking at the bottom-line, the fiscal 2014 fourth quarter net earnings were 2.3 million, or $0.21 per share, versus a net loss of 48,000, or zero cents per share, a year ago. You will recall that in the fiscal 2013 fourth quarter we had 2.1 million in restructuring and impairment charges at our European operations. Adjusting for this and other one-time items, the current quarter was an improvement versus a year ago. Year-to-date net earnings were 3.6 million, or $0.32 per diluted share, versus 3.9 million, or $0.34 per diluted share, a year ago.

EBITDA for the fourth quarter was 6.5 million compared to 4.7 million a year ago and year-to-date EBITDA was 19.5 million compared to 21.1 million for the prior fiscal year.

Turning to the balance sheet, we ended 2014 fourth quarter with a net cash of 6.4 million. Total debt at June 30, 2014, declined 32%

to 18.4 million from 27.2 million at June 30, 2013. Fiscal 2014 was another good year for cash flows, as we generated 25.7 million from our operating activities.

Inventory in the quarter declined 7.5 million from 105.1 million to 97.6 million and is 5.2 million lower than the start of the full year. The bulk of the decline in the year and in the quarter came from a manufacturing sub (ph) with increased level of shipments again in the fourth quarter, but we also saw reductions with at most of our distribution subsidiaries as well.

Returning to our six-month backlog, the 8.5 million increase from 57.6 million at the end of the third quarter to 66.1 million was, as I said, driven by new unit orders for the North American oil and gas markets. We also continued to receive new orders for the 8500 and 7500 series oil field transmissions for China. With respect to our marine and industrial products, the stronger transmission backlog was offset by a slightly weaker marine backlog, which reflects continued market weakness in the lower horsepower range of our marine transmissions.

Turning to the outlook, the 2014 fiscal fourth quarter, like fiscal 2013, was a nice rebound from the third quarter, which in the past two year has been our most challenging quarter. The new order activity in North America in oil and gas makes Management more optimistic about fiscal '15 when compared to fiscal 2013 and 2014. We continued to see strong demand from our global commercial marine customers, again especially in the offshore markets, which is somewhat offset by the continuing weakness in many of the European marine markets, and as I mentioned earlier, there are some bright spots in the larger pleasure craft marine sector, primarily with our Joystick and the CAT Joystick Systems.

With respect to a broad recovery in North American oil and gas markets, I would just reiterate that the situation is different with each player and each type of application, but there's no doubt that the excess inventory in the market has come down significantly. Even with a recent ramp up on oil and gas shipments, our lead times remained historically short for both our land-based and marine transmissions. The 8500 series lead times remain 12 to 14 weeks compared to 26-plus weeks for the competition. As a result, our customers are placing orders just when we need them, and this is allowing us to fill new orders within the quarter for the next quarter, at the latest. Middle to longer term, we are well-position with product, people, and strategy and a healthy balance sheet to take advantage of the global opportunities ahead of us.

That concludes my prepared remarks and now Chris and I will be happy to take your questions. Leah, 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 are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, that is star, one, for questions.

We will go to Josh Chan of Baird. Please go ahead, sir.

Josh Chan: Hi, good morning John and Chris.

John Batten: Good morning, Josh.

Chris Esperjesy: Good morning, Josh.

Josh Chan: Good morning. Just wanted to ask more about the excess inventory comment that you just made there. I think there's been some recent comments about part capacity being brought back and just wondering what you're hearing on industry capacity and how broad-base of a demand that you're seeing across your oil and gas customer base.

John Batten: Josh, did you say part capacity?

Josh Chan: Part capacity going back, yes, and then what do you think about industry over capacity at the moment?

John Batten: I'll speak for what we're seeing, not necessarily what everyone else is seeing. What we're seeing is that some of the smaller independent operators and builders in the industry seem to have worked through their excess inventory faster than maybe some of the larger players, and so they are the ones that have been placing orders on us sooner. That's kind of what leads us to believe there's a bit of still an unbalance. Some of the larger players still have excess inventory, but we are seeing—particularly in higher horsepower from the smaller independents, that's where we're beginning to see—you know, that's where we saw the demand push at the end of the third quarter with new orders, and that continued through the fourth quarter.

Josh Chan: Okay. Do you have any sense in terms of how long it would take the larger players to sort of work through to their relatively higher inventory?

John Batten: I'm sensing that it's, you know, maybe this quarter, but I would say certainly within the calendar year. I mean, I know that the larger players have been ordering some new spread, but I think as a percentage of their overall fleet, it's smaller as a percentage of their fleet versus the smaller independents, if that makes sense.

Josh Chan: Right, that (cross talking).

John Batten: (Cross talking) seem to be having the impact that the independents are at this point.

Josh Chan: Okay, and then you talked about the moderate pace of recovery, and that certainly makes sense. I appreciate the color there. Your backlog this quarter did improve at a pretty healthy rate, and so—in fact, pretty similar to the rate of improvement that you've seen at the beginning of the last cycle. So I'm wondering are there any other sources of strength that you're seeing in terms of your backlog, or are you perhaps being a little bit conservative in terms of what to expect in terms of demand?

John Batten: Of course, we're probably being a little bit conservative. Certainly the biggest improvement in this quarter was oil and gas, but I would say in general how we feel about the rest of the businesses in the backlog, we're feeling pretty good, specifically because the second half of the year, for both marine and industrial, the (inaudible) transmission (ph) is stronger than the first half.

So, there is definitely better momentum in oil and gas, specifically North America, and then as far as the shipment and the orders in the second half of the year for marine and industrial than in the first half. So, you know, we—Management here, we're feeling a lot better today than we were a year ago on the conference call as to what the fiscal year ahead of us was going to present.

Josh Chan: Okay, great. That's encouraging. Then if I can ask about the comment about the cap ex, pretty sizable ramp, so I'm wondering what do you expect to work on next year in terms of capital spending-wise.

John Batten: Well, it continues with some targeted machine tools that we just didn't get in this year, and again it has do with years (ph) and housing. To be honest, we didn't get a lot done in our European operations in kind of the last four months of the year, for obvious reasons, so we have some PP&E to do there as well. I neglected—we have a plant, a fairly large one that started this year on improvements on the corporate facilities here.

So those are the big ones, but we also have some machine tools going in into India and upgrading and new service facilities going in in Asia, outfitting those, so it kind of covers everything, but a little—a lot of it has to do with make up on what didn't happen in Europe in fiscal ‘14.

Josh Chan: Okay, great. Thanks for your time and good luck in the next year.

John Batten: Thanks, Josh.

Operator: Ladies and gentlemen, we do have one question remaining in the queue. If you would like to ask a question, once again that is star, one, and Ryan Cassil of Global Hunter Securities will have our next question.

Ryan Cassil: Hey guys, good morning.

John Batten: Good morning.

Ryan Cassil: Thanks for taking my question. Just a question on orders. If my quick math is right, the orders were above 30% and you had some weakness, I guess, in commercial, as expected. Would you mind just breaking out the transmission-related order growth. That something you guys want to break out?

Chris Eperjesy: We don't typically, you know, disclose the order activity, and I noticed in your early report that you guys tried to calculate it. That's tough to do with the information we do disclose because we only report a six-month backlog and there could be things that—growth in the beyond six-month backlog. But to John's comments earlier, the majority of the growth in our backlog, more than the majority of our growth in the backlog, came from oil and gas sector, with the marine market which had—you know, fiscal 2013 was a record year, despite the pleasure craft market being down. Actually, the backlog did come down a little bit in the quarter.

Ryan Cassil: Okay.

John Batten: Again the mix—what was different than any quarter this year or last year was the waiting (ph) towards North America as the end market for oil and gas.

Ryan Cassil: Okay, that's good color. I know you talked about shortening lead times and, you know, last quarter you talked about increasing inventory to try to take advantage of the shortening lead times, but has that actually—have they actually become shorter than you had expected, and are you positioning yourself to take advantage of that?

John Batten: The answer to last question is yes, but are they shorter than we anticipated? The answer to that is no, but I will say—modify that. We've held—we've now going through a quarter of bump up in production in oil and gas, and we're holding the lead time, and we've made that a priority here where the transmissions are produced here on the scene. But we're going to do whatever we can which is prudent and possible to maintain those lead times as long as we can.

So, you know, if we have a steady state increase in demand, I think we can continue to hold these types of lead times, despite back in 2010 and 2011 just blew everything out of the window because everyone was ordering at once and there was a rush of spare parts at aftermarket as well. But if we can—if the market comes back consistently and the growth is consistent, then I—you know, we're going to do whatever we can to hold these lead times.

Ryan Cassil: Okay. Yes, I know you talked about a more gradual ramp. Is it fair to think about, you know, the shipments you had in the transmission side, you know, kind of a base here in Q4 and then going forward we should see gains on top of that as this cycle plays out?

John Batten: That is the indication that we're having. We're just beginning to start a ramp up and improvement. Now having said that, you know, it may not be a nice, smooth line going up, but I definitely see the trend, at least for the next six to eight quarters, of an overall improving market in oil and gas, particularly in North America. So, you know, the second quarter maybe slightly lower than the first quarter, or the third quarter may be lower than the second quarter, but we definitely see the trend—that fiscal '15 should be better as—will be better than fiscal '14.

Ryan Cassil: Okay, and then as we ramp the transmission orders—and this has been a pretty strong margin, or at least a great incremental margin business in the past. Has anything changed from a margin perspective, or what are the kind of the expectations there as we ramp?

John Batten: We're expecting to hold the same margins, you know, within a point here or there that we had in the last ramp up.

Ryan Cassil: Okay, and then for commercial marine, you had a tough compare this year. What are your expectations for '15? Is that kind of a flat to slightly growing market, or what do you guys (cross talking)?

John Batten: I would say it's certainly flat to growing. There are some markets that have—particularly in some of the Asian economies, or Asian countries and South America, there is always politics involved with elections and this, that, and the other. So we're expecting some of that to move past us early this fiscal year, so there should be improvement. One of the markets I'm thinking about in particular is Indonesia with the coal tugs. That took a turn backwards in fiscal '14, but we see that improving heading into 2015. So there are some of our lower horsepower markets that hopefully will bounce back, and we're optimistic that flat to growing is what we're going to see in commercial marine.

Ryan Cassil: Okay, and then pleasure yachts, it's been a challenging past couple years. I heard you've mention something about the sport fishing, a sport fishing win. Could you just talk about what you're seeing in pleasure yachts, and does that even classify as—are you putting that in the (cross talking) bucket?

John Batten: Sure. Overall I think the pleasure craft market is still down, you know, almost to where it was when it dropped. Where we're seeing our improvement really are in applications with our joystick system where we can differentiate ourselves and then take market share from the competition.

The two that I've mentioned, one is in Australia in the overall yacht market where the Australian market has gravitated towards the joystick technology and are demanding yachts with that in it. The win here in the US was directly related to our partnership with Caterpillar and the EJS and also the CAT360 precision control system, which they have been pushing heavily through their dealer network into some of the custom yards and some of the production builders, and I'll mentioned Viking is one. So, that has been a market share win for us.

So, you know, there are—while the market is down, I do believe that our pleasure craft sales are going to increase in fiscal '15, and it's primarily driven by those two areas, what's happening in Australia and what's happening on—from, you know, the Mid-Atlantic region down through the Carolinas in the sport fish—custom sport fish market. So, I think we'll see some growing, you know, production of marine transmission and then our boat management, the control systems and the thrusters, all should see an increase in the pleasure craft market this year.

Ryan Cassil: Okay, that's great to hear. All right, thanks guys. I'll jump back in queue.

John Batten: Thanks, Ryan.

Operator: If you have a question, ladies and gentlemen, or a follow-up question, please press star, one, at this time. No one is queued up at this time, so I'll turn the call back to John Batten for any additional or closing remarks.

John Batten: Thank you, Leah. 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 Chris or myself. We look forward to speaking to you again in October following the close of our fiscal first quarter for 2015.

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

Operator: Thank you for your participation and this concludes today's conference.