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Twin Disc, Inc.

Fiscal Third Quarter 2019 Earnings Conference Call

May 6, 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*

Tom Wojs, *Robert W. Baird & Co.*

PRESENTATION

Operator:

Good day, and welcome to the Twin Disc Inc. Fiscal Third Quarter 2019 Earnings 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, Sandi. 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 third quarter and nine months 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.

Hosting the call today are John Batten, Twin Disc's 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 2019 Third 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 in detail, I will touch on some of the operational highlights from the quarter.

In many ways, our fiscal third quarter was frustrating and not representative of the amount of work and effort that was put into it. Sales for the quarter easily could have been $6 million to $8 million higher than what we achieved. Some of this was due to order push-outs, particularly in oil and gas. Continued supply issues in critical components, like outsourced gears, castings, forgings and heat treat furnaces, all caused certain delays during the quarter. Additionally, we had internal inefficiencies with new employees and training, and much higher turnover than we have historically experienced, all which led to increased internal capacity issues within the quarter. Things have started to improve, but more of our oil and gas has been pushed into fiscal '20, Q1.

On a positive sign, our marine backlog is growing globally and we're starting to see signs of life and inquiries in the offshore space. Parts demand remains at historic highs and we enter into our fourth quarter in fiscal '20 with an extremely strong backlog in this market. The Veth backlog is growing in North America and we couldn't be happier with the progress that we're making there, and we'll know more after the offshore conference in Houston this week what our oil and gas projects, as far as applications for new rigs, are also growing.

We also added over $2 million in cap ex during the quarter. These will come online in the fiscal fourth quarter and into next year, but they should help add capacity, particularly in our gear manufacturing space. Our Lufkin facility got under construction in the quarter and we are currently moving this week our aftermarket business to its new facility. Both of these will allow for more assembly space and more machining space in our Racine operation. Lufkin will also tap into a completely new labor market for us, which will be critical for our next upcycle.

Finally, we couldn't be happier with the Veth acquisition so far. We have seen great results both in Europe and their business in general, but particularly in North America, and we've brought a salesman over from the Netherlands to oversee this market development. Additionally, the added engineering capacity and capability is dramatically speeding up our marine hybrid activities, both with the Veth product line of thrusters, but also our conventional marine transmission.

We also announced recently, last week, the hiring of Jim Feiertag as our new President and Chief Operating Officer. For the last five years, Jim has been the CEO of Bemis Manufacturing, and some of you remember that he was our Executive Vice President of Operations up until 2014. We've also announced the retirement of Mac Moore, who was our Chief Operating Officer, and Jim will be able to hit the ground running, knows our facilities, knows our people well, and knows our markets. We couldn't be happier with the transition from Mac to Jim.

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

Jeffrey S. Knutson:

Thanks, John. Good morning, everyone. I'll briefly run through the third quarter numbers. Sales of $77.4 million for the quarter were up $12.1 million, or 19%, from the prior year third quarter. The quarter results include the impact of the acquisition of Veth Propulsion, which closed on July 2. Excluding the impact of Veth, sales were actually down 5%, compared to the prior third second quarter. The primary driver for the decline in revenue in the quarter is a reduction in North American aftermarket demand, primarily related to oil and gas products, following an historically high level of aftermarket demand in fiscal '18. The quarter was also impacted, as John referenced, by continued supply chain challenges resulting in some delayed shipments and excess inventory in the quarter.

We continue to see strength and positive momentum in nearly all of our markets, including the global industrial, commercial, marine and patrol craft markets. Through the first three quarters, sales are now up $63.3 million, or 38%. Adjusting for the Veth acquisition, the organic increase is over 12%. While much of this growth was driven by oil and gas demand, industrial product sales have increased nearly 16%, compared to the prior first nine months, and marine transmission sales increased nearly 3%.

Our gross margin performance for the quarter was hampered by an unfavorable product mix, with lower aftermarket demand being the primary driver. The third quarter margin percent was 29.9%, a decline of 200 basis points from the prior year third quarter. This result includes the impact of the Veth acquisition and related purchase accounting amortization. Excluding the Veth non-cash purchase accounting amortization, gross profit was approximately 31.2% for the third quarter.

Spending on marketing, engineering and administrative costs for the fiscal 2019 third quarter increased $2.8 million, or roughly 19%, compared to the prior year. The entire increase can be attributed to the addition of Veth and the related amortization of acquired intangibles. We also had some increased spending on professional fees, salaries, stock comp, travel and marketing, compared to the prior year. These increases were essentially offset by reduced global bonus expense and a foreign exchange impact. As a percent of revenue for the fiscal 2019 third quarter, ME&A expenses were essentially in line with the prior year third quarter at 22.4%, compared to 22.3% for the prior year. Through the first nine months, ME&A expenses fell to 24% of revenue, compared to 25.8% in the first nine months of fiscal '18.

Included in the third quarter results are two other operating items totaling $1.4 million. These relate to a $900,000 gain on the sale of the Mill Log business and related assets and a $500,000 adjustment to an accrual associated with the Veth Propulsion acquisition.

With the improved volume impact, reduced restructuring spending and the other operating income items just noted, our operating results improved by $1.2 million, from a $5.8 million operating profit in the prior year third quarter to a $7 million operating profit this year. Through the first nine months, operating profit has improved by $11 million to $18.5 million in fiscal '19, compared to $7.5 million in the prior year.

The effective tax rate for the third fiscal quarter was 23.9%, reflecting the continued impact of the new tax legislation, compared to the prior year rate of 20.7%. The change from the prior year rate is reflective of the jurisdictional mix of earnings, with no significant or material discrete items recorded in the quarter of either year.

Net profit for the quarter of $4.6 million, or $0.34 per diluted share, reflects a slight increase from the prior year fiscal third quarter net profit of $4.3 million, or $0.37 per share. Through the first nine months, the bottom line has improved by $7.9 million to a profit of $11.5 million, or $0.90 per share, compared to a profit of $3.6 million in the prior year.

Positive EBITDA of $10 million for the quarter reflects a $2.8 million improvement over the fiscal '18 third quarter. On a trailing 12-month basis, we are now at $37 million of EBITDA, which includes restructuring charges of $1.6 million.

The balance sheet remains healthy as we close out the third quarter of ’19, with the impact of the $61 million Veth acquisition and subsequent $32 million follow-on offering remaining in the headlines for the year so far. We finished the third quarter with $33.5 million of debt, debt to total capital of 20.9%, and a debt to EBTIDA ratio of 1.3 times.

The slight decrease in inventory during the third quarter didn’t meet expectations, but we feel like we have positive momentum and processes in place to drive a meaningful improvement in the fourth quarter. Backlog finished the quarter at $114 million, which is down $24 million from the Q2 level. We did experience some additional order cancellations in Q3, as we proactively validated backlog levels to ensure we weren’t bringing in unnecessary inventory. While incoming order levels softened in Q3, market activity and inquiry levels remain strong and we are encouraged by positive trends in our end markets.

Operating cash flow was negative $8.4 million and free cash flow was negative $10.6 million in the third fiscal quarter, impacted by a ramp-up in capital spending, limited improvement in inventory level, and temporary payment delays from a few key customers. Significant payments have been received in early Q4, and inventory reduction efforts remain a high priority. We look for improved cash flow results as we finish fiscal ’19 and move into fiscal ’20.

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

John H. Batten:

Thanks, Jeff, and now I’ll spend a quick moment or two on the outlook.

Looking to Q4 and beyond, we feel that we have the backlog and demand to achieve quarters like our third fiscal quarter. Oil and gas for both new units and aftermarket continues to be a bit unpredictable as far as quarterly timing for improving trends, but we do not think we are seeing anything like 2015, and as Jeff mentioned, our other markets remain stable and we enter the fourth quarter and going into fiscal ’20 with a very good backlog in all of our other markets.

Our main operational focus remains improving our internal capacity, primarily here in Racine, and getting our Lufkin facility operational by January 2020. New product development continues to be a priority, as we look beyond marine hybrid and the electrification of our other product end markets, and as we develop and take what we’ve learned with Veth and our marine markets and apply it to our other product end markets.

Those conclude our prepared remarks and now Jeff and I will be happy to take your questions. Sandi, could you please open the line for questions?

Operator:

Absolutely. 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, press star, one to ask a question. We will pause for just a moment to allow everyone an opportunity to signal for questions.

We will take our first question now. It is from Noah Kaye at Oppenheimer.

Noah Kaye:

Thanks. Good morning, and appreciate you taking the questions. John, you called out a couple of different factors as drags on the operating efficiency in the quarter. You mentioned supply chain, labor, just the space constraint. How dos we kind of parse out which of those are relatively bigger factors, and then can you talk about the actions you're taking to kind of ease each of the bottlenecks?

John H. Batten:

Sure. I would—Noah, to be fair, I would put them roughly at 50/50, and it's—what we're seeing, we went from a few years of zero oil and gas and then had to ramp up very quickly, so we're taking capacity away from our suppliers, and then when the other markets ramped up, we're trying to get all of this hyper-demand through people who are supplying us gears, castings, forgings, and they have labor issues. As the bubble in oil and gas slowed a little bit, it's getting better to get stuff for our marine transmissions and RF market, those supplies through them. What was new in the quarter, I would say, is one of our primary heat treat suppliers for gears had some furnace issues continually through the quarter, so that was the new whack-a-mole issue that came up in the quarter that hindered us.

But, I'd attribute roughly half to that, but half also to just trying to hire and find—we've had continued retirements throughout the fiscal year and we're bringing in new younger employees, and people are moving up and stepping up, but they have a long ways to go to get to the capability that our guys that were retiring had, but we've also seen, I would say, a much higher turnover rate than what we're used to seeing. We're having to hire more and having to train more. The key part there, Noah, is not that they can't—training them on just, for instance, one machine tool or another, or assembling marine transmissions versus oil and gas, it's just that the guys that were retiring, that were here 35, 40, 45 years, they could assemble all of the transmissions or work multiple machines. It's been a challenge this year with the surging oil and gas demand, the other markets improving, to get the headcount up, but get the headcount that's as well trained as the headcount that was leaving.

Does that answer your question?

Noah Kaye:

Yes, it does, thank you, and then just kind of a follow-on to that. You commented that you expect the June Q to have kind of comparable results, financial results, to the March Q. Would that include on the gross margin line, as well?

John H. Batten:

The gross margin, I'd say, for what's been happening as far as supply issues, I'd say that the gross margin is—I would say, for the next couple quarters, that's a fair estimation going forward for the next two, although once we get to fiscal '20, the purchase accounting drops off, so we lose that anchor.

Noah Kaye:

Sure.

John H. Batten:

But, I would say right now, what we have in available backlog, the ship looks fairly constant for the next six months.

Noah Kaye:

Okay, very helpful, and turning to the backlog, I just wanted to understand—last quarter, you were pretty explicit that a lot of what happened with the backlog was you guys really shaking out and making sure you didn't have any kind of duplicative or soft orders in there. How much of kind the step-down this quarter was the same versus kind of any actual softness in the market?

John H. Batten:

Noah, this time, I think this was just—this was oil and gas shipping and not being replaced. We're waiting for—we have some new orders for oil and gas, but we shipped more than we took in orders.

Jeffrey S. Knutson:

I think the cancellations were around the—in the $6 million range, if I remember right, Noah.

Noah Kaye:

Okay, all right, perfect, and maybe if I can sort of just squeeze one more in here. You commented on the strength and the continuing strong interest on the marine propulsion side. Sort of specific to Veth, can you give us a sense of what kind of development synergies you're actually seeing here on the hybrid products?

John H. Batten:

Sure.

Noah Kaye:

You mentioned a benefit not just to thrusters, but for the transmissions. Can you elaborate on that a little bit, please?

John H. Batten:

Yes. Veth, the engineers in Rotterdam have a lot more experience in dual inputs into the gear box for the propulsion system, so electric motor and diesel direct, which is where we're going with our marine transmissions. We're developing master clutches for our standard marine transmissions to have that dual input. The engineers there have been doing this for a few years on the software, but they also have the hardware developed, so the screens and the control handles that let it all happen from the helm. It has jumpstarted our hybrid for our standard marine transmissions. We've seen—we're so much farther ahead, just after a year of integration, of where we were before the acquisition. Our engineers in Racine have designed the mater clutch module to go on our marine transmission and we're able to utilize the expertise from Veth on the control system. Could not be happier about where we are there. It's just taking the same philosophy of controlling the gearbox, whether it controls the propeller, steers the thruster or controls the output of a vehicle transmission. Like our oil and gas, we're well on the way to understanding the software of how to do it, but also the hardware to make it happen.

Noel Kaye:

Perfect. Thank you so much.

John H. Batten:

Thanks, Noah.

Operator:

If you find that your question has been answered, you may remove yourself from the queue by pressing the star key.

We'll take our next question from Tim Wojs at Baird.

Tim Wojs:

Hey, gentlemen, good morning.

John H. Batten:

Hey, good morning.

Tim Wojs:

I guess, maybe, I'll start on free cash flow. How much of the working capital drag that you saw in the third quarter maybe reverses in the fourth quarter, and is it enough to get free cash flow to slight positive for the year, or do you think that's going to be a little bit of a stretch?

Jeffrey S. Knutson:

I think positive for the year at this point is a stretch, to be honest. I think we have a good chance of having very positive cash flow in the quarter, but I don't think we reverse the three quarters that we've had so far. There's a good chunk of cap ex spending that will be flowing through, at least we anticipate flowing through in Q4, as well.

Tim Wojs:

Okay, and as we look at kind of 2020, you should see some further progress on the inventory drawdown, and then I would imagine that cap ex would step down in 2020 from '19 levels?

Jeffrey S. Knutson:

I think we still have a fair amount of investment that we'll be doing with the new Lufkin facility. It might come down some, but I think it'll still be at—historically, at slightly higher than average level.

John H. Batten:

Just given Veth, too.

Jeffrey S. Knutson:

Veth, right, adding to that mix. I think working capital-wise, we have a good opportunity, again, through the fourth quarter and also into fiscal '20.

Tim Wojs:

Okay. Then, on the marine business, John, you sound a little more positive there, and I know, probably, over the last six years, maybe that business has kind of bumped along the bottom a little bit. Are you seeing kind of a notable improvement in kind of the discussions you're having with your marine customers now? You mentioned offshore, which I don't think you've mentioned offshore in a couple of years.

John H. Batten:

No, we're just starting to see some—I'm very interested to see what happens. OTC, they arrived today, so I'm interested to see what comes out of it, but I've seen a little bit more signs of life in discussion of projects, and it helps, because Veth doesn't have any market share there, so this is a growth opportunity on a certain size class for Veth, but continued activity here in Racine. Again, it's being driven by the North American market, honestly, the Gulf Coast up through the inland river, but we've also seen some new orders from Asia, which has been a long time coming. That's kind of what's changed a little bit even since the last quarter, is the slightly stronger orders and improving trends from Asia.

Tim Wojs:

Okay. Then, on oil and gas, how did orders kind of progress through the quarter, because I know we've had some kind of bottlenecks in the Permian?

John H. Batten:

Yes.

Tim Wojs:

Has that kind of extended into the summer, or how are your customers kind of talking about what's going on down there?

John H. Batten:

Try and remember, I mean, we didn't get a lot of cancellations early in the third quarter at all. I would say it was more in that late February, March timeframe, with some push-outs into late this fourth quarter, but they're going international, so they'll fall into next year, but everyone that I talk to, they don't want to go on record, but, you know, kind of thinks that it will be late summer/fall when we see—we have a lot of projects going, both domestic and in China. We should see some improving trends the second half of the year, as far as orders and results.

Tim Wojs:

Okay.

John H. Batten:

Tim, we have inventory to ship.

Tim Wojs:

Yes, okay, got you, okay. Then, the Veth that's in the quarter, was there a way to give us what the revenue dollars were for Veth in Q3, and then just curious what the reversal was, was that just an accounting thing?

Jeffrey S. Knutson:

The reversal—oh, in other operating income, is that what you're referring to?

Tim Wojs:

Yes.

Jeffrey S. Knutson:

Yes. What that was, we had an accrual—as part of the acquisition, there was an earn-out provision. That earn-out was to be paid either in cash or Twin Disc stock at our discretion. We made the determination within the quarter that we would be paying that in stock and, therefore, there was a sort of mark-to-market adjustment, because of the change in the stock price from the timing of the agreement to the end of Q3.

Tim Wojs:

Got you, okay, and then was the revenue $14 million or so in the quarter?

Jeffrey S. Knutson:

A little over $15 million.

Tim Wojs:

Got you. Great, thanks for the time, guys. Good luck on the rest of the fiscal year.

John H. Batten:

Thanks, Tim.

Operator:

Once again, if you would like to ask a question, please press star, one.

It appears there are no further questions at this time. I would like to turn the conference back to your hosts.

John H. Batten:

We can close, Sandi.

Operator:

This concludes today's call. Thank you for your participation. You may now disconnect.