Twin Disc, Inc.

Fiscal Second Quarter 2018 Investor Conference Call

February 2, 2018

CORPORATE PARTICIPANTS

Stan Berger, *SM Berger & Company*

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

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

CONFERENCE CALL PARTICIPANTS

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

John Braatz, *Kansas City Capital*

PRESENTATION

Operator:

Good day, and welcome to the Twin Disc, Inc. Fiscal Second Quarter 2018 Investor Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Mr. Stan Berger of SM Berger. Please go ahead.

Stan Berger:

Thank you, Matt. 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 2018 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 the course of this conference call, especially those that state Management's intentions, hopes, beliefs, expectations or predictions for the future, are forward-looking statements.

It is important to remember that the Company's actual results could differ materially from those projected in such forward-looking statements. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements are contained in the Company's annual report on Form 10-K, copies of which may be obtained by contacting either the Company or the SEC. By now you should have received a copy of the news release which was issued this morning before the market opened. If you have not received a copy, please call Annette Mianecki at 262-638-4000, and she will send a copy to you.

Hosting the call today are John Batten, Twin Disc 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?

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John H. Batten:

Thank you, Stan, and good morning, everyone. Welcome to our Fiscal 2018 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 first quarter results, I'd just like to take a few moments to go over some of the highlights from the quarter.

Sales for the quarter rose 68% year-over-year, driven by a surge in demand in the North American oil and gas market, and our aftermarket spare parts business. Activity in our global marine markets also improved slightly, with the offshore oil and gas markets remaining the lone exception. We are still estimating that up to 25% of the OSVs and SF (inaudible) vessels are idle worldwide, but the rising price of oil should increase the utilization rates going forward.

New rig construction and retrofit and overhaul activity in the North American pressure pumping fleet is increasing at an accelerating rate. Rotary rig counts are up and inventories are down, so we see this trend continuing to expand the available horsepower rate in the North American fleets continuing.

We have also seen a lot of new project activity in our industrial markets in the higher horsepower hydraulic clutch space, and we expect these new orders to grow as we move through 2018. Again, with the exception of marine offshore, there's been a lot of new project activity across all regions in our marine market.

The rapid increase in oil and gas demand is putting a huge strain on the entire supply base. A lot of supplier capacity from the 2011 to 2013 run-up is no longer available, so we are actively developing new partners to help us meet the surge in demand. Our restructuring and operational improvements in 2015 and 2016 are helping us to keep up the demand at the moment, but we are also actively increasing our internal capacity through headcount, cap ex, and sourcing partners. We believe that our quality, capacity and durability will allow us to have a greater market share in this run-up.

Had it not been for the new tax legislation and our deferred asset reevaluation, this quarter would have been an $0.08 per share gain, or just under a million dollars. Jeff will explain more of that in a few moments.

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 second quarter numbers in a little more detail. Sales of $56.5 million for the quarter were up $22.9 million, or nearly 68% from the prior year second quarter. This represents the fourth consecutive quarter of year-over-year growth, demonstrating a sustained and accelerating growth trend. The primary driver, as John mentioned, for the improved revenue in the quarter, remains the improved shipments of oil and gas transmission units primarily into North America, along with improved North American demand also led by oilfield activity.

In addition, we've seen growth to varying degrees in nearly all of our markets, including European and North American commercial marine, global patrol craft, pleasure craft, global industrial and Asian commercial marine. As John mentioned, the global offshore supply vessel market remains depressed.

For the first half, sales are now up $32.1 million or 46% to $101.6 million. Our gross margin percent for the quarter improved by 550 basis points to 32.1%, compared to 26.6% in the prior year second quarter. This improvement is primarily volume-driven, but also reflects improved operating efficiencies and a

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global reduction in fixed cost. Year-to-date gross margin was 31.5% compared to 26.1% for the fiscal 2017 first half.

Spending on marketing, engineering and administrative costs for the fiscal 2018 second quarter increased $2.7 million or roughly 21% compared to fiscal 2017, but decreased as a percent of sales from 37.3% in the prior year second quarter to 27% in the current quarter. This increase in spending was related to increases in global bonus, stock compensation and volume-driven salary expenses. For a similar reason, the year-to-date spending has increased by just under $4 million or 16%, but has declined again as a percent of sales, from 36% to 28.5% in the fiscal 2018 first half.

We continue to invest in restructuring, and invested another $800,000 in the quarter, now $2 million for the half, related to action driving additional cost reductions and efficiencies primarily at our European operations.

With the improved volume and margin performance, our operating results improved by $6.5 million from a $4.4 million operating loss in the prior year second quarter, to a $2 million operating profit in fiscal ’18. For the first half, operating results have improved by $9 million compared to the prior year, to an operating profit of $1 million.

The new tax legislation obviously had a very significant impact on our tax expense for the quarter. As with all companies that have a U.S. deferred tax asset, the reduced corporate rate resulted in the significant write-down of these assets. We booked a $4.6 million or $0.40 per share non-cash charge in the quarter to account for the re-measurement of our U.S. deferred tax assets. Similarly, there were rate reductions in some of our foreign jurisdictions as well, primarily Belgium, that resulted in an additional $400,000 or $0.04 per share non-cash charge in the quarter, also due to the write-down of deferred tax assets.

The good news is for the remainder of fiscal 2018, we are now projecting our effective tax rate to be approximately 29%, reflecting a blended half-year of the reduced rate structure in the U.S.

Net loss for the quarter of $4.1 million or $0.36 per diluted share, despite a pre-tax profit of $1.9 million, reflects the impact of the tax legislation. Positive EBITDA of $3.5 million for the quarter reflects a $5.7 million improvement over the fiscal 2017 second quarter, despite the incremental million dollars in restructuring charges. On a trailing 12 months basis, we are now at $5.6 million of EBITDA, which includes restructuring charges of $5.4 million.

The balance sheet remains in a very strong position with $11 million in net cash, debt to total capital of 3.5% and over $23 million of availability on our revolving credit facility. While inventory has increased $7.8 million since the end of fiscal 2017, this reflects strong demand along with a positive exchange impact of $4 million.

Free cash flow was positive $3.7 million in the second quarter, benefiting from a strong receivable collection performance, a $1 million tax refund and a strict focus on working capital management. Through the first half, we’ve generated $800,000 in free cash flow compared to negative free cash flow of $3.5 million in the first half of fiscal 2017. We have spent $3 million through the first half on capital improvement, and anticipate capital spending to fall in the $7 million to $9 million range for fiscal 2018 as we continue to invest in modern equipment, global sourcing programs and new products.

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

John H. Batten:

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Thanks, Jeff, just a quick look at the outlook. Obviously with year-to-date sales up 46%, year-to-date gross margin up 540 basis points and the backlog up 124% versus a year ago, and 36% up versus the previous quarter, we're feeling pretty optimistic about the balance of fiscal '18 and see a strong push into fiscal '19. Operationally, we will continue to restructure the Company for the future as we remain conscious that this growing oil and gas demand is always cyclical.

As I mentioned last quarter, how much we improve in fiscal 2018 will depend on the collective effort of our internal operations coupled with our supply chain. For many here in Racine and across the globe, meeting this demand has become a full-time job. Capturing an increasing market share in the North American pressure pumping fleet will allow us to speed up the process of investing in new markets, technologies and products that will provide new growth opportunities in the future, while most likely not as hyper-cyclical as the frac market. That is not to say that we are backing out of the pressure pumping space. On the contrary, we are here to stay.

With that, Matt, I will open it up 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're 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 to ask a question.

We will go first to Tim Wojs from Baird.

Timothy Wojs:

Hey guys, good morning.

John H. Batten:

Morning.

Jeffrey S. Knutson:

Morning, Tim.

Timothy Wojs:

Nice job on the quarter. It seems like the outlook is pretty good.

John H. Batten:

(Inaudible).

Timothy Wojs:

Yes. I guess maybe the first thing, it looks like—I mean, over the last couple quarters you've seen some pickup on the pressure pumping side, but your commentary does kind of indicate that you're seeing a broader improvement in the demand environment just outside of pressure pumping. Maybe if you can just walk us through a little bit on what's changed over the last six months in terms of some of your end markets, specifically marine?

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John H. Batten:

I would say that obviously pressure pumping and oil and gas is up huge numbers. Marine, I would say depending upon the market, it can be flat to up 10%. It's just being dwarfed by the run-up in oil and gas, but it is good to see that projects that had been idled are pushing forward. We see some exciting new projects for some hybrid activity, we see some push boat activity increasing, some pleasure craft, there are pockets that are doing well here in the Southeast of the U.S., a couple applications in Europe and then the Australian and Asian market for importing back is doing well. It's just right now, it's dwarfed by the flurry of activity in oil and gas, but some nice numbers—and last quarter in marine.

Again, as I mentioned, the one that is yet to show the most sign of recovery is just the offshore fleet, for instance the Gulf of Mexico and Southeast Asia.

Timothy Wojs:

Okay. Kind of based on a lot of the moving parts, how would you—I don't know what the right way to think about it is, but in terms of pressure pumping, maybe trailing 12 months or annualized, how much of your revenue right now is pressure pumping? I'm just trying to think of now versus maybe what it was five or six years ago.

John H. Batten:

Well, it's—let's just say in shipment amount, we're still, I would say, on a monthly average just for the recent run-up, we're still—we're not quite to half of where we were in shipment.

Timothy Wojs:

Okay. Then what's the—Jeff, the incremental margins have obviously been a lot better. When you think of maybe slightly more steady state operating environment for Twin Disc now, how should we think of the go-forward incremental gross margins for the business?

Jeffrey S. Knutson:

We always look for incremental gross margins to be over 40% as volume goes up, and I think we're delivering a little better than that so far. I think that's where our expectation is as we go through the next few quarters at least.

Timothy Wojs:

Okay. I guess the last question just on capital. I think you guys have spent a little bit more on cap ex. I'm just curious what that's being spent on. Then, any update or any consideration to maybe reinstating the dividend?

John H. Batten:

Sure, it's John here. The cap ex is really focused on, right now, either increasing capacity, or back up to an internal process where we can't find that on the outside. With that, we're looking at new machine tools, both for gears and housings, machining the housings. We're also looking at investing capital at our suppliers that supply us gears and housings that we can do the machining at their facility. That's kind of where the new cap ex is focused right now. We have some cap ex for increasing the efficiency at assembly and test.

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Then to your last question on the dividend, as you know we had our Board meeting yesterday. We decided not to reinstitute it at this point. We're still on the ABL agreement. Certainly all signs are pointing to improving quarters coming up, and it's something that we're just looking at quarter-by-quarter. It's just that right now we do see an increased demand for cap ex, both internally for machine tools and fixtures and tooling here, but also at select suppliers to increase our capacity there. It's something that we're—typically and historically we review dividends at the January meeting, this current meeting, but it's now something that we discuss quarter-over-quarter, and right now, is that the best use of cash at this moment for the Company.

It was decided that there are a couple little bit more strategic things right now, but we'll revisit it in May.

Timothy Wojs:

Okay, great. Good luck on the rest of the year.

John H. Batten:

All right, thanks.

Jeffrey S. Knutson:

Thanks.

John H. Batten:

Thanks, Tim.

Operator:

As a reminder, that is star, one for questions.

Next we will go to John Braatz with Kansas City Capital.

John Braatz:

Good morning, John and Jeff.

John H. Batten:

Hey, John.

Jeffrey S. Knutson:

Hey, John.

John Braatz:

If you back at the years 2011, 2012 when things were hot again, your gross margins were maybe 34%, 35%, your SG&A was in the low 20s. During the period 2012 to 2018, you've taken a lot of costs out of the business, you've restructured the business. I guess my question is, can you exceed, assuming the market continues to be strong, can you get to an operating margin level in excess of what we saw back in 2011, 2012? I guess maybe that should be tempered a little bit because of what you're talking about,

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supply chain initiatives and expenses and costs. But can you give me a sense as to how that might all play out?

John H. Batten:

Yes. I'll answer it and then Jeff can give you more of the details. Certainly, as we sit here today and compare the Company across all of our operations, we certainly are leaner at every level: fewer executives, fewer middle management and just fewer hourly workers. If you look at every section, we're down. I think we've probably peaked around in the low 80s for ME&A, back in that '11, '12, and we're currently in the—I would say, somewhere—55 to 60.

Certainly, John, we can get back to that level of business without adding back that $20 million of ME&A, for sure. Operationally, I think we can also do it with fewer headcount and being more efficient. I think that we have potential to grow the operating margin both on an ME&A spend that's not as high, so a lower ME&A percentage, and a gross margin that is higher. If we get back to a mix that we had back in that 2011, 2012, where we are today, the results would be significantly better.

Jeffrey S. Knutson:

Yes, and John, I really don't have much to add to that. I agree with that. I think operating efficiency wise, I think we're better than we ever have been, in the plants in particular. I think as we continue to ramp up, what we're seeing now in terms of some of the growth year-over-year in ME&A cost is really a bonus, which was zero at this point last year. Obviously this year as things are ramping up, we have some catch-up accounting that we're doing on bonus and some stock compensation. It's maybe even a little bit elevated from what normal would be, but I agree. I think if we get to those peak levels again, I think we'll certainly have better gross and operating margins.

John Braatz:

Jeff, can you quantify how much bonuses and stock compensation expense might have been in the quarter versus last year, and maybe if things continue the way they are, will there still be room for a sequential improvement in the ME&A expenses in the second half?

Jeffrey S. Knutson:

Yes. Yes, there is. The second quarter, the year-over-year incremental for bonus was about $1.6 million and for stock comp was about $200,000, so about 1.8 of our…

John Braatz:

Okay.

Jeffrey S. Knutson:

Two-point-six ish increase year-over-year. Like I said, that included a little bit of catch-up forwards that were not projected to be in the money and now with new outlook they are.

Last year's second half we did start recognizing some bonus expense, so the comps will be a little bit better in terms of bonus expense as we get into the second half, and we won't have catch-up. So yes, I think there is potential for the second half to be favorable to the first half.

John Braatz:

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Okay. Then, looking at gross margins, improvement in gross margins; is that going to be more a function of just the volume as opposed to any other internal improvements that you might be generating?

Jeffrey S. Knutson:

Yes, I think it's going to be mainly volume. I think we've done a lot of things to improve our ability to deliver high margins in terms of efficiencies. As John alluded to, right now with the volume that we're dealing with, we might be—have a slightly higher cost to achieve volume levels that we're trying to get to, but certainly the volume is going to contribute significantly to an improving margin.

John Braatz:

Yes, okay. Thank you.

Operator:

There are no further questions at this time.

John H. Batten:

All right. Thank you, Matt, and thank you for joining our conference call today. We appreciate your continuing interest in Twin Disc and hope that we have answered all of your questions. If not, please feel free to call Jeff or myself. We look forward to speaking with you again in May following the close of our fiscal 2018 third quarter.

Matt, with that, now I'll turn it back to you.

Operator:

Thank you. That does conclude our call for today. Thank you for your participation. You may now disconnect.

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