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Twin Disc, Inc.

Fiscal Third Quarter 2021 Earnings Conference Call

April 30, 2021

C O R P O R A T E P A R T I C I P A N T S

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John Batten, *Chief Executive Officer & Director*

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

C O N F E R E N C E C A L L P A R T I C I P A N T S

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

Noah Kaye, *Oppenheimer*

P R E S E N T A T I O N

Operator

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

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

Stanley Berger

Thank you, Christina.

On behalf of the Management of Twin Disc, we are extremely pleased that you have taken the time to participate in our call. Thank you for joining us to discuss the Company's Fiscal 2021 third quarter and nine months 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 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. 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 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 2021 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 quarter results, I'll touch on some of the operational highlights from the quarter. Our global team continued to do a great job keeping our employees and their families' safe while continuing to operate the business. More so than in North America, we saw significant challenges, both in Asia and Europe, as COVID cases rose and in office work became more restrictive. Our teams in those two regions did a fantastic job keeping the facilities running, employees safe and product moving to the customer.

As you can imagine, Twin Disc, along with everyone else, faced several COVID-related supply chain issues in the quarter, especially with respect to container ships inbound from India and container ships outbound to China. Unfortunately, we expect that this will continue to linger through mid-summer until things get back into full swing and ships are moving more freely.

As I mentioned at the last quarter conference call, our facility in Lufkin came online in late November and early December. It is now in full production of our mechanical clutches and PTOs. We continue to staff the location for the future. Sourcing and planning, employees, engineering and sales are all being added as we speak. In the fourth quarter we will be moving our remote actuated PTOs, and then followed by our hydraulically actuated PTOs in our Fiscal '22.

Orders in the third quarter started off strong and seemed to take a spring break vacation with the rest of the country in late March. But I'm happy to report that April orders are back in line with what we were seeing in January and February, continuing the quarter-over-quarter improvements that we have seen since last summer. As I've been mentioning in previous calls, our R&D and project activity in hybrid and electrification continues to increase. We've rolled out the Go Electric portion of our website that lays out our product development plan for our future products in our global and off-highway markets.

We continue to work through the inventory at our distribution partners and new unit orders on the factories continues to improve. We saw this improvement first in Europe before we saw it in North America. But we're starting to see that trend in North America as well. Happy to also report that we're starting to see rebuild activities for our North American frac rigs at our distribution, both in Canada and the U.S. Our new oil and gas unit shipments to Asia remained steady and should increase later in this fiscal year and into Fiscal '22. Our projects in global marine markets remained strong and we should start to see improving orders—continued improving orders and shipments throughout the remainder of the year.

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

Jeffrey Knutson

Thanks, John, and good morning, everyone.

I'll again briefly run through the Fiscal ’21 third quarter numbers. Sales of $57.6 million for the quarter were down $11 million, or 16% from the prior year third quarter. The quarter declined from the prior year was the result of the generally weak global economy due to the ongoing effects of the COVID-19 pandemic. Compared to the prior year third quarter, transmission sales were down 13.4%, industrial sales down 14.8%, marine and propulsion down 23.2%.

Looking by region, sales into North America were down 29%, while sales into Europe were down 10% and sales in Asia Pacific were down 6%. Foreign currency exchange was a net positive $3.9 million impact to sales in third quarter. Through the first three quarters, sales are now down $24.2 million or 20.4% compared to the prior year. Foreign currency translation contributing a positive impact of $7.5 million compared to the prior year versus three quarters.

The third quarter margin percent was 24.2% compared to 24.1% in the prior year third quarter. The third quarter benefited from the employee retention credit which contributed $1.2 million to the gross profit for the quarter. Adjusting for this benefit, gross profit would have been 22.1%, a sequential improvement and reflecting an overall continuation of a less profitable mix of revenues with declines in aftermarket volume and shipments into the North American oil and gas markets.

Gross profit for the first nine months finished at 21.4% compared to 22.3% for the Fiscal ’20 nine months. Spending on marketing, engineering and administrative costs for the Fiscal ’21, third quarter decreased $2.2 million or 14% compared to Fiscal ‘20. The decrease is primarily the result of reduced payroll costs, amortization expense and marketing activities as well as a $600,000 favorable impact from the employee retention credit I just noted.

We continue to aggressively pursue cost reduction opportunities to compensate for the decline in revenues. As a percent of revenue for the third quarter, ME&A expenses were 22.9% compared to 22.4% in the prior year third quarter. For the first nine months, ME&A spending is down $9.1 million or nearly 19%, finishing at 25.6% of revenue compared to 25.7% for the same period last year.

A restructuring charge of $251,000 was recorded in the third fiscal quarter, primarily related to actions to adjust the cost structure at our domestic operation and ongoing cost reduction and productivity actions at our European operations.

The prior third quarter operating income was impacted by a $27.6 million impairment charge. Excluding this charge, operating income was essentially level with the prior year, a reduced volume of nearly $11 million. For the first nine months, the operating loss of $7.2 million reflects a $3.9 million improvement over the Fiscal ’20 first nine months exclusive of the prior year impairment charge.

Effective tax rate for Fiscal ‘21 nine months was 28.9% compared to just 8.9% from the same period last fiscal year. The impairment loss recorded in Fiscal ‘20 resulted in a decrease to the prior year rate of 13.8%. During the current fiscal year, the Company was able to take advantage of the newly enacted high tax exception regulations resulting in an increase to the rate.

The net profit for the third quarter of Fiscal ‘21 was $100,000, or $0.01 per diluted share compared to a net loss of $25.2 million or $1.92 per diluted share in the prior year third quarter. Through the first nine months, we reported a net loss of $8.2 million or $0.62 per diluted share compared to $38.1 million or $2.89 per diluted share in the prior year comparable period. EBITDA of $3.8 million for the quarter was improved from negative $24.9 million in the prior year third quarter. For the year so far, EBITDA of $1.3 million is over $30 million improved over the prior year.

Turning to the balance sheet, inventory was down $5.5 million in the quarter and $3.9 million year-to-date, despite a $3.2 million currency translation driven increase. With the focus on liquidity and cash flow, we were able to generate $2.2 million of operating cash flow in the quarter, and bringing free cash flow to positive $1.2 million for the first nine months. Capital spending at $1.1 million for the quarter and $3.9 million year-to-date has been focused on the new Lufkin facility and modern machine tools and testing equipment.

As we remain in a very challenging market environment, we continue to defer all non-essential capital spending and continue to expect to invest roughly $5 million to $7 million during the fiscal year.

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

John Batten

Thanks, Jeff.

Now I'll just spend a couple moments on the outlook. As mentioned earlier in the call, April orders have rebounded from a little bit of a March low, which continues our thought that our markets are going to be improving throughout the calendar year. We've seen upticks in order and spare parts, new units. We've seen some activity in North American oil and gas rebuilds. Optimistic that our markets continue to improve from their lows late last calendar year.

During the last 12 months, as everyone has been analyzing how we do business, and as travel continues to open up, we'll begin to implement some of the changes that we've been planning with respect to facilities, further cost reduction activities and new sourcing initiatives.

As you can imagine, much of this has been difficult to do via email or video conference. One of the first things that you'll see is, as I've mentioned in calls, our corporate headquarters in our original plant here in Racine, about 186,000 square feet, represents about 30% of our square footage in the Racine area. Given work from home, modernizing the plant to 21st Street, taking old machine tools out, we have room to fit almost everyone from this facility into our larger plant across town, and in our aftermarket facility. We may need to lease some office space. But you'll see us winding out of this facility throughout the calendar year, and expect to see some other changes in facilities in the coming future.

Finally, we continue to invest heavily in our electrification efforts, both in SYS (phon) products, systems and the data security, and we are very optimistic in our ability to bring competitive solutions into our global off-highway markets. As we come into further conference calls, hopefully we'll have some customer information and detail that we can share with you but nothing that we can share at this point.

With that, Christina, that completes our prepared remarks. We'll be happy to take questions at this time.

Operator

We'll take our first question from Josh Chan with Baird.

Josh Chan

Hey, good morning, John. Jeff, thanks for taking my question.

John Batten

Hi, Josh.

Jeffrey Knutson

Hi, Josh.

Josh Chan

Hi. Hey, guys. Just on the oil and gas side, you mentioned some improved rebuild activity. When do you think that you'd see a more pronounced type of uptick, including new equipment? Is that still several quarters away, or do you see that becoming a little bit more clear at this point?

John Batten

I think we'll see the rebuild activity can probably continue for the next quarter. I would anticipate units maybe late summer, early fall would be my guess at this point.

Josh Chan

Okay. That's fair. Staying on oil and gas, if end customers have the desire eventually for a hybrid or electric type fracking equipment, do you—or will you have products that is able to serve that particular desire?

John Batten

Yes, and I would hope that in maybe the next call, or the one after that, I'll actually be talking about one in (inaudible).

Josh Chan

Wow, okay. I look forward to that. Last question that I have is, what kind of incremental gross margins can we expect (inaudible), assuming that the market recovers? I'm just wondering, off of these more trough levels, how do you see gross margin improving over the next year or so as the end market improves?

Jeffrey Knutson

Yes, Josh, this is Jeff. We're a heavily mix-impacted company based upon what's happening in North American oil and gas and aftermarket, I think we would look for incrementals to be in the mid-30s as the markets recover. It can be a little bit higher than that if it's heavily weighted towards North American oil and gas, a little bit lower if it's some of our lower margin products. But we've been very successful over the last 12 months in driving costs reductions into some of our key products. We're seeing that margin improvement start to hit the P&L now. I think mid-30s on the incrementals as we work through into Fiscal '22.

Josh Chan

Great. Thanks for the color, guys.

John Batten

Thanks, Josh.

Operator

We'll go to our next question from Noah Kaye with Oppenheimer.

Noah Kaye

Good morning, John, Jeff, thanks for taking the questions. I think in the prepared remarks, you talked a bit about some of the supply chain issues and I think any industrial company is going through that this quarter so I don't think it's a huge surprise and it will continue, as you said, in future quarters. Can you first just dimension for us, if you can, the margin headwind impact of some of those supply chain issues? Do they actually manifest more in things like premium freights, materials cost inflation, what was the margin drag in the quarter?

John Batten

Noah, that is a good question. I'm trying to quantify it quickly in my head. I think our team did a very good job mitigating. I know we had some air freight coming on parts from India. I would say, to be honest, Noah, the impact probably wasn't that great in the quarter. I think it's things that are—bills that we will be paying this month and next month. I will try to get an answer. I don't want to throw something out that's going to be wrong. But it hasn't been—I wouldn't say you see it in the P&L yet. It's something that we're mitigating.

We've announced price increases, effective July 1, in that 4% to 5% range based on what we've seen in steel, surcharges, steel pricing and increased freight. We've anticipated that it's going to be—that the impact going forward is in that 3% range. That's 3% to 4%. Depending on the product we're in, that 4% plus percent pricing range. I hope that helps.

Noah Kaye

Yes, so it sounds like you do expect (inaudible) in this quarter and beyond there, or do you think that maybe (inaudible) this quarter? (inaudible)

John Batten

Yes, sorry, Noah, you are going a bit digital there. It just would—was I hearing you think it's going to be impacted in this quarter but we're mitigating in quarters going forward?

Noah Kaye

Right, so you'll be positive price cost for the September quarter, but you may have a drag in this next quarter. Is that a fair …?

John Batten

That is exact. Yes.

Noah Kaye

Okay.

John Batten

Yes, exactly.

Noah Kaye

All right. Yes, Sorry for the digital entertainment. Then just, to make sure, we're—in terms of any supply chain bottlenecks, were you able to produce to end market demand this quarter, and do you anticipate any issues with that on any of your key SKUs or feel pretty good in terms of (inaudible) going through?

John Batten

The products that were affected most were the industrial products that we produce in Lufkin because a lot of their parts come from India. The team in Texas and here in Racine has scrambled and worked very hard with the shipping companies to get stuff. We were caught behind the—was it Evergreen or—the Suez ship. But that they've got that in, they airfreighted some parts in, so we look good right now through most of the fourth quarter. We have container ships that are due in—that are scheduled to be due in late May.

If anything, we may lose a little bit of industrial. The revenue dollars won't be big, but whatever we miss in the fourth quarter, we certainly made up in the first quarter. The other parts that we have coming in from India, as Jeff was alluding to, is some of our cost reduction initiatives. There we're actually just bringing a lot of those parts in, the trials we have, we already have parts here in North America. I think the impact, it may—there may be an impact in the fourth quarter. At this point, I don't think it'll be significant at all.

Noah Kaye

Yes, that's helpful. Well done on generating the positive free cash flow. For the fourth quarter here, any working capital headwinds to be aware of or do you feel pretty comfortable that you'll be positive for the year at this point?

Jeffrey Knutson

Yes, I'm not aware of any headwinds, Noah, I think we'll continue the discipline that we've had through the year. Hope to, again, be marginally positive free cash flow in the fourth quarter operationally, and yes, hope to continue that trend and then come out, as volume comes back, to maintain that discipline in the working capital area, and continue to focus on that as we grow.

Noah Kaye

Great, and if I could just sneak one last one in. We talked about kicking an industry when it's down, but the California fracking ban that's being proposed to start in 2024. Something that some Investors have noticed, and just may be helpful for Investors to better understand your regional exposure with your North American oil and gas business, whether that announcement was something that concerns you? If not, why?

John Batten

Noah, it's John. Not really, there wasn't a whole lot of activity going on there. Our exposure, as the industry exposure, really. We're in the Marcellus, we're in and around Texas, and all the Southern, and Canada and the Dakotas. New York and California don't really play into the dollars of the number of units at all. I guess the short answer is no, doesn't really concern us.

Noah Kaye

Yes, you're aligned with (inaudible).

John Batten

Yes.

Noah Kaye

I'm sorry, I didn't mean to cut you off. You were finishing your thought.

John Batten

No, I just say that we are a strong believer in natural gas for the future. As our markets continue, the hybridization and electrification we need, this country needs to generate electricity, and we need to upgrade the grid and generate electricity. It's great to see solar and wind more of a percentage, but we definitely feel that natural gas is that replacement energy source, as compared to coal. Again, that speaks—that plays right into our 7,600 and 8,500 for the foreseeable future.

Noah Kaye

I really appreciate the color. Thank you.

John Batten

All right, thanks, Noah.

Operator

As it appears there are no questions at this time, I'll turn the call back to your, Mr. Berger, for any additional or closing remarks.

John Batten

Thank you, Christina, and thank you for joining our conference call today. We 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 look forward to speaking with you again at the close of our Fiscal 2021 quarter in August. Christina, I turn the call back to you.

Operator

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