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Twin Disc, Inc.

Fiscal First Quarter 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

Noah Kaye, *Oppenheimer*

Josh Chan, *Baird*

Barry Haimes, *Sage Asset Management*

PRESENTATION

Operator

Good day and welcome to the Twin Disc, Inc. Fiscal First Quarter 2021 Earnings Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Mr. Stan Berger.

Stanley Berger

Thank you, Cody.

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 first quarter financial results and business outlook.

Before introducing the 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 the copy to you.

Hosting the call today are John Batten, Twin Disc's Chief Executive Officer, and Jeff Knutson, the Company's Vice President. By this, 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 first quarter conference call. As usual, I'll 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 just touch on some of the operational highlights of the quarter. As you saw in the release, sales year-over-year were down significantly, really across all geographical regions and market with the exception of Australia. We continue to see very strong demand for marine product down there, either in the pleasure craft market or the commercial market, and one area and one geography in one market that continues to exceed our expectation.

During the quarter, operationally at our plants, we had extended shut down in the U.S. and in Europe and then we had the normal vacation in Europe. So, all in all, it was just historically our slowest quarter our fiscal first quarter should be again this year, and it was hampered a little bit higher expenditure down. What we've been doing to the management team and around the world is focusing on our cost control, cash flow and keeping employees safe. We've done I think an outstanding job, all of our managers around the world keeping at the COVID impact to a minimum. We've had very few infections and very in-plant, in-office transmission.

We also have been working hard on getting our facility in Lufkin up and running. We've taken possession of the 50,000 square feet facility and as we are having this conference call today, the team from Lufkin is up in Racine, loading inventory for industrial products, starting with the clutches and then the mechanical PTOs and later the hydraulic clutches, and those are moving down to Lufkin as we speak. We've gone through our conference room pilot and we should be in pre-production on clutch line next month in November. We plan to move the rest of the inventory over the Christmas shutdown and start production in full in January.

We've also had obviously as everyone has a lot of virtual meetings with customers. I have been amazed at the number of hybrid and electrification projects that have ramped up even in these last three months. It seems that a lot of people are taking this different type of work environment to look at doing things differently and it's been across our market. It's been in marine, it's been RF and it's been in the industrial space and a lot of work has been done with partners getting projects ready that I think you'll see rolling out in the years to come. We've also been re-looking at our SIOP process, sales inventory and operations planning, doing a lot of work on that again why people can't travel and they're here in the plant and we will be implementing that coming in 2021.

We've also been re-imagining the work from home. It's obviously a new paradigm now, a lot of functions have been doing extremely well. Finance, IT, not coming into the office very much at all. As a result, we've had been analyzing our footprint, and as we mentioned in the release, one of the things we're looking at is selling our corporate office here and we're seeing currently we have three facilities in Eastern and Western County (phon) and under this new paradigm, we probably only need two, particularly with Lufkin, coming online and taking a lot of the inventory that we are holding at this facility.

With that, now, I'll turn it over to Jeff for some comments on the financials and then Jeff and I will be back for questions.

Jeffrey Knutson

Thanks, John. I'll briefly run through the Fiscal '21 first quarter numbers. Sales of $46.1 million for the quarter were down $13.2 million or 22.2% from the prior year first quarter. The quarter decline for the prior year was a result of a generally weak global economy due to the ongoing effects of the COVID-19 pandemic.

Compared to the prior year first quarter, transmission sales were down 23.7%, industrial sales down 22.5% and marine and industrial sales down 25.2%, so a broad based decline across our products in the market. By region sales in the North America were down 34%, sales in Europe are down 29.3%, while sales into Asia Pacific, as John mentioned were up slightly on improving Australian market demand.

Foreign currency exchange was a net positive 1.5 million impact to sales in the first quarter. First quarter margin percent was 22.3 compared to 16.3% in the prior year first quarter. The prior year, if you remember included a $3.9 million one-time product performance charge. Adjusting for this, the Fiscal '20 first quarter margin percent would have been 22.8, again compared to the 22.3 this year. The slight decline from this level in Fiscal '21 was due to the reduced volume and a slightly less profitable mix, partially offset by improved efficiencies, proactive expense management and the positive impact of foreign COVID-19 release programs that we benefited from in the first quarter.

Spending on the marketing engineering and administrative costs for the Fiscal '21 first quarter decreased 3.3 million or 20% compared to Fiscal '20. The decrease is a result of reduced payroll cost, bonus expense, corporate travel and marketing activity. Along with the announced 50% reduction on all North American wages, we continue to aggressively pursue cost reduction opportunities to compensate further decline in volume (phon).

A restructuring charge of $400,000 was recorded in the first fiscal quarter. This charge primarily relates to actions to adjust the cost structure at our domestic operation and ongoing cost reduction and productivity actions at our European operations. With the reduced first quarter volume and challenging product mix, we reported an operating loss of 3.2 million in the quarter compared to a loss of 6.8 million in the prior year fiscal first quarter. The improvement is a function of the prior year product performance charge in a successful cost reduction, partially offset by the volume decline. The effective tax rate for Fiscal '21 first quarter was 19.1, consistent with the 20.5% for the same period last year. The slight decline is the result of the mix of earnings by jurisdiction.

The net loss for the first quarter of Fiscal '21 was $4 million or $0.30 per diluted share compared to a net loss of 6.3 million or $0.48 per diluted share in the prior year first quarter. EBITDA of negative 1.6 million for the quarter was improved from negative 4.6 million in the prior year first quarter.

As we communicated last quarter, we finalized an amendment to our BMO credit agreement that provides covenant relief through our Fiscal '21. This amendment removed the leverage ratio covenant, beginning with the fourth quarter of Fiscal '20 through the fourth quarter of Fiscal '21 in favor of a cumulative minimum EBITDA covenant and at minimum liquidity covenant. Our first quarter numbers resulted in continued compliance with both of these covenants.

Turning to the balance sheet, inventory was down just slightly despite a $1.8 million currency driven entry. Domestic operations delivered a $5 million reduction since year-end. This was partially offset by an increase in our Dutch operation due primarily to customer requested delivery push out. Despite the reduced volume, operating cash flow was just $700,000 below breakeven, capital spending at 1.4 million for the quarter, focused primarily on the Lufkin facility resulted in negative free cash flow of 2.1 million for the first quarter of the year.

As we enter what we continue to anticipate, it will be a challenging Fiscal '21 market environment. We will continue to defer all non-essential capital spending and expect to invest between $5 million to $7 million during the year.

Now, I'll turn it to John for final comments.

John Batten

Thanks. As Jeff mentioned, it's hard to predict Fiscal 2021. Orders at the second half of the first quarter were improving. These U.S. leading indicators that we track are all improving. We know that our equipment that were on is being used. We know inventory is coming down. What we don't know is how much the second wave of COVID-19 could impact that delay, but we feel that we are at the bottom and most of the leading indicators are tracking up and the inventory we track in the channel is coming down, and it is pointing to better quarters ahead.

Having said that, we're going to prepare for the situation markets to stay as they are. We're going to focus on cash flow liquidity and operational improvement and doing what we can to execute on our strategic objectives of diversification and work towards hybridization and electrification.

Finally, I'd just like to thank our employees around the world who had to do a lot of different things since COVID-19 struck, different jobs to make things happen, work from home, but particularly the employees here in the U.S., where we had most impacted——most of the restructuring, still are working at slightly reduced salary and continue to do an excellent job, keep it safe and keep product going out the door to our customers.

So, that concludes our prepared remarks, and now Jeff and I will be happy to take your questions. Cody, please open the line up.

Operator

Absolutely. 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 that your mute function is turned off to allow your signal to reach our equipment. Once again that is star, one if you would like to ask a question. We will pause for just a moment to allow everyone an opportunity to signal.

We will take our first question from Noah Kaye with Oppenheimer. Please go ahead, sir.

Noah Kaye

Good morning, John and Jeff. Good to be with you.

First question is really on managing the cost structure going forward. If I look at the current run rate on the ME&A in this low revenue environment, I mean it's kind of comparable on a full year basis (inaudible) in 2017, sort of the comparable revenue run rate. My question is really, you talked about some planning optimization adjusting to the new normal. Do you think you can hold the line at this current run rate on ME&A as revenues—should revenue come back? Or, I guess that's a different way, do you think all the planning you are doing might set you up for a lower level of ME&A spending at comparable revenue as we kind of look towards a recovery here, and if so, any way to quantify that, and if not, any way to qualify that?

John Batten

Okay. I'll try to answer that one Noah.

I would say we can maintain this level of spending at current volume. So I think, plus or minus where we've cut, maybe there are places we can still cut, but we're about going forward, where we can be. I think we'll get a little bit more savings out of the cost reduction actions without sort of a mid-quarter action in Q1, corporate travel is at a bare minimum. All of our sort of discretionary spending is that a bare minimum. As we change structure a little bit, so for instance, a successful sale of this facility will allow us to reduce spending, but on the other hand, as volume comes back, activity comes back, we'll certainly have additional spending to drive that additional travel, and there is no—there will likely be the recovery of the wage reduction. I think there are pluses and minuses, but I would say at comparable volume levels we will have lower ME&A going forward. I think that—that's a fair to statement that we'll focus on.

Noah Kaye

Okay. That is helpful. Thanks. Yes, John, can you talk a little about where you're seeing the signs of life. You said you feel we're kind of at the bottom here, you're seeing some of the improving words (phon). mid-quarter. Where are things picking back up, and then, if you think about how that might translate to mix and where margins could head, I think that would direction helpful for.

John Batten

Sure. So in general, the orders have been improving I would say in Europe first. Again, I think it's a function of the distribution network not having as much inventory there. So, as projects come up, everyone needs to order something, whereas here in North America, our distributors typically hold a lot more inventory than their global counterparts. So, in Europe and it has been primarily marine, a little bit of industrial in the U.S., we've seen some good activity to more on some work those up and down, you know, river, push boats, up and down the Mississippi. Industrial here in the U.S., and again, as we were talking earlier, in Australia, the Australian market is doing remarkably well given where the rest of the world. So, their orders have been strong.

What we haven't seen yet in orders, although we've had calls and we've discussed project is really get anything in North American oil and gas. That's been very quiet, but again our distributors pretty much any part that's been needed is already at the distribution level. Those inventories are coming down and a lot of horsepower, the older rigs have been scrapped. So, there are fewer and fewer rigs out in the fleet. But they're operating. So, we would expect to see some activity there in the next three months.

Then again what's been more or less stable, would be our military business for what we sell to the government and our—it's had a bit of a slowdown, kind of seeing a COVID hangover, there was a lot of markets slowed down right away in March as COVID hit, and then other new orders slowed down a little bit in the summer. So, I would say more in that—in the airport, rescue, firefighting, not a lot of quarters over the summer, so that's going to be slow on shipment coming up here in December and January. But overall, we have good weeks and bad weeks, but the trend is improving. In fact the point to the improvement, it's going to be in Europe primarily and then secondary is the product market marine seems to be improving more than other markets.

Noah Kaye

Thank you, that's helpful. Just to be clear, to the extent that there is potential for sequential revenue improvement from here, should we think about favorable mix on that, potentially gross margin expansion sequentially, or would you say that there is going to be some overhang?

John Batten

I would say—just trying to get—I would say the gross margin, there is going to be a little bit of upward pressure, it's not going to be significant, but really significant, it's something that's going to push would be obviously some oil and gas, but just a little bit more aftermarket activity across the board. But right now, I would say if it's marine or industrial, they are about equivalent on margin, so it doesn't—the mix is going to be the same, as Jeff pointed out, there is going to be more improved margin because we have more days at a lower cost structure than we did in the first quarter.

Noah Kaye

Yes. I'm going to follow this with my colleagues here after asking too many questions, but I just did want to sneak in one more. Because you mentioned you're seeing a real upswing in hybrid and electric design work, maybe you could talk and you mentioned it was fairly broad-based, but a, talk about what you've been (inaudible), and b, talk about where the interest is in terms of your product portfolio and offering, and do you say that will start to materially impact your mix in terms of evolving towards more hybrid and electrical (inaudible).

John Batten

Yes, I'm going to try to give a short answer to a really good question. It is—there is definitely there is no question that in all of our markets, all of our geographies, this is number one or number two on everyone's list of things to talk about and discuss. Unfortunately, it's not like automotive on highway where you can design one hybrid solution or one electric solution and apply it to a million vehicles. Case in point, one industrial customer, you're doing a hybrid solution and they may sell 10 to 12 cranes a year of that.

So it's—there is a lot of work in going into it. So, we're seeing a huge ramp up in application activity and I think what you will see and it's again an industrial, whether it's construction equipment, it could be marine, it could be a tugboat, it could be a pushboat, it could be a patrol boat, and then it could be an ARFF vehicle. But I think what you're going to see in off-highway markets in our space is a lot of customers building their first couple of hybrid and then seeing what the market will bear for them in being able to sell it. It does mean—it's a potential huge shift in content for us where maybe we're going to sell a $30,000 torque converter. But now we're going to sell a $150,000 hybrid system. So, there is a chance for companies like us, Twin Disc, where you don't have to increase the number of crane, ARFF vehicles or both, and our sales can go up. Now, the average margin will probably go down, because we're not going to produce all the components that are in that system.

But, what's great to see is that because of our Control technology, more and more of the customers are looking to us to provide the entire solution. So, you can't just buy an electric motor, throw it into a boat and expect it to work. There's a lot of controls work going into that, and that is—one of our core competencies, is being able to manage whether diesel engine or electric motor, we can manage dual inputs into one output or we can manage electrical power into a propeller shaft or axle.

So, there are more and more of these applications. I think we're going to be swamped with applications for the next couple of years, sell some initial systems, but I do think that it will take a while before we see a revolution in the off-highway space other than the big guys, CAT will do their own system, Volvo will do their own system and their equipment come (inaudible), but there are a lot of other players out there. It's just going to—it's going to take a little bit of time, but there is going to be a lot of upfront application where iteration, if this is going to work, what are you trying to achieve though. But, there's no question that the momentum is there and it's the future.

Noah Kaye

I appreciate that color. Thank you.

Operator

Thank you. We'll now take the next question from Josh Chan with Baird.

Josh Chan

Hey, good morning John and Jeff.

John Batten

Hey, Josh. Good morning.

Josh Chan

Morning. John, I guess I was wondering if you feel a little bit better about the oil and gas market now then you gave maybe a couple of months ago, and if that kind of become more positive, I guess what has driven the improvement there.

John Batten

Yes. Josh. I guess—I'll take the $40 now to negative futures, a few months ago for sure.

Josh Chan

Right.

John Batten

No, what feels good in talking to some customers, equipment is being used, we know our equipment is being used heavily and the available horsepower continues to come down as customers scrap entire spread. So, I think—I truly believe that there is an opportunity for some much better market in Fiscal 2021. I think one of the only things that needs a change and that we're the second wave of COVID could delay a little bit is just travel, whether it's business travel, air travel, just general travel is down. So, there isn't that demand for more oil and more gas. But there is very limited—I think people will be surprised how much the available horsepower has come down. So, I don't think it's going to take much whether an increase in demand—higher price definitely will help, but just an increased demand in oil and gas could have a huge impact on the North American market next year. So, I would expect it to start improving throughout calendar 2021.

Josh Chan

Okay. That's incredible (phon), and then let's actually jump over to Europe, I guess, you mentioned COVID. I think some of the government over in Europe have kind of been increasingly putting on more restriction. So, what are you seeing over there and any chance for potential disruption in your Europe operations.

John Batten

So far—so yes, we've been hearing from our employees in Europe, particularly in France that they are stay at home, restricted travel. So far, all of our facilities are going to remain open. I think by and large, I think where we are, so Belgium, Netherlands, Italy and Switzerland are going to do everything they can to keep manufacturing facilities open. If there is a shutdown, we will deal with it. I think we did a very—our operations team did a great job managing through that this spring. So, I know we can do it again. But yes, there is a potential for disruptions from suppliers and customers not being open to receive product, but we manage—I think we managed through it very well the spring. I think we'll do a better job this time just because we've had practice and everyone knows how to do Zoom calls with all of our customers and suppliers. So, it potentially could have an impact, but I don't think it would be as big as it was in the fourth quarter.

Josh Chan

Okay. That kind of makes sense. Then I guess the last one that I have is that I think you've talked in the past about trying to make the Company a little bit less reliant on oil and gas market. I'm just wondering if that's sort of still the aim and then how are you thinking about that at this factor (phon).

John Batten

Josh, absolutely. Diversification away from oil and gas without—we don't want to give up the market, we think we're very good player, but we want to grow the other parts of our business is much faster, and that has been the reason why we've been pushing so hard, doing as much research, developing relationships with partner providers for the hybrid system as we can, because we want to emphasize and grow our marine market, our industrial market, whether it's construction or whatever outside of the oil and gas case, so a lot of our focused on this hybrid electrification is growing those markets other than oil and gas. We still see a strong demand particularly for gas for a long time, just generating electricity, but a lot of our product development is focused away from markets tied to oil and gas and will continue to be.

Josh Chan

That's great. Thanks for the call and thanks for the time.

John Batten

Thanks Josh.

Operator

Again, once again that's star, one if you would like to ask a question.

We will hear next from Barry Haimes with Sage Asset Management.

Barry Haimes

Thanks so much for taking my questions. I had a couple of questions on the cost structure. So, if we take the first quarter as a baseline if you will, when Lufkin is fully up and running and operating normally, how much cost will you see versus the first quarter, either because you had extra expenses to get it up and going in the first quarter and then the sort of a lower run rate expense to produce the same products and the new facility. That's the first question, thanks.

John Batten

You asked a good question. We didn't have, I would say a real significant increase in cost in the first quarter to get it up and running. We've used our own people to move things. We've capitalized certainly some of the cost down there to get equipment and get the building up. So, I think what we'll see and it's probably not until next fiscal year when we're up and running, the benefit of the efficiencies of the new production line that's put in down there, a better approach to the manufacturing of that product.

I hesitate to give you a quantification of that or a margin impact on that. But, we definitely expect to see improved margin in our industrial product, which should also drive additional volume. They're more competitive pricing, more available and shorter lead time. So sort of hitting on all those good things to help that product grow.

Barry Haimes

Okay, great. Then the other question again sticking on the cost side is the sale of Racine, could you talk about what sort of range of proceeds you might expect from that? Then again, in terms of reduction in cost structure, in terms of the cost of real estate, any feel for that. Thanks.

John Batten

Sure. I mean, obviously we're just hitting the market on the building. So, it's a pretty wide open range right now. I think what we've been told is we could expect something in the $3 million to $5 million range for the facility. But, maybe as important to us is what you mentioned next is the cost savings, and we see that at roughly the cost of $1 million a year right now to operate this facility. So, that's a huge chunk of costs that really isn't contributing any meaningful way to the business, so it's a big incentive for us.

Barry Haimes

I'm sorry, I didn't catch the number. What was that cost number? Sorry.

John Batten

Roughly $1 million a year.

Barry Haimes

Okay, thanks.

John Batten

Yes, so Barry, this is that—the building that we're talking about is our corporate headquarters, which was the original plant and we haven't done any assembly or manufacturing here in about eight years. So, it's just the corporate offices, there's sales offices here and we hold excess slow-moving inventory for the plants across town. A lot of that inventory is industrial.

So, with Lufkin coming online, a lot of what was in this building is going to be headed down to Texas, and we just opened up an aftermarket facility in 2018 out near I-94 to be much easier shipping, regular shipping instead of having to come 8 miles east of I-94 to pick up. So, with work from home and in COVID, it was easy to imagine everything that was happening here at this location, either going to Texas or one of the other two facilities; the plant, which has office space and aftermarket which can hold the rest of the inventory.

So, what's nice, Jeff mentioned $1 million. What we would say is on annual expense here basically more than pays for the lease payment in Lufkin. So, if you combine the two together, bringing Lufkin on online and eliminating this facility, it's definitely a gross margin improvement.

Barry Haimes

Got it, and then last question. Just actually asking since you mentioned that evaluating sort of work from home and how that's worked for a number of different functions. If you were to take the non-manufacturing employees and had to take a shot at, what percent do you think will work from home going forward versus what percent will go into an office. We're just kind of curious as you look at how that works. Thanks.

John Batten

That is a very good question. There is two different—I have can say that I'm amazed that our finance and IT group has done incredibly well, exceptionally well almost not to being here at all other than to pick up checks and deposit them in the bank and come in. They demonstrated they can—they can do it from home 100% of the time.

We have done that with engineering, HR, sales has had to deal with customers, they can't see customers. You know, we tried to get back 25%, but we saw the spike and we're in the hotspot of the country in Wisconsin, so that slowed down a lot of other companies here. It's a good question. I don't know if it's 50%. That's one of the things that led into the—and why we have not made decision on where we're going to potentially—if we can't fit in two facilities, where would we add a corporate headquarters. How many people are going to be able to work from home continually, that's one of the things we want to address. How many want to work from home, can work from home, how many want to come into the office, but I think we're going to start with the assumption that it's going to be in that we have 50% to 75% coming in of the employees, and that's going to be kind of our model to think about going forward when we're planning office space, but in this market with the traffic and where we are located, it's a commute for people to get to downtown (inaudible). So I, I wouldn't be surprised if our numbers are higher from people working from home Barry.

Barry Haimes

Great, thanks so much. Appreciate that. Good luck.

John Batten

Thank you.

Operator

Thank you. At this time, it appears there are no additional questions in the queue, I'd like to turn the conference back over to management for any additional or closing remarks.

John Batten

Thank you, Cody and thank you everyone for joining us on our conference call today. We appreciate your continuing interest in Twin Disc and hope that we've answered all your questions. If not, please feel free to call or email Jeff or myself. We look forward to speaking with you again following the close of our Fiscal 2021 second quarter. Cody, now, I'll turn it back to you.

Operator

Thank you so much. That does conclude today's conference. Thank you all for your participation, you may now disconnect.