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Twin Disc, Inc.

Fiscal Third Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Stanley Berger, *President, SM Berger & Company*

John Batten, *Chief Executive Officer*

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

CONFERENCE CALL PARTICIPANTS

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

Noah Kaye, *Oppenheimer*

Rand Gesing, *Neuberger Berman*

PRESENTATION

Operator

Greetings. Welcome to the Twin Disc, Inc. Fiscal Third Quarter 2022 Earnings Conference Call.

A question-and-answer session will follow the formal presentation. Please note this conference is being recorded.

I will now turn the conference over to your host, Stan Berger. You may begin.

Stanley Berger

Thank you, Shamali.

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 2022 third quarter and nine-month 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 states Management's intentions, hopes, beliefs, expectations, or predictions for the future are forward-looking statements. It is important to remember that the Company's actual results could differ materially from those projected in such forward-looking statements.

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 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 2022 third quarter conference call.

As usual, we will begin with a short summary statement, and then we'll be happy to take your questions.

Before we go over the quarter results, I'll touch on some of the operational highlights from the quarter. As we mentioned in the last call, we headed into the third quarter with a nice backlog and our orders continued to improve in the quarter. Supply chain issues from a few key vendors really hampered our shipments, especially for our transmission and marine transmission product lines at our Racine, Wisconsin and Nivelles, Belgium facilities.

While all component and raw material lead times have shot out over the past year, we had particular problems with some large casting deliveries, and electronic components, connectors, and wiring harnesses were also in incredible short supply. Our team has been working hard to reschedule incoming inventory to meet the cadence of components that are in short supply. While lead times are not improving, predictability is improving, and that gives us confidence that we'll be able to improve on our shipments in coming quarters.

Obviously, supply chain issues caused some inventory issues as we had several $50,000 and $150,000 transmissions, waiting for $200 harnesses before shipment. We also had several millions of dollars of inventory on the water headed to both China and Australia that did not leave in time to be shipped on to end customers in the quarter.

Oil and gas demand for our pressure pumping transmissions continued at a strong pace for China, and for our aftermarket parts for the North American fleet. Besides orders for our 7,600 transmission, we also have orders for our 8,500 transmission for China; 8,500 rebuild in activity for the North American fleet has almost doubled in the past six months, and we are receiving requests for quotes for new spreads.

One of the bright spots in production was our facility in Lufkin, where we produce all of our North American industrial PTOs and clutches. With the least amount of reliance on electrical components and a very resilient Indian supply base, their run rate has increased over 40% since they went into production over a year ago. We will be moving the hydraulic PTO product line there this spring and summer.

Jeff has the specific numbers in his comments but this quarter's results were really driven by improved industrial sales, modest growth in transmission shipments, and strong shipments into North America in general, but particularly of the aftermarket parts for oil and gas. This mix drove both sales and the improved gross margins.

The outlier in my comments right there were strong marine and other shipments into our Australian market. Twin-Pac handles the entire market in Australia and has strong demand for our marine product line, but they also handle the Seakeeper gyro for the Australian market, and those sales have grown significantly in the past quarters and in the past years.

During the quarter, we continued to work extensively with our customers who are designing hybrid and electric prototype equipment, and a few have moved into their prove-out phase. Once we can share the details, we will, but so far, we are very pleased with the results and our team is working hard on this day in and day out.

Hopefully, this will be the last call we discuss COVID specifically but late December and January were not good months for either Twin Disc internally or our supply chain. Internally, we had several lost days due to quarantine and the same can be said for our suppliers. Staffing shortages in the cost of goods sold area is a global problem.

Many of our electronics and connector shortages can be traced back to China, and we are hopeful that the lockdown and bottlenecks at their ports will improve this spring and summer.

Now I'll turn it back to Jeff for some financials.

Jeffrey Knutson

Thanks John and good morning everyone. I'll briefly run through the Fiscal 2022 third quarter and year-to-date numbers.

Sales of $59.3 million for the quarter were up $1.6 million or 2.9% from the prior-year third quarter but down $600,000 or 1% from the previous quarter. The sales increase compared to the prior year reflects continuing growth in demand across our markets, although shipment performance has been severely limited by supply chain challenges across our locations.

As noted in previous quarters, and as John just mentioned, we've experienced a significant increase in lead times from suppliers. Unpredictable delivery performance and difficulty in receiving primarily electronic components are specifically challenging. This has resulted in delayed shipments, an increase in past due backlog, and an increase in inventory levels as we await delivery of final components before being able to ship complete units.

As the industrial product line has the least exposure to the electrical component shortage, sales of industrial products improved by nearly 45% compared to the prior-year third quarter. With greater exposure to that supply chain weakness, off-highway transmission sales grew by just 5.4% and marine and propulsion sales actually declined by just 1.7%.

By region, sales in North America were up 26% while sales in Asia Pacific were down 10% and sales into Europe were down 14%. Foreign currency exchange was a net negative $3 million impact to sales in the third quarter, and through the first nine months, we are now 9.6% or $14.6 million ahead of the prior year.

The third quarter margin percent was 29.8% compared to 24.2% in the prior-year third quarter. The improved margin in the current year is the result of increased revenue, more profitable mix of product, and the positive impact of pricing actions taken early in the quarter to offset the impact of inflationary cost increases across our supply base. We continue to monitor the inflationary environment and are prepared to react with any additional required pricing actions.

Spending on marketing, engineering, and administrative costs for the Fiscal 2022 third quarter increased $1.2 million or 9% compared to Fiscal 2021. The increase in the quarter is primarily due to the return of a global bonus program, spending on professional fees, a return of spending in marketing and travel, and inflationary increases, partially offset by the favorable impact of a Dutch COVID relief subsidy that was recorded in the quarter.

As a percent of revenue for the third quarter, ME&A expenses were 24.3% compared to 22.9% in the prior-year third quarter. For the nine months, ME&A expenses were 25.6% of revenue for both Fiscal 2022 and Fiscal 2021.

We recorded restructuring charges of $300,000 during the quarter, primarily related to an adjustment to the carrying value of an asset held for sale, specifically the corporate headquarters building and with an agreed price—the price was slightly lower than what we had accounted for earlier.

Including the restructuring charge, the operating profit for the quarter was $3.1 million compared to an operating profit of $0.5 million in the prior-year third quarter. The first three quarter's operating income of $3.3 million, which includes a $2 million gain on the sale of our Swiss facility, is $10.5 million improved from the Fiscal 2021 first three quarters.

The effective tax rate for the first nine months of Fiscal 2022 was 76.5% compared to 28.9% in the prior-year comparable period. The current year rate was significantly impacted by the domestic full valuation allowance, resulting in no tax benefits being recognized on current domestic losses.

The net profit through the third quarter of Fiscal 2022 was $300,000 or $0.02 per diluted share compared to a net loss of $8.2 million or $0.62 per diluted share in the prior-year nine-month period.

EBITDA of $5.8 million for the quarter was improved from $3.8 million in the prior-year third quarter, and for the first nine months, EBITDA has improved by $12.3 million from the prior-year from an EBITDA loss of $1.3 million to positive EBITDA of $11 million.

Turning briefly to the balance sheet. Inventory was up $16.1 million through the first three quarters, driven primarily by the supply chain imbalances John noted. We are focused internally on inventory planning and sourcing strategies that will balance incoming components, with the shortage items currently preventing final assembly and shipment of units.

With a significant increase in inventory, operating cash was negative $7.2 million in the quarter. Capital spending at just $2.4 million for the first three quarters remains well behind schedule, impacted by lead times on machine tools. Given the slower start in capital spending, we now anticipate that we'll invest in the $4 million to $6 million range in Fiscal 2022.

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

John Batten

Thanks, Jeff.

Just to spend a quick moment on the outlook. Clearly our backlog is improving and orders continue their improving trend. Supply chain issues continue to concern us, particularly in our European supply area who rely more heavily on Russian and Ukrainian raw material. So far, we have not seen any huge impacts other than elevated prices and delayed deliveries due to temporary shutdowns.

Longer term, we feel that the demand for North American natural gas is going to drive a lot more U.S. and Canadian production. This, however, will be tempered by labor and supply shortages. All in all, we see quarter-over-quarter improvements headed out through the balance of the year, provided some sanity rules the day with respect to Ukraine and Russia.

That concludes our prepared remarks. Now Jeff and I will be happy to take your questions. Shamali, please open the line for questions.

Operator

Our first question comes from the line of Josh Chan with Baird. Please proceed with your question.

Joshua Chan

Good morning, John and Jeff.

John Batten

Hi Josh.

Jeff Knutson

Hi Josh.

Joshua Chan

Hi. Good morning. I guess my first question on—John, your comments on getting some quotes for the new oil and gas spreads. I guess could you talk about the kind of urgency or the timing behind those requests? Is it next calendar year, or is there a willingness or ability to kind of pull that spend forward, even?

John Batten

I think the spend, I think you'd see—I don't think you—sales wouldn't affect this fiscal year, obviously. It would be the first half of our Fiscal 2023. Probably—I don't know, I can't say if the deliveries would be the end of Q1 or Q2 but sometime in that late fall area.

Joshua Chan

Okay. That's encouraging. I guess in terms of the trajectory of this recovery, do you expect kind of a rush like in some of the prior cycles? If so, are you prepared to kind of service that, potentially?

John Batten

I think, Josh, what's different this time is just the availability of people and material, whether it's to build new rigs. I think this wave is just going to be different because it's going to be constricted. So I just—I see—which hopefully, means it will be a longer recovery.

Joshua Chan

Right.

John Batten

Yes. I just think it's hard to find people to build rigs. Hard to find, get everything. So that's why I think you see a lot of rebuild activity right now, because you've got the rig, you rebuild the engine, you rebuild the pump, you rebuild the transmission, so there's a lot of that going on.

I do think that certain operators need new equipment, but we see that—I think the lead times through everything for that are at least six to nine months out. That's why I'm thinking it's going to be October-ish timeframe. November, second quarter.

Joshua Chan

Understood. That makes sense.

Then on the revenue progression into next quarter. I think you might have made some comments at the end, John, but usually, you see like an uptick in the fourth quarter compared to your third, but is it possible with the supply constraints that you're seeing now?

John Batten

To me, everything is lining up that the fourth quarter will be the strongest quarter of the year, on the top line, unless something hits us that we're not even—that hasn't hit us yet as far as a supply crunch. But we have the orders, we have most of the inventory here. It's just execution on some last critical components.

Joshua Chan

Okay. That's great. I guess, last question for me. Like, very strong gross margin this quarter. I guess your pricing actions are coming through. Is this level sustainable going forward, or was there anything unusual that kind of helped the margins this quarter?

John Batten

Well, I think the margin was absolutely—I mean, you saw that it's the mix of the products. So, heavier on oil and gas transmissions to China. That didn't go backwards because of supply chain. We had a lot of spare parts activity for North American oil and gas, and the mix was bigger for North American industrial. So certainly pricing was part of it, but mix was a big part of it as well.

Joshua Chan

Okay. That's good color.

Jeffrey Knutson

In terms of sustainability, I guess, that's the question is, what is the mix in Q4? It was a similar mix. Yes.

John Batten

Yes, and that's what's shaping up for the quarter is a similar mix.

Joshua Chan

Okay. Great. Thanks for the colour and good luck on the rest of the year.

John Batten

Thanks Josh.

Operator

Our next question comes from the line of Noah Kaye with Oppenheimer. Please proceed with your question.

Noah Kaye

Good morning. Thanks for taking the questions.

I would love to actually dig into the quarter a little bit more here. First, I don't know if you've got it, but if you've got it, how much did total price benefit growth?

Jeffrey Knutson

Yes. I can give you a couple of things, I guess, Noah.

If we look—and maybe, the more interesting thing is Q2 to Q3, because that was a significant increase. The way I look at that, we had about a 730-basis point improvement in margin, quarter-to-quarter. I would say something just over half of that is sort of the net price inflationary impact, so somewhere around 380-ish basis points. Mix is probably another 220 to 250. The rest is sort of a different kind of mix, so a customer mix within product lines and cost reductions.

Yes, I think when we look at it, what price did for us really was get us back to what we would consider a normal non-heavy oil and gas kind of margin in that 26% range. I think that's kind of what we've talked about at the call last quarter was, given the mix we had in Q2, with the pricing, we should get by the end of the year into the mid to upper 26% range—26% to 27%. I think that's what we actually did see.

Noah Kaye

Well, I would just comment first that to get positive price cost in this environment is alone a significant accomplishment, so well done.

To your point around the mix being an uplift, can you just repeat because I didn't quite catch it, what happened with land-based transmissions in the quarter. I think you said industrial sales were up 45% year-over-year but marine was down slightly, and I think you said off-highway was down. Can you just repeat that?

Jeffrey Knutson

Sure. So yes, land-based was up 5.4%, but I think the bigger story there is the oil and gas part of land-based was up—I don't have that number, but more than 5.4% offset by the other areas. So the RF (phon) and military were offsetting that to get to a net 5.4%. But the oil and gas component of land-based was up, and the aftermarket component of land-based was up. So those are the—when we talk about mix driving higher margin, those are the key aspects.

Noah Kaye

Yes. If some of the inventory tied up in various supply chain issues and freight, if that actually comes into the quarter—if that had come into this quarter, is that kind of corporate average contribution margin a little bit better? What I'm trying to figure out here is, if some of the bottlenecks start to ease a little bit, it seems like margins might actually be able to break 30%. I'm not going to quote you on that but just let me know what you think.

Jeffrey Knutson

Yes. I think that's not out of the question. We finished at 29.8% for the quarter. So yes, things—volume alone with a similar mix, just more volume of everything would get us there. So yes. I think with the continuation of what we did in Q3, which is a pretty healthy mix, that's kind of what we're seeing as we work into Q4. Yes, with some things going our way, it's not out of the question I guess.

Noah Kaye

Yes. Okay. Then, just a last question around the inventories and the working capital management. Is it feasible to bring inventory levels down sequentially in 4Q? Is that sort of in your plan? How should we be thinking on a full year basis about working capital?

Jeffrey Knutson

Yes. I think, yes, we're really focused on driving inventory. We want to be smart about it, obviously. We don't want to shoot ourselves in the foot going into Fiscal 2023, but I think what we see is some of those things coming together and us being smarter about bringing inventory in. That should drive some inventory reduction as we close out the year.

So, that should drive a bit of a reversal in free cash flow in Q4, not to the extent where we reverse our negative Q2 and Q3, but I think we reverse that trend and get positive in Q4. That's sort of where we're focused in getting the planning done to bring components in, get product out, and be smart about what we're bringing in.

Noah Kaye

Okay. Maybe just a little bit longer-term question here, but how are some of the electric programs going? I think in the last couple of quarters, there's just been a ton of activity to mention nothing hugely material in terms of revenue. At this point, do you have a view to that changing maybe as we look into 2023?

John Batten

So I do. I think it's still really early as far as on the revenue side. Tons of work so far on the project side and the prototypes at our customers. I think we have the order for the first system for one of our land-based customers. I'm just waiting for them to release it. It's—no, unfortunately, they want to release these in shows, trade shows where people are in-person. So I think that you'll see that over the summer.

So hopefully, at the next call, the fourth quarter, we can share one. But I think we'll start to see—and again, it's just the dollar amount. One $30,000 component versus a hybrid system that's $200,000 for the same piece of equipment. It's a huge potential, so we're excited to see how the market embraces this and the growth opportunity.

I think starting the second half of this calendar year, we'll start to have some more news about all the projects they've been working on as customers release either their vessel or their piece of construction equipment.

Noah Kaye

Okay. Perfect. Thanks so much for the color.

John Batten

Thanks Noah.

Operator

Our next question comes from the line of Rand Gesing with Neuberger. Please proceed with your question.

Rand Gesing

Hey guys.

John Batten

Hey Rand.

Jeffrey Knutson

Hey Rand.

Rand Gesing

Talking about like way the heck out there in the future, but we're hearing people in the oil services equipment business sort of repurposing technologies for non-carbon energy extraction. So one of the things I heard is that a frac rig is being used to eject water deep into the earth and that it comes back up pressurized and runs a turbine.

I know this is sort of way out there, and I've just begun hearing about the technology. Have you heard about any of this type of—I think there's a company out there. I can't remember the name of it, but have you guys been participating in any of these trials or even this type of next-gen technology?

John Batten

So, I don't know that one specifically. I think (multiple speakers) yes or no, but we've been working on and getting ready to prototype and going to customers with an electric solution with one of our transmissions, and it's too soon to say. If you can think of a way to do pressure pumping, we're involved in some form of a project to do it differently.

So, lots of different projects, lots of different power generation and delivery of the energy to the pump. Yes, there are a lot of different solutions being discussed, designed, and getting ready to be prototyped.

Rand Gesing

Yes. I'll share with you this company,

John Batten

Thanks, Rand. That'd be very interesting.

Rand Gesing

Yes. Okay. Great. Glad to hear that we're getting a little bit of a demand signal. I think that's to your point of sustainability, that would be—if we had a couple of years of sustainable demand, hat would be really helpful to the company.

John Batten

Absolutely. Thanks, Rand.

Operator

We have reached the end of the question-and-answer session. I'll now turn the call back over to John Batten for closing remarks.

John Batten

Thank you Shamali and thank you everyone for joining our conference call today. We truly appreciate your continuing interest in Twin Disc and hope that we have answered all of your questions. If not, please feel free to call either Jeff or myself and we will get your question answered as quickly as possible. We look forward to speaking with you again following the close of our Fiscal 2022 fourth quarter and year-end conference call.

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

Operator

Thanks John. This concludes today's conference and you may disconnect your lines at this time. Thank you for your participation.