Twin Disc, Inc.

Fiscal Fourth Quarter 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

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Noah Kaye, *Oppenheimer*

Josh Chan, *Robert W. Baird*

Barry Haimes, *Sage Asset Management*

PRESENTATION

Operator

Good day, and welcome to the Twin Disc, Inc. Fiscal Fourth Quarter 2020 Earnings Conference Call.

Today's conference is being recorded.

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

Please go ahead, sir.

Stan Berger

Thank you, Eduardo.

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 2020 fourth quarter and full year 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. Additional facts that could also cause actual results to differ materially relate to the global COVID-19 crisis. 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.

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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 H. Batten

Thank you, Stan, and good morning, everyone. Thank you for taking the time to join our conference call.

As you all can imagine, the fourth quarter was a challenge, but I thought our team responded very well and delivered results even above our expectations. Again, facing really in the fourth quarter, the third challenge that this team has had to face and the two headwinds that continued to push us before COVID were the global trade wars, especially with China; the Saudi-Russia oil war, which drove the price of oil down even before COVID; then COVID on top of that, which really affected all of our markets that had remained somewhat healthy, whether it's marine or industrial. We saw a dramatic slowdown in projects and new orders.

In general, I thought our team did a fantastic job globally, getting products out the door that mattered most to our customers. Priorities were always changing. You never knew, particularly in Europe, what supplier was going to be open or closed and which customer was going to be able to take product and pay.

Our facilities in Racine and Papendrecht, Netherlands remained open throughout the quarter, throughout the COVID crisis. Even with the forced shutdowns in Italy, Belgium and Switzerland, our team did a great job of bouncing back and getting everything out the door that could go out the door. Earlier in April, at the end of our—the third quarter call, we announced that we applied for and received the PPP loan, just over $8 million, and we used the vast majority of that to pay full salary, wages and benefits here in North America—well, in the U.S. Racine and our Racine-based employees. Those funds ended on July 24, and we had to react based on the conditions that we faced and we see for the next few months. Really, the known conditions that we can see at this time, are the unknown length of the bottom. Jeff will provide more detail on those cuts.

But at the end of the third quarter call, we announced $4 million in cost savings from the PPP. Yet, this morning, we announced just over $7 million. Those aren't additions, that's just a ratchet up. Three months ago, we thought $4 million would be the right number. Today, we think that's just over $7 million. A lot of things, I would say, we see some signs of life. Our average daily order rate has ticked up slightly. But it's certainly not back to the level where we're going to see the backlog growing. So it was necessary to make these cuts.

Jeff, with that, I'll let you go over some of the numbers before I come back on the outlook.

Jeffrey S. Knutson

Sure. Okay. Thanks, John.

Good morning, everyone.

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Briefly on to the Fiscal '20 fourth quarter numbers, sales of $59.4 million for the quarter were down $13.1 million or 18% from the prior year fourth quarter.

The decline from the prior year, as John mentioned, principally driven by the ongoing effect of the COVID-19 pandemic on the global economy, significant reduction in the North American fracking market, along with the softening in the global marine and industrial markets.

The oil and gas decline, in particular, accounted for approximately $8 million of the fourth quarter reduction in sales.

For the full year, sales were down $55.8 million or 18.4% compared to the prior year, with foreign currency exchange contributing $4.8 million to this decrease. The fourth quarter margin percent was 23.2% compared to 22.7% in the prior year fourth quarter.

Favorable gross margin performance for the quarter versus the prior year was a result of some targeted cost reduction efforts on key products along with a global focus on cost reduction. The margin percent for the full year fell to 22.6% compared to 29.6% for the Fiscal '19 performance on a more difficult product mix. If you recall, we had a $6 million product performance charge that we reported in Fiscal '20.

Spending on our marketing, engineering and administrative costs for the Fiscal '20 fourth quarter decreased $1.2 million or 7% compared to Fiscal '19. The decrease is a result of sort of broad-based focus on reducing costs, in particular, reduced professional fees, salary expense, corporate travel, marketing activities, etc. With the oil and gas market struggling over the past four quarters now, along with the downturn associated with COVID-19, we have aggressively pursued cost reduction opportunities to compensate for the decline in gross profit.

For the full year, MD&A spending was down $8.3 million or 12%.

As John just noted and as we announced in the press release this morning, we have taken cost reduction actions that will provide $7.2 million in annualized savings, primarily at our domestic locations. Again, to be clear, this is not in addition to the $4 million in savings we discussed at our third quarter call, it is a reaction to the full utilization of the PPP fund and the current market condition, indicating that we needed to, again, take an aggressive action to put our cost structure where it needs to be for the next few quarters. The current action reinstates the savings that we announced earlier with an additional $3.2 million of annualized savings.

Restructuring charge of $200,000 was recorded in the fourth fiscal quarter, similar activity to what we've had throughout the year, primarily related to ongoing cost reduction and productivity actions at our European operations.

With the reduced fourth quarter volume and challenging product mix, we reported an operating loss of $1.5 million in the quarter, compared to a breakeven quarter in the prior fiscal year. For the full year operating profit has declined by $58.8 million to an operating loss of $40.3 million compared to an operating profit of $18.5 million in Fiscal '19.

The Fiscal '20 year-to-date results includes $5.1 million of restructuring charges, the $6.1 million product performance charge I noted and the $27.6 million impairment charge reported in the third quarter. Adjusting for these items, the year-to-date operating loss would have been approximately $1.5 million or a $20 million decrease from Fiscal '20 on a $56 million reduction in sales.

The effective tax rate for Fiscal '20 was just 9.5%, significantly lower than the prior year rate of 25.6%. The current year rate was significantly impacted by the $26.7 million impairment charge recorded in the

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third quarter, which resulted in a 13.3% decrease to the current year effective rate. The current year rate was also impacted by the GILTI provisions of the Tax Cuts and Jobs Act, which required the inclusion of foreign income, but prohibits certain foreign deductions and credits when in a domestic loss position. The GILTI inclusion decreased the year-to-date effective rate by 2.8%.

The net loss for the fourth quarter of Fiscal '20 was $1.8 million or $0.13 per diluted share compared to a net loss of $0.8 million, $800,000, or $0.06 per diluted share in the prior year fourth quarter. For the full year, net loss of $39.8 million or $3.03 per share compared to a net profit of $10.7 million or $0.83 per share in Fiscal '19.

EBITDA of $1.3 million for the quarter was down from $2.9 million in the prior year fourth quarter. For the full year, EBITDA finished at negative $30.2 million compared to $29.9 million positive EBITDA in Fiscal '19. The current year EBITDA includes a $27.6 million impairment loss recorded in the third quarter.

As we indicated during the third quarter call, challenging market conditions made it highly likely that we would not be in compliance with the leverage ratio covenant included in our BMO credit agreement for fourth quarter reporting. We began discussions with BMO during our fourth fiscal quarter, and were able to finalize an amendment to address this issue on July 22. This amendment removes the leverage ratio covenant beginning with the recently completed fourth quarter of Fiscal '20 through the fourth quarter of Fiscal '21 in favor of a cumulative minimum EBITDA covenant. Certain projections indicate compliance with this revised covenant but do require improving market conditions through Fiscal '21.

Inventory was down $7 million in the quarter and $14 million in the second half as reduction efforts remain a priority. With solid inventory improvement and good working capital results, operating cash flow was positive $4.3 million in the quarter.

Capital spending was the lowest level this year at $1.5 million for the quarter, resulting in a positive free cash flow of $2.7 million for the final quarter of the year.

As we enter what we anticipate will be a challenging Fiscal '21 market environment, we will be deferring all nonessential capital spending, and expect to invest $7 million to $9 million during Fiscal '21.

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

John H. Batten

All right. Just a quick look at the outlook. As you can imagine, our big takeaway from Q4 is that the second half of 2020, the first part of our Fiscal '21 would be very challenging in all of our markets. Orders were not strong. That's reflected in the backlog. Although I would say in July, the average daily order rates did improve, showed some sign of life, but they have a ways to go. In some other areas that we're seeing signs of life, we had active projects in oil and gas in China, some military projects in marine that are close to fruition, new applications and volume in North American industrial customers with our new products, and word from our customers in the North American oil patch are 8,500 are working strong and working every day.

We continue to be impressed with our team in the Netherlands and their resiliency to drive projects through to fruition, get new projects and do this all remotely around the world without traveling. We also continued in the fourth quarter and up to now active projects in design and getting product ready in hybrid and electrification projects with cranes, parked vehicles in oil and gas and in marine. So our product development continues to push forward despite the market conditions around us.

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A little bit of clarification in the press release on operation on the Lufkin facility. We took possession and occupancy on August 1. So we plan to be in production with our first model of PPOs probably in middle to late second quarter. We are very optimistic that this will drive future growth in our industrial business as we have a team in Texas focused on our customers every day on this product, which has a very different cadence than the other products that are at our Twenty-first Street facility, which are the oil and gas transmissions, ARFF transmissions and marine transmissions, much different cadence, different suppliers. We're very optimistic about the future of the Lufkin facility in our industrial business.

The Racine facilities, we're looking—work from home and a reduction in headcount. We are looking at how we can get all of us into one facility here in Racine and support each other as one team, one facility. So we're actively looking at that, how we can be more cost-effective here in the corporate and Racine-based operations.

Other than that, I'm going to open it up to questions now.

Eduardo, could you open the line up? Jeff and I are happy to take questions.

Operator

Thank you. If you'd 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 on your telephone keypad to ask a question. We'll pause for just a moment to allow questions to come through.

I'll take our first question from Noah Kaye at Oppenheimer. Please go ahead.

Noah Kaye

Good morning and thanks for taking the question.

To start with, one thing that stood out to us is, sure, I'm reading the press release right, a 26% increase year-over-year for the fourth quarter for Veth. Can you—just given—can you talk a little bit about how you're able to achieve the growth there? Should we be expecting it to continue to outperform in future quarters, kind of the market trend?

John H. Batten

It's John.

I guess, just to provide color, I would say the fourth quarter last year was a little bit worse than expected. This quarter is a little bit better than expected. So if I had to just give you my thumb in the wind, I would say it's more like—I would (audio interference) 10%. But again, the Veth team and that product and the markets that they serve have done a much better job holding up year-over-year in the crisis. So can we expect continued growth in favorable comparisons? I think if there's one area in our business right now, that's the area that can perform the best with all the headwinds facing it.

Noah Kaye

Is that share gains or is that end markets? Can you talk a little bit about their positioning? If you comment as well on some of the sales synergies starting to translate, so I just want to tease that out a little bit more.

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John H. Batten

I'd say it's a mix of share gain and that market growing. So it's got, actually, I would say, two tailwinds. We have a great product, a great team. They're now part of a global Twin Disc team, which helps open doors and ease people's mind on having global service for that product. But we also see more vessels being built with that technology. So where other markets are facing headwinds, they're certainly facing the COVID-19 headwind, but they have tailwinds that are also helping them.

Noah Kaye

Yes. On oil and gas, I mean, it basically seems like the producers are saying with cap ex, they're done for the year, right? So basically, they're going to be on the OE side, continued headwinds in your first fiscal half of '21. How is the aftermarket holding up? What are sort of—what's activity like and what are sort of share dynamics like there?

John H. Batten

So aftermarket, I would say, is slower than I would have expected, given the number of, I would say, anecdotally, just talking to customers, the rate at which our rigs are working. So I would have expected a little bit more aftermarket activity. I guess what's happening right now is that something is—again, this is not a new playbook. If a rig needs maintenance and it’s a certain dollar amount, they'll park it and use another rig. So we have to get through that a little bit. Again, fleet horsepower is reducing. People are scrapping fleets.

So I think right now, we're just battling—let's use an idle rig versus doing the maintenance. I mean, we are getting some, but given the amount of—given the activity that we know about, and then it's our rigs being used, I would have expected more aftermarket right now than we're actually getting. So I think there is future demand coming, I just—it's hard for me to predict when that's going to be. But we're not banking on it for the next six months.

Noah Kaye

Right. So as you think about—and this is in relation to the commentary around prospects for compliance with the covenants. You are expecting some gradual recovery over the course of the fiscal year. If you had to put your finger on it, where would that really be?

John H. Batten

I would wait till Calendar '21.

Noah Kaye

I mean in terms of the end markets improving.

John H. Batten

Yes. So end markets improving. I'm not expecting end markets to improve until Calendar '21.

Noah Kaye

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Okay. That's helpful, and maybe just a last one, you mentioned a number of cost actions. It sounds like there's a contemplation of potential just real estate consolidation in Racine. Just tentatively, I mean I don't know how far you are with planning. But if you were to do that, what would kind of be the implied savings?

John H. Batten

We would shoot for a seven-figure savings in operating expense. It's really—we are at the point now with work from home. The number of people in the office every day, and we don't see that changing dramatically in the next six months. Then it's—if it doesn't—if it's not changing because it can't, then we can decide how we want to operate and have a different style of office versus dedicated office to kind of the hotel model.

If we can get into one facility, I think we should absolutely look at that. That is something that what we should seriously consider. We've started the analysis and the planning of how would we fit everyone that's in the corporate office into our TwinCo or North American operations facility. So it would be a shoehorn right now, but it's absolutely worth looking at because this facility that used to house 40, 50, 60 people every day is now under eight. So it's the right thing. It's the right analysis to do.

Noah Kaye

Okay, all right. Thanks very much for taking questions.

John H. Batten

Thanks, Noah.

Operator

Again it's star, one if you'd like to ask a question.

We'll now take the next question from Josh Chan at Baird. Please go ahead.

Josh Chan

Hi. Good morning, John and Jeff.

John H. Batten

Hi, Josh.

Josh Chan

Just if I can dovetail off of the cost savings question. So of the $7.2 million annualized, I guess, how much of that did you realize this year? Then, I guess, how much does it leave for next year? Then also do you think that those savings are more temporary in nature, just in response to the demand? Or are they kind of like structural costs there (inaudible) out with it?

Jeffrey S. Knutson

Yes. I can jump. John, you can comment.

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I think based upon the actions and the timing we could get 80% of that within this fiscal year. I would say that it is a reaction to the markets and the incoming order rate. As markets recover, I think we would adjust our cost structure. It is impacting everybody in Racine in one way or another, and it's not what we would consider a permanent situation. It's a temporary reaction to the current market environment.

Josh Chan

Okay. Yes, that makes sense. Then John, you talked about the average daily order rates kind of improving a little bit. Is it kind of a broad-base you're seeing it across many different markets or are there specific spots that you're seeing that are coming back a little bit there?

John H. Batten

I would say, yes. I would say that the—and Jeff can jump in because I know you've got the chart in front of you. I would say, Josh, it's aftermarket, marine and industrial. Typically—and aftermarket across like oil and gas are everything. But our new unit order in transmission, whether it's ARFF, military or oil and gas comes in buckets, huge buckets. So what we're seeing is marine new unit, industrial new unit and aftermarket. Those are the daily order rates that have shown some—and again, we're measuring off the—we're measuring from in the basement. So we're kind of stepping up the stairs out of the basement. But at least, they're going in the right direction, and they're not getting worse.

Josh Chan

Yes. That makes sense. It's definitely, a good sign. It's about kind (phon) of—I'm sure you would hope for, a greater improvement.

John H. Batten

Yes. Jeff, correct me if I'm wrong. But off the top—okay. Sorry, go ahead, Jeff.

Jeffrey S. Knutson

What was your question, Josh?

John H. Batten

I just going to add, Josh, the bottom was April, and Jeff—could be wrong, and it improved slightly since April, month over month.

Jeffrey S. Knutson

Correct.

Josh Chan

Okay. All right. I appreciate the color there. I guess my last question is on the gross margin, I guess, in 2020, you had a few kind of items that kind of impacted the gross margins. So I guess, you do get the benefit of lapping those items. So how do you think gross margin could shape up in '21 versus '20 as you kind of anniversary the one-timers, but then the demand is probably softer to start the year at least?

Jeffrey S. Knutson

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Yes. That's a good question. Obviously, for us, mix is such an important factor in what our margin looks like. I think with a similar mix, without that $6 million charge in '20, we would have been about 25%. We've had, I think, really, really good cost reduction effort improvement through the year kind of demonstrated in our fourth quarter year-over-year improvement. So I think annualized with the same mix, we could do slightly better than 25%, even with what might be a little bit softer volume.

I think we will get some good cost savings. So I think we'll be in that range with a similar mix. Obviously, we would certainly enjoy some improvement in our mix and volumes coming back in oil and gas in the second half, which would drive us into the higher 20s.

Josh Chan

All right. (Inaudible) All right. Thanks guys. Good luck in the rest of the year.

John H. Batten

All right. Thanks Josh.

Operator

We'll now take our next question from Barry Haimes at Sage Asset Management. Please go ahead.

Barry Haimes

Thanks so much. Just wanted to make sure I understood the PPP impact in terms of how it affects the P&L, if it does, or if it's just a cash item, that is to say. Again, am I right, this is forgiven, assuming you spend it down against the employee expenses and so on? So that's right. Is there a P&L impact? In terms of the cash impact, you mentioned it ended in July. So how much of it was in the fiscal fourth quarter versus how much of it might have gone into the first quarter? Thanks so much.

John H. Batten

Yes. So a good question for Jeff.

Jeffrey S. Knutson

Yes. Good question. Yes. So to answer the first part, it—the spending was expense, right? So there was no forgiveness assumed in our fiscal fourth quarter. So no P&L impact as it relates to PPP forgiveness. We spent approximately $6 million of the $8.2 million within the fourth quarter and the remainder—the remaining $2.2 million in the First Fiscal Quarter of '21. The way to forgive this process, at least we anticipate it working, we will apply for forgiveness this quarter later in August. Then there is a process that is followed by our bank and the SBA to determine ultimate—the ultimate level of forgiveness.

You're right, there is a formula, and there's specific spending you need to have spent some money on, which we, obviously, we focus very much on getting it spent on the right kinds of items. It's one of the reasons we brought back people and returned wages to their normal levels when we receive the funds.

I think look for more information on that when we do our first quarter follow-up, a better look at where we are in the figures we process.

Barry Haimes

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Great, thanks so much. Appreciate it.

Operator

There appears to be no further questions as of right now. I'll turn it back to the speakers for any additional or closing remarks. Please go ahead.

John H. Batten

All right. Thank you, Eduardo, and thank you, everyone, for joining our conference call today. We truly appreciate your continuing interest in Twin Disc and hope that we've answered all of your questions. If not, please feel free to call Jeff or myself.

We look forward to talking with you after the close of the first quarter. I don't know if the call will be the last day of October or early November, but it will be after our Annual Meeting.

Eduardo, now turn it back to you.

Operator

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

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