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Twin Disc, Inc.

Fiscal First Quarter 2019 Investor Conference Call

October 29, 2018

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CONFERENCE CALL PARTICIPANTS

Tim Wojs, *Robert W. Baird & Company*

James J. Dowling, *Jefferies Capital Partners*

John B. Walthausen, *Walthausen & Company, LLC*

Timothy J. Curro, *Value Holdings, L.P.*

PRESENTATION

Operator:

Good day, and welcome to the Twin Disc, Inc. Fiscal First Quarter 2019 Investor Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Mr. Stan Berger of SM Berger. Please go ahead, sir.

Stan Berger:

Thank you, Naomi. 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 2019 first quarter financial results and business outlook.

Before I introduce 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. Additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statements are contained in the Company's Annual Report on Form 10-K, copies of which may be obtained by contacting either the Company or the SEC.

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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 President and Chief Executive Officer, and Jeff Knutson, the Company's Vice President of Finance, Chief Financial Officer, Treasurer and Secretary.

At this time, I will turn the call over to John Batten. John?

John H. Batten:

Thank you, Stan, and good morning, everyone. Welcome to our Fiscal 2019 first 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 results from the quarter.

Historically, our first quarters are the most challenging due to facility shutdown and summer vacations in many of our European markets. The Fiscal 2019 first quarter exceeded our expectation in a few areas.

When backing out Veth shipments in the quarter, core Twin Disc sales were up 36% versus—compared to last year. Much of that demand was driven by our North American customers, but we also saw increases in our Asian marine customers and from our global ARFF markets.

Gross margins, while not at Fiscal 2018 fourth quarter levels, were better than anticipated for Q1. Jeff will have more of an explanation on the effect of the Veth purchase accounting on our overall gross margin.

Operationally, we did bring more people online in our Racine operations, and that did affect our efficiency somewhat, but we expect that to improve going forward. Jeff will also have more color on our ME&A spending for the quarter, which was driven by a lot of one-offs and the addition of Veth.

I would like to highlight two of the activities that drove our spending considerably. The first was our centennial anniversary, which included our global distribution meetings. and the creation of our Heritage Gallery here in Racine, which highlights the evolution of our technology and strategy since the very first Twin Disc clutch in a Wallis tractor to the acquisition of Veth and the push in to marine hybrid propulsion. The gallery is open to the public and we invite anyone visiting in the area to stop by and see it.

The second item to note is the follow-on offering that we did in September, which was actually announced on our 100th anniversary date of September 19, 2018. The follow-on offering was not a decision that we took lightly. As we have mentioned in previous calls, Management is determined to grow, to do it wisely and to be ready for the right acquisition, despite market conditions and timing. We are not announcing that anything is imminent, but we want to maintain our flexibility.

In the prior two calls, we also touched briefly on the need for additional floor space for our domestic operation. Over the past two years we have consolidated some of our depot and assembly operations back to Racine. To free up space for the 21st Street operation here in Racine, we are moving our aftermarket business plant operation out six miles west, just off the I-94, and which will allow us more flexibility in shipping and to run this business as a separate entity. We have also decided to move our North American depot and industrial assembly functions to a new 50,000-square-foot facility in Lufkin, Texas. This should be ready by next summer. These two moves will free up at least 50,000 square feet in our plant, which will allow us to expand our transmission assembly and test area, and to install our new marine—sorry, our new machine tools that are arriving in the coming months.

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With that, I'll turn it over to Jeff for some comments on the financials.

Jeffrey S. Knutson:

Thanks, John, and good morning, everyone. I'll briefly run through the first quarter numbers. Sales of $74.7 million for the quarter were up $29.6 million or 66% from the prior year first quarter. The quarter results include the impact of Veth Propulsion—the acquisition of Veth Propulsion, which closed on July 2. Excluding the impact of Veth, sales were up 36% compared to the prior year first quarter, which represents the seventh consecutive quarter of year-over-year growth, demonstrating the sustained growth trend we've enjoyed since the middle of Fiscal 2017.

The primary driver, as John mentioned, for the improved revenue in the quarter remains the improved shipments of oil and gas transmission units into North America, along with the improved North American aftermarket demand, which has also been led by oilfield activity. In addition, we continue to see improving trends in nearly all of our markets, including the global commercial marine and patrol craft markets. Marine and propulsion sales increased nearly 13% compared to the prior year first quarter.

Our gross margin performance for the quarter was solid, with a margin of percent of 32.1, an improvement of 110 basis points from the prior year first quarter. This result also includes the impact of Veth—of the Veth acquisition and related purchase accounting amortization. Excluding Veth, gross profit was approximately 35.5%. This improvement is primarily volume driven, but also continues to reflect the strong oil and gas and aftermarket mix.

Spending on marketing, engineering, and administrative costs for the Fiscal 2018 first quarter increased by $0.6 million, or roughly 42% compared to the prior year. Approximately half of this increase represents the addition of Veth and the related amortization of acquired intangibles. We also had roughly $2 million of non-recurring spending related to unique activities during the first quarter, as John mentioned. These included marketing costs associated with the Veth acquisition, and the Company's centennial celebration. Also included professional fees related to the acquisition, debt financing, equity offering, and significant recruiting activities in the quarter.

As a percent of revenue for the Fiscal 2019 first quarter, ME&A expenses declined to 25.4% compared to 29.7% in Fiscal 2018. With the improved volume in margin performance and reduced restructuring spending, our operating results improved by $5.5 million from a $600,000 operating loss in the prior year first quarter to a $4.8 million operating profit in Fiscal '19.

The effective tax rate for the first quarter was 23.4%, reflecting the continuing impact of the new tax legislation. The prior year rate reflects the significant impact of the reversal of a $3.8 million valuation allowance. Net profit for the quarter of $2.9 million, or $0.24 per diluted share, reflects a slight decrease from the prior year fiscal first quarter, due to that significant impact of the valuation allowance reversal in the prior year.

Positive EBITDA of $8 million for the quarter reflects a $7.5 million improvement over the Fiscal 2018 first quarter. On a trailing 12-month basis we are now at $28.6 million at EBITDA, which includes restructuring charges of $2.4 million.

The balance sheet remains very healthy as we close out the first quarter of Fiscal '19, with the impact of the $61 million Veth acquisition and subsequent $32 million follow-on equity offering being the headlines for the quarter. We finished with $20.9 million of net debt, debt to total capital of 17.4%, and a debt-to-EBITDA ratio of 1.3. This returns our balance sheet to a position of strength, allowing us to continue to be aggressive in pursuing strategic action.

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The increase in inventory in the quarter is largely explained by the Veth acquisition, along with an operational increase at our U.S. operation to accommodate increasing order activity. This increase is supported by the continuing growth in our six-month backlog, which reached $146.3 million in the quarter, a 27% increase over the previous quarter. This includes the impact of Veth—of the Veth—the acquired Veth backlog. Excluding the Veth impact, backlog was up nearly 8% compared to the previous quarter, and nearly double the first quarter of Fiscal 2018.

Operating cash flow was positive $800,000, while free cash flow was negative $2.7 million in the first fiscal quarter, with a significant bonus payment, a ramp up in capital spending, and increased inventory in the quarter, and now I'll turn it back to John for some final comments.

John H. Batten:

Thanks, Jeff, and I'll just spend a quick moment on our outlook. As Jeff mentioned, our six-month backlog is up 27% and 8% on traditional Twin Disc business. We're very pleased to see some nice Veth orders for the North American market, the strongest three months ever for Veth in this market. We are also experiencing the strongest demand in my history at Twin Disc for our ARFF transmissions. Our introduction to Veth to the global distribution network is just beginning, and we are very optimistic about our ability to be successful in growing this business.

Finally, we are still bullish on our ability to continue our strong shipments in oil and gas, whether it is for new construction, retrofit, or rebuild activity. Heading into the balance of 2019, we feel very good about another strong year.

That concludes our prepared remarks, and now Jeff and I will be happy to take your questions. Naomi, can you please open the line for 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 that your mute function is turned off to allow your signal to reach our equipment.

Once again, please press star, one to ask a question, and we'll pause for just a moment to allow everyone an opportunity to signal for questions.

We'll go ahead and take our first question from Tim Wojs from Baird. Please go ahead.

Tim Wojs:

Hey guys. Good morning.

John H. Batten:

Hey Tim.

Jeffrey S. Knutson:

Good morning, Tim.

Tim Wojs:

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Hey, so yes, I just had a—I had a few questions maybe to start off with—start off just maybe the oil and gas business. There's been some of your suppliers talking about kind of takeaway issues in the Permian, so I'm just curious if you're kind of seeing that show up in the customer order books at all, and maybe over the next six months is there any sort of kind of puts and takes to how we should think about backlog conversion to revenue if there's any sort of kind of pause in spending related to that?

John H. Batten:

Well, I'll answer the first question. Certainly that's been a topic of discussion everywhere. I would just say that the mix—what we have seen in the mix of our backlog and new orders, Tim, is—I would say are more units for retrofit and rebuild, taking out some of—some older transmissions, primarily from some competitive transmissions and putting ours in. I would say, though, in general, our customers, the ones that we’re selling to, still are very optimistic about 2019 and heading into 2020, but again, still (inaudible) I would just say that the mix of what we see is new rig construction versus what we're selling to replace an existing transmission in a rig. That mix has definitely, I would say, in the last month or so, shifted higher to rebuild activity, so not necessarily building to add new horsepower, just replacing existing horsepower.

Tim Wojs:

Okay. Okay, and then just as we think about the overall backlog, is there a way to think about that kind of—that core Twin Disc backlog by maybe end market. I'm just curious if all of the industries were maybe up sequentially in organic basis, marine, industrial, and oil and gas, and then, I guess, secondarily, how does that compare to maybe where we were a few quarters ago, and really why I'm asking is just are you seeing a broadening out of the strength in your back-loggers is still specific to a couple of sub industries?

Jeffrey S. Knutson:

Yes. Tim, this is Jeff. We have seen growth across the product families to varying degrees. I think marine, in particular, commercial marine has shown significant growth, not quite in line with oil and gas, but significant. As I've said, sales were up about 13%, backlog probably even a little bit higher than that in the marine space. Industrial up probably high single-digits, so yes, I would say broad positive movement across the product lines.

Tim Wojs:

Okay. Okay. That's good, and then on Veth, was the first quarter in line with your expectations in terms of the financial contribution, and I guess it's just the revenue's a little shy of what we were looking for, so I just—I'm curious if there's some seasonality in Europe that might negatively impact that?

Jeffrey S. Knutson:

Yes. I think you're right. I think there was some seasonality and some—maybe some unfavorable mix—slight unfavorable mix. We're still really working to understand the details of how their business works quarter-to-quarter, but I would say broadly in line with what we had expected.

Tim Wojs:

Okay. Okay, and then just two last ones. What should we think about for the pro forma diluted share count for the second quarter, and then just free cash flow generation for Fiscal '19, will you be able to generate a modest amount of free cash for the year?

Jeffrey S. Knutson:

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Yes, so the first one, we're at about 13.1 million shares outstanding, so that average will continue to grow through the course of the year, so probably around—I think we're at 11.7 million roughly Q1. Probably 12.1 million, 12.2 million on average for Q—year-to-date Q2, and free cash flow, yes, I think we did probably a little better, quite honestly, then we expected free cash flow wise in the first quarter, especially considering the ramp up in inventory and the significant payments we had go out, so we expect to generate cash the rest—over the course of the rest of the year, to be positive free cash flow full year.

Tim Wojs:

Okay, and just to confirm, so the end of the quarter share count was 13.1 million?

Jeffrey S. Knutson:

Right.

Tim Wojs:

Okay, great. All right. I'll hop back in queue. Thanks, guys.

Jeffrey S. Knutson:

Thanks.

John H. Batten:

Thanks, Tim.

Operator:

Thank you. We'll move on to our next question from Jim Dowling from Jefferies Capital. Please go ahead.

James J. Dowling:

Good morning. I have three questions. I know you've addressed the issue of margins, but if you can, can you give us a little bit more quantification on the margins for the basic business without the Veth acquisition? You've had the benefit of various projects you've completed over the last 18 months or so, and you've got increasing backlogs, all of which would argue for expanding margins, offset possibly by some headwinds from labor, but as you look at the quarter that just ended and the next two quarters as we look out, can you give us some quantification at all on those margins from the basic business?

John H. Batten:

Yes. Excluding the Veth acquisition entirely, margin for the first quarter was 35.5%, which is roughly what we'd have expected coming off of a very strong Q4, over 37%; obviously volume significantly higher in Q4 compared to Q1 on that base business. Q1 always has the summer shutdowns, etc., so performance-wise, margin-wise, still pretty much in line with the Q4 levels, and I think that's what we would expect on that base business going forward.

James J. Dowling:

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The two projects that you just announced that will be completed sometime in the middle of next calendar year, what will they do to margins?

John H. Batten:

I would say probably in a couple of quarters they'll be headwinds, but we expect the overall efficiency in our 21st operation, again, to expand, so while—the lease expense and the overhead expense as we're starting up both facilities will be a little bit of a drag, but again, within a couple of quarters we expect certainly be able expand our capacity and our shipment volume levels in the Racine operation, which should more than make up for the gross margin impact of having those two additional facilities, so the aftermarket facility will—I'm sorry. I meant to be more specific in my comments. The aftermarket facility six miles west of our operation here in Racine, that should be fully operational in February and free up about 30,000 square feet in our Racine operation, which we will expand assembly and test, and then the Lufkin facility, the depot and industrial facility, that will go online probably in July of next year, so we're staggering them apart, so we tackle one, then tackle the next one, but we're looking to increase, again, our square footage in the Racine operation by about 60,000 square feet for new machine tools to allow us to cut bigger gears, reduce costs, so we're not buying some of these very expensive components on the outside, but then also expand our capacity for assembly and test, so overall, when all are done, you should see this greatly help the gross margins here in our North American operations.

James J. Dowling:

Okay. My second question is just to backtrack a little bit on your comments on the backlog. I was writing quickly, so I may have missed it. I thought you said that, excluding the Veth acquisition, that the sequential backlog increased about 8% from the previous quarter.

John H. Batten:

That's correct.

James J. Dowling:

Okay.

John H. Batten:

That's correct.

James J. Dowling:

Then you gave some numbers. You said that—and I don't know whether this was with or without Veth. You said marine was up 15%, industrial was up high single-digit. If that's true, it would suggest that oil and gas was flat.

Jeffrey S. Knutson:

It kind of depends on which—what period you're comparing it to, so if we're comparing to the previous quarter, yes, I would say oil and gas was relatively flat. We shipped significant orders. We took in new orders, so it was up—probably up slightly, marine in that 10% to 15% range, and industrial, high single digits.

James J. Dowling:

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Okay, and then my third question is what are the early returns, to the degree that you can qualify or quantify them, for the cross selling between the basic business and the Veth acquisition?

John H. Batten:

It's John here. I would say that—I don't really think it's a coincidence that Veth had their strongest three months of North American orders now that they were part of Twin Disc. I think it gave a lot of our customers here, which were joint customers—they had gone to Veth for some application and maybe bought some smaller thrusters, but now that they're part of our team, I think there was a lot of confidence in the customers here to finally order big projects from Veth, so we're very happy about that going forward. We think we'll grow the business here. I would say, as far as synergy and cross selling, I think the big thing you're going to see is in Veth's hybrid and diesel electric development, whether it's software or hardware, and our—the hybrid in diesel electric that we're working on for our traditional transmissions, mostly it's our hybrid, that you'll see a lot of cross selling of components where we can use some of the Veth hardware in our system and Veth can use some of our clutches in theirs, so the cross selling has begun with our customers, but also in the joint utilization of components that we've already developed.

James J. Dowling:

Okay. Thank you. That's all for me.

John H. Batten:

Thank you, Jim.

Operator:

Thank you. We'll move on to our next question from John Walthausen from Walthausen & Company. Please go ahead.

John B. Walthausen:

Oh, yes. Good morning. Thank you for taking my call. Just a quick question. I don't think we've mentioned steel prices and what you expect—what you're seeing out there and what you expect the impact of pricing—steel prices to be.

John H. Batten:

Yes. We're starting to see that impact. We've seen pricing increases on components. We don't buy, I would say, typically, raw steel. We buy raw material, but it's coming from bar stocks, forgings, castings, and we've seen pricing impacts in the mid single digits; in some cases, closer to 10. On some of the electronic components that we do source from China for our control system, we have seen that 25% increase. Thankfully, on that it's a very small percentage of our overall product cost structure, but we have had recent pricing actions on a lot of our larger transmission projects to compensate for that, so yes, to answer your question, we have seen the impacts of the tariffs on domestic suppliers. We're buying castings, forgings, and bar stock from domestic suppliers.

John B. Walthausen:

Good. That's helpful, and are you addressing that by price increases yourself, or...

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John H. Batten:

Yes. We are instituting price increasing—price increases to capture those increased costs. Yes.

John B. Walthausen:

Okay. Thank you.

Operator:

Thank you. We'll move on to our next question from Tim Curro from Value Holdings. Please go ahead.

Timothy J. Curro:

Hi. I was just hoping you could clarify an accounting question regarding the gross margin. If I exclude the amortization associated with the write-up of inventory, does your gross margin go up or down?

Jeffrey S. Knutson:

Where are you starting from? From the 32.1%, if you—the amortization was about $1.2 million in the quarter, so 32.1% becomes a little over 33%. If you are comparing it to our Q4 results, certainly it's down because of the overall Veth business not coming in at 37% gross profit. Does that answer your question?

Timothy J. Curro:

Yes. Thank you.

Operator:

Thank you. We'll move on to our next question from Tim Wojs from Baird. Please go ahead.

Tim Wojs:

Hey. Just two more kind of model things, guys. I guess the first, what's the expectation for purchase accounting for the year, just so we can kind of make sure we have that in our numbers, and then should there be any more restructuring charges over the next three quarters?

Jeffrey S. Knutson:

I think we'll answer the first one to begin with. What you saw in Q1 was about $1.2 million in cost of goods sold, and about $600,000 in ME&A related to purchase accounting amortization. Right now we're projecting that to be the same. The valuation work is still underway, still preliminary, so there is a chance that those intangibles could move around a little bit, but at this point we don't have any reason to expect that, so that's the most logical assumption. Sorry, what was your second question, Tim?

Tim Wojs:

I was just asking about restructuring, but on that question, how much of the inventory write-up continues, because that should go away at some point, right?

Jeffrey S. Knutson:

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That's a four-quarter phenomenon, so $1.2 million for just this fiscal year, but it's the full year.

Tim Wojs:

Okay. Okay, got you, and then—yes, just restructuring. Sorry.

Jeffrey S. Knutson:

We'll continue to see some level of restructuring. We don't anticipate anything significant at this point, so plus or minus a reasonable range, around what you saw in the first quarter.

Tim Wojs:

Okay, great. Thanks, guys.

Operator:

Thank you. Ladies and gentlemen, as a reminder, if you'd like to ask a question, please press star, one on your telephone keypad.

We have no further questions at this time. I'd like to turn it back over to you, Stan.

John H. Batten:

Naomi, it's coming to me, John. Thank you, and thank you for joining our conference call today. We appreciate your continuing interest in Twin Disc, and hope that we have answered all of your questions. If not, please feel free to call Jeff or myself, and we look forward to speaking to you—with you again in February following the close of our Fiscal 2019 second quarter. Naomi, I'll turn the call back to you.

Operator:

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

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