Twin Disc, Inc.

Fiscal 2021 Fourth Quarter Conference Call

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CORPORATE PARTICIPANTS

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John Batten, *Chief Executive Officer*

Jim Feiertag, *President and Chief Operating Officer*

CONFERENCE CALL PARTICIPANTS

Noah Kaye, *Oppenheimer*

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

PRESENTATION

Operator

Good day and welcome to the Twin Disc Fiscal 2021 Fourth Quarter Conference Call.

Today's call is being recorded.

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

Stanley Berger

Thank you, Katie.

On behalf of the Management team of Twin Disc, we are extremely pleased that you have taken the time to participate in our call. Thank you for joining us to discuss the Company's Fiscal 2021 Fourth Quarter and Full Year financial results and business outlook.

Before introducing Management, I would like to remind everyone that certain statements made during the conference call, especially those that state Management's intentions, hopes, beliefs, expectations or predictions for the future, are forward-looking statements.

It is important to remember that the Company's actual results could differ materially from those projected in such forward-looking statements. Information concerning factors that could cause actual results to differ materially from those in the forward-looking statements are contained in the Company's Annual Report on Form 10-K, copies of which may be obtained by contacting either the Company or the SEC.

By now you should have received a copy of the news release, which was issued this morning before the market opened. If you have not received a copy, please call Annette Mianecki at 262-638-4000, and she will send a copy to you.

Hosting the call today is John Batten, Twin Disc's Chief Executive Officer.

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 Fourth Quarter and Year End Conference Call. As usual, we will begin with a short summary statement, and then I'll be happy to take your questions.

Most of you will notice that Stan did not mentioned Jeff Knutson at the host today. Unfortunately, Jeff was involved in unfortunate incident earlier this week, which will require him to be on leave for the next few weeks. He is doing well and most likely listening to the call right now. The good news is that we are expecting a full recovery. The bad news is you just have me for the numbers, but joining me today are Jim Feiertag, our President and Chief Operating Officer, and Tim Batten, our Vice President of Sales.

Before I go over the quarter and year end results, I'll just touch on some of the operational highlights from the quarter. As I've been mentioning in the past, the number of hybrid projects and electrification projects continues to grow, as does our product development in that area. Once our customers are ready to release their products, we will share them with you. As I've mentioned in the past, the development cycles for these applications is not a short one.

The COVID-related supply chain issues that we were seeing in the first half of the year continued throughout the fourth quarter, but we have seen some easement, particularly from supply coming from India. Shipments from our new facility in Lufkin are hitting full steam. They've been hampered a little bit by the supply chain issues from India, but they are hitting full stride and all of our mechanical clutches and PTOS that were once in production in Racine are now being produced in Lufkin.

Orders in the fourth quarter was strong and driven by a strong aftermarket demand, including parts for North American oil and gas rebuilds. While the six-month backlog is down versus our third quarter backlog, the overall backlog increased nicely. The shift out past our six-month window is a combination of customer requirements for those dates and also a realization that we're going to still have some supply chain issues.

We continue to work through our inventory at our distribution partners, and we're confident that as they get new orders, new orders will improve on the factory. This inventory is being sold off, and projects in our global marine markets are driving this. Those projects remain strong and we should see new orders on marine continuing to improve in the coming quarters. New oil and gas shipments to Asia continues to be very steady and should increase later in this calendar year.

Looking at the numbers, the Fiscal '21 Fourth Quarter and full year numbers, sales of $66.2 million in the fourth quarter were up $6.8 million or 11.5% from the prior year fourth quarter. The quarter improvements in the prior year was a result of strengthening global economy as the ongoing effects of the COVID-19 pandemic began to ease. Compared to the prior year fourth quarter, transmission sales were up 28.9%, industrial sales up 21.1%, and marine and propulsion sales down 3.8%.

By region, sales into North America were up 9%, sales into Europe were up 11%, and sales into Asia Pacific were up 5%. Foreign currency exchange was a net positive $4.1 million impact to sales in the fourth quarter. For the full year, sales are down $28.2 million or 11.4%, foreign currency translation contributed a positive impact of $11.6 million compared to the prior fiscal year. The fourth quarter margin percent was 27.7% compared to 23.3% in the prior year fourth quarter.

Similar to the third quarter, the fourth quarter benefited from the Employee Retention Credit, which contributed $1.2 million to gross profit. Adjusting for this benefit, gross profit would have been 25.8%. Still a significant sequential year-over-year improvement, reflecting a more favorable sales mix driven by aftermarket activity in the North American oil and gas market and the positive impact of targeted cost reduction activities.

Gross profit for the fiscal year finished at 23.3% compared to 22.6% for Fiscal 2020. Spending on marketing engineering and administrative costs for the Fiscal '21 Fourth Quarter increased $1.6 million or 11% compared to Fiscal '20. The increase in the quarter is primarily to the partial achievement of global incentive metrics resulting in a bonus expense of $2.3 million in the quarter along with a positive currency translation impact. These increases were offset by the M&A portion of the Employee Retention Credit and the ongoing focus on cost containment having a favorable impact on global discretionary spending.

As a percent of revenue for the fourth quarter, ME&A expenses were 25.3% compared to 25.4% in the prior year fourth quarter. For the fiscal year, ME&A spending is down $7.5 million or 11.8%, finishing at 25.5% of revenue compared to 25.6% for the prior fiscal year. We recorded a restructuring charge totaling $6.6 million in the fourth quarter. This is comprised of a $2.3 million charge for a restructuring program at our Belgian operation, which will result in the elimination of 23 positions and drive annualized savings of approximately $1.6 million. This charge represents the legal minimum cost of the action. Negotiations are ongoing and we anticipate a final charge will be recorded in the first half of Fiscal 2022.

We also recorded a $4.2 million impairment charge related to the write-down of our corporate office building to an estimated fair value, as this asset is currently held for sale. During the fourth quarter, we received notification of full forgiveness of our $8.2 million PPP loan from the Small Business Administration, resulting in other operating income benefit of $8.2 million reported in the quarter.

Including the significant impacts of restructuring and PPP forgiveness, operating income for the quarter was a positive $3.2 million compared to $1.5 million operating loss in the prior year. The effective tax rate for Fiscal 2021 was negative 110.4% compared to 9.5% for Fiscal Year 2020.

During the current fiscal year, the Company received full forgiveness of its PPP loan, which resulted in an increase to the effective tax rate of 17.5%. In the prior year, the Company determined that the carrying value of certain goodwill and intangibles exceeded the fair value and a $27 million impairment loss was calculated, which resulted in a decrease to the prior fiscal year effective tax rate of 13.8%.

During the current fiscal year, the Company was able to take advantage of the newly enacted high tax exemption regulations. The Company filed its federal tax return utilizing this exception and had no guilty inclusion, increasing the current rate by 12%.

Due to continued historical domestic losses on uncertain future domestic earnings, the Company recognized the full domestic valuation allowance, reducing the effective tax rate by 158.6%. The net loss for the fourth quarter of Fiscal '21 was $12.7 million or $0.96 per diluted share, largely due to the $15 million deferred tax valuation allowance recorded in the quarter, compared to a net loss of $1.8 million or $0.13 cents per diluted share in the prior year fourth quarter.

For the fiscal year, we reported a net loss of $20.9 million or $1.58 per diluted share compared to $39.8 million or $3.03 per diluted share in the prior year. EBITDA of $4.9 million for the quarter was improved from $1.3 million in the prior year fourth quarter. For the year so far, EBITDA of $3.6 million is nearly $34 million improved over the prior year.

Turning to the balance sheet. Inventory was down $1.7 million in the quarter and $5.6 million for the year, despite the $3.4 million currency translation driven increase. With a focus on liquidity and cash flow, we were able to generate $1.5 million of operating cash flow in the quarter, bringing free cash flow to positive $2.1 million for the fiscal year.

Capital spending at $0.6 million for the quarter and $4.5 million year to date has been focused on the new Lufkin facility and modern machine tools and testing equipment. As we work through a very challenging fiscal year, we focused on preserving liquidity and deferred all non-essential capital spending. This will result in some catch-up spending in Fiscal 2022 where we expect to invest $10 million to $12 million during the fiscal year while monitoring the ongoing market recovery for any pauses or setbacks.

Getting past the numbers just a quick moment on our outlook before I open up on the questions, obviously, in the fourth quarter, we were very encouraged by the improvements we're seeing in the markets and our order trends. This should continue throughout Fiscal 2022 and we are expecting a much improved Fiscal 2022 compared to Fiscal 2021.

We mentioned on the last call that we've been analyzing our global footprint and how we do business. You saw some of those actions that we took in the fourth quarter to make us more profitable. Basically, it's a realization of right-sizing our operations to the size of what we manufacture inside versus what we outsource on the outside.

Finally, we’re continuing to invest in our electrification efforts, both in systems and data security, and we are very optimistic in our ability to bring competitive solutions to our markets.

That concludes my prepared remarks. And now Jim, Tim, and I will be happy to take your questions.

Katie, could you open the line for questions?

Operator

Thank you. We'll go to Noah Kaye with Oppenheimer.

Noah Kaye

Hi, good morning. Thanks for taking the questions.

First, best wishes to Jeff. Hope he is back and well soon; although, John, I will say you rushed through that with great efficiency.

John Batten

Noah, before you ask your question, I just realized that I printed the wrong version of the script and that the forgiveness of the PPP loan is not up and operating income as of the press release. It’s income from the extinguishment of the loan. So, that was my bad, but it's hard to stop once you're actually reading it.

Noah Kaye

Yes, thank you for the clarification.

Can we just start with maybe a little bit more meat on the bone in terms of your electric product development and pipeline? Specifically, we understand these are relatively long product development cycles, but I would just love to understand the potential revenue magnitude of what you're working on and bidding on. Is this a $10 million, $20 million, $30 million pipeline? Anything that will help folks to understand where this opportunity may be headed.

John Batten

That is a great question. I asked it, the Board asked it, we all ask it. So, just to give you on a just kind of an industrial application. So, where we used to sell a $15,000 or $20,000 pump drive, a hybrid system can be anywhere from $130,000 to $180,000. So, that kind of shows you for one piece of equipment. So, the multiplier on your content is huge. Gross margin is roughly the same, might be a little bit less because we're not producing everything. We're not manufacturing everything in the complete system. So, we won't have the same margin on all the components.

The issue that you face is we have NDAs and we've got applications, I'm looking at our VP of Sales, in pretty much every market segment that we operate. The issue is it takes a year to develop the product, it takes a year to test, and then it'll be the market acceptance. So, if we could go from the first inning to the ninth inning where everything is hybrid, you would see our revenues increased dramatically. It's just a ramp up of how quickly are we going to be able to prove these products out in the field, meaning us and the OEM. How quickly is there market acceptance for those products? So, it's a huge opportunity, Noah.

I sound like a broken record, Noah. It'll happen much quicker in automotive, because you have the car companies controlling everything and it's been in production and testing for a while. The off-highway markets, I'd say it's a scramble to catch up, but there's so many different applications and so many different variations. Everyone's trying to figure out what combination is going to work. So, I'm really optimistic, because the projects that we're involved in I think are going to be accepted very well in the market. It's just a question is how quickly will it happen.

Noah Kaye

Yes, that's very helpful. I mean, it sounds fair characterization maybe we're in sort of the top of the second here, if you want to use a baseball analogy.

John Batten

Yes.

Noah Kaye

Okay, let's move on to oil and gas. I mean, just given the extremely low death counts, particularly the live death counts. It feels like the tables could be setting up for an uptake in an activity. Talk a little bit about your pipeline and your expectations for that market over the next year.

John Batten

I would expect Asia to show some, I don't want to say significant improvement, but noticeable improvement in the demand, and so the units that we shipped there.

North America, we've had kind of the first two markers for new spending, and that has been aftermarket demand, ordering spare parts for rebuilds, and request for quotes and lead times. So, we've gotten to that point.

I think at some point in the next couple of quarters we'll actually see new unit orders for the North American market. I would say, no, much more cautious on Capex spending right now. I still think there's some deals out there for idle equipment, used equipment that hasn't been used very much. Some of the big players, whether they're public or independent are snapping up some used equipment.

Noah Kaye

Okay. Then just the last general one. At this point, within the portfolio, where are you actually capacity constrained and still working to catch up with demand? Where is that sort of less of an issue?

John Batten

I'm going to have Jim answer too.

I think all of the supply chains are still constrained. The one that has been the most challenging would be a lot of our industrial products that we produce in Lufkin have a supply chain coming from India, which was constrained. So, relatively long lead time, the delays, but for a product that has short lead times to the customers, we're seeing long lead times for other products, our marine transmissions and power shift transmissions, but they have a longer lead time in general. So, the impact as a percentage has not been as great.

I'll let Jim answer.

Jim Feiertag

Well, John's comments are correct. The issue with the Suez Canal put us back. That has been rectified; we're seeing supply increase. So, we're looking at a much better fall than we struggled with when the Suez Canal went down. So, I think that that's going to clear itself.

With regard to oil and gas, we have the inventory on hand to support the market.

With marine, the issue is not with getting parts for suppliers. We're working closely with all of our suppliers, and we do not foresee that being a problem as we go forward over the next 12 months. The biggest issue that we have is electrical connectors, which is the same thing the automotive has and everybody else around the world, but we are getting what we need to continue our shipments.

Noah Kaye

Okay. That was extremely helpful. Thank you and good luck to all.

John Batten

Thanks, Noah.

Operator

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

Josh Chan

Hi, good morning. Hope for speedy recovery for Jeff, if he's listening.

John Batten

Thanks, Josh.

Josh Chan

I guess my first question, John, is on the backlog. I guess your six months backlog was down a little bit, but the total backlog went up. I guess what that meant to me was that you had some longer-term projects that get booked in the quarter. I would have thought that that might be oil and gas, but it doesn't sound like that’s coming back as quickly yet. So, can you explain sort of what you booked kind of farther out beyond the six months?

John Batten

Sure. The biggest driver would be some military transmissions, U.S. or domestic, and some oil and gas for Asia are the two big ones that drove backlog outside of the six-month window. And then there’s also realization just in general, as I've mentioned, going through our sales and operation planning, the discipline that we're putting on the fact is primarily the one in here in Racine is scheduling to capacity and don't overcommit.

Just in general, things have been scheduled out to the realization of when we're going to get inventory and when we have capacity, but the two drivers are the transmission business, XT1410 and some other components, and then oil and gas for China.

Josh Chan

Okay, that makes sense. Thanks for the color there.

John Batten

I would just add that, Josh, there’s also a great job on the facilities pushing; a lot of sales went out in the fourth quarter. So, we shipped everything we could.

Josh Chan

That’s right. Yes, definitely. On the gross margin side into next year, could you give us sort of pluses and minuses that you see? You maybe you get better volume, and hopefully you get better mix as well as if oil and gas picks up in the second half? How do you see gross margin trending?

John Batten

Gross margin should be trending up. One of the biggest pluses that I saw during the fiscal year was the focus on gross margin improvement at a product level, cost reduction, finding new suppliers. Remember from calls in prior quarters, in the last oil and gas run up in 2018, we actually had a couple suppliers go bankrupt and we were forced to scramble to find new suppliers, primarily with castings and forgings. So, we've been able to resource that and recognize some cost reduction savings.

There's been the variable cost reduction, we're going through and we've done fixed cost reduction during the year. These gross margins have been improving, including bringing Lufkin online. I've been very pleased to see the gross margin improvement in industrial. With some of the actions that we announced in Belgium and the sale of this corporate facility, there were still some costs in the gross margin line. Once we finalize the sale on this facility, that will take some fixed costs out.

Josh, I expect gross margins to continue to improve nicely through Fiscal '22. Volumes certainly will help.

Josh Chan

Okay, yes. That's good to hear. Then, I guess, last one for me, could you talk about the Capex and what you plan to spend the Capex on this year? Any thought on free cash flow, given that the Capex is higher?

John Batten

Again, we're still expecting positive free cash flow for the year. So, the Capex, we have some big machine tools on order, a gear grinder for Belgium, some test stands for the hydraulic PTO product line for Texas. There's some big-ticket items that we're seeing.

Jim Feiertag

There's a few test stand upgrades we want to do to improve our efficiencies and reduce our test time. In addition to that, we have ancillary products going on in some of our core manufacturing sells of gear grinding and shafts, and we'll be adding specific pieces of equipment to improve our efficiencies there.

John Batten

We also have, Josh, some noticeable engineering Capex and electrification and hybrid test stands and equipment for that. There's a lot of development there, and we're excited about it, but the development is not free.

Josh Chan

Right, absolutely. Thanks for the color and your time. Best of luck into '22.

John Batten

Okay. Thanks, Josh.

Operator

With no additional questions in queue at this time, I'd like to turn the call back over to our speakers for any additional or closing remarks.

John Batten

Thank you, Katie, and thank you for joining our conference call today. We appreciate your continuing interest in Twin Disc and hope that we've answered all of your questions. If not, please feel free to call me, email me, reach out to me and I'm sure there's a question or two that wasn't asked because Jeff wasn't here, but if you send it to me, I will get an answer to you as quickly as possible. We look forward to speaking with you, including with Jeff, again at the close of our Fiscal '22 first quarter.

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

Operator

Thank you. That will conclude today's call. We appreciate your participation.