Twin Disc, Inc.

Fiscal Fourth Quarter 2018 Investor Conference Call

August 6, 2018

CORPORATE PARTICIPANTS

Stan Berger, *President and Managing Director, SM Berger & Company*

John H. Batten, *President and Chief Executive Officer*

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

CONFERENCE CALL PARTICIPANTS

Tim Wojs, *Robert W. Baird & Co.*

Simon Wong, *Gabelli & Company*

PRESENTATION

Operator:

Good day, and welcome to the Twin Disc, Inc. Fiscal Fourth Quarter 2018 Investor Conference Call and Webcast. 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, James. 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 2018 fourth quarter and full year financial results and business outlook.

Before I introduce Management, I would like to remind everyone that certain statements made during the course of 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.

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.

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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 2018 fourth quarter and year end 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 will touch on some of the operational results and highlights from the quarter.

Many of you may not have been on the conference call in June, after we announced the Veth deal, which then closed in July. We apologize for the short notice, but both Jeff and I were in the Netherlands for the signing, and that day we were meeting with all of the Veth employees. I just want to take this opportunity to reiterate how excited we are to have both the Veth people and products part of the Twin Disc family. I encourage everyone to explore their website, vethpropulsion.com, to see their range of products and how they fit in with our marine business. This acquisition takes us to new levels, both in technology and horsepower, without leaving our core competencies. With the vast majority of their sales currently in Northern Europe, we have the very real opportunity to grow their business in the Americas and Asia through our global distribution network. You will also note that we have had a two-year relationship with them as their dealer in the U.S. and parts of Asia.

So, just a few comments on the quarter. Clearly, this was our best quarter in quite some time. Sales for the quarter rose 38% year-over-year, compared to fourth quarter sales a year ago, and demand was up in most of our markets. In addition to oil field transmission, shipments grew in most of our segments. Our industrial and marine demand continued to post stronger results than a year-ago level. The strong margin performance also reflects the improved efficiency, expense control and the drop-through on the volume effect. Our Operations Team did a very good job during the quarter increasing both internal and external capacity through our supply chain. This $6 million to $7 million in cap ex that was on order last quarter is just starting to be delivered, so we anticipate being able to make incremental improvements throughout the coming quarters.

In the May call, we also touched briefly on the need for additional floor space for our domestic operations. Over the past two years, we had consolidated some of our depot and assembly operations back to Racine. With the increased activity in oil and gas, but also in marine and industrial, we are actively pursuing options to move the depot and light assembly functions back closer to a port, mostly likely the Greater Houston Area.

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 fourth quarter numbers.

Sales of $73.8 million for the quarter were up over $20 million, or 43% from the prior year fourth quarter, which represents the sixth consecutive quarter of year-over-year growth, demonstrating the sustained growth trend we've enjoyed since the middle of fiscal 2017. The primary driver has consistently been the improved shipments of oil and gas transmission units into North America, along with improved North American aftermarket demand, which has also been led by oil field activity. In addition, as John pointed out, we continue to see positive trends in nearly all of our markets, including global commercial marine, patrol craft and our industrial markets. For the year, sales finished higher by nearly $73 million, or 43%, to $240.7 million.

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Our gross margin performance for the quarter was very strong with a margin percent of 37.3%, an improvement of 590 basis points from the prior year fourth quarter. This is the second highest quarterly margin percent in the history of Twin Disc, and this improvement is primarily volume-driven, but also reflects the very strong oil and gas and aftermarket mix, improved operating efficiencies and a global reduction in fixed costs. The full year gross margin finished at 33.3%, compared to 28.7% for fiscal 2017.

Spending on marketing, engineering and administrative costs for the fiscal 2018 fourth quarter increased $4.2 million, or roughly 30%, compared to fiscal 2018. Most of this increase was driven by $1.7 million of transaction costs related to the Veth acquisition, a $1.8 million increase in incentive and stock-based compensation, and a $300,000 increase due to currency. As a percent of revenue for the fiscal 2018 full year, ME&A expenses declined to 25.7%, compared to 31.4% in fiscal 2017. We invested $900,000 in the quarter and now $3.4 million for the full year related to restructuring actions to drive additional cost reductions and efficiencies, primarily at our European operations.

With the improved volume and margin performance, our operating results improved by $6 million, from a $2.4 million operating profit in the prior year fourth quarter to an $8.4 million operating profit in fiscal ’18. For the full year, operating results have improved by $23.9 million, compared to the prior year, to an operating profit of $14.9 million.

The effective tax for the fiscal fourth quarter was 28.5%, consistently reflecting the impact of the new tax legislation, along with some smaller favorable discrete items.

Net profit for the quarter of $5.9 million, or $0.51 per diluted share, reflects the $4.8 million improvement over the prior year fiscal fourth quarter, resulting in a year-to-date profit of $9.5 million, compared to a prior year loss of $6.3 million.

Positive EBITDA of $9.9 million for the quarter reflects a $6.6 million improvement over the fiscal 2017 fourth quarter, and on a trailing 12-month basis, we are now at $21 million of EBITDA, which includes the restructuring charges of $3.4 million.

The balance sheet remains in a very strong position as we closed out fiscal 2018, with $10.3 million of net cash, debt to total capital of 3.3%, and $45 million of availability on our new revolving credit facility. As you know, we closed on the acquisition of Veth Propulsion in the first week of our fiscal 2019, resulting in additional borrowings of roughly $61 million. Our initial review of fiscal 2018 pro forma results reflecting this acquisition leaves us in a comfortable position in relation to our new net debt to EBITDA covenant level of 3.5.

While inventory has increased $17.8 million since the end of fiscal 2017, this is consistent with the growing demand, as inventory turns have actually increased 17% over the prior year results. This increase is supported by the remarkable growth in our six-month backlog, which reached $150 million in the quarter, a 148% increase over the prior year end.

Free cash flow was positive $3.5 million in the fourth quarter, with strong earnings and reduced working capital offsetting an increase in capital spending. For fiscal 2018, we reported free cash flow of slightly above breakeven, about $200,000, which was in line with the fiscal 2017 results. This comes despite an increase in capital spending of $3.2 million and a volume-driven increase of working capital of $12 million. The increase in working capital represents just 16.6% of the increase in sales for the year, reflecting our effort to control the working capital investments required to support the growing volume level.

Now, I’ll turn it back to John for some final comments.

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John H. Batten:

Thanks, Jeff, and I'll just spend a quick moment on the outlook. For fiscal '19, we're heading in with a backlog, as Jeff mentioned, up 148%. Note it was down slightly versus the end of the third quarter, but this was due mainly to the rescheduling of non-oil and gas business outside of the six-month window. In addition to strong orders from our oil and gas customers, we've also seen an increase in demand from our industrial and marine customers. So, heading into 2019, we feel very good about another strong year as we celebrate our 100th anniversary and begin our 101st fiscal year.

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

Operator:

Thank you, Mr. Batten. If you would 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, press star, one to ask a question.

We'll take our first question today from Tim Wojs with Baird.

Tim Wojs:

Hey, guys, good morning.

John H. Batten:

Good morning, Tim.

Jeffrey S. Knutson:

Good morning, Tim.

Tim Wojs:

So, nice job. I just had a few, you know, more modeling questions. I guess, if I look at the gross margin and really strong performance there in the fourth quarter, and you've done a lot just to kind of take some costs of the business, I'm just curious what you would think is kind of a normalized incremental margin today relative to maybe—and how that compares maybe relative to the history. I know (inaudible) can kind of be hard there, but just kind of curious what you're thinking normalized incremental should look like from here.

Jeffrey S. Knutson:

Yes, we ask ourselves that a lot, Tim, because we have seen a very strong quarter, and obviously, this was—and we've never seen a margin level like this at these volume levels. So, you're right, we have taken costs out, but we're also benefiting from a very strong mix. So, as far as incremental, I think we saw something like 53% incremental volumes this quarter. I think that was very strong. I think, as we head in the first quarter, what we realized is the first quarter is always challenging with the shutdowns and restarting the factories after shutdowns, lower volume levels, so I think we're looking at the fourth quarter as one that will be challenging to match, especially as we roll into the first few quarters, but our expectation is to stay in the mid-30s.

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Tim Wojs:

Okay.

Jeffrey S. Knutson:

Does that answer your question?

Tim Wojs:

No, no, that's helpful. Then, I know you've given EBITDA margins for Veth, but is there a way to kind of think about what the gross margins should look like, so we can just kind of make sure the modeling is accurate?

Jeffrey S. Knutson:

Yes, I'll be honest, Tim, we're still figuring out—because they have never reported in a U.S. level, breaking out their costs between cost of goods sold and ME&A the way we need them to, so we believe their margins will be in line with, so sort of in that 30% to 35% range is what we think it'll shake out to, but we're still working through the details there.

Tim Wojs:

Okay. Then, any sense for what the purchasing accounting impacts for Veth could be? My guess is you'll probably include those in your reported numbers. Any sort of just kind of, you know, dollar figures there, estimates that we could think about?

Jeffrey S. Knutson:

I'll say it's pretty early. We're going through the valuation work now, but I think we'll have some pretty significant amortizations to talk about. In particular, the year one amortization of a wright-up of inventory, I think that's something we would expect would be significant at this point.

Tim Wojs:

Okay.

Jeffrey S. Knutson:

So, significant, when I say "significant," in the probably $4 million to $5 million range year one, is what we're estimating.

Tim Wojs:

Okay, okay, great. Then, when we think about—so, it looks like you're planning for a pretty considerable uptick in cap ex for this year, so how should we think about free cash flow as you look at fiscal '19? I think you've been breakeven the last couple years. Even though you have higher cap ex, should you be able to generate positive free cash flow for fiscal '19, or is that the target?

Jeffrey S. Knutson:

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It is, yes. I think we continue to target, I think we'll—depending on the timing, the spending on that cash, around that capital, it will be a little bit lumpy, so I think we'll have some pluses and minuses, but I think we'll continue to drive to be positive free cash flow.

Tim Wojs:

Okay, and then the last one. John, just on the overall market within maybe oil and gas, how do you feel position-wise? You guys are, you know, maybe, relative to some of your competitors. Do you feel like you're gaining share or do you feel like you're kind of just growing in line with the market? Secondly, how would you consider the pricing environment today to maybe other oil and gas recovery situations?

John H. Batten:

All good questions, and wrapped up in one question. Certainly, the market is growing, so we're enjoying that. I do believe we're gaining market share. We're gaining market share in our units going in to replace existing units and rebuilds and refits for other customers, so I do think we're getting some incremental market share, but there is no doubt that the overall market is growing, and it's really looking back at a lot of the rebuilds that weren't done, really, between 2014 to 2017. So, there's new unit construction, we think we're gaining incremental market share there, there's the refit activity of our units going in and taking out other brands, so I think we're gaining market share there, but, really, what's—one of the limiting factors for the whole market, in general, is just capacity and getting that supply chain even further up to speed.

We're addressing, as I mentioned in the beginning in some of the comments, we're going to help address some of our internal capacity by getting some additional square footage down in oil and gas country, down in Texas, to help free up some space here in Racine, which we need for new cap ex, but also to expand our existing assembly operation here in Racine. So, I think you'll see some additional chess moves from us in the coming months to help grow our capacity and our market share even further.

Tim Wojs:

Okay, and then how would you characterize just the pricing environment today, you know, relative to prior recoveries? It sounds like it should be pretty good.

John H. Batten:

The pricing opportunity certainly is better. I mean, everyone's reading the same headlines, short supply, inflation, tariffs. As long as you can keep your delivery up to match what you have to do in pricing, I think you'll be okay.

Tim Wojs:

Great. Well, nice job on '18 and good luck on '19, and with the 100th anniversary.

John H. Batten:

All right, thank you very much.

Jeffrey S. Knutson:

Thanks, Tim.

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Operator:

As a reminder, press star, one if you have a question. We'll pause for a moment.

Next, we'll hear from Simon Wong with Gabelli & Company.

Simon Wong:

Hey, good morning, John and Jeff.

John H. Batten:

Good morning, Simon.

Simon Wong:

Just a couple quick questions. With the completion of your Veth acquisition, what percent of your business is now energy-related?

John H. Batten:

Yes, Simon, that's a good question, because that percentage fluctuates drastically depending on the year we're in. Obviously, with that, it lowers that base. What would you…

Jeffrey S. Knutson:

I would say it probably lowers it by 10%. Yes, I would say by 10%.

John H. Batten:

Yes. Maybe it's a third. Maybe we're looking at between 30% and 40% as we roll into fiscal '19.

Simon Wong:

So, it looks like $100 million of your business is energy-related. Would you be—on a more strategic question—would you be interested in further reducing the cyclicality of business by separating the energy and marine business, or do you think the energy business has enough scale to stand on its own?

John H. Batten:

I think the energy business on its own, as it relates to us, is hyper-cyclical. I think that would be a tough business to stand on its own. What's nice is how—in our transmission business, we have military, we have ARF, we have oil and gas. In marine, we have energy-related and offshore, but we also have the brown water and the push-boat activity. Then, you have industrial as a base that has some energy and oil and non-energy. I think the businesses in marine and transmission are best left together, because you're using a lot of the same technology and assets to play in different markets.

Simon Wong:

Okay. Then, just staying on the energy side, I'm hearing or seeing the pressure pumping market to be balanced, slightly oversupplied. I'm also hearing the providers, or some of the service providers are

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seeing white space on the calendar. Can you describe how your order rates have been holding up in light of all this? Are your customers delaying or deferring deliveries, given that dynamic?

John H. Batten:

I would say months have been lumpy, but, in general, quarters have been equally as strong, and we certainly, Simon, have not seen any requests for white space or delay in delivery.

Simon Wong:

Okay, that's good. Then, going back on the Veth acquisition, any incremental or extra expenses associated with integrating this acquisition?

Jeffrey S. Knutson:

There will be some, sure. I don't think it will be—in terms of cash expense, I don't think it will be a real—I don't think it'll move the needle in fiscal '19. I think we had recorded the great bulk of the transaction costs to get the deal done in fiscal '18, so that should be behind us. I think we'll see some marginal incremental costs for integration.

Simon Wong:

Okay, and then finally, I'm just wondering, your tax rate, 28.5%, a little higher than I expected. What's the reason for that and what's the outlook for '19?

Jeffrey S. Knutson:

Yes, if you remember, we're—because we're a June 30 fiscal year, our tax rate is blended this year, so it's part of the old rate, part of the new tax law, so it will go down as we roll into fiscal '19, statutory in the U.S. So, we would expect it to be in that 24%, 2.5% kind of range, depending on the mix of where the earnings are taking place.

Simon Wong:

Got it. Thank you so much.

Operator:

As a final reminder, press star, one if you have a question. We'll pause for a moment.

That will conclude today's question-and-answer session. I'll now turn the conference over to Mr. John Batten for any additional or closing comments.

John H. Batten:

Thank you, James, 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. We look forward to speaking with you again in October on the close of our fiscal 2019 first quarter, and hope that many of you shareholders will be able to join us for our Annual Meeting in October, when we celebrate our 100th anniversary, and you'll have a chance to look for yourselves at our 100ths anniversary gallery at the first floor of corporate headquarters.

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James, with that, I'll turn the call back to you.

Operator:

Thank you. That will conclude today's conference call. Thank you for your participation. You may now disconnect.

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