Twin Disc, Inc.

Fiscal First Quarter 2017 Investor Conference Call

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CORPORATE PARTICIPANTS

Stan Berger, *SM Berger & Company, Moderator*

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

CONFERENCE CALL PARTICIPANTS

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

Walter Liptak, *Seaport Global Securities, LLC*

PRESENTATION

Operator:

Good day, everyone, and welcome to the Twin Disc Fiscal First Quarter 2017 Investor Conference Call. Today's call is being recorded.

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

Stan Berger:

Thank you, Vicki. 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 2017 first quarter 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 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 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.

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

John H. Batten:

Thank you, Stan, and good morning everyone. Welcome to our fiscal 2017 first quarter conference call. As usual, we begin with a short summary statement, and then Jeff and I'll be happy to take your questions.

Before Jeff goes over the first quarter results, I'd just like to take a few moments to go over some of the key operational points of the first quarter. Despite 4.1% lower sales in the fiscal 2017 first quarter versus the prior year, gross margin improved from 21.9% to 25.7%, which represents an $8 million to $10 million cost of goods sold that we have taken out of the organization in the past 12-months. Additionally, our first quarter ME&A spending is $12.5 million is the lowest that we have spent in over a decade, and this was done without sacrificing our product development pipeline.

A year ago, after seeing the rapid decline in our backlog due to the low price of oil, we set out to make out business "oil and gas" proof and profitable at $200 million. We firmly believe that we are on-track for a lower break-even point. When comparing our end markets to a year-ago, it's hard to point to one that's currently doing better. A year-ago, we entered the new fiscal year with a larger, but declining backlog as market conditions were quickly worsening. This year, we have entered the new fiscal year with relatively stable trends from 2016, our first quarter has historically the weakest quarter both on the top line and the bottom line, and this should prove to be true this year, as well.

Our Sales Group continues to spend a lot of their time going after new applications and is focusing heavily in our Industrial market to expand our growth potential. While I'm happy to report that we have won new business in several different applications, we are still at the early stages of shipments, and still in weak market conditions.

Now, I'll turn it over to Jeff who will quickly go over the results of the quarter.

Jeffrey S. Knutson:

Thanks, John. Good morning everyone. I'll summarize the first quarter results; sales of $35.8 million for the first fiscal quarter were down about $1.5 million or approximately 4% from the prior year first quarter. This decline is largely due to reduced activity in the Asian market for the Company's Commercial Marine products. North American and European Commercial, Marine, and Industrial product demand was stable compared to the prior year. I'd also point out that while the year-over-year comparison is relatively flat, global demand for the Company's oil and gas related products remained severely depressed through the first quarter, inline with global market activity.

FX had just a small positive impact on sales in the first quarter, compared to the prior year. Despite the $1.5 million decline in sales, as John mentioned, gross profit increased by nearly a million dollars and our gross margin percent improved by 370 basis points, to 25.6% in the current quarter, compared to 21.9% in the prior year first quarter. This positive result is reflective of the Company's aggressive cost reduction initiatives over the past several quarters in response to very difficult market conditions in many of our end markets.

Spending on marketing, engineering, and administrative costs of $12.5 million, declined $2.8 million or 18% compared to the prior year first quarter, and was also the result of previously announced cost reduction actions and a global focus on managing costs, along with reduced pension expense and lower spending on corporate development activities in the quarter.

We remain committed to optimizing our cost structure, in light of current market dynamics, recording an additional restructuring charge of nearly $600,000 in the second quarter related to manpower reductions at our US and European operations. With the improved margin performance and reduced ME&A spending in the quarter, our operating loss improved nearly $3 million compared to the prior year on lower sales volumes.

Our effective tax rate, after adjusting for non-deductible losses and a full valuation allowance jurisdiction, was slightly higher at 39.6% due to jurisdictional mix and reduced foreign tax credit. Net loss for the quarter of $2.7 million or $0.24 per diluted share was improved from the prior year loss of $4.3 million or $0.39 per diluted share.

EBITDA for the first quarter was negative $1.8 million, an improvement of $2.4 million compared to the prior year first quarter. Our balance sheet remains in a very strong position, with net cash of $6.4 million, debt to total capital of 7.8%, and over $11 million of availability on our revolving credit facility.

After reducing inventory 17% in the prior fiscal year, inventory was relatively flat in the first quarter of fiscal '17, after a somewhat biased supplier issue. While free cash flow was negative $3.2 million for the quarter, this reflects an improvement of $1.6 million from the prior year first quarter, and continues a positive trend on a trailing 12-month basis. We remain committed to optimizing free cash flow including close management and prioritization of capital spending on key new products, global sourcing, and process improvements.

With that, I'll turn it back to John.

John H. Batten:

Thanks, Jeff, and now, I'll spend a quick moment on our outlook. While our backlog dropped from 35.7 million to 33 million during the quarter, we remain optimistic that there are enough opportunities in front of us to make fiscal 2017 a better year than 2016, both on the top line and bottom line. No doubt that the markets are still facing headwinds, but we have been very encouraged by the recent application and quoting activity in the oil and gas market, specifically, the pressure pumping area.

I don't think any of us realized the full extent of the percentage of the North American frac fleet that is non-operational. We have heard anywhere from 35% to 50%. While it's hard to know the true number, it is clear that the days of picking up functioning frac rigs for pennies on the dollar are over. Furthermore, the amount of cannibalization of operator's current fleets has been significant. We have quoted more replacement units than new units in the last month, then we have in the last year and a half. We will be able to book and to ship in the second quarter, if these orders materialize.

We are not calling this a recovery, but it does appear that even to continue at this level of activity, and at this price of oil, the overall fleet needs some refurbishment. As always, we will manage our balance sheet, both to be able to respond to this new business, but any corporate development opportunity that comes our way.

Finally, on behalf of Management and the Board, Jeff and I would like to thank all of you for your continued interest, your questions today, and your continued support of the Company.

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

Operator:

Thank you and if you would like to ask a question, please press the star key, followed by the digit one on your touchtone telephone. Make sure your mute function is turned off to allow your signal to reach out equipment. Again, that is star, one to ask a question.

We will take the first question today from Josh Chan with Baird. Please go ahead.

Josh Chan:

Hi. Good morning, John and Jeff.

John H. Batten:

Good morning, Josh.

Jeffrey S. Knutson:

Good morning, Josh.

Josh Chan:

Good morning, just wanted to ask for a little bit more color on the oil and gas comments. Obviously, those are very encouraging and so basically, how broad-based are those discussions? What does that tell you about kind of the inventory on the field? Do you think the inventory has been absorbed, at least in certain regions?

John H. Batten:

Yes, it's—again, it's going to be, you know, the percentage of operational versus non-operational will be different at every company, but kind of the themes that we're hearing is a lot of people were out in the last two quarters, even the last year, trying to pickup good rigs for pennies on the dollar. It seems that those were picked up a long time ago and the frustration that you can't find good rigs for sale. So, those that are in need of equipment are having to buy equipment that needs refurbishment and so the trade-off now is do we refurbish this, replace it, or do we buy new equipment? I would say on balance, right now Josh, that it's—what we're seeing is it's probably 60/40, 60% of what we have been quoting is new, for actual new, a completely new rig; 40% would be for replacing—well, we know that they're replacing the transmission at least, and they're probably having to go through the engine and the pump. But it's been primarily I would say to this extent, most of it has been in North America, and most of it's been, you know, in the Texas area, so even for some harder applications, you know, higher horsepower.

Josh Chan:

Okay. Why do you think the activity picked up in the last month, that quickly I guess, and then what do you think their urgency in terms of customer's placing orders? Do you think it's…

John H. Batten:

I think a lot of—I mean, a lot of the companies that we've been dealing with, it always seems that they're dealing with a 10-1 cap ex budget, and so I think a lot of them have been getting quotes out because they need to do some work or they're going to have budgets that have been improved in October. That's just been historically our experience, both Canada and in Texas. I think the realization that they've been running the rigs a long time, and I've mentioned in past calls, we knew that our equipment was running, but we were—we knew that it was lasting a long time, but we had hoped that there had been a somewhat higher order rate for the aftermarket parts to support it.

It seems that we're coming to that point that even to continue, you know, we're going to see some aftermarket activity, and then of course, some unit activity. I think it's just everyone's been running the rigs and doing the same thing, rather than buy a part, if they have it sitting on another rig somewhere, they've just been stealing it from that so it seems that everything is—I can't say because we don't sell to everyone in the market. So, I'm dealing with our set of customers that have come to the point where they can't continue to steal from parked rigs because that's already been done.

Josh Chan:

Okay, that's encouraging. That's good to hear. So, on the margin front, you mentioned that Q2 you should see kind of a seasonal step-up, and you've done some cost reductions, so should we see kind of a step-up in Q2 gross margin as well, versus what you did in Q1 which is very, very good already?

John H. Batten:

Yes, I would say if—I would hope to see a step-up, but I'd just like to prepare you that it may be flat. We've also run into the amount of shipping—the first quarter and the second quarter, both are challenged, they have fewer shipping days then the second half of the year. It's really going to come down to the aftermarket component that's going to help on the gross margin line and how we do there. Certainly, if we get some oil and gas orders that we can book and build in the second quarter, I definitely would see a strengthening, but I would just caution that any real gross margin improvement opportunities in the second half of the year from where we were the run rate in the first quarter.

Josh Chan:

Okay, and then, you mentioned that you won some new business. What markets are those in?

John H. Batten:

It's industrial; it's been some components that go into oil and gas that are not transmissions. They're pump drives, pump drives on some airport-type equipment, tugs, moving planes around. We've shipped some into the military for some compressor applications, some of our new PTOs that are coming out, the remotely actuated for some snowplow applications in Canada, so snowplows that are bigger than you and I are used to. Just some taking business back in some wood chipping with new HTPOs, so it's been pretty balanced, but again, it's just in its infancy and again, the overall markets are struggling so hopefully, going forward in the quarters, and years to come this is a good base for growth.

Josh Chan:

Okay, and lastly for me, sounds like you're expecting maybe a little bit better demand soon. So, how do you balance kind of near-term costs with having enough capacity to support kind of the initial uplift in demand?

John H. Batten:

That's a see-saw; it's a balancing act. Kind of want to get some clarity on whether or not this activity—how big it is, how sustainable it is, is this, you know, what we've been quoting and hopefully, get. Is it just a blip or is it a sign that, you know, the business—that the oil and the frac fleet has bottomed out as far as new construction or refurbishment activity and do we see growing trends. It is a concern. We have taken a lot of cost out. The majority of the cost has been here in our Racine operations, which had the biggest impact of Asia Marine coming down, and the oil and gas coming down. So, fortunately it's localized and it's something that we can monitor on a week-to-week basis as far as what resources we need here to capture the business going forward. But, we went into the oil and gas downturn with a significant amount of inventory that we have, so our ability to respond on any up-cyle right now is far better than it ever has been in the past.

Josh Chan:

Sounds good, yes. Thanks for the time and good luck in the next quarter.

John H. Batten:

Thanks, Josh.

Operator:

We'll now go to Walter Liptak with Seaport Global.

Walter Liptak:

Hi, thanks. Good morning, guys, and good work on the hard work of managing through the downturn and it's going to show up in the gross margin. I wonder if we can continue the conversation about the oil and gas markets. I wonder if maybe you can put in perspective what the, you know, the quoting activity that you talked about over the last month? Maybe, number of units, type of units, geographic region (inaudible)?

John H. Batten:

Sure, it's been—Walt, it's been primarily the 8,500 and it's variant to 8,700 which is the 3,300 horsepower variant. It's been primarily for—I would say Eagle Ford applications, higher horsepower. But, understanding that it's going to be—these rigs need to either have come out of dry gas or need to be used in dry gas and everything else. There's been a little bit of activity and interest in the 7,500 for some lower horsepower activities, but primarily it's been 2,500 horsepower and above. One of the trends that I think that we're seeing on a macro-level is that there's probably going to be fewer players, rig builders going forward. Just some of them have not made it through, some of the rig builders, some of the smaller operators. You know, what is the trend going forward? Are they're going to be larger frac builders? Is it going to be more of a lease-type activity to the big guys for oilfield services?

So, I'm encouraged to see that the demand has still been now coming out of this slump, at least on the quoting activity, and the application on the higher horsepower side, because that definitely bodes well for us, that's out sweet-spot. So, certainly it hasn't ticked up yet significantly north of the border, in Canada, and certainly hasn't ticked up in Asia. So, really it's the first glimmer of hope is here in North America, primarily in Texas. But, as I mentioned in my comments, we've had more activity in the last month than we have in the last year and a half, which is good to see. We're hearing kind of the same themes and the same facts or the same comments from multiple different people. So, through triangulation, we feel that there's at least a blip coming up for refurbishment activity on the existing fleet.

Walter Liptak:

Okay. You know, I wonder if you can help us with maybe the sense of urgency from the quoting that you're getting, that you know, you made it sound like it could turn in the second quarter or is this something where we have to wait for cap ex budgets to get refreshed for 2017?

John H. Batten:

Well, I think everyone is very—no matter how big or how small the companies are, they want to make sure that they have approval to purchasing and engineering and operational guys, they want to make sure, obviously, that they have approval. But it is kind of one of those that—I get the feeling that when we get the order, when we get an order the delivery's going to be how quickly can you get X number here? So, I know it's going to be a rush and we certainly can get units out in this—the calendar fourth quarter of 2016. I have no doubt about that. We can probably get not a huge number out, but a pretty good number so everything that we've really been working on so far, they want by the end of the third quarter.

Walter Liptak:

Okay, and it sounds, you know, in the past and on this call, you commented that the products are really performing well and getting great utilization out in the field. Do you get a sense that you're gaining new customers from (inaudible)?

John H. Batten:

Yes, because a good portion of what we quoted is—on the refurbishment side is to replace someone else's transmission, not ours, so that's a market share and a new business win.

Walter Liptak:

Oh, okay. All right, that's great. Maybe, just to broaden the conversation into you, know some, of the other product categories. Any change in the outlook for pleasure craft or work boats? (Inaudible).

John H. Batten:

I think—well, I'll start with pleasure craft; I think that we have been bouncing along the most recent bottom. I would say the pleasure craft still has never recovered from the 2008 level, but we've been, you know, very happy with the success of Australian subsidiary with the joystick getting new business. We've won new business here in North America. It's just that it's coming off such a low level that the incremental gains have not been enough to offset what we've—what the commercial markets have done, and specifically, the offshore oil and gas. So, as we've seen small gains in pleasure craft, it's been dwarfed by the slowdown in offshore, which kind of came after the pressure pumping slowdowns, specifically in Asia, and then in North America.

Still have applications, orders, shipments for North American oil and gas offshore, but it's been very, very, very slow in Asia, and when you couple that with—we had a lot of business in to coal barges, you know, bringing coal up from Indonesia to China. We had some inventory there so we're selling out of inventory, but hopefully, you know as we go into 2017, that that will improve. Certainly, everything that we're hearing for our markets is that calendar 2017 should be a better 12-months than calendar 2016. But for offshore oil and gas, you know, I think to get back to what we consider good healthy levels is going to be at the end of 2017, going into 2018.

Walter Liptak:

Okay, and in industrial, you know, we've been kind of choppy I guess, in some of the more mechanical products. I wonder can you comment on any trends you saw in the quarter.

John H. Batten:

Yes, again, I'm going to go back to the comments I made last time. We were surprised at how much of our industrial business and our customer's business was driven just by the activity in oil and gas. We're seeing, I would say the industrial orders have been stabilized. I'm hopeful that calendar 2017, again, will be a better year. We certainly going into 2017, have more possibility for growth because we have more applications that we're on, so and the sales group has been reorganized and we have different groups focused on direct OEMs, different groups focused on distribution. So, I think we're getting a lot more coverage and a lot more focused. So, I'm hopeful that even in stable market conditions, we're going to grow our industrial business in calendar 2017 and we should be able to do it.

Walter Liptak:

Okay. Okay, good. Thank you.

Operator:

If there are any additional questions, please press star, one at this time, and we'll pause for a moment. Once again, that is star, one if you have a question.

It appears there are no further questions, so I'd like to turn it back to John Batten for any additional or closing remarks.

John H. Batten:

Thank you, Vicki. Again, 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 directly here in Racine. We look forward to speaking with you again in January, following the close of our fiscal 2017 second quarter. Vicki, I'll turn it back to you now.

Operator:

Thank you very much. That does conclude our conference for today. I'd like to thank everyone for your participation and have a great day.