Twin Disc, Inc.
2011 Second Quarter Financial Results Call
January 24, 2011

Operator: Good day, ladies and gentlemen. Thank you for standing by. Welcome to the Twin Disc second quarter financial 2011 results conference call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be opened for questions. If you have a question, please press the star, followed by the one on your touchtone phone. If you would like to withdraw your question, please press the star, followed by the two. And if you are using speaker equipment, please lift the handset before making your selection. This conference is being recorded today, Monday, January 24, 2011.

I would now like to turn the conference over to Stan Berger. Please go ahead.

Stan Berger: Thank you, Alicia. 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 2011 second quarter and first half 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 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 is 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 the copy of the news release which was issued this morning before the market opened. If you have not received a copy, please call Annette Mainaki (sp?) at 262-638-4000 and she will send a copy to you.

Hosting the call today are Michael Batten, Twin Disc's Chairman and Chief Executive Officer; John Batten, President and Chief Operating Officer; and Chris Eperjesy, the Company's Vice President of Finance, Chief Financial Officer, and Treasurer. At this time, I will turn the call over to Mike Batten. Mike?

Michael Batten: Thank you, Stan, and good day, everyone. Welcome to our second quarter 2011 conference call. Today, I will start with a brief statement and then John, Chris, and I will be available to take your questions.

We assume that you have already read our press release. Twin Disc posted financial results for the quarter that continued to improve sequentially, as well as year-over-year. Diluted earnings per share for the quarter rose $0.35 per diluted share compared to a loss of $0.04 per diluted share for the same period a year ago. Our backlog rose to the highest level in the past two years, and we expect continued improvement in the second half of the fiscal year.

Sales for the second fiscal quarter of fiscal 2011 were 75 million compared to 55 million for the same three months in fiscal 2010. For the first six months of the current year, sales totaled 137 million compared to 102 million for the first half of fiscal 2010. The growth in demand resulted from strong sales of our pressure pumping transmissions through the oil and gas market. The market for unconventional drilling remains robust. Orders for our 8500 series transmission systems have returned to peak levels. Stable demand was experienced in our ARFF land and marine-based military and commercial marine markets. We continue to see challenges in the pleasure craft marine market.

Gross margin for the second quarter of the current year was 31.6% compared to 26.8% for the same quarter a year earlier and 32.6% for the first quarter of fiscal 2011. The significant improvement in margin compared to a year ago was due to increased sales volumes, improved manufacturing efficiencies in absorption, as well as more profitable mix of business.

The sequential decline in margin from the first quarter of 2011 resulted from a shift in product and market mix from the previous three months. Year-to-date gross margin was 32.1% compared to 24% for the first fiscal half of 2010.

Marketing, engineering, and administrative, or ME&A, expenses for the current quarter were 24.8% compared to 27% for the second quarter of fiscal 2010. Of the 3.7 million increase in ME&A expenses between the two comparable quarters, approximately 2.2 million, or 58%, was the result of increased stock-based compensation driven by the increase in the Company's stock price in the current second quarter, as well as domestic bonus expense.

Year-to-date ME&A expenses as a percent of sales were 24.5% compared to 27.1% for the first half of last year. Of the 5.7 million increase in expenses between the two years, 4.2 million, or 73%, related to stock-based compensation and domestic bonus expense. The net remaining increase in ME&A expense both for the quarter and the half was driven primarily by higher salary and benefits, increased travel and project related expenses, and a continuing emphasis on our product development program.

The effective tax rate for the first half of fiscal 2011 was 23.6%, which is significantly lower than the prior year rate of 37.6%. The rates for the comparable second quarters were 11.5% and 37.1%. The current year's rate includes a $794,000 benefit resulting from the increase in the estimated tax rate from 34% to 35%. The current year also includes the favorable impact of the reinstatement of an R&D credit that was passed into law during the second quarter of fiscal 2011.

Net earnings for the second quarter of fiscal 2011 were $4 million, or $0.35 per diluted share, compared to a net loss of 490,000, or $0.04 per diluted share, for the three months a year ago. Year-to-date net earnings totaled 6.7 million, or $0.59 per diluted share, compared to a net loss of 2.9 million, or $0.26 per diluted share, for the first half of fiscal 2010.

Our balance sheet remains strong. We've generated 4.4 million in cash during the current quarter. Total debt, net of cash, was 6.4 million at the end of the three months compared to 12 million at the end of fiscal 2010 and 9.7 million at the end of the first quarter.

Working capital increased to 103 million in the quarter, reflecting a 20% increase in inventories to support the growth of the oilfield business. In addition, we expect capital expenditures to be about $15 million for the current fiscal year as we continue to reinvest in new machine tools and programs to fund our anticipated growth.

Our backlog of orders to be shipped in the next six months was a $119 million at the end of the second quarter compared to 100 million at the end of the first quarter and 70 million one year ago. We are clearly benefiting from the resurgence of oil and gas exploration and development.

Orders and shipments of the 8500 series transmission are at record levels, and the development of the 7500 series transmission system is ongoing. 7500 series units have been delivered to customers for field testing, and we anticipate this process to be completed over the next few months, with initial production units shipping in the fourth quarter of fiscal 2011. We are optimistic about our business prospects as we enter the seasonally strong second half of the fiscal year, and our product and geographic diversity continues to serve us well.

That concludes my prepared remarks, and now John, Chris, and I will be happy to take your questions. Alicia, please open the line for questions.

Operator: Thank you, sir. As a reminder, ladies and gentlemen, if you have a question, please press the star, followed by the one on your touchtone phone. If you'd like to withdraw your question, press the star, followed by the two. And if you are using speaker equipment, please lift the handset before making your selection.

And our first question is from the line of Peter Lisnic with Robert W. Baird. Please go ahead.

Peter Lisnic: First question on the gross margin. The adverse mix from first quarter to second quarter, is there any way of giving us a little color commentary on what the impact exactly was on the mixed volume?

Michael Batten: Sure. John, do you want to handle that?

John Batten: Yes. Pete, it's two parts. It's product, market, and geography related. Oil and gas has pretty strong margins, as you know, but we saw, as a percentage of sales, an increase of the marine business and primarily coming out of Europe. And the European facilities are still not operating at full potential, so as their business level, in terms of dollars, the euros, increases, it actually has, as a percentage of the wholesale, is kind of a downward pull on the gross margin. Short term, it's not a good thing on the gross margin, but for us in the long term, it's definitely headed in the right direction to get them back up and operating at full potential.

Peter Lisnic: Okay, and then if you continue that or, I guess, if you look for the second half, should we assume gross margins—there is that dampening effect from Europe and thinking of production there, or should we see sort of a reacceleration in the gross margin or the incremental gross margin in the second half?

John Batten: I would see the gross margins improving in the second half.

Peter Lisnic: Okay, all right. And then when you look at the mix in backlog, can you maybe give us a sense as to how that's evolved over the past quarter or, too, are we seeing a significant piece of that becoming oil and gas like we have? Is it more significant than in the past, or maybe some quantification on what exactly is in backlog?

John Batten: Yes. For oil and gas, it's definitely still at a record backlog. But, I guess, I'm happy to say that aftermarket, industrial, and some of the commercial marine backlog has also improved.

Peter Lisnic: Okay.

John Batten: It's just not oil and gas.

Peter Lisnic: So you're across—okay. So it's across the board improvement.

John Batten: Yes.

Peter Lisnic: Okay. And then if we're, what, two quarters away from 7500, I guess, maybe being out there and being sold outside of fuel production, is it safe to say that you've got 7500 in the six-month backlog number now or no?

John Batten: They're not—they're very—we have very few that would be in the six-month backlog, but I see that changing over the next month or two. We have—I mean assuming we finish the field test in this quarter, we will be shipping in the fourth quarter. How many, I can't say for sure, but we're definitely—I've got inventory coming in, so we're getting ready to produce and to ship.

Peter Lisnic: Okay, great. And then last question, Chris, I guess with the growth in backlog and sales, can you give us a feeling for what the second half working capital requirements might be of significant or further significant inventory and receivables billed (sp?), or how should we think about the back half working capital?

Chris Eperjesy: You know I think you're seeing a lot of that already, so I don't know that we're expecting the significant increase in working capital. Certainly, you've seen the increase in inventory which is an anticipation of what John just described in terms of the oil and gas markets. So I don't think we're expecting a significant increase in working capital.

Peter Lisnic: Okay, perfect. Thanks for your time and nice quarter.

Chris Eperjesy: Thanks.

Operator: Our next question is from the line of Greg Garner with Singular Research. Please go ahead. Mr. Garner, your line is open.

Greg Garner: I'm sorry, I had it on mute here at my end. My mistake. First of all, thank you for taking my question and very nice quarter, gentlemen. Regarding the 8,500 that's selling at peak levels right here, how does that—how might that change your view on the market size for the 7500,? Are there potential demands for the 7500? Is that moving up to a higher level of drilling activity or of pressure pumping demand? I'm just wondering if the dynamic is changing here for the sizes of these two end markets.

Michael Batten: John, do you want to get that?

John Batten: Exactly. Greg, that is a good question. I think it’s changed somewhat over the—this last six months for us. The 8500 is definitely being used in some lower horsepower applications that it wasn't before, just because the demand for overall pressure pumping is so great. You would think that that would eat into the demand of the 7500, but these rigs are now engineered, and I do believe that some rig builders are looking at the 7500 as additional capacity in pressure pumping in general, kind of at the horsepower it’s targeted at and maybe even below. Because regardless of your—whoever is producing the pump, the transmissions, or the engines, there is still is a shortage of supply into the pressure pumping market, currently. So I think when we—when the 7500 goes into production, I guess the way to answer your question is, we don't think it's going to take that much away from the current 8500 business because no one wants to slow down a rig that's been engineered and designed and in production. So I hope that answers the question.

Greg Garner: Okay. And if this is a new horsepower range market for Twin Disc, who would you be taking share away from?

John Batten: Well, currently the dominant player in this range is Allison. Caterpillar also has a transmission in this horsepower range, but I would say everybody in the market is scrambling to keep up with the demand.

Greg Garner: And would you be able to release any info on how many field tests are going on right now or how many have completed?

John Batten: We currently have three, and we should be adding another two in the next four to eight weeks to be more thorough but hopefully move the process along at a quicker pace.

Greg Garner: And the increase in cap ex, I presume that has to do with the production of the 7500 primarily? Is it proper to look at it that way?

John Batten: Well, it has to do with the 7500, but no, it's more an increase in just internal machining on our core competencies, whether it's a complex housing or gears. So of that some of it will be definitely used on the 7500, but it's not solely for the 7500.

Greg Garner: Okay. And then finally, a question about the commercial marine. That is the area on the marine side that's showing some increases. Is that right versus the pleasure craft is not really picking up yet? Is that…

John Batten: Yes, the pleasure craft is improving but it's still at, with respect to 2008, still at low levels when you look back two years. Commercial marine did not have that kind of fall off. It had some quarters that maybe up and down in shipment and order levels, but overall we're more optimistic now than we were even six months ago on commercial marine, primarily again driven by Asia, North America, and some business in South America as well.

Greg Garner: And the Joystick is primarily for the pleasure craft, is that right?

John Batten: Well, the first applications were targeted at pleasure craft, but it can be applied at this point on vessels, be the twin engine—any twin engine vessel with our QuickShift Transmissions we can apply the Joystick System. So it's a fairly complex product to design and to release and do the application work, so there are some pleasure craft builders that we're working with, but we're looking to move into some of the commercial markets like patrol boats, pilot boats that could also benefit from the technology.

Greg Garner: Okay. And one final question on the pleasure craft, is there any sign that that might be changing or is there any leading indicator that there's more inquiries from the boat manufacturers of any kind, or is that still looking weak?

John Batten: Well, in some of the yards in the US, in Australia, some yachts are produced from the Far East and even in the UK and some in Italy. You know there is an increase in employment level in production. If you're looking for a macro indicator, as the stock market typically does well in the US and Europe and oil does well, we would hope that that would drive increased demand in the mega yacht market. It has in the past. Whether it happens this time remains to be seen.

Greg Garner: Okay. All right, thank you very much.

Operator: Ladies and gentlemen, if there are any additional questions, please press the star, followed by the one at this time. And as a reminder, if you are using speaker equipment, please lift the handset before making your selection.

The next question is from the line of Jon Braatz with Kansas City Capital. Please go ahead.

Jon Braatz: Good afternoon, gentlemen. A couple questions. Can you speak a little bit about your production capacity? You’re bringing on some new equipment, and I assume that's going to enhance production rates. Can you talk a little bit about how you see second half production rates relative to maybe first half, John?

John Batten: Well, we definitely see the second half being higher than the first half in production, both in hours and dollars. And it should be a fairly good jump.

Jon Braatz: Okay. And I assume that essentially the oil and gas, what we are talking about, right?

John Batten: Well, it's oil and gas. Obviously, the pressure pumping units in aftermarket, but also industrial and aftermarket in general for commercial marine and the industrial products.

Jon Braatz: Okay. Can you talk a little bit about pricing and lead times in—for the oil and gas products?

John Batten: Sure. We just had—for most products here in the US, we had an October 1—in North America an October 1 price increase. We're looking at surcharge levels right now and we're looking at what would need to be done maybe in the next coming up year as far as any pricing actions. Lead times are probably right now for oil and gas in the 8 to 10 months range right now for pressure pumping units.

Jon Braatz: Okay. What was the October price increase?

John Batten: Depending upon the product, it ranged from 1% to 6%.

Jon Braatz: Okay. Would you think the expected surcharges would be similar to that going forward?

John Batten: Yes. If the end of the second quarter, surcharge is starting to creep up a little bit, that definitely—I mean the 1% to 6% depending upon the product is not—wouldn't be out of the range again for this year.

Jon Braatz: Okay. As I look back historically at your ME&A cost as a percent of revenue back in 2008, 2007, it was around 20%. Today, we're sitting at 24%. Is there any structural reason that we might not be able to get back to those levels? And then secondly, as it relates to the second quarter, were there any catch-up accruals in the second quarter regarding bonuses or stock compensation expenses or anything like that that may not be there in the third and fourth quarters?

Michael Batten: Chris, do you want to take that?

Chris Eperjesy: Yes, let me take that. I guess the answer to the first question, you know, the 24% is on a lower volume level, so I guess the answer to the first one, there is no reason why we couldn't back to that 20% range.

Your second question, you know as we noted in the press release, there weren't any catch-ups with respect to the bonus expense. The bonus plan was frozen last year, so there was no bonus expense. I disclosed them, both in the first quarter and the second quarter what the impact was, which was just under a million for both quarters. So that takes care of bonus expense. With respect to stock-based comp, there was a catch-up on both the second and the first quarter. The second—the first quarter catch-up related to awards for a future year coming, I'll say in the money, so we had five quarters of catch-up. The second quarter, the stock price moved from, I think, roughly $13 to just under $30 from basically the end of September till the end of December. So that was—obviously had an impact on the stock-based comp.

To give you a relative idea, at the stock price at the end of the second quarter, which was just under $30, going forward without any other adjustments, that we translate to a normalized just over $800,000 for stock-based comp expense. So that gives you kind of the rough magnitude of what the catch up was in the second quarter.

Jon Braatz: Okay. So going forward, if this—not that we want this to happen, but if the stock stayed flat there would be no additional stock-based comp in the second half?

Chris Eperjesy: There would be no additional catch-ups.

Jon Braatz: No additional catch-up?

Chris Eperjesy: Correct. Now if the stock price for some reason were to go the other way, obviously, then there would be a good (inaudible) adjustment.

Jon Braatz: Right, absolutely.

John Batten: Jon, can I just add one thing?

Jon Braatz: Yes.

John Batten: We're not looking—going forward, even as volumes return, we're not looking to go on an ME&A hiring spree or anything like that. A lot of it was some one-time things happening in the quarter.

Jon Braatz: Right. Are there, you know, relative—thinking back to 2006, 2007, are the ME&A expenses—more specifically, I suppose, marketing expenses—a little bit higher on the oil and gas business than the other pieces of the business?

John Batten: No. The answer is no.

Chris Eperjesy: Not sig—no. I couldn't get—on a dollar level, I know, but not significantly, if they are.

Jon Braatz: Okay. Thank you very much, guys.

Operator: Your next question is from the line of Rand Gesing with Neuberger Berman. Please go ahead.

Rand Gesing: Yes, hi. Good afternoon. I was wondering can you give us any help in terms of understanding the market opportunity for you guys from the 7500? I haven't really, heard you be—you know to try to size that in any which way or give us any sort of color around how we might try to size it.

Michael Batten: John, do you want to take that?

John Batten: Sure. You know, Rand, that is a—it's a moving amount for us because the market has been in such flux. But just, I guess, we had estimated that the 7500 horsepower range, what we look at as kind of 2250 to 2500, being roughly five times, maybe more than that, than what the 8500 is. I have to admit there has been—everyone has been so busy getting pressure pumping units out, whether that has remained the same or a lot of the 3000 horsepower engines and transmissions or even the 3000 horsepower transmissions which we know are being used on lower horsepower engines, how that all is shaking out. We don't know right now because everyone is so busy producing and shipping. But we still believe that the 7500, in that horsepower range, even going down to 1800 horsepower up to 2250 and a little bit is a bigger market globally than the higher horsepower market is. So we remain very optimistic that there is a big market for Twin Disc for the 7500 that is not being capitalized on with the 8500.

Chris Eperjesy: (Inaudible), it's really hard—everybody, all frac builders, engine OEMs, are scrambling to getting units out and there hasn't been a lot of market share data being complied.

Rand Gesing: My understanding is that your product is sort of one of the—is maybe the only one hitting the market that is sort of specifically designed for this application. Is that right or…

John Batten: Well, it's the only transmission that has been, you know, from the first pen to paper, so ink to paper, designed specifically for pressure pumping. All other transmissions had a life doing something else first before they were put into oil and gas.

Rand Gesing: Right. Do you envision that we'll get a little better clarity on this in the next six months into the size of the market, or do you think…

John Batten: Absolutely. Once we are delivering production units and getting in there as they've designed rigs to take them and we get into the production flow, we'll get a much better sense of how it's all been shaking out the last 12 months and how fundamentally the sizes of each market have borne out.

Rand Gesing: All right. I guess we'll stay tuned. Thanks.

John Batten: Thanks, Rand.

Operator: Once again, ladies and gentlemen, if you have a question, please press the star, followed by the one at this time.

And our next question is a follow-up from the line of Peter Lisnic with Robert W. Baird. Please go ahead.

Peter Lisnic: Yes, just a couple of quick ones. Just on the 15 million of cap ex, can you maybe talk about what that means in terms of productive capacity? Does it significantly add to what you've got in place? And then are there any sort of one-time tooling costs or setup costs that we should think about in the second half of the year as you kind of get that capacity up and running?

John Batten: Well, the answer to your second question is no, there aren't going to be any specific charges or costs for that. The capacity that we are looking at and the cap ex for this year that we're looking at for next year is really designed for us to get doubling our production capability for oil and gas. And it has a carryover to commercial marine in some of our ARFF markets, because a lot of what we do with our large housing relies on our capacity, the machines, the housings for those transmissions. So for us to grow and grow in size in those markets, we needed to increase our capacity. And it is actually reducing our footprint in Racine. We've consolidated the two plants into one plant, our larger plant, but we'll be increasing overall capacity with the new machine tool asset. So I guess to give you—you know we have to grow our ability to produce for oil and gas and commercial marine, and these cap ex expenditures are designed specifically to do that.

Peter Lisnic: And it effectively doubles your capacity to serve oil and gas? Is that…

John Batten: That is where we're headed once we have some of these key pieces in place, yes.

Peter Lisnic: And would there be incremental dollars that you need to add to that in 2012 to get to that sort of doubling run rate, or is this sort of the—kind of bulk of the expenditures?

John Batten: Well, we'll be replacing machine—some older pieces of equipment with newer ones that tend to be more efficient. Each one we add is more efficient than the previous ones. But really, the ones that are coming up are more to replace older equipment that had been doing some of the key processes for us in the past.

Peter Lisnic: Okay, got it. All right, that is very helpful. Thank you again for your time.

John Batten: Thanks, Pete.

Operator: And the next question is from the line of Shawn Boyd with Westcliff Capital Market. Please go ahead.

Shawn Boyd: Thanks and congrats on the quarter, gentlemen.

Michael Batten: Thank you.

Shawn Boyd: Just a couple clarifications here. On the ME&A expense, if I heard the commentary earlier correctly, at existing stock prices we could expect about 800,000 a quarter in stock-based comp.

Chris Eperjesy: Correct.

Shawn Boyd: Okay. And did you say what the bonus expense would be?

Chris Eperjesy: I don't anticipate any significant changes to what's been accrued in the first two quarters. It could be slightly up or down, depending on the results.

Shawn Boyd: Okay. So at the end of the day we end up around in the high 17, 17.5, 18 million in quarterly ME&A expense. Is there anything else that we need to think about that takes that structurally higher?

Chris Eperjesy: There's nothing that I am aware of that would take it structurally higher. There may have been some one-time items just in terms of the timing of some expenditures that hit the second quarter that may not be in the third or fourth quarter that could make the numbers you gave be lower, but I think directionally you're not far off.

Shawn Boyd: Okay. And then hence, we get back to that 20% of sales fairly quickly if we continue to (inaudible) revenues. Okay. Tax rate going forward, did you guys address that earlier?

Chris Eperjesy: We did not, but our number really hasn't changed from where it was in the past. There were some adjustments in the second quarter that kind of made that number, obviously, be smaller. And that's the two adjustments that Mike talked about in terms of the deferred tax asset adjustment, as well as the R&D tax credit. I mean in a typical normal quarter, depending on geographic mix because, obviously, the tax rates are different in the different geographic markets we compete—but generally 35% to 37%, I think, is a reasonable number.

Shawn Boyd: Okay. And last question. On the 7500, as this goes into production, do we have separate manufacturing sort of dedicated to that? Or would those orders sort of kind of fall in line behind 8500 orders with that 8 to 10 months lead time right now?

John Batten: Well, the lead times for the first production units would be shorter, because we have a lot of the inventory and the forgings and the castings already in-house. But it would probably be—once you're in a production run rate, the lead times would be very similar to the 8500, whether they are maybe four months together or 10 months together, they'd probably move the same. But we have a lot of the raw material in-house already for them. So we'll be quick to react and get it into production.

Shawn Boyd: Got it, okay. And on the increase in a cap ex, potentially doubling your production capacity on oil and gas, so that would take us to—can you just give us what level would that be, what kind of quarterly revenue level would that be?

Chris Eperjesy: I don't give specifics, but you could—we generally don't give that type of guidance, but obviously, based on what John has said, in terms of the increased production capability and depending on the volume and success of the 7500, obviously, it's going to be an increase.

Shawn Boyd: All right. Okay. Good enough for now. Thank you.

Chris Eperjesy: Thanks, Shawn.

Operator: And I'm currently showing no further questions. I'll turn it back over to Mike Batten for any closing remarks.

Michael Batten: Thank you, Alicia. And again, everyone, we thank you all for joining the conference call today. We appreciate your continuing interest in Twin Disc and hope that we've answered all of your questions. If you have any follow-on questions, please feel free to call Chris, John, or me. We look forward to speaking with you again in April following the close of our third quarter. Alicia, we'll turn it back to you now to close the call.

Operator: Ladies and gentlemen, this does conclude our conference call. You may now disconnect. Thank you for your participation.