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Twin Disc, Inc.

Fiscal Year 2017 Second Quarter Conference Call

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CORPORATE PARTICIPANTS

Stan Berger, *SM Berger & Company, Moderator*

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

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

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

Operator:

Good day, ladies and gentlemen. Welcome to the Twin Disc Fiscal Year 2017 Q2 Conference Call. Today's call 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, Catherine (phon). 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 Second Quarter and first six months' 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.

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 2017 Second Quarter Conference Call. As usual, we'll begin with a short summary statement, and then Jeff and I will be happy to take your questions.

Before Jeff goes over the second quarter results, I'd just like to take a few moments to go over some of the key takeaways from the second quarter and the first half of the year.

We continued to struggle with lower demands in the second quarter, almost 25% below year-ago levels, yet continue to hold or to improve our gross margins. This continues to be a focus for us across the globe.

Part of the top line miss can be attributed to almost $4 million in past due for one of our legacy military contracts. A year ago, one of our key founder suppliers went bankrupt, forcing us to move the castings for these transmissions. To say that the castings are complicated would be an understatement.

We have been working with the military and our direct customer to get these new castings approved and into production. That process is almost complete, and we began shipping in January. The $4 million in past due should flow through in the second half of the year.

Jeff will have more on margins, and while we are not satisfied with the year-over-year decline in sales, we are pleased to see the performance in our gross profit holding.

Second quarter ME&A spending continued at the Q1 level with $12.5 million, without having to slow down our product development efforts. Through a lot of hard work and inter-department coordination and lean-type exercises, we have actually been able to increase our new product development process while decreasing our overall ME&A spend.

Given our current cost structure and gross margins, we feel that we have the cost structure in place to be profitable at $200 million, probably even lower as we work to address our variable cost.

For almost eight quarters, it has been difficult to see recovery trends on the horizon. Oil's crash had a lot of collateral damage in many of our end markets. Our Sales Group continues to go after new industrial applications to expand our growth potential. Many of our new products will not have impact until fiscal 2018, where we are confident that the technology upgrade, serviceability and global support of these products will have an impact.

In total, our global end markets remained depressed in the second quarter. The bright spots were our first oil and gas transmission unit order for North America in over two years, and the abrupt pickup in aftermarket parts orders for the North American fleet. Unfortunately, this uptick did not spread over into the Asian oil and gas markets, which remain severely depressed, or the global offshore market which remains at an overcapacity situation.

Looking at bright spots beside North American oil and gas, we would have to highlight an improved demand situation for our mid-range of marine transmissions as a result of new orders for patrol boats and small workboats, and a general resilience in our European market.

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

Jeffrey S. Knutson:

Thanks, John, and good morning, everyone. Sales for the second fiscal quarter, $33.7 million, were down about $11.2 million or 25% from the prior year second quarter. Year-to-date, sales are now $12.7 million or 15% below the prior year level. The decline, as we've spoken in previous quarters, is largely due to the reduced activity in the Asian market for the Company's commercial marine product, delayed shipment due to a supplier transition issue that John just described, general softness in the industrial markets, and a decline in oil and gas transmission shipments compared, in particular, to the second quarter of last year.

As John pointed out, we have received an order for oil and gas transmissions, but had no shipments in the second quarter. We expect this should begin early in our third fiscal quarter.

FX had a small positive impact on sales in the first half compared to the prior year, about $600,000.

Despite the $12.7 million decline in sales, gross profit decreased by only $1.7 million, a drop through of 13% on the reduced volume.

Our gross margin percent improved by 200 basis points, to 26.1% in the first half, compared to 24.1% in the prior year first half. This positive result is reflective of the Company's aggressive cost reduction initiatives over the past several quarters and in response to very difficult market conditions in many of our end markets.

Also contributing to the result was an $800,000 Belgian property tax refund recorded in the current year's second fiscal quarter.

Spending on marketing, engineering and administrative costs of $25 million declined $4.8 million or 16% compared to the prior year first half. This decline 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 current year.

With the improved margin performance and reduced ME&A spending, our operating loss improved by over $2 million compared to the prior year, on lower sales volumes. We invested an additional $800,000 in the quarter, and now $1.1 million to the first half in restructuring actions, to drive additional cost reductions and efficiencies at our domestic and European operations. These actions are expected to generate annualized savings of approximately $2.1 million.

Net loss for the quarter of $2.9 million or $0.26 per diluted share was greater than the prior year loss of $2.3 million or $0.21 per diluted share. For the first half, the net loss has improved by $1 million to $5.6 million, or $0.50 per share, compared to $6.6 million or $0.59 per share in the prior year.

EBITDA for the first half was negative $4 million, an improvement of $1.8 million compared to the prior year first half.

Our balance sheet remains in a very strong position; net cash of $5.2 million, debt to total capital of 6.6% and over $16 million of availability in our revolving credit facility.

After reducing inventory 17% in the prior fiscal year, inventory was relatively flat through the first half of fiscal ’17, hampered somewhat by, again, the supplier issue that we've touched on a few times.

Our goal in the quarter was to achieve a break-even free cash flow level. We fell just short of that. We came up at negative $300,000 for the quarter but positive operating cash for the quarter. The negative $300,000 of free cash flow represents a $3.2 million improvement over the first quarter, and a $4.2 million improvement over the second quarter of the prior fiscal year.

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.

We are pleased to see our backlog improve from $33 million to $38 million in the quarter. About half can be attributed to the military past due issue, but the other half is a direct result of the improved order trends for the North American oil and gas market, and our mid-range marine market.

These improved order trends have continued into our third quarter, and we can safely say that this is the most optimistic we have seen our North American customers in a long time, for new rig construction. Our application reviews and quoting activity continues to increase.

As always, we will manage our balance sheet, both to be able to respond to any returning business, and any corporate development opportunity that comes our way.

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

That concludes my prepared remarks. Now, Jeff and I will be happy to take your questions. Catherine, please open the line for questions.

Operator:

Absolutely, gentlemen. For those on the phone lines, if you'd like to queue up for a question or comment, please press star, one on your telephone keypad. If you're on a speakerphone, please pick up your handset and make sure your mute function has been turned off to allow your signal to reach our equipment. Once again, ladies and gentlemen, that's star, one for questions.

We'll go to Tim Wojs with Baird.

Timothy Wojs:

Hey, gentlemen, good morning.

John H. Batten:

Morning.

Jeffrey S. Knutson:

Morning.

Timothy Wojs:

So, I guess, just my first question, thinking about—how to think about the model for maybe the second half of '17 and into 2018, and just as you kind of talk about some of the increased activity that you've seen in North America oil and gas. I mean, is it too early for us to think that revenue can grow in the second half of '17, or is that more of a—kind of a 2018 type of event for you guys, in your eyes?

John H. Batten:

I definitely think revenue can grow in the second half of the year.

Timothy Wojs:

Is it really just all oil and gas and kind of mid-range, and then kind of the catch-up from the military issue?

John H. Batten:

Yes, it's—I would say, either, every—with the exception of Asia, most of our global markets and end markets are either holding or improving. I would say the ones that are improving are North American oil and gas, which was effectively zero last fiscal year. So, that would be the biggest impact of a market growing, and we—there are just so many signs there that calendar 2017 is going to be significantly better than calendar 2016. Then we have a lot of projects in our mid-range, of our marine transmission market, which are definitely improving year-over-year.

How much the improvement is in the second half, I mean, I think our fiscal third quarter certainly has the potential to be the first year-over-year improvement on a quarter that we've seen in a while.

Timothy Wojs:

Okay. Then, how should we think about, just kind of the incremental dropdown on sales as you—just given a lot of the restructuring things you guys have done. I mean, from an incremental margin perspective, can we think that incremental gross profit margins could be above 50% with that revenue?

John H. Batten:

Fifty percent—above 50% might be a bit of a stretch, Tim. I think, obviously a lot of it depends on mix, and with the volume that we're getting and the orders that we're seeing now, in particular in after market, that's in the ballpark. I think we would hold ourselves in the mid 40% to 50%, I think, is a reasonable standard.

Timothy Wojs:

Okay. Then, just—John, I mean, from a pacing activity, a couple months ago when we were on this call, you were pretty excited about the quarter activity. Has it inflected higher, or is it still kind of a steady state, in terms of how you're seeing inquiries and quoting activity and that type of thing? I'm just trying to understand the trajectory, maybe, and what's changing.

John H. Batten:

I would say what has inflected noticeably higher since the last call would be the spare parts order activity, and the activity on doing application reviews for new rig builds.

Timothy Wojs:

Okay.

John H. Batten:

Which, always has to—that has to happen first before the new orders for new construction inflect. So, it's safe to say that those are the two activities that have inflected since our last call.

Timothy Wojs:

Great. Well, I appreciate the color. Good luck on '17 here, it's good to hear the encouraging signs.

John H. Batten:

Thanks, Tim.

Operator:

Once again, ladies and gentlemen, that's star, one for questions.

With no additional questions in the queue, I'd like to turn the floor back over to our speakers.

John H. Batten:

All right. Thank you, Catherine. 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 May, following the close of our fiscal 2017 third quarter.

Catherine, I'll turn it back to you.

Operator:

Thank you. Ladies and gentlemen, once again, that does conclude today's conference. Thank you all again for your participation. You may now disconnect.