Twin Disc, Inc.

Business Update Conference Call

July 7, 2020

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

Noah Kaye, *Oppenheimer*

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

Douglas Dethy, *Dc Capital Partners*

Kurt Caramanidis, *Carl M. Hennig, Inc.*

PRESENTATION

Operator

Good day, and welcome to the Twin Disc, Inc. Business Update Call. Today's conference is being recorded.

At this time, I'd like to turn the call over to Stan Berger. Please go ahead.

Stan Berger

Thank you, Matt.

On behalf of the management of Twin Disc, we're extremely pleased that you've taken the time to participate in our call, and thank you for joining us to discuss the business update relating to the COVID-19 pandemic and our business trends.

Before I introduce management, I would like to remind everyone that certain statements made during 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 and discussed related to the COVID-19 crisis, as well as other 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 the—contacting either the Company or the SEC.

Hosting today's call are John Batten, Twin Disc's 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

Thanks, Stan, and good morning, everyone, and thanks for joining us on our Business Update Call.

When we scheduled this call after our third quarter call, we had anticipated that this would be the close of our PPP funds and that we would probably be announcing some actions based—to adjust our cost structure, but as all of you know, the PPP funds were extended now through July, in which case we still have everyone here in our North American operations back at full time and with full pay, full wages.

Happy to update, though, with respect to COVID, we have just had a handful of cases through here in the U.S. All were contracted while they were out of the facility, so we've yet to have a case in the facility. All of the cases that we've had in Europe, primarily in Belgium, have recovered and are back at work. Here in the North American operations in Racine, we have not had to shut down because of any PPP—sorry, PPP—we've not had to shut down operations because of COVID-19, and our facility—the Veth facility in the Netherlands also never shut down. However, we did have to shut down in the third—in the fourth quarter in Belgium, the two plants in Italy, and one in Switzerland.

The COVID activity certainly has had another impact on our incoming order rates that we talked about at the end of the third quarter. Order rates have dropped significantly on a non oil and gas business. That trend has continued since our—we talked in May. We don't anticipate anything really changing in the next month, so actions that we were considering to take at the end of the PPP funds at the end of June will most likely—we'll be talking about those at our fourth quarter conference call coming up in August.

Looking at our order rate globally, I would say the market—the geographic market that has been impacted the most is North America. This is after oil and gas, which was down significantly, obviously, from last year, but our—just our normal marine and industrial and other transmission order rates for the U.S. and Canada were down significantly. I say that order rates have recovered in Europe after that initial COVID panic, I would say. Industrial and marine are doing nicely. We have service work out of our plants in Italy, and a very healthy service order board from the Veth facility in the Netherlands.

In talking to some of our distributor principles and customers here in the U.S., it's obvious that our customers here are working through inventory to generate cash flow, and we've been seeing, as we discussed at the end of the third quarter, order rates that seem to be half of what they were a year ago, and that trend has continued. Obviously, we still have a very good backlog to work off of here in North America, so it's not panic yet, but we are definitely pushing for every order that we can here in North America, and comforting to see that inventory is coming down at our distribution partner, so those order rates should increase in the near future.

We are working extremely hard on a lot of our electrification projects, both in marine, oil and gas, and industrial, and you'll see more of those roll out through the year. We are committed to keeping our product development and electrification efforts on schedule, albeit they may—they—again, on our effort, they may spill down to some of our customers based on their income and order rate, but we have healthy projects both in the marine and the land-based area.

That's all I have, really, right now for prepared comments, and if you—anybody has specific questions on our PPP or anything else, Jeff and I are available for comments.

Matt, could you open the line up for questions?

Operator

Certainly. If you'd 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, that is star, one if you'd like to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal.

The first question will come from Noah Kaye with Oppenheimer.

Noah Kaye

Hey, John. Thanks for giving us the updates here, and glad to hear that cases have been sparse and contained.

I guess a couple of questions. First, you mentioned all the distributors are managing for cash flow. Can you talk about cash collections? Are you seeing any meaningful lag in payments, and in general, kind of how are you managing the cash position here?

Jeffrey S. Knutson

Yes, I can take that one, Noah.

Yes, we've been, I think, really pleased with collection levels through the last quarter; really no unusual delays. All of our key distribution partners have been paying on time, so it's been really positive to this point, and like John said, I think, hopefully for us, that's a sign that they are moving product and generating cash and there will be a—what we're experiencing right now is a—kind of a pause in order activity that hopefully comes back as they work through that inventory.

We're doing everything I think everybody else is doing, knowing that—the uncertainty going forward in terms of cash. We're maximizing our availability. We're managing our payments. We're timing cap ex to only those things that are critical, and then looking at every cost that we have, so yes, I don't know if that answers your question entirely, but right now we're—we feel pretty comfortable where we are as we close out the year with liquidity and collections and limited risk in—on the AR list (phon).

Noah Kaye

Okay. That's very helpful. Thanks, and then you talked about your order trend rates, so it's a two-parter here. One, is that kind of net order rate? How have cancellations of backlog been trending. And two, I guess just—it's tough to have a crystal ball given how uncertain things are, but as you talk with your distributors, how close do you think we are to a point at which restocking is going to start to occur and your order rates will start to inflect back up again? Does it feel like a month, a quarter, or just too early to tell?

John H. Batten

Noah, it's John. I feel it's kind of a two to three month (inaudible). I think the first—this—our first quarter is going to be tough. I think we're going to bounce along the bottom here, and it'll start to improve this fall. That's my gut, just going on kind of our normal—our normal base business is kind of repeat. It's not necessarily project-specific. It's what they hold in inventory for things that pop up; replacement units for marine, replacement units for industrial, spare parts, service work. My gut is that's still got about two to three months to go; kind of through the summer and get back into the fall. That's just kind of—and again, that's talking to a handful of our really good customers and what they're seeing.

Noah Kaye

Okay, great. Thanks so much. I'll hop back.

Operator

Thanks. We will hear from Tim Wojs with Baird.

Timothy Wojs

Hey guys. Good morning. Thanks for the time.

John H. Batten

Good morning.

Timothy Wojs

Maybe just to dovetail on the last question, how are your order—I guess, how are your order rates kind of—if you would look at maybe the oil and gas business, and you look at maybe new equipment, parts and service, and maybe refurbishments, have you seen any improvement on the parts' side or the refurbishment side that would suggest that inventory's being used and you could start seeing new transmission orders?

John H. Batten

Yes, I guess what's happened since the last call—I would say our distributors had a lot of inventory on parts I would say for the first five, six months of the year, and we weren't getting calls because they were working off of their inventory and parts on the refurbishments that they were doing. I'd say in the last month we have gotten calls for quotes on some new units and some spare parts, so they're working through their inventory. I think equipment is still getting used in the field, obviously.

Again, rigs are being—older rigs are being cut up. Doesn't matter the make of the engine or the transmission, the old stuff's getting cut up and they're focusing on their newer product in the field, and they are taking care of it. The customers who are going to survive are taking care of it, so I still think it's going to be, again, a couple of quarters at least before you see new spreads being built. There'll be the odd unit here or there sold brand new to take care of some rigs here and there, but I still think we're six months away from new equipment being purchased, but I still think you're going to see some improving rebuild activity on the rigs that are still in operation.

Timothy Wojs

Okay. Okay. That makes sense, and then on Europe, the improvement there kind of getting things back to kind of the pre-COVID levels, is that just based on spec and marine?

John H. Batten

Well, I think it's pent-up demand for service work, and some stuff that wasn't happening in April, May, and part of June. I'm very pleased at how quickly the Veth group and—has recovered and bounced back, and our Technodrive, primarily industrial business out of Italy. They have bounced back nicely, again, serving their markets. Their markets have bounced back.

Again, though, for Veth and the Technodrive business, it's primarily direct to the OEMs, so there isn't as much inventory built up in the system like you have here in North America. There's just more inventory for any market in North America, so that's why I don't—I feel it hasn't bounced back as quickly, because people, again, are working down their inventory, so as those levels come down, that's why three months-ish I feel that those order rates will improve here in the U.S.

Timothy Wojs

Okay. Okay. That's helpful, and then from a profitability standpoint, if we could just maybe think about EBITDA, where do you feel comfortable thinking that we can maybe kind of get back to positive EBITDA growth, or at least just positive EBITDA?

Jeffrey S. Knutson

Yes, that's a good question. Obviously, that all depends upon the recovery and order rates. I think at current levels it will be a challenge. I think we would—we're striving to get to breakeven EBITDA in Q1, so our hope is that order rates recover and we can get there, but it's not an easy road.

Timothy Wojs

Okay. Okay, understand. Appreciate the time. Thank you, guys. (Inaudible).

John H. Batten

Thanks, Tim.

Operator

Next we will hear from Douglas Dethy with Dc Capital Partners.

Douglas Dethy

Hey. Good morning.

John H. Batten

Hey, Doug.

Jeffrey S. Knutson

Hey, Doug.

Douglas Dethy

Nice to hear your voices. Could you talk a little bit about what happens post-PPP in terms of cost reduction if you—both, I guess, fixed and variable cost, what you can do on that?

John H. Batten

Well, I think it's—it will be a balancing act, Doug, because we feel at this—the bottom here is—has been driven down for—we had oil and gas driving it, partly, but then COVID driving it, so...

Douglas Dethy

Right.

John H. Batten

...we want to be very mindful of any permanent cost reductions that we do because coming up the other side, we want to make sure that we can deliver. On top of this, we're building our facility in Lufkin, so I think it's—and we're still—we're on track with that to be—that facility to be ready in our first quarter. We'll be in it in the first quarter. We'd probably be shipping just in the couple—probably October, November timeframe...

Douglas Dethy

Okay.

John H. Batten

...so we've worked hard on variables and we've worked hard on fixed. I think a lot of what you'll see going forward is what we initiated before the PPP where we had temporary salary and wage reduction and furloughs, rotational, so I think you're going to see a mix of all three again because it's—we want to keep the talent we have for the upside, so we'll be mindful of the extra costs of the Lufkin facility, but again, that's geared towards our industrial business and we are seeing some positive trends there, so we have scrubbed everything, Doug, and we'll be ready to go, but it's nothing that we will have invented. It's things that we will take—what we've seen the best that's worked for us and worked for other people, but we're very mindful that we'll have to hit our numbers. We have to maintain the margins, and it's just going to be a mix. I think you'll see that rotational furlough that we initiated earlier in the spring.

Douglas Dethy

No, that's promising, and just sort of related to that is could you just comment a little bit about your—I guess your bank line and availability and any covenants we—liquidity, I guess, generally talk about those?

Jeffrey S. Knutson

Yes, sure. Doug, this is Jeff.

Douglas Dethy

Yes. Thanks, Jeff.

Jeffrey S. Knutson

I think, like a lot of people, we're watching that very closely, and like I said earlier, we feel like we're in pretty good shape right now, but obviously with our debt to EBITDA covenants, we did an amendment less than a year ago, I think, that provided some relief, but we'll need to address that amendment again as we look forward into Fiscal '21. We're having discussions with BMO, productive discussions. I think we'll have something in place before we report our Q4 numbers that will address at least the next four quarters based upon how we forecast the results. Right now we have sufficient liquidity availability on the line. We brought back a lot of cash in—from Europe and Asia in June, so obviously the PPP was a big assist there for us, that $8.2 million of cash, as we utilized that, so what happens after that, obviously, like John said, we're going to address it with cost reduction activities and continue to manage cash as best we can.

Douglas Dethy

Just a minor question, Jeff. I should know the answer. The PPP money you received, how does that go in? Is that like a reduction in cost of goods sold or labor? How does that go into your financial statements?

Jeffrey S. Knutson

Yes, it's not—so once we get forgiveness, that's when we get that—that's when we have to answer that question, and I don't think there's been clear guidance yet. I think it could be treated as kind of a negative restructuring charge, but there's also some conversation around it—you reversing the expense where it was recorded, so some in cost of goods sold, some in MD&A. I think that would be a messy answer, but I don't think there's been clear guidance on that just yet.

Douglas Dethy

Will that be in a first quarter or second—first part of next year type of thing, you think?

Jeffrey S. Knutson

It will probably—depending on what—again, the guidance. We'll probably ask for forgiveness in our first quarter. The bank, then, has, I believe, 60 days to recommend their solution to the SBA, and then the SBA has 90 days, so there's potentially five months before we get a final answer once we submit our request for forgiveness. When we record it, again, would be subject to that accounting guidance. Do we have a reasonable and—reasonable probability and estimable number when we apply for forgiveness or do we wait until the very end when we get final conclusion from the SBA? I'm not sure on that one, but we'll intend to ask for forgiveness within our first quarter.

Douglas Dethy

Before that happens, Jeff, and this is the very last thing, it goes on as a loan, then, and then you record the, I guess, a debit is either cost of goods sold, earnings expense, or inventory or something. Is that how it works?

Jeffrey S. Knutson

Correct. Well, we got the funds. It's a debit cash credit loan, and we're using those funds—so, in place our cash number for a period of time.

In terms of the covenants, that loan is not counted. It's ignored for covenant purposes, so there's that relief as well.

Douglas Dethy

Thank you. A lot of detail, but thanks, Jeff. I really appreciate it.

Jeffrey S. Knutson

Sure.

Douglas Dethy

Thanks, John.

John H. Batten

Thanks, Doug.

Operator

Once again, that is star, one if you'd like to ask a question.

We will now hear from Kurt Caramanidis with Carl M. Hennig, Inc.

Kurt Caramanidis

Thank you. My questions have mainly been answered, but following up on North America marine, it seems like the market is real strong, so you're saying, basically, once they get through the inventory, then you could get some on the backside of that, because certainly it seems like sales are quite strong.

John H. Batten

Yes. It's John. We have been shipping—we have a nice backlog in North American marine. The market generally—looking out in the universe, we would consider it still a strong market, but again, a lot of this North American market is served through our distribution network, and they hold inventory for projects, so they're working down inventory, they're managing their cash flow, and so that is—that has suffered for our new unit order. However, we have had significant orders as of late, but it's just—it's—you can see the trends. Our new order rate does not reflect the health of the market, and you can see where our distributors have been working down their inventory. Hopefully, again, that—we're still, I would say, two to three months from, I would say, that trend reversing, but yes, it's—it is one of the things that's sustaining our aftermarket orders is that North American marine brown water river market.

Kurt Caramanidis

Great. Thank you.

John H. Batten

All right. Well, thanks, Matt.

Everyone, thank you for taking your time on a normally un—a non-standard call kind of in between the quarters. Jeff and I will be back with you at the end of our fourth quarter year-end call, which is in just about a month or so. We'll have the PPP update, any of our actions to address our cost structure at that point, some more updates on Lufkin, the facility, when we anticipate moving in, and just other general updates.

Again, we really do appreciate the time that you took today to check in with us, and I hope everyone had a safe 4th of July weekend, and if you're headed off to vacation, please have a safe vacation as well, so Matt, that's all we have today. Appreciate your time.

Operator

(Inaudible) ladies and gentlemen, that does conclude our call for today. Thank you for your participation. You may now disconnect.