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Twin Disc, Inc.

Fiscal Fourth Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Stanley Berger, *SM Berger & Company*

John Batten, *President, Chief Executive Officer and Director*

Jeffrey Knutson, *Vice President, Finance, Chief Financial Officer, Treasurer & Secretary*

CONFERENCE CALL PARTICIPANTS

Jason Vernoff, *Oppenheimer*

Simon Wong, *Gabelli Funds*

Robert Schultz, *Robert W. Baird*

PRESENTATION

Operator

Greetings, and welcome to Twin Disc, Inc. Fiscal Fourth Quarter 2022 Financial Conference.

As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Stan Berger. Thank you. You may begin.

Stanley Berger

Thank you, Doug. 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 2022 fourth quarter financial results and business outlook.

Before introducing 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 in such forward-looking statements.

Information concerning factors that could cause the 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 Nancy Rasmussen at 21—I'm sorry, 262-638-4000, and she will send a copy to you.

Hosting the call today 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 Batten

Thank you, Stan, and good morning, everyone. Welcome to our Fiscal 2022 fourth quarter and year-end conference call. As usual, we will begin with a short summary statement and then we'll be happy to take your questions.

Before Jeff goes over the quarter results, I will touch on some of the operational highlights from the quarter. Obviously, with demand, a lot went right in the fourth quarter, and our global operations team did a great job getting out as much as we did. The momentum built through the quarter as we got in a lot of the much-needed missing components, whether it was chips, wiring, harnesses, gears or castings, and we were able to catch up on our backlog.

We continue to see strong demand in Asia for oil and gas but we also saw improving demand in our global marine markets, industrial markets and our domestic oil and gas markets. We have received new unit orders for the domestic pressure pumping fleet and we're optimistic that this will improve in Fiscal '23. We have orders for both our 7600 and 8500 transmission series.

Every facility, every product did a great job delivering in the fourth quarter, but there was a tremendous push from the team here in Racine to catch up on past due products because of supply chain issues. Their ability to overcome part shortages was impressive. Whether it was redesigns for alternate parts availability or developing new sources, it all came together this quarter. Their efforts also flowed down through the margin lines with better mix, better efficiency and quicker reactions to inflationary pressures. Operational performance was better across the board.

During the quarter, we continued to work extensively with our supply chain to prioritize our order board and to take care of as many customers as possible. Electrical and other components out of Asia, especially China, continue to be the most unpredictable but is increasingly difficult in Europe as well as the energy prices are soaring and companies choose to take a temporary shutdown versus paying 10x on utility bills. This should continue to be an issue throughout the summer and fall.

Our team in Lufkin did a great job getting into full production of our mechanical PTOs and clutches, and handling all the supply chain issues from India. Our hydraulic PTOs will be moving down in the next few months. Veth Propulsion continued to develop new projects in Asia and North America, and we will see the benefit of these projects in the coming Fiscal year.

During the past couple of years, we have done a lot of analysis on our global footprint and the size and location of all our facilities. You've seen some of the moves in Europe with the sale of a small building in Italy and the sale and leaseback of our Rolla facility in Switzerland. We anticipate another move in Belgium this year as we look for a smaller and more modern facility that focuses just on gear production and assembly and test.

We had announced a buyer for our corporate headquarters, but that transaction will not happen by tomorrow, and we are now in active conversation with an alternate buyer. It is our intent to be out of this building by December with everyone relocated either to our 21st Street facility across town or our new office in Milwaukee.

Now I'll turn it over to Jeff to talk about the financials.

Jeffrey Knutson

Thanks, John. Good morning, everyone, and I'll briefly run through the Fiscal '22 fourth quarter and year-to-date numbers. Sales of $76 million for the quarter were up almost $10 million, nearly 15% from the prior year fourth quarter, and up $16.7 million or 28.1% from the previous quarter. The sales increase reflects continuing growth in demand across our markets, along with the improved operational execution John was talking about through the ongoing supply chain challenges.

The operations team has managed to overcome many of the supply chain constraints that hampered production in previous quarters. However, these supply chain imbalances persist and will continue to challenge our operations team as we move into Fiscal '23. Electronic components remain the most challenging area to manage as the industrial product line has the least exposure to the electrical component shortage.

Sales of industrial products improved by nearly 42% compared to the prior year fourth quarter. With greater exposure to electrical components, off-highway transmission sales grew by 21.4% and marine propulsion sales were up by 6.7%.

By region, sales in North America were up 28%, Asia Pacific was up 40%, and Europe was down 15%. Foreign currency exchange was a net negative $5.1 million impact to sales in the fourth quarter and negative $8.5 million for the full year. For the 12 months of Fiscal '22, sales finished ahead of the prior year by $24.3 million or 11.1%.

The fourth quarter margin percent was 31.8% compared to 27.7% in the prior year fourth quarter. The improved margin in the current year is a result of increased revenue, a more profitable mix of product and the positive impact of pricing actions taken early in the second half to offset the impact of inflationary cost increases across our supply base. We continue to monitor the inflationary environment and remain prepared to react with any additional required pricing actions.

Spending on marketing, engineering and administrative costs for the Fiscal '22 fourth quarter increased just $600,000 or 3.5% compared to Fiscal '21. The increase in the quarter is primarily due to inflationary impacts and a return to more normalized spending on travel and marketing activities partially offset by a currency translation driven reduction. As a percent of revenue for the fourth quarter, ME&A expenses were 22.8% compared to 25.3% in the prior year fourth quarter. For the full year, ME&A was 24.7% of revenue compared to 25.5% for Fiscal '21.

We recorded a restructuring benefit actually of just $600,000 during the quarter, which relates to an adjustment to a previously recorded charge for the ongoing activities in Belgium. Including the small restructuring benefit, the operating profit for the quarter was $7.8 million compared to an operating loss of $5 million in the prior year fourth quarter. The full year operating income of $11 million, which includes a $3.3 million gain on the sale of our Swiss facility, is $23.3 million, improved from the Fiscal '21 operating loss of $12.3 million.

The effective tax rate for Fiscal '22 was 17.8% compared to negative 200% for Fiscal '21. The unusual prior year rate was significantly impacted by the recording of a full domestic valuation allowance in Fiscal '21. The net profit for Fiscal '22 was $8.1 million or $0.60 per diluted share compared to a net loss of $29.7 million or $2.24 per diluted share for Fiscal '21.

EBITDA of $10.6 million for the quarter was improved from $4.9 million in the prior year fourth quarter. For the full year, EBITDA improved by $18 million from $3.6 million in Fiscal '21 to $21.6 million in Fiscal '22.

Turning briefly to the balance sheet. Inventory was up $12.1 million for the year, driven primarily by supply chain imbalances, although we did see a decrease of $4 million during the fourth quarter, thanks to the improved operational throughput noted. We continue to focus on refining inventory planning and resourcing strategies that will balance incoming components with the shortage items currently preventing final assembly and shipment of units.

With a significant increase in inventory and strong June revenue driving an increase to trade receivables, operating cash was negative $8.3 million for the year. Capital spending at $4.7 million for the year was significantly less than we had intended, impacted primarily by the lead times on machine tools.

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

John Batten

Thanks, Jeff. I'll spend a quick moment on our outlook. Obviously, when you look at our backlog, up 40% versus a year ago, we are feeling proportionately better heading into Fiscal '23. New unit orders for North American oil and gas have started back up and the fleet continues to be overhauled. our backlog in marine and industrial is very strong as well.

Our concerns continue to be everyone's concerns, global supply chain issues and the situation in Europe and the toxic cocktail of the war in Ukraine, Russian national gas supply and soaring energy prices in Europe. However, I hope many of you have had the chance to see the press releases on the Hinckley Yachts' SilentJet. Our engineering team worked very closely with the team at Hinckley to develop a parallel hybrid system for their boats. The result is amazing and a glimpse into the future.

This project helped us tremendously to develop our hybrid control system, which can be used for many, many different applications in many markets. I could not be more proud of our engineering team and the (inaudible) processes in supply chain that they have developed and continue to develop.

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

Operator

Thank you. Our first question comes from the line of Noah Kaye with Oppenheimer. Please proceed with your question.

Jason Vernoff

Hi. This is Jason Vernoff for Noah Kaye. Can you help us unpack how much of the gross margin improvement was price versus mix? As you look around the backlog composition, do you foresee gross margins remaining above 30% in the next few quarters? Thank you.

Jeffrey Knutson

Yes, I can answer that one for you. As we look at year-over-year Q4, about $3 million of the increased gross profit was volume with another $2 million combination of mix and price. I would say, of that remaining $2 million, about $1.5 million would have been mix driven with the remainder being price. This is high-level ballpark on that.

As far as going forward, gross profit, I think it's going to be heavily volume related. I think at a $75 million run rate, we would expect to stay over 30%. I think what we're seeing is—as John mentioned, everything really went right as far as operational execution in Q4. We are now facing the return of supply chain challenges.

I don't think we'll see a $75 million in Q1. I think our Q1 will be more like volume levels we saw middle of last fiscal year. I think we'll have a gross profit approaching 30%. I don't think we would indicate that we'll stay above 30% at what might be a lower volume level as we start Fiscal '23.

Jason Vernoff

Thank you. If I could just get one more question in. You highlighted the SilentJet launch with Hinckley. Can you discuss the impact of elevated fuel prices on your marine customers demand preferences for diesel electric, hybrid and full electric? Thank you.

John Batten

Well, tough to say on the demand. Just from a 50,000-foot level, obviously, higher fuel prices, I think, would put a damper on the pleasure craft market. I do see fuel prices coming down. I think everyone is trying to offer an option, whether it's a diesel—a hybrid system or fully electric.

I think you're just going to see year-after-year every boat builder is going to be developing an electric or a hybrid option and then see where the market goes. We're just basically in the very infancy of this market. But I think this is going to be a big growing part of the market. There's no doubt about that.

Jason Vernoff

Thank you.

Operator

Our next question comes from the line of Robert Schultz with Robert W. Baird. Please proceed with your question.

Robert Schultz

Hey, good morning, guys. This is Bobby on for Josh. Last quarter, I think you guys noted some increased quoting activity in oil and gas and thought there could be delivery sometime in Q1 or Q2 in 2023. Are you guys still comfortable with that timeline for deliveries there, or any update?

John Batten

Yes. Actually, we delivered—we were able to take some orders and ship in the fourth quarter, and we've taken more orders and we'll be shipping in the first quarter and second quarter as well.

Robert Schultz

Got it.

John Batten

Yes. This is what helps to actually having some excess inventory. We were able to react very quickly.

Robert Schultz

Got it. Thanks. Then, maybe if we were to look at the 4Q results and annualize that for 2023, you maybe have around $300 million in revenue and maybe $40 million of EBITDA and over $2 a share in EPS. What do you think the puts and takes are to doing that?

John Batten

Well, I think it's one, we're going to go—this year will be like most years, where we will—volume and margins should build through the year. Q1 will be the lowest sales and margin quarter. It's, again, just by days availability of shipping, we have shutdowns here in North America but we have extended shutdowns in Europe.

I'm going to—I will let Jeff answer on the FX component, but we're going to be looking at a dollar that is 15% stronger than it was a year ago. That's going to—that will affect the comparisons year-over-year significantly.

Again, when we look at our backlog and we look at, in general, the supply chain should be getting better, particularly out of Asia with fewer COVID shutdowns in China. I'm hoping that energy—but the mix there, the wild card is what happens to energy prices in Europe and the availability of parts through Europe. Right now, with our backlog and our outlook and how strong our markets are, Fiscal '23 should be better than our Fiscal '22.

What's hard to predict is when all the parts come in. Our fourth quarter was amazing compared to the other quarters, but we really would have wished some of that volume were in Q3 and Q2. What's hard to predict is will parts come in, in enough time in September for us to ship in September or are they shipping in October. That's going to happen every month and every quarter. On balance, Fiscal '23 should be a noticeably better year than Fiscal '22.

Robert Schultz

Got it. Thank you. Then just one more. For '23, what are you guys thinking from free cash flow? What sort of debt paydown are you looking at?

Jeffrey Knutson

Yes, it's a good question, right? We had a really good end-of-year volume push. Receivables were up. We should be driving some good collection activity through the first quarter. Inventory should continue to come down through the year. Barring a—some sort of a strategic action, I think we'd be looking at something in the $3 million to $5 million of free cash flow.

A lot will depend on our Capex program and how much we're able to actually get into the year. I think we have some pent-up demand given the low levels for the last few years. That's a pretty big variable as well. We're looking at somewhere around the $14 million range in Fiscal '23. Yes, we'll see where it is. I think we're very confident we'll be positive in the $3 million to $5 million range.

Robert Schultz

Awesome. Thanks, guys. I'll leave it there.

Operator

Our next question comes from the line of Simon Wong with Gabelli Funds. Please proceed with your question.

Simon Wong

Hi. Good morning. John and Jeff, the oil and gas business, how big is that in the quarter?

Jeffrey Knutson

Good question, Simon. It was probably—we're trying. The problem we have is the units are pretty straightforward, and then there's the aftermarket piece, which is a little less straightforward. It's anecdotal, what percentage of our overall aftermarket volume is going to the oil and gas market. I think about...

John Batten

I'd say 20%, 25%.

Jeffrey Knutson

Say around, yes. Say, 20% to 25% of the $75 million so $15 million to $18 million of the quarter was oil and gas related.

Simon Wong

How much is that as new equipment versus consumable? I would imagine that consumable is a big driver of your gross margin improvement, right?

John Batten

Absolutely. Yes.

Jeffrey Knutson

Units are what, 30, 40 units. A little less than half would have been new units.

Simon Wong

Okay. Great. Then in terms of the—your pipeline for new equipment orders, what are—are you seeing the orders for rebuilds? Or is it more for reactivations? Or, what's that pipeline look like?

John Batten

I would say it is a mix of—so there's new rig construction, there's also a lot of new—our new units for us going into rebuilding existing rigs. I'm just trying to come up with a percentage. It's probably—it's close to 50%—well, I would say it's a little bit stronger, they're replacing engines and transmissions on rigs and not building a complete new rig. A little bit more towards that, but they're putting in new units versus rebuilding again because some of these units, the transmissions have 20-plus thousand hours on them.

Simon Wong

Can you tell if they're rigs that have been working or they're rigs that have been sitting on the sideline for the last three years that they're trying to bring back online?

John Batten

Most of the ones that we've been doing have been working.

Simon Wong

Okay. Great. Then in terms of the trends, the pressure pumping, a lot of talk about e-frac and that orders for e-frac. Do you have anything in your pipeline that addresses that market?

John Batten

Yes. Yes, we do. We have orders for e-frac rigs. We do. It's the minority of them right now. Again, we're facing supply chain issues there as well as getting the motors for that. We'll see what the percentage is. It's still a small—it's for us, it's a small percentage, but it's a growing percentage.

Simon Wong

Now is that the 7600 or 8500 that's going to e-frac? Or is that a completely new product?

John Batten

Yes. It's just—it's a version of the 7600.

Simon Wong

Okay. Great. Then just to confirm, the Capex for 2022 will look at $14 million. Is that correct? I just want to make sure I got that right.

Jeffrey Knutson

Yes, that's correct.

Simon Wong

Okay, great. Thank you for your time.

Operator

There are no further questions in the queue. I'd like to hand the call back to Management for closing remarks.

John Batten

Thank you, Doug, and thank you, everyone, for joining our conference call today. We appreciate your continuing interest in Twin Disc and hope that we've answered all of your questions. If not, please feel free to call either Jeff or myself and we will get to your questions as quickly as possible. We look forward to speaking with you again following the close of our Fiscal '23 first quarter.

Doug, now I'll turn it back to you.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.