Twin Disc, Inc.
First Quarter Fiscal 2015 Financial Results
October 28, 2014

Operator: Good day and welcome to the Twin Disc First Quarter Fiscal 2015 Financial Results conference call. Today's conference 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, Christy. 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 2015 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 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 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 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 Chief Executive Officer, 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 John Batten. John?

John Batten: Thank you, Stan, and good morning, everyone. Welcome to our Fiscal 2015 First Quarter conference call. As usual, we will begin with a short summary statement and then Chris and I will be happy to take your questions.

First, looking at the first quarter results, sales for the 2015 first fiscal quarter were 64.8 million, down 2.5% from 66.4 million for the same period a year ago. The slight decline in year-over-year and sequential quarterly comparisons were driven by moderating demand from our Asian markets for commercial marine and oil and gas transmissions. Partially offsetting the decline in sales to Asia was an increased demand into our North American markets, driven by stronger activity in our oil and gas and industrial markets. Overall sales into our European markets showed some slight improvement year-over-year, but remained at historical weak levels.

Looking at our broader product markets, the slight decrease in sales can be attributed to a decline in demand for our pressure pumping transmissions in China and softness in some of our Asian commercial marine and patrol boat markets, primarily in the lower horsepower ranges, but also in some select high horsepower projects. However, crew boat demand in Asia and the US Gulf Coast remained strong for our higher horsepower marine transmissions. Sales of our propulsion products in the quarter also declined slightly year-over-year, as many of the global patrol market projects have fallen behind schedule. The global pleasure craft market, specifically, in the 40-foot to 80-foot range, remained at historically weak levels. However, as we mentioned in our fiscal 2014 fourth quarter call, we did see some increase in activity in the Australian yacht market and the North America custom sport fish market, where we have been successful with our Express Joystick System in cooperation with CAT and their 360PC system.

While our marine shipments were lower versus year ago levels, demand remained at high level for the offshore oil and gas markets, especially in the US Gulf Coast. First quarter sales into our industrial markets increased when compared to last year. The majority of the improvement was driven by an increase in demand from our North American market sectors, including oil and gas, irrigation, recycling and construction. We anticipate this trend continuing throughout the fiscal year.

Sales into our transmission markets improved versus fiscal 2014 first quarter levels. Shipments into our North American oil and gas markets improved significantly, but partially offsetting this increase was a decline in the oil and gas demand from China and the anticipated slowdown in our legacy military contracts.

Gross margins for the quarter were 34.5%, compared to 31.1% a year ago and 29.2% in the previous quarter. A better mix of products specifically within our transmission products drove the gross margin improvement over the previous quarter.

First quarter spending in marketing, engineering and administrative or ME&A expenses increased by 2.5% for 393,000, versus the same period last fiscal year, from 15.5 million to 15.9 million. Most of this increase was driven by inflationary items, offset by slight decreases in pension and stock-based compensation expenses.

Turning to the bottom line, the fiscal 2014 first quarter net earnings were 4 million, or $0.36 per share, versus 1.3 million, or $0.11 per share, a year ago. EBITDA for the first quarter was 9.4 million, compared to 6.6 million a year ago.

Turning to the balance sheet, we ended fiscal 2015 first quarter with total debt of 23.6 million, compared to 18.4 million at the end of the previous fiscal year. Contributions to our domestic pension plan of 3.4 million were the primary factor in the increase. Inventory in the quarter declined slightly by 126,000, from 97.6 million to 97.5 million. Our balance sheet remains strong, with debt to capital still low at 13.5% and a positive net cash position.

Our six-month backlog decreased from 66.1 million to 63.4 million. Orders for our North American markets improved, while Europe remained stable, and net new orders for Asian decreased in the quarter. While taken as one data point, the slight decline is not good news, but we remain confident that the positive trends that we have been seeing in North America can continue despite the many conflicting global macroeconomic indicators, and that our momentum in Asia will return during the fiscal year.

Certainly, our first quarter results, especially on earnings and margins, were a good start to the fiscal year, but the slowdown that we have seen in Asia began to solidify some of those global macroeconomic trends that we have been following. While we feel that fiscal 2015 will be an improvement over fiscal 2014, it is too soon to predict by how much. Our lead times remain historically short for our higher horsepower transmissions, including those in oil and gas, to reacting to any new orders can happen within the quarter, and we still feel that there is some opportunity to take market share with these competitive lead times.

Looking at the longer term, we still feel that our overall energy markets are still a good place to be and we continue to develop new products for these markets, and acquisition opportunities to enhance our position within these markets.

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

Operator: Thank you. If you'd like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speaker phone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one to ask a question. We'll pause for a moment to allow everyone an opportunity to signal for questions.

We'll take our first question from Josh Chan with Baird.

Josh Chan: Hey, good morning, John and Chris.

John Batten: Good morning, Josh.

Chris Eperjesy: Good morning, Josh.

Josh Chan: Hi. I was wondering if you can talk a little bit more about the softness that you're seeing in Asia, both on the marine side and oil and gas side, what's causing that, and then also what gives you confidence that might recover within the year?

John Batten: I guess I'll start with the easy one first. Some of the marine softness is really driven by the demand for coal in China, and so a lot of the activity that's lower, versus the year ago level, has been some of the coal tugs and barge activity. There was kind of a slowdown in orders and building, and we think that that has flattened out and should improve at some point during the fiscal year, and then there were some higher horsepower projects that were kind of delayed—not kind of delayed, they were delayed. Overall, we think that those opportunities are still there, they've just been pushed out a quarter or two, or maybe more.

Oil and gas—I should have been little bit more specific—we did have demand with some of the—our customers in China are purchasing in the US, so they showed up as North American sales. I just think that there's been a slowdown in China in the plan and developing, and issuing new leases, and some of the planned activity. We don't see that going away. It just looks like they've moderated a bit in building new equipment, because they're not sure of the timing of when they're going to get the new leases for new activities.

So, those are the two primary places that we saw the slowdown.

Josh Chan: Okay, okay, that's helpful, and if I can look into the North American market, the oil and gas market, you said in your comments that customers have been more cautious in placing orders, and I was wondering if you're seeing customers potentially wanted deferred deliveries, as well?

John Batten: We've had a mix. There's been some activity pushed out from one quarter to another, but then we've had other things pulled in. I guess one of the best signs that we've seen, Josh, really, is the increase in rebuild activity and aftermarket, rebuilding the equipment that's being used, and so that's one of the data points that makes us feel a lot better about the North American market, in general, going forward, if they are spending the money to rebuild things that have been used for the last probably three to five years that they've been postponing. So, there have been push-outs from one quarter to another. There have also been units that they have been pulled in. Again, it's the mix depending upon the customer and what fleets they're concentrating on at any one time.

Josh Chan: Okay, okay, and how big is the rebuild in terms of order of magnitude compared to new equipment for you guys?

John Batten: I don't have in front of me. I would say, off the top of my head, it was extremely low for many quarters, but we're probably up, I would have to say maybe in the 20% range, and I would say we're—it's just kind of at the beginning of that, Josh.

Josh Chan: Okay, okay. So, if we think about the North American oil and gas market in an environment where pricing of oil has come down significantly, how should we think about kind of the trajectory of this market looking out six, 12, 18 months or so?

John Batten: That is a very good question. Because that $20 drop in oil happened so late in the quarter, I can't say what effect it had on the first quarter results, but looking forward—certainly, you know, the drop in oil, it doesn't improve the prospects any, but I don't know how much it damaged it because there's still the supply here, there's still a demand. I can't tell you what is the price point that is going to curtail activity significantly, I don't know, I mean, if it's in the 70s, if it's below 70, below 70, but certainly I think there's some other constraints on it, whether it's the sand or the trucking and expense side. I guess part of that question is how much is the expense side going to go up with the barrel price? I don't like to see it at 70, it kind of makes you wonder a lot more, but my gut feeling is that it's going to start to go back up in the 80s, because I just don't see it coming down. I know there's some people who—I forget the guy's name who thinks it's going to go down into 20s. I personally don't buy that, I don't think we buy that here, but I don't know when it's going to get back up over 100, but I see that a much more likely scenario than going down into the low 70s and 60s. I can honestly say, Josh, so far it has not had an impact, but it's too soon to tell.

Josh Chan: Okay. So, you haven't had anybody, you know, customers come and call because of the price movement, basically, is what you're saying?

John Batten: Yes, yes.

Josh Chan: Okay, okay. All right, yes, thank you for the color. I'll jump back in queue.

John Batten: Okay.

Operator: We'll take our next call from Walter Liptak with Global Hunter Securities.

Ryan: Hi, guys, this is Ryan on for Walt.

John Batten: Okay, hi, Ryan.

Ryan: Just to elaborate on the North American oil and gas market a little bit, could you talk about the order trends as you worked through the quarter, and possibly quarter to date? It doesn't sound like things changed too materially, but any color there?

John Batten: Yes, I mean, I would—again, I just want to preface everything. It's hard to read on a quarter-to-quarter basis, because we did have a lot of—not a lot—a good number of customers, when they started ordering, were placing, you know, a demand for six months, and so that their overall demand and the number of units hasn't changed, really, at all. It's more of the timing of when they want it, and depending upon who we are selling it to, when their customers want it.

I do sense that the increase in rebuild activity and replacing units with a transmission or engines with new units is on the increase. So, regardless of the price of oil, I guess going back to that, they still have to bring a certain amount of energy, let's call it energy up out of the ground, and I know they're looking at it every day, whether it's going to be a rebuild activity, replace that with new units, or just by new rigs altogether, and keeping the cost down, because one of the most expensive things you can do is get to a frac site and have several units not working, and that frac job just got significantly expensive. So, I see the overall momentum still as positive, and for me—for us, it's the increase in aftermarket activity and rebuild activity.

So, I suspect that we still have a good run here on orders from North American, but it could moderate quarter to quarter, and we don't report out at six months, so a lot of what we could get on order is going to be planned for seven/eight months from now and it won't show up. So, overall, positive, but the quarter-to-quarter could be up and down a little bit, like it was this quarter.

Ryan: Okay, thanks. Just go back to the shadow inventories that we've talked about in the past, where do you think we are now in the channel and are we kind of at equilibrium going forward?

John Batten: We're a lot closer to equilibrium given the actual market activity. I think a lot of what they were doing was—when a unit, for whatever reason, was not operable, they replaced it with a new unit from inventory, and I think in the last three months we've gotten down much closer to zero; again, with the preface that there's still some operators who have slightly more than others, so it's not uniform, but I'd say we're very close to that point where a lot of the inventory has been used up, or will be in this quarter.

Ryan: Okay, great, thanks for the color. I guess then, finally, it sounds like in North America the industrial end markets, general industrial, is strong for you guys. Could you just elaborate a little on what you're seeing there and where that demand is coming from?

John Batten: Actually, I would say it's broad based, we just had a lot more activity, and I know talking with our sales guys and our distributors, it just seems like a lot of projects that had been put on hold finally came through. I think we've also won a couple projects with our pump drive, which we have been slower than we would have liked to get into markets. We're battling a couple of domestic players that have an entrenched market share. This is a product that we acquired many years ago from Techno—well, when we acquired Technodrive in Italy, and we're starting to see much better market penetration with our product, so that has improved, but if there's one product, that's where I think we've improved, but, overall, I would say it's just broad, you know, some of our customers are just feeling more confident and moving ahead with projects.

Ryan: Okay, okay. This is my last one, I promise, but it sounds like your second quarter sales are going to be flat to slightly up from last fiscal '14. Is that in line with your overall plan? I know you guys have better visibility on the timing of shipments. I guess, is that in line with your thoughts to begin the year, and have you always thought about the second half being strongly weighted?

John Batten: Yes, the short answer is yes. I do miss the days when our trends used to be that sales and earnings improved sequentially as we moved through the year, so the first quarter was the weakest and the fourth quarter end the strongest. That trend has gone away. So, now we're dealing with, typically, a first quarter that can be very strong and then a second quarter or third quarter not as strong as the first quarter, but the fourth quarter, typically, is very strong. So, you have a first quarter and a fourth quarter that now seem to be the trends of the strongest quarters and the second and third quarter flip-flopping, which can be the most difficult, but I guess the second half of the year, I think is going to be better than the first half of the year, and it's a question of will the second quarter—and, again, it's not that I'm trying to be coy or anything, but for us, it can be the timing of shipments. For instance, if we ship 12 8500s to Asia, if we don't make the cut-off in the second quarter as far as the timing, all of that will show up in the third quarter. So, there are very discrete packets of shipments that can affect which quarter is going to be stronger, the second or the third quarter.

Ryan: Okay, great. Thanks for the color. I'll catch up more offline. Thanks, guys.

John Batten: Thanks, Ryan.

Operator: We'll take our next call from Steve McManus with Sidoti & Company.

Steve McManus: Hey, guys, how are you doing?

John Batten: Hi, Steve.

Chris Eperjesy: Hey, Steve.

Steve McManus: Just a quick question regarding ME&A. It jumped to about 24.5% of sales this quarter. I just wanted to see your thoughts, do you think that's a fair run rate going forward, or is it kind of hard to tell?

Chris Eperjesy: No, I mean, it's not a fair run rate, because, you know, taking into accounts John's comments just now, typically, the top line still will grow throughout the year. You won't see a comparable growth in ME&A. So, the answer is no. I mean, that's a high point. Also, we are expecting this year to be a better year than last year, so there is some incentive compensation that's built into the numbers this year, when there was virtually none last year. But the answer to your question is no. I mean, that's the high point I would expect for the … (cross talking).

John Batten: It's a percentage.

Chris Eperjesy: It is a percentage for the full year.

Steve McManus: Okay, great. Thanks, guys. Then, just to getting back to the product mix shift, has there been a significant change weighting more towards the power transmission systems since last quarter, and what are your thoughts on the mix moving forward?

John Batten: Yes, there were a few shifts. One, the oil and gas shipments as a percentage of our overall sales increased, and there was a shift from the shipments going to Asia versus the shipments staying here in North America, and the biggest—I would say the biggest impact of that, certainly, is it drove the margins up just on the mix, but then the geographic mix and the timing—you know, when we shift to North America we essentially can recognize the sale immediately, so we get that margin effect. Typically, when we're shipping to Asia, it's spanning quarters. So, that shift to North America, in a higher margin mix shift, had a good impact on the first quarter.

Steve McManus: Okay, great. Thanks a lot guys. I appreciate it.

John Batten: You're welcome.

Operator: Again, that is star, one to signal for a question, and we'll take our next question from Doug Dyer with Hartland Advisors.

Doug Dyer: Good morning, gentlemen.

John Batten: Hey, Doug.

Doug Dyer: In terms of Caterpillar's pricing, is that helping or hurting you at this point, and do you sense that your market share is going in which direction?

John Batten: In the quarter, I have to say I haven't looked at it. I think—I truly believe that both of our market shares is increasing and I don't think —I think they share the same philosophy as we do. I don't think they're out to set any type of price war. The CAT pricing does come up. I think the CAT financing comes up more. So, builders who do need that channel of financing to operate, I think that is certainly a competitive dynamic that we are well aware of. But, to date, you know, it doesn't come up as a major threat on CAT as far as pricing, if that's the question, I haven't seen that. I mean, we're working hard on, as I think they are, on getting as much of the business that's out there, and certainly I do think that their market share is increasing, and I think that our market share in the markets that's here and now, right now, is also increasing, particularly what we've been able to do in Asia.

Doug Dyer: All right. Thank you very much for the color.

John Batten: You're welcome.

Operator: We'll take our next question from Josh Chan with Baird.

Josh Chan: Hi, guys, just a couple of follow-up questions. In your outlook comment you said that Q2, the top line might be similar to last year. I guess, is it fair to assume that perhaps you would still have a better mix than you did last year?

John Batten: Yes, I think certainly there is, and I've got to say it can change, because the order lead times for a lot of the products is very short, but, yes, certainly, I think that given where we are today and what we've delivered in the first quarter, I think that's a fair expectation.

Josh Chan: Okay, and then the last question is—you said that you expected fiscal '15 to be better than '14 on the top line. I guess, like, the first half is going to be down slightly, so what in your mind will kind of drive the growth in the second half to make up for the difference?

Chris Eperjesy: I can take your question, Josh. In the first quarter already, I think we beat the first half of last year in terms of the bottom-line, so … (cross talking).

John Batten: Josh said the top line.

Chris Eperjesy: Oh, the top line?

John Batten: Yes.

Chris Eperjesy: Josh, were you talking the top line or the bottom line?

Josh Chan: Yes, the top line, top line.

Chris Eperjesy: Top line. John, go ahead.

John Batten: Yes, well, I do think, as long as turnkey, we take turnkey out, I think that we can—there's a chance that we can hit last year and that we will beat last year in the first half, there is that chance. Certainly, I think in the full fiscal year, it is a safe assumption, barring anything that we don't know now, that we will beat the top line of fiscal 2014.

Josh Chan: I guess what I wondering was is are there any specific markets that you sort of think can drive that growth, compared to last year, that you're more confident in than other markets?

John Batten: Well, certainly, North American oil and gas is one, and just the North American broader industrial business is going to help drive it.

Josh Chan: Okay, okay, great. Thank you for your time.

John Batten: Thanks, Josh.

Operator: We'll take our next question from Walter Liptak with Global Hunter Securities.

Ryan: Hi, guys, just one more. It sounded like the pleasure craft market picked up a little bit and maybe outpaced your expectations. If that's true, has your outlook changed in pleasure craft throughout the year, because I know it's coming off almost zero, so I just wanted to get your thoughts there?

John Batten: I would say no, and I'm going to be specific on the pleasure craft. Certainly, we don't participate in that trailer boat market, which I think is actually doing quite well, and then the mega—I would call it the mega-yachts, super-yachts, things above 100 feet, those are still doing relatively well, but there's just so few of those built, they don't really move the needle on them, because there's just few transmissions and propellers available in that market. The real market that has suffered versus 2008, pre 2008, is that 40-foot to, you know, let's say 90-foot, 83 feet, 78 feet. Those are the ones that are the multi-million-dollar yachts that people were financing and that financing is generally gone, and in Europe, even if you can pay cash for it, every time—literally, there are horror stories in Italy and France—like, every time you move out of the harbor Customs is there to make sure that you have your tax returns there and that you've paid taxes, that you can prove that you didn't have illegal funds to finance it. Here in North America, that's not as much of an issue; it's just a general financing. I still think that we are years away from that market recovering.

Having said that—we were just talking about CAT and oil and gas, how we compete on transmission—in this market, CAT is our best ally, because, typically, our marine transmissions are designed around their engines, and we have the joint Joystick System, and the CAT marine sales group is pushing hard to gain market share. They have new engines coming out. They've got pods coming out. I do think that being teamed with them in this market will eventually get us more business, albeit in a much smaller market historically than we what we've been used to, at least in the 2000s, kind of from the first of the tech bubble up to 2008. I don't know when that growth in that range of boat is going to come back, because it's not going to be driven in Western Europe at all, so we're going to rely on North American, Australian, and to some extent people from Hong Kong and China, you know, where are they going to—they can buy the boat. The question that they have in that market is where they are going to put the boat. So, we still see a lot of opportunity, but it's going to be, overall, in a smaller market. I hope that helps.

Ryan: Yes, no, it sounds like it's kind of unchanged and any upside would be kind of incremental to people's expectations at this point.

John Batten: I would 100% agree with your statement.

Ryan: Okay, all right. Thanks guys.

John Batten: Thank you.

Operator: It appears there are no further questions at this time. I would like to turn the conference back over to Mr. John Batten for any additional or closing remarks.

John Batten: Thank you, Christy, and thank you 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 Chris or myself. We look forward to speaking with you again in January following the close of our second fiscal quarter.

Christy, I'll now turn the call back to you.

Operator: That does conclude today's conference. Thank you for your participation.