Twin Disc, Inc.
2010 Second Quarter Financial Results Conference Call
January 21, 2010

Operator: Good afternoon ladies and gentlemen and thank you for standing by. Welcome to the Twin Disc Incorporated 2010 Second Quarter Financial Results Conference call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be open for questions. If you have a question at that time, please press the star followed by the one on your touchtone phone. Please press star zero for operator assistance at any time. For participants using speaker equipment, it may be necessary to pick up your handset before making your selection. This conference is being recorded today, Thursday, January 21 of 2010.

And now I'd like to turn the conference over to Mr. Stan Berger. Please go ahead sir.

Stan Berger: Thank you Josh. 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 2010 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 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 Mainaki 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 Christopher Eperjesy, the company's Vice President of Finance, Chief Financial Officer and Treasurer.

At this time, I will turn the call over to Michael Batten. Mike?

Michael Batten: Thank you Stan and good-day to everyone and welcome to our second quarter conference call. As Stan has indicated, I will start with a brief statement and then John, Chris and I will be available to take questions.

Before getting into the details of our second quarter, I would like to emphasize the following points. First, in line with expectations our financial results showed nice improvement sequentially from the first quarter. In addition, our operating cash flow reached 16 million for the first half of the fiscal year and we were able to reduce our debt by 18% during the first half to 41.6 million. And finally, our six month backlog has improved 15.6%, since the beginning of the fiscal year. All of these results point to an improving trend for the company.

Now, let's turn to revenues. As just mentioned, while we experienced a sequential improvement in sales from the first to the second quarter our comparisons to the near record levels posted in fiscal year 2009 were unfavorable. Net sales for the second fiscal quarter of 2010 were 55.2 million compared to the near record level of 81.6 million for the same quarter a year ago. Year-to-date sales were 102.2 million compared to 154.3 million last year. Our revenues continue to be affected by the impact of the global recession, specifically customers in the mega yacht and industrial markets. Offsetting this weakness has been a stable demand from the airport, rescue and firefighting, land-and marine-based military and Asia-Pacific commercial marine markets. Sequential improvement was also seen between the first and second quarters of the current fiscal year, from 20.7% to 26.8% in terms of gross margin for sales reflecting increased sales, volumes and product mix. Comparing fiscal years, gross margin percent was 26.8% for the fiscal second quarter compared to 28.1% for the comparable period a year ago. Year-to-date gross margin percentage for the first six months was 24% compared to 27.9% for the same period last year.

Marketing, engineering and administrative expenses for the fiscal 2010 second quarter were 14.9 million and decreased 2.1 million compared to the same period a year ago. While year-to-date ME&A expenses were 27.7 million and declined 5.6 million compared to the first-half of last year. The reductions reflect the impact of our cost reduction and our cost avoidance programs placed into effect at the beginning of the fiscal year.

The company recorded a net loss of 490,000 or $0.04 per diluted share for the second fiscal quarter compared to net income of 3.4 million or $0.31 per diluted share for the same period the previous year. Quarterly sequential improvement was experienced compared to the 2.4 million net loss or $0.22 per diluted share sustained in the first quarter of fiscal 2010.

For the first half of fiscal year, the company reported a net loss of 2.9 million or $0.26 per diluted share compared to a net income of 5.9 million or $0.52 per diluted share for the first half of fiscal 2009.

During the first half of this fiscal year, we have generated 16 million in cash as previously noted from operations compared to 13.7 million for the same period last year. Total debt has been reduced in the first six months by 18% to 41.6 million and we have 16.7 million in cash at the end of the first half. Total debt to capital now stands at 27.5% compared to 31.1% at the end of the first half last year. This is the strongest balance sheet that we've had in the past several years.

Turning to our outlook, our six-month backlog at the end of fiscal—the second fiscal quarter was $70 million compared to 60.6 million at the end of last fiscal year and 62.5 million at the end of the first quarter. This increase was driven primarily by higher activity for the 8500 series transmissions for use in our oil and gas pressure pumping markets. Additional activity was seen in our land-based and our marine-based military markets. We continue to develop new and differentiating products for our customers and are encouraged by the response we are receiving for the 7500 series transmission as well as the new joystick marine control system that we've introduced. While challenges will remain, we continue to expect improving sequential quarterly trends for the balance of the year.

That concludes my prepared remarks and now John, Chris and I will be happy to take your questions.

Josh, you can turn to that now.

Operator: Thank you sir. We will now begin the question-and-answer session. As a reminder, if you have a question, please press the star followed by the one on your touchtone phone. If you would like to withdraw that question, please press the star followed by the two. And if you are using a speakerphone today, please lift the handset before making your selection.

One moment please for our first question.

Our first question comes from the line of Paul Mammola with Sidoti & Company.

Paul Mammola: Good afternoon everyone.

Male Speakers: Hi Paul. How you doing?

Paul Mammola: Good thanks. First, ME&A, I know you highlighted obviously down year-over-year, but a pretty good jump sequentially. Could you flush that out a bit and is any of that associated with the development of the 7500 series.

Michael Batten: Paul, it's Mike. It's largely attributable to timing in the fiscal year. Our first quarter generally is of a lighter quarter in terms of ME&A as you go back over the last several years, I think we would see that. We continue to expect that our cost reductions will impact our spending and we don't foresee any further increases, significant increases in the coming quarters.

Paul Mammola: Okay, so 15 million run rate for ME&A is about right you'd say?

Michael Batten: Plus or minus, yes, but not a significant jump the way you saw in the first to second quarter.

Paul Mammola: Okay, fair enough. And on that 7500 series, how much is that going to cost to produce in market and how much of the costs lay ahead?

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

John Batten: Yes Paul, I'm trying to understand as far as engineering expenses and ME&A expense develops the market?

Paul Mammola: Correct.

John Batten: I guess the first answer is, it's not going to greatly affect the balance of the year of the going (sp?) quarters. It's been pretty much spread out; most of the development expense is behind us and we have marketing expense ahead of us which is already factored into the remainder of the year, so, it's not going to be a big impact from quarter to quarter.

Paul Mammola: Okay, fair enough.

Michael Batten: Paul, if I could just come back to the ME&A. For the first quarter for Twin Disc, we don't have any trade shows. They all start in the second quarter and we did have, you know, further development expenses for the marine and joysticking control systems which was previously mentioned. And we have go live on some ERP in Europe which was some ramped up activity in the second quarter as well, but that's pretty much the difference.

Paul Mammola: Okay, understood. Has BJ Services given you guys a look at their 2010 cap ex budget yet?

Michael Batten: The 2010 cap ex budget, I have not seen it. We’ve received some orders from the region on the 8500, but I'm not sure if that's related to the timing of their cap ex budget though.

Paul Mammola: Okay and Chris, obviously generated good cash flow for the first half of the year, would you say that that's probably the bottom for you know, receivables and inventory at this point or do you think you have more room to go?

Chris Eperjesy: In terms of receivables, obviously as we ramp up on sales there is the potential that receivables would (inaudible). I think we would all say that, you know, inventory continues to be something that we're focusing on, so I wouldn't necessarily make the same comment with respect to inventory.

Paul Mammola: Okay, thanks for your time.

Right oh Paul, thanks.

Operator: Thank you. Our next question comes from the line of Peter Lisnic. Please go ahead.

Peter Lisnic: Good afternoon gentlemen.

Male Speakers: Hi Peter, how are you.

Peter Lisnic: Good how are you guys?

Male Speakers: Good thanks.

Peter Lisnic: Excellent. I just want to ask another of Paul's questions on the ME&A side. When I look at the numbers of the percentage of sales it's about 27%, you traditionally run in the low 20's. So, I'm wondering are we at the point from a sales level where that 27% kind of rate is—were basically at a fixed level? Or are there, can you maybe quantify what some of the, what I call a one- time development expenses are in that number?

Michael Batten: Well, it's Mike, Peter. When we talk about the ME&A expense obviously with the reduced sales percentages has gone higher so we expect that percentage to come down as we go forward and as revenues pick back up. I mean clearly, you'll see our order backlog trend growing and we expect a good result out of those shipments primarily driven by oil and gas considerations. So the ME&A side of things, we expect to more or less continue at level rates as we go forward and that revenues will reduce the percentage.

John Batten: Peter it's John. The ME&A expenses as dollars will not be growing at the rate of sales revenues (inaudible), you know, going forward.

Peter Lisnic: Okay so in other words we should probably, as the revenue line improves, retreat back to that low 20 percent kind of level. In other words, there's nothing structural here regarding the cost structure which I wouldn't think there would be.

John Batten: No, you're correct.

Peter Lisnic: Okay. All right. Fair enough on that. Then in terms of the backlog you've given pretty good color commentary on that. I'm just wondering if you can paint us a little picture on maybe what we're not seeing or numbers outside of backlog, what you're hearing from your customers in particular end markets, that wouldn't be showing up on (inaudible), in terms of order inquiries or how their order books might be shaping up or your order book might be shaping up, relative to maybe not the next two quarters, but a little bit further out from that, because some of these businesses obviously are clearly a longer cycle.

John Batten: Peter, it's John. I guess from a high level, I would say that obviously the oil and gas industry is starting to pick up and we're seeing that in our 8500 orders and inquiries for the 7500. As was previously mentioned, in military projects both land-based and marine-based have been growing. Our military is stable and our patrol boat markets have been growing and we see that going in out past the next two quarters. As just a general comment on industrial and kind of the rest of the business, certainly Asia as an overall market has been stronger. It didn't subside very much you know, it held pretty stable. We see, you know, some increase in activity both in orders and interest in quotes in North America. I would say that in Europe, by and large, for everything they obviously have a large pleasure craft and mega yacht industry. I would say that region would be the slowest in overall recovery and pickup.

Peter Lisnic: Okay, that does it for me. Thank you very much.

Male Speaker: Thanks Peter.

Operator: Thank you. Once again ladies and gentlemen. If there are any additional questions please press the star followed by the one at this time. As a reminder, if you are using a speakerphone, please lift the handset before making your selection.

Our next question comes from the line of Shawn Boyd with Westcliff Capital Management. Please go ahead.

Shawn Boyd: Good morning all. I'd like to come back to ME&A expenses for just a second. If I'm looking at this correctly, expenses were down about 3.5 million in the September quarter on a year-to-year basis and then December down, oh a little over 2 million and you made the point about the quarter-to-quarter timing, so I'm trying to understand can we take that $2 million drop and assume that kind of a year-over-year change again off the year ago March and June quarters as we think about forward quarters here or do we need to be using this shifting $14.9 million run rate as more of an absolute level going forward. If you can clarify that, it would be very helpful.

Chris Eperjesy: Yes, Shawn, this is Chris Eperjesy. Unfortunately, you can't do that. One of the reasons you can't, is that if you look at the third and fourth quarter of last year and then go back and look at our announcements back then, you'll see that there is, what I'll call (inaudible), there was some reversals of stock based compensations expenses and some incentive compensations, so those numbers were artificially low. So if we adjusted for those, I think then your analysis might be a little more—and I think a better statement is to say that we don't see a significant move off of the levels of the second quarter.

Shawn Boyd: Okay,

Chris Eperjesy: For the balance of this year.

Shawn Boyd: Okay, I got it.

Chris Eperjesy: In particular, the fourth quarter of last year would have had a bunch of what I just described, so it's artificially low.

Shawn Boyd: Okay, I got it. And, getting away from that for a minute on the mega yacht, if we could, can you give us a little bit more color on what it takes to get that business back, and what I mean is, is there a ton of inventory out there on, you know on vessels that haven't been built? Is it a fact that now inventory is pretty much been burned through and we just need orders to pick up? What would it take to get that business going again to contribute to Twin Disc?

Michael Batten: A little bit of everything you just said. There is still quite a bit of inventory in probably in the 40 to 60-70 foot range and there is a lot of inventory that still needs to be worked through. In the larger range, in kind of the 70+, certainly above 100 feet, there really is no inventory as everything was built to order. It's going to take, you know, realistically, an increase of disposable income. The feeling that you have the money to spend, so stock markets coming back, and the ability, probably most importantly to finance it. You know, even people buying these boats are financing them and they need to have access to capital to do it.

Shawn Boyd: Got it. Okay, so it sounds like that business is probably going to be, you know, pretty cold for a little while here.

Michael Batten: I would say, that looking at the recovery of that market your measuring it in years, not quarters.

Shawn Boyd: Okay. And that's about 20% of sales?

Michael Batten: No.

Shawn Boyd: What was that historically?

Michael Batten: Well, the pleasure craft market, not so far off in terms of 15 to 20%. You will recall we are also represented significantly in the commercial markets and the patrol boat markets around the world, so, that is an area that I think you're close to the number there.

Shawn Boyd: Okay, but just pleasure craft maybe 15% to 20%.

Michael Batten: Yes, I mean this is, the comments that we've made and that we've been talking about this right now applies specifically to the pleasure craft market. When you go to commercial fishing, other work boat applications, or the patrol boats, the patrol boat market is actually growing for us and the commercial markets are holding depending upon the region of the world that you're talking about. Growing in Asia - holding in the US. Europe is particularly hit in this recession for a number of different market places. That's a little bit surprising, this go round is how badly the European markets have been hit.

Shawn Boyd: Understood. That clarification is really helpful. Can we think about it—can we talk to the industrial in the same vein, meaning, you know, industrial is kind of a fairly large catch-all. What, within that group is hurting the most here and what do we think on timing, because my gut, is that that probably comes back a lot faster then something like the pleasure craft.

John Batten: Shawn, no question. There are different parts, there's construction, I mean our products go into construction, equipment, irrigation for agriculture, some agricultural equipment, recycling, rock (sp?) crushers, wood chippers, biomasts. Each one of those that I've mentioned has been down. Which one would come back the soonest, I can't say, it's just that you know, by-and-large our clutches and PTOs have had increased order activity in the US, North America and not necessarily in Europe. So, yes, but I would foresee that coming back much quicker than pleasure craft and marine.

Shawn Boyd: Got it. Okay. And moving to, you know something I think a lot of us are much more interested in, or not more interested in, but see as a potential contributor (inaudible) here. Let's just talk about that backlog (sp?) grown for one second on the existing 8500 series. How does that look to you? How sustainable does it feel? Is it fairly broad? Is it one or two customers? Is it a particular geography? Is it, you know, anything, any more detail you can give us on that?

John Batten: Shawn, it's John again. I would say compared to last time, the geography is broader. It's the US. It's Canada. It's Asia, and our customers now, the number of customers that have orders is more diverse than it was previously. Is it sustainable? I think so. I think there are other indicators out there that the overall economy is heating up, not actually heating up, but it's improving. I see it continuing for the next few quarters certainly and beyond.

Shawn Boyd: Okay. And with the launch of the 7500 coming on, can you remind us again as to the market size that you're going to be able to tap with it. The 7500 versus the 8,500? And then also, any thoughts on what that initial order ramp or revenue ramp looks like?

John Batten: Well, the best estimate is that the size of market for the 7500 is 10x that of the 8500. The 8500 really is 2700 horsepower to 3,000 or 26 to 3,000. The 7500, you know, can tackle really a market from 2,500 down to 1,500 and be competitive. The market for new builds is much greater and the market for retrofits, there is just a lot more older rigs out there that could be retrofitted with this unit. How quickly it ramps up to, you know, a sizeable market share, it's a balance of doing retrofits, new construction and improving it in the field on different applications. So, we want to do it right and be cautious, not cautious, but be prudent in the release. It will be a significant player in the market, that's for sure. A larger player than the 8500.

Shawn Boyd: Okay, very good. And would you expect to start actually taking orders in the June quarter on that?

John Batten: I anticipate taking actually the first orders sometime this fiscal quarter, the third quarter.

Shawn Boyd: In the March quarter? Okay. Very good, so that starts to come in at backlog at that point.

John Batten: Yes, I would anticipate not a huge amount, but you know, a sizeable amount for the 7500 in this quarter.

Shawn Boyd: Okay. And just one last question on the pressure pumping. Can you give us a feel for, kind of the current size of the business is, of course, is without the 7500, maybe just borders on the existing 8500 series versus what they were say in peak ‘07/’08 levels?

John Batten: I would say that right now, we're somewhere as far as new construction, we’re somewhere in the 20 to 25%, 20% range maybe of what the build rate was to 2 to 2 1/2 years ago.

Shawn Boyd: 20% of that. Got it, so down 80%. Okay. Very helpful. Let me jump back in queue. Thank you.

Operator: Thank you and our next question is a follow-up question from Peter Lisnic. Please go ahead?

Peter Lisnic: I just wanted to follow-up on gross margins. As I look at the numbers this quarter the (inaudible) looks, you know, better than it has during the downturn I think period. So, just wondering if maybe you can cull that out a little bit in terms of what drove that in terms of either mix or some of the restructuring savings that you had put through, whether those had come through or are coming through according to plan? What might be happening on the price cost or on the materials cost side as well?

Male Speaker: Actually, Peter, I think you hit them all, I mean everything that you identified is something that had an impact in that whatever 600 and some basis points improvement. So, it was all those things. It was the mix? Certainly there was mix as John was talking about, you know that some of the markets that were up in the quarter, there was clearly the effect of volume and absorption. We continued to see the ramp-up on the savings effect both on costs of goods sold and ME&A. So, if there were some bad guys in terms of the pension expenses we acknowledged at the beginning of the year was going to be up slightly this year, but overall, everything that you identified is something that we're seeing the effects of in the second quarter.

Peter Lisnic: Is there a way to weight those? In terms of which were bigger contributors than others?

Male Speaker: From the first quarter to the second quarter?

Peter Lisnic: Yes, either that or year-over-year, either way it works.

Male Speaker: First quarter to second quarter certainly the volume and the mix are going to be the two leading, but I think a close third would be the savings initiative.

Peter Lisnic: Okay. All right.

John Batten: Peter, it's John again. The biggest impact is going to be here in North America we were seeing operations had a four week shutdown which obviously they didn't have, they had a one week in the second quarter. So that would probably be just for volume and absorption that would be the biggest impact and we started shipping 8500's again in the second quarter.

Peter Lisnic: Okay, so that whatever, so like 40% manufacturing? I think you were down 40% in the US in the first quarter at some point there if I remember? (Inaudible) Okay, that was the big one. The one thing that we haven't really talked I think about a whole lot is that you introduced some of these new products like the 7500. Just sort of, and I know this will be sort of tricky, what expectations might be in terms of margin contribution? Are these products where you expect the return profile to be comparable to what you've got in the portfolio now? Or is there a chance that these products actually turn out to be markedly higher return products for you?

Michael Batten: The margins on the 7500 are going to be on a percentage basis comparable to other oil and gas kinds of margins. So I would see that there's leverage to be added (sp?) as we go forward from all the products that are used in the oil and gas industry which would be the 8500's, the 7500's. We have some large air clutches and some other products, industrial products that go into servicing equipment. So, by and large, I think we will see some leverage there, Peter.

Operator: It looks like we've lost Peter's line. Our next question comes from the line of John Debs with Bodri Capital.

John Debs: Yes, thank you. There is a push to replace diesel engines with, you know, with natural gas engines going forward. Supposedly there is a bill into Congress that would help this happen. Would that help or hurt your business, or what impact if any, would it have?

John Batten: An increased demand for natural gas will absolutely help the business. A lot of these, the pressure pumping activity is in natural gas, and those prices you know, have not recovered as they have in oil. So, I see that as a plus.

John Debs: What about vehicles though, that you would supply transmissions or whatever for?

Michael Batten: I think that the vehicles would probably, that would be benefited from natural gas would be in the lower horsepower automotive range, rather than in the larger heavy-duty construction or other off-highway equipment. It would take some time, I think, to have that developed as a market, but having said that John, the, we're not too concerned about either what the power source is because of we provide the products at the aft (sp?) end of the power source.

John Debs: Okay, and how important can pressure pumping be to you if the business comes back somewhat, in terms of your overall sales.

Michael Batten: It could be very helpful to us. As I mentioned in the previous response or question and response, we do get leverage from this particular industry, oil and gas. So we would benefit more on the bottom line than necessarily on the top.

John Debs: All right, thanks very much then.

Operator: Thank you and our next question is a follow-up question from the line of Shawn Boyd. Please go ahead.

Shawn Boyd: Thank you. I just wanted to come back to the margin structure of the company thinking about the answer on the ME&A expenses and some of the discussion there. The company, you know, in previous peaks (sp?) and gross margins over 30%, operating margins over 10% certainly, are we still going back to that? Is there a different kind of, maybe, medium trend target that we should think about and can you give us some sort of a revenue run rate that we might able to think about with Twin Disc going forward?

Michael Batten: We don't do a lot of specific forecasting Shawn, but let's go back to your original question on the gross (sp?) margin. Our targets would be to get back on an interim basis in the three zero kind of numbers and to work our way up to the mid-30's which is where we got. Now of course the mid-30's reflected a lot of oil and gas business during those years of starting 2007 and up to 2009. That was largely driven by mix, but we get them focused on getting our overall run rate and margins 30% and above. So that's where our target would be.

Shawn Boyd: Sounds good.

Michael Batten: And as far as revenue run rates, that is, we got some mixed bags as markets, Shawn, I mean oil and gas is coming back, the Pacific Basin and Asia are growing nicely, but we do have obviously some issues in the European market that we're having to deal with and we're just going into our planning process for fiscal '11 and I wouldn't want to be premature at this point to talk about a number until we've gotten through the scrubbing of our sales' forecasts. That would be for fiscal '11. Looking at our outlook longer term, I'm very encouraged by where we're positioned as a company in terms of the markets that we're serving and the technologies and the products that we're bringing to the market on an annual basis that differentiate us from the competition and provides real value to our customers. I'm looking with anticipation for the next three to four years, because I think we've got a lot to offer as we go forward.

Shawn Boyd: Understood. And the question about the revenue run rate was in conjunction with the margins so, for example, going back to an interim target of 30%, you know, with striving towards that 35%, hitting that 30% gross margins or particular revenue run rate level that you need to hit that?

Michael Batten: Well, we've got some good things. It'll depend upon the product mix because the various products that will get us there with higher margins could get us there sooner than with others. So a lot depends upon how much of the oil and gas comes back, as to how soon we get to the numbers. So, if we see a good run in the global oil and gas markets, it would be sooner.

Shawn Boyd: All right then.

Michael Batten: Rather than later.

Shawn Boyd: Got it. I understand you're not really interested in disclosing exactly what those margins are. But from the commentary here, I'm guessing they're a lot more than, you know, 100 or 200 basis points above the corporate average. You make a significantly better margin on that oil and gas product.

Michael Batten: Well, you've made the comments.

Shawn Boyd: Okay, good enough. Thanks for the clarity and good luck, gentleman.

Michael Batten: Josh, are we still on?

Operator: Yes sir. Once again ladies and gentlemen, if you'd like to ask a question at this time, please press the star followed by the one. As a reminder, if using speaker equipment, please lift the handset before making this selection. One moment please.

I'm showing no further questions in the queue. Please continue with any closing remarks.

Michael Batten: Okay, fine Josh, thank you. Well again, we would like to thank all of you who participated in today's conference call. We appreciate your interest and attention to our company and the progress that we're making going forward. So, thank you for your insightful questions today and we look forward to sitting down with you again in 90 days after the April quarter or the March quarter in April. So, thanks again and we'll talk to you soon.

Operator: Thank you, ladies and gentlemen. This concludes the Twin Disc Incorporated 2010 Second Quarter Financial Results Conference Call. If you'd like to listen to a replay of today's call, you may do so by dialing 603-590-3030 or toll free at 1-800-406-7325 and entering the pass code 4200481.

Thank you for your participation and you may now disconnect.