Twin Disc, Inc.
First Quarter Fiscal 2014 Financial Results
October 22, 2013

Operator: Good day, ladies and gentlemen. Thank you for standing by. Welcome to the Twin Disc Incorporated First Quarter Fiscal 2014 Financial Results Conference Call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be opened for questions. If you have a question, please press the star, followed by the one on your touchtone phone. For participants using speaker equipment, it may be necessary to pick up your handset before making your selection.

I would now like to turn the conference over to Mr. Stan Berger. Please go ahead, sir.

Stan Berger: Thank you, Camille. 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 2014 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 states 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 the 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 Chris 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 I'd also like to add my welcome to you all to our first quarter 2014 conference call. Today we will depart a little bit from our normal call format, and I'm going to ask John to take the lead to provide you with a brief review of the results of the first fiscal quarter, as well as his outlook for the year. I will return at the end of the call with some concluding remarks. John?

John Batten: Thank you, Mike, and good morning, everyone. Welcome to our fiscal 2014 first quarter conference call. As usual, we will begin with a short summary statement and then Mike, Chris and I will be happy to take your questions. First, I'd like to cover just a few of the highlights from the quarter.

Sales, as you know, were down slightly from the same period a year ago driven by lower sales in North America and Europe. Offsetting this, were higher year-over-year sales into Asia. Margins improved in the quarter due to improving mix and controlled spending. And as we previously announced, we recorded an additional 1.1 million of the restructuring charges at our Belgian operations. Finally, our balance sheet continues to improve despite the near-term financial results.

Turning to those results, sales for the 2014 fiscal first quarter were 66.4 million, down from 68.8 for the same period a year ago. The 3.5% decline was primarily driven by lower sales in the North American and European markets. Higher quarter-over-quarter sales into Asia partially offset these declines as demand for our pressure pumping transmissions in China grew in the quarter.

Looking at our broader markets, global sales for our Industrial products and marine transmissions were down slightly in the quarter, offset by the higher shipments of pressure pumping shipments into China. Gross margins for the quarter were 31.1% compared to 28.2% a year ago and 27.2% in the previous quarter. Favorable mix, including the oil and gas transmissions was the primary driver for the improved margins.

Spending in marketing, engineering and administrative, or MEA expenses, declined 1.1 million versus the same period last fiscal year from 16.6 million, or 24.2% of sales to 15.5 million and 23.4% of sales. The lower MEA spending for the quarter relates to lower stock-based compensation and incentive expenses and controlled spending throughout our global operations.

As we mentioned in the fiscal 2013 fourth quarter call, we recorded an additional 1.1 million charge for the restructuring of our Belgian operations and targeted reduction in the workforce. If you recall, the legal minimum of 708,000 was reported in the prior quarter, but negotiations had not been finalized from the quarter and fiscal year it closed.

Looking at the bottom line, fiscal 2014 first quarter net earnings were 1.3 million or $0.11 per diluted share compared to 1.2 million or $0.11 per diluted share for the same period a year ago. EBITDA for the first quarter was 6.6 million versus 5.3 million a year ago and 4.7 last quarter.

Turning to the balance sheet, we generated 8.9 million in free cash flow in the quarter. As a result, we were able to reduce debt net of cash from 6.4 million at June 30th, 2013 to 773,000 at the end of the first quarter. As we mentioned in the press release, we still intend to spend between 10 and 15 million in capital in the fiscal 2014 as we continue investing in modern equipment and facilities, our global sourcing program and new products.

The 9 million decline in our six-month backlog from 66.7 million to 58.1 million certainly was a disappointment in the quarter. Incoming orders from North America and Europe were generally weak during the first quarter. We think that this was primarily due to the macroeconomic uncertainties in North America, including the buildup to the shutdown and Europe, and also the inventory reduction activities at our distributors, dealers and OEMs.

We also recognize that during the fourth fiscal quarter of 2013 and the first quarter of this year, we announced reduced lead times across our product ranges. All of our production models are now within the six-month window of the reported backlog. As a result, we are seeing some orders delayed to these shorter lead times.

Fiscal 2014 continues to be influenced by the same dynamics that have affected our business during the past fiscal year. We continue to see strong demand from our global commercial marine customers and international oil and gas markets which is somewhat offset by continuing weak activities from the European markets and global mega-yacht customers. At this point, it looks like the recovery in North American oil and gas will be postponed another quarter or two as the overcapacity situation continues, even with the increased utilization of the pressure pumping fleet.

Middle to longer-term, we are well-positioned to take advantage of the global opportunities ahead of us. Our leading positions in the markets we serve, our innovative product development and our geographic diversity reflect a sound strategic plan for the future.

That concludes my prepared remarks, and now Chris and I will be happy to take your questions. I should add that Chris is joining us from our plant in Belgium so there might be a small delay in any responses to questions that he is taking. Camille, please open the line for questions.

Operator: Thank you, sir. Ladies and gentlemen, we will 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 your question, please press the star, followed by the two; and if you are using speaker equipment, you will need to lift the handset before making your selection. One moment please for our first question.

Our first question is from the line of Peter Lisnic with Robert W. Baird. Please go ahead.

Josh Hansen: Hi, good morning. This is Josh Hansen in for Pete.

John Batten: Hi, Josh.

Michael Batten: Good morning, Josh.

Chris Eperjesy: Hi, Josh.

Josh Hansen: Hi, good morning. Just wanted to start off with gross margin which was very strong this quarter. Is there any reason to think that mix was unusual or, I guess to ask another way, you know, is this quarter's mix representative of what you think you'll see for the rest of the year?

John Batten: Josh, it's John. I think that this—the high 20s to 30 is still possible, you know, going forward each quarter. We're having good aftermarket and industrial orders filling in the quarter. It's just really is a question of, you know, how many 8500s and other oil and gas products that we can get in the quarter. But it's—you know, we were very happy to get back above 30 and it's still what we're shooting for every quarter.

Josh Hansen: Okay, great. And then on the—a question on the backlog decline. Is there a way you can talk about what market contributed to that decline? I mean, assuming that—I'm assuming that North American oil and gas has very little to do with it at this point; is that correct?

John Batten: That's correct. I would say there was a slight decline in all of the product categories and, in general, that was driven by North America and Europe, just a quarter of orders. Then there's the slight decline also in the backlog for international oil and gas, but, you know, I'm optimistic that that's going to rebound a little bit. I'm also optimistic that the other backlogs will rebound.

It was a very uneven quarter as far as ordering. We had a bad month, then a good month, then a bad month, and October's turning out to be a better month; so just a very uncertain summer as far as in the ordering pattern for products.

Josh Hansen: Right. So it—but it seems like—from your comments it seems like you think that it's more contemporary do anything, right?

John Batten: Josh, I certainly hope so. I hope that—I think that the—the activity that we've seen as far as the market activity looks positive. I think people were reducing, you know, whether it's our distributors, dealers, OEMs, reducing inventory over the summer and I think it is a timing issue of when the orders come in for international oil and gas and some of the bigger projects that we have. So, yes, correct. I don't see it, you know, staying down at this level for extended periods of time.

Josh Hansen: Okay. I see. And then can you talk about the shift in timing for the North American oil and gas recovery? And then, I guess, in particular I was wondering whether some of the field productivity improvement that is being achieved is actually contributing to a delayed recovery, if you will.

John Batten: I—to answer that last question, I do. I've been reading some of the other conference calls and press releases, and what I'm seeing from the big guys is that their efficiency is up, their utilization is up and so they are working through that. It's a range between 15 and 20% overcapacity slower than everybody thought they would. The unused units sitting on the floor are being taken, but it's just not as fast as everyone thought it would.

Josh Hansen: Okay. That makes sense. And then lastly, you know, as China oil and gas becomes more and more important, is there a way that you can ballpark for us, you know, how fast that market is growing for you?

John Batten: I'll let Chris take how far. It is growing very nicely. I mean, it's become—you know, it's certainly—it's not half of what the North American market is, but it's nice steady growth and it's turning into a very viable market, but it's not nearly the size of what the North American market is as far as millions of horsepower and number of rigs inside, yet. But we are enjoying a very good market share in-country.

Josh Hansen: Okay. Okay. I appreciate the color there. Those are all the questions, so thanks for the time and congrats to Mike (cross talking).

John Batten: Thanks, Josh.

Josh Hansen: Thank you.

John Batten: Thanks, Josh.

Michael Batten: Thanks, Josh.

Chris Eperjesy: Thanks, Josh.

Operator: Ladies and gentlemen, if there are any additional questions please press the star, followed by the one at this time; and if you are using speaker equipment, you'll need to lift the handset before making your selection.

Our next question is from the line of Walt Liptak with Global Hunter Securities. Please go ahead.

Walter Liptak: Hi, thanks. Good morning, guys.

John Batten: Morning.

Michael Batten: Morning.

Chris Eperjesy: Hey, Walt.

Walter Liptak: I wanted to ask a little bit about the oil and gas markets and, you know, and try to get an understanding of discussions you've had with customers and if we could drill down into maybe the basins that are strong and which are weak.

John Batten: Mm-hmm. Well, I would say that still the majority of the fleets have switched off of pure unconventional are back in oil and wet gas. We just see the number of hours being put on the rigs a lot lower than they used to be. And in China they're still, you know, easing into the pure unconventional horizontal drilling. A lot of the rigs over there right now are still, you know, getting used to doing that type of drilling, so it's—the rigs are definitely, and the plays are definitely being used on easier applications at this time.

So, you know, I see the activity. Everyone is striving, you know, with getting back into unconventional and striving to get back in, doing it a lot more efficiently with less equipment and people there. So, that's what we're seeing right now.

Walter Liptak: Okay. We're hearing about 2014 cap ex increases…

John Batten: Mm-hmm.

Walter Liptak: …and, you know, maybe albeit small. Is that something similar to what you're hearing?

John Batten: Correct. That's what we're hearing. That they'll start to, you know, issue orders for new equipment sometime in calendar 2014.

Walter Liptak: Okay. How does—so with the, you know, the modest change or the push out, I guess, though in the outlook for oil and gas, how does it change, you know, your 2014 production schedules or any sort of changes that you need to make to capacity or pricing?

John Batten: Well, we had, you know, most of what he had actually planned on building in 2014 for oil and gas primarily was for Asia. I mean, we were hopeful that 20—that North America would come back, but if orders start to come back in the first quarter of 2014 calendar, that really would just affect our fourth quarter so, you know, there will be some orders, some aftermarket orders and probably replacement units, but if what I'm reading is the same, you know, press that you're reading is that they won't start ordering until calendar 2014. That really just affects our fourth quarter and would be, you know, later into the summer, the middle two calendars of the calendar year—middle two quarters, sorry.

Walter Liptak: Okay, got it.

John Batten: So, as far as capacity, we have capacity. We're—our lead times are under six months so, you know, if we had orders today we could react in the third quarter fairly—I mean, our fiscal third-quarter quite easily.

Walter Liptak: Okay. And kind of along those lines—and, you know, you made the comment about—a couple of times—about all your forward production is within that six-month window.

John Batten: Correct.

Walter Liptak: Does that mean that you're expecting that your production levels are sort of matching what your backlog level is? So we should see a similar level of revenue in the coming quarters unless we see a buildup in backlog?

John Batten: No. You'll just see a lot—there'll be a lot of turnover in the backlog. You've never really been able to add our six-month backlog, double it, and get the forecast for the whole fiscal year, so it's not a perfect measurement. The backlog can come up.

If you go back three years ago, you saw how quickly the backlog comes up, and even when we had, a—you know, you could—there's potential to have a six-month backlog that, you know, more than double what our production would be—or, sorry, for the whole fiscal year. So it's an indicator. It's not a perfect indicator, but you'll see this—when we reduce lead times, people will tend order to both lead times, so all of our industrial products are well within orders, so within three months in all of our marine and oil and gas is now within six months. So if they need it in six-month or if they need it in four months, they're going to order it four months out. So the backlog is a reflection of—partially reflection of what's happened with our lead time.

Walter Liptak: Okay, got it. So as we're thinking about the quarter that we're in, the visibility that you have, it's sort of on a month-to-month basis to some extent?

John Batten: Correct. It's on—yes, it's—you know, the visibility is much better on the second quarter than it is on the third quarter or the fourth quarter which is different than it was in 2010 when the backlog bottomed out. The visibility there was much better, you know, in month's four, five and six than it was in one, two and three.

Walter Liptak: Okay. Okay, got it. And, you know, some of the macro industrial data points are starting to pick up a little bit.

John Batten: Mm-hmm.

Walter Liptak: And I'm wondering, you know, you talked about, you know, some of the industrial end markets and airport, the ARF (ph) business as being stable. Any, you know, recent trends within the last month or two to suggest that anything's getting bigger, or getting better?

John Batten: I would say October. As I mentioned at the beginning, I think in Josh's question, the month of October as far as orders is a much better indicator than the first quarter. I mean, much better sign than the first quarter with a much stronger order month. I think that the markets have picked up, and maybe it was, you know, just a quarter of adjusting inventories. And I think the industrial—the leading economic indicators that we're watching suggest that the general industrial production should be increasing in the next few quarters.

Walter Liptak: Okay. Okay, thanks very much.

John Batten: Thank you.

Operator: Our next question is from the line of Peter van Roden with Spitfire Capital. Please go ahead.

Peter van Roden: Hey, guys.

John Batten: Hello.

Michael Batten: Hello.

Chris Eperjesy: Hey, Peter.

Peter van Roden: Just a quick question to start on China. Who are your customers there? Are you guys working with U.S pressure pumping companies or is it more Chinese manufacturers?

John Batten: It is almost 100% Chinese production whether it's SJ, Shaanxi Yanchang (ph) or Baoji or—I'm not going to try to pronounce the fourth one because I'll butcher it, but it's domestic Chinese producers.

Peter van Roden: Okay. And are your margins there kind of similar to what you would see in North American pressure pumping?

John Batten: They are basically spot-on to what we see in North America.

Peter van Roden: Got it. Okay, and then—if you were to sort of look a couple of years and think about margins in the context of a North American pressure pumping recovery, would you ever get back to that kind of 2011/2012 or 2012 number, or was there a decent amount of pricing that you guys were getting because the market was so tight?

John Batten: I think we would get that. If we got back to that type of volume in oil and gas in North America, our margins would come back to the mid-30s, correct.

Peter van Roden: Okay. Those were my two questions. Thanks, guys.

John Batten: Okay. Thanks.

Michael Batten: Thanks Peter.

Operator: I'm showing no further questions at this time. I'd now like to turn the call back over to Mr. Batten for closing remarks.

Michael Batten: Thank you, Camille. As all of you know by now, I will be stepping down as CEO effective November 1st and this will be my last conference call with you. While I've been an employee of Twin Disc for 43 years and while I have many wonderful memories—and I have to admit that some memories are truly challenging times during the 1980s—I want to focus my remarks on the successor team and the future.

As I look ahead, I see a bright future for Twin Disc. The Company is well-positioned for continued success in the years to come. We have embarked on a strategy of product innovation and differentiation, as well as market and geographic diversification that will spur the growth and profitability of Twin Disc going forward. We're either number one or number two in each of our product market sectors and we will continue to build on these core business areas for the future.

Most importantly, we have developed a successor Management team that has the knowledge, experience, discipline to execute the strategic plans and deliver the value that our shareholders expect from us. Each and every year and over the long haul, they seek to maximize our economic profits defined as our earnings in excess of our cost of capital.

This Management team knows how to manage a complex mix of products, markets and cultures in a cyclical global environment. This is not an easy task. As a small-cap company, we face all the challenges of large-cap multinational enterprises many times our size. However, we view this as an opportunity and a competitive advantage.

And finally and most importantly, the team exemplifies the tone at the top character traits that are necessary to lead a successful company. Integrity, honesty, respect for the dignity of others and leadership by example defines the value system of the successor Management. All in all, I have great confidence in our successor team. They are very capable people and capable Managers, and as—they will do a fine job going forward.

In closing, I would like to thank our Board of Directors for their role in supervising the succession plan and providing their valuable input along the way. In addition, I would like to thank the Directors, both present and past, for their support of Twin Disc Management over the last 30 years. Our Management team and I, in particular, have truly benefited from their wise counsel and constructive criticism.

And finally and most importantly, I would like to thank all of you, our shareholders, for your continuing support over the past three decades. I've gotten to know many of you personally and appreciate your counsel and friendship.

Thank you, again, for attending the conference call today, and I know that John and Chris look forward to speaking with you again in January following the close of the second fiscal quarter.

Camille, I'll turn the call back to you.

Operator: Thank you, sir. Ladies and gentlemen, that does conclude our conference for today. Thank you for your participation. You may now disconnect.