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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Second Quarter 2023 ESCO Technologies Earnings Call. (Operator Instructions) Please be advised that today's conference is recorded. On the call today, we have Bryan Sayler, President and CEO; Chris Tucker, Senior Vice President and CFO. And now I would like to hand the conference over to our first speaker today, Kate Lowrey, Vice President of Investor Relations. Kate, you now have the floor.

Kate Lowrey - *ESCO Technologies Inc. - VP of IR*

Thank you. Statements made during this call, which are not strictly historical, are forward-looking statements within the meaning of the safe harbor provisions of the federal securities laws. These statements are based on current expectations and assumptions, and actual results may differ materially from those projected in the forward-looking statements due to risks and uncertainties that exist in the company's operations and business environment, including, but not limited to, the risk factors referenced in the company's press release issued today, which will be included as an exhibit to the company's Form 8-K to be filed. We undertake no duty to update or revise any forward-looking statements, except as may be required by the applicable laws and regulations.

In addition, during this call, the company may discuss some non-GAAP financial measures in describing the company's operating results. A reconciliation of these measures to their most comparable GAAP measures can be found in the press release issued today and found on the company's website at www.escotechnologies.com under the link Investor Relations.

Now I'll turn the call over to Bryan.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Thanks, Kate, and thanks, everyone, for joining today's call. We appreciate all of you taking time to get an update on ESCO this afternoon. So our year is off to a great start, and I'm pleased to speak with all of you about our second quarter results. The first 6 months of fiscal 2023 have gone well, and we're pleased that the outlook remains robust as we look forward.

Before I jump into the highlights for the quarter, I do want to take a moment to thank all of our employees. ESCO has delivered strong results over the last 1.5 years, and our talented and dedicated employees have been essential to these outcomes. Business has been very good, but we continue to experience a challenging operating environment. Supply chain performance has steadily improved, but it's not quite delivering with the efficiency that we experienced pre-pandemic.

We also see challenges at a number of locations related to getting up to full staff. These issues do create extra burdens for our operating teams across the company, and I appreciate everyone's extra efforts to help the company adapt and improve as we continue to drive growth. With that, let me pivot into the quarterly results.

We had a really strong second quarter with good sales and earnings growth. Even more exciting is the continued strength that we're seeing with orders and backlog. All 3 of our segments had book-to-bill ratios in excess of 100%, and we finished the quarter with $741 million of backlog. That represents a $70 million increase over March 2022 and a $46 million increase from September of '22. It's clear that we serve a dynamic customer base in high-growth industries.

ESCO has the right products and the right services for the right markets. It's a powerful combination that gives us confidence in our future. Chris will get into some of the financial details in a few minutes, but I do want to offer some top level commentary about each of the operating segments.

Starting with Aerospace & Defense, where we had another great quarter. Sales increased by 17% and adjusted EBIT dollars were up by over 35%. As you all know, ESCO has a broad collection of product lines here, and we are continuing to benefit from robust market conditions. Growth continues to be driven by commercial aircraft recovery, but we're also seeing good activity in military aircraft and Navy businesses as well.

The operating challenges that we see across ESCO are most pronounced in the Aerospace & Defense group. While ESCO's supply chain performance is improving, we still have past due backlog issues, which are primarily the result of industry-wide supply chain instability. The teams continue to work the issues aggressively, and we will continue to see strong sequential growth in our revenues, but we do not expect full resolution of past due backlog in the near term.

Next up is the Utility Group, which also had a strong quarter. Revenue growth was over 23% in the quarter, and adjusted EBIT margins expanded by 13 basis points to 17.8%. The core utility business continues to be solid as customer base invests in electric infrastructure, and we continue to see our backlogs grow. In particular, we're seeing strong orders and sales activities from our condition monitoring product lines. This is a trend that we anticipated as utility customers continue to push for high reliability by monitoring their critical assets in real time.

On the renewables side, our growth continues to exceed our expectations, with particular strength in solar resource monitoring. 2023 looks to be the third year in a row of sales growth in excess of 20% for NRG. The USG is a good story for us. We've built a great team. We've expanded our product offerings in both utilities and renewable market spaces, and we're performing well for our customers, all of which is driving above-market growth.

The Utility Solutions Group has made investments in inventory in order to protect our customer commitments as we manage through supply chain challenges. We expect that these investments will moderate as we move forward and inventory will start to burn down in the second half of 2023.

Finally, I will touch on the Test business, where we did see a bit of a drop in sales and EBIT in the quarter. The Test business has seen tremendous growth over the last few years, and Q1 was strong as well. We mentioned during our earnings call in February that this business was expected to be weaker in Q2, driven mostly by lower activity in China. That did come to pass as we experienced significant disruptions as the economy opened up post pandemic. In the end, sales were down by 9%, and EBIT margins came in at 14.2%. The business did see a book-to-bill ratio of 109%.

Overall, the backlog situation here is good. So while we could see another soft quarter in Q3, we expect the sales growth to return by Q4.

So to summarize, it's been a great start to the year for ESCO, with 2 really strong quarters. We're on a good path overall as we drive to deliver our targets for the full year. Chris will provide some additional detail in a minute, but we are increasing the full year outlook again this quarter. Now I'll turn it over to Chris to give some more financial highlights on the second quarter.

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Thank you, Bryan. Everyone can follow along on the chart presentation. We will start on Page 3, where we have the overall financial highlights. As Bryan mentioned, we had a great quarter, and this chart illustrates that very well. Sales were up nearly 12%, adjusted EBIT was up over 21% and adjusted EPS was up over 17%, another great quarter of overall growth for ESCO.

Orders growth in the quarter was over 6%, and we once again finished with record backlog at $741 million. We had $0.07 of adjustments to EPS in the quarter. The biggest driver there was additional costs related to our CEO transition with a $0.04 add back for that. We had an additional $0.02 added back for onetime purchase accounting amounts related to the CMT acquisition that we announced in February and another $0.01 related to the restructuring charges in the quarter.

If we go to the next, Chart 4, we'll get into segment results, starting with Aerospace & Defense. This business really had a strong quarter, delivering 17 for sales growth -- 17% sales growth overall. Organic sales growth was 14%, and the CMT acquisition added another 3 points of growth. Adjusted EBIT dollars were up 35% and margins improved by 270 basis points compared to the prior year quarter. Dynamics are solid across the entire segment, but we've seen notable strength from the commercial aerospace business, where sales grew 27% in the quarter.

Backlog ended at $435 million for this segment with the CMT acquisition adding $7 million in acquired backlog. We've continued to battle operating challenges in this group, which has led to higher-than-normal levels of past due backlog and increased working capital levels as well. The teams are working this aggressively, and we have seen some improvements. But overall, we expect these conditions to persist as we move forward.

I also wanted to comment on EBIT margins for this group. Really great performance to get the adjusted margins up to 19.8% in the quarter. Obviously, we are seeing nice leverage on the increased volumes, and we've also seen good execution on price increases, which more than offset material inflation during the quarter.

Next, on Chart 5 is the Utility Solutions Group, where we also had a very strong quarter. Sales growth was 23% with Doble and NRG both posting double-digit growth. Adjusted EBIT margins went from 17.7% in the prior year quarter to 17.8% this year. The flow-through on the sales increase was held back somewhat by unfavorable mix and increased cost for travel and in-person customer events. Orders were down 2% in the quarter, which was driven by comps to the prior year when we booked a large multiyear order for a Doble Universal Controller enterprise customer. Even with the orders down in the quarter, the business still finished with backlog of $143 million, which is up more than 20% compared to March of '22. We are seeing high levels of business activity here in both the core utility customer base as well as the renewables markets, and we continue to have a very favorable long-term outlook for the Utility Solutions group.

The last segment we'll talk about is Test, which did experience a bit of weakness in the second quarter. This result was expected, and we had mentioned this during the earnings call last quarter. Weakness in China was the main driver here as we saw a significant disruption to the business as China shifted from a zero COVID approach. Margins did drop in the quarter but still came in at 14.2%, which is a solid result. Orders were flat to prior year second quarter, and the book-to-bill ratio was 1.09. So the business still has a healthy backlog. As we move forward, we expect the third quarter here to still be a bit soft, and we would anticipate growth to return by the fourth quarter.

Chart 7 has year-to-date cash flow highlights. Cash used by operating activities was $5.5 million during the first 6 months. Working capital was unfavorable in the first 6 months with accounts receivable, inventory and accounts payable all driving unfavorable impacts to operating cash flow. Capital spending was down just over $10 million and acquisition spending increased by $2 million.

On share repurchases, we have completed just over $12 million so far this year compared to nearly $18 million in the prior year period.

I did want to provide a little commentary on full year operating cash flow expectations. We don't generally provide guidance for operating cash flow. But given the worst -- the weak first half, we wanted to state that the expectation for operating cash flow is that it will improve in the second half, but the full year will be down approximately $20 million to $30 million compared to fiscal '22. This is mostly driven by the timing of milestone payments received in 2022 that don't repeat in '23 as well as cash payments for taxes, which will be significantly higher in '23 compared to '22.

Chart 8 is our guidance for earnings per share. The full year outlook has been increased. You'll recall that the prior guidance was $3.50 to $3.60 per share on an adjusted basis. We have increased that to $3.55 to $3.65 in the current outlook. As we mentioned in the press release, the full year guidance is based on sales in the range of $930 million to $950 million. For the third quarter, we expect a range of $0.96 to $1.01 per share on an adjusted basis.

That concludes the financial update, and now I'll turn it back over to Bryan.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Thanks, Chris. I touched on quite a few of my thoughts earlier in my commentary, but I will offer just a few more comments before we move to the Q&A session.

You saw the numbers from Chris. So obviously, a great start to the year for ESCO with strong financial performance. The company is operating at a high level, and our outlook for the future continues to improve. Our portfolio of businesses provide critical solutions for markets with long-term high-growth characteristics. And whether it's strength from aircraft components, continued momentum for utility customers or success on Navy programs, there are a number of positives, and we're excited about our prospects going forward.

Lastly, before Q&A, I do want to say thank you to Vic Richey once again. As you all know, Vic was the CEO here for over 20 years. We mentioned in the press release that he will fully retire effective June 30 and will no longer be a member of our Board or an employee of the company. Vic has been extremely supportive of me throughout my career and throughout this transition. Our Board has managed a very orderly transition from Vic to myself, and the process has been very smooth. Vic is looking forward to the next phase of his life, and we are very grateful for his significant contributions over the years.

As I said before, this is a great time for ESCO, and we're really excited about our future. Vic played a huge role in building the foundations here, and we wish him all the best in his retirement. So with that, we'll open it up for questions and answers.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) First question comes from the line of John Frenzer (sic) [John Franzreb] from Sidoti & Company.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

I'd like to start with the supply chain issues and the bottlenecks. Can you give us a little color of what the issues are and maybe when you expect them to be resolved?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Sure. So I'll give you an example from -- over on the Aerospace & Defense side. And I think there's 2 different types of phenomenon that are occurring there. The first one is that during the course of the pandemic, the supply chain was pretty efficient. A lot of small players when they reduce their bill rates and cut back on personnel, a lot of those smaller businesses had to give up some people. They're having a really hard time building themselves back up. And so these are things like outside processing, whatnot. And so those guys are really struggling. We are limited in our ability to replace them in some cases because of the special qualifications and certifications that are required on specific parts. So that does kind of slow things down.

But another big area for us is we do have a lot of customer-directed materials that we have to purchase per the customer's direction, things like castings and whatnot. And in some cases, those casting suppliers and others are receiving direction from our customer to prioritize other work. So we do think it's going to take several quarters to work through that. Now having said that, I want to be clear, we're making good progress on this front, and you will -- you should expect to see good growth sequentially in our revenues as we move forward.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

Okay. That helps. And in regards to Test, why is China still an issue? And it also seems like there was some weakness in the quarter here in the States. Maybe a little thought on when Test can finally turn around being that, I kind of figured, post-COVID-related issues would really be relatively far in the rearview mirror by now.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Yes. So in China, the issue is not so much that people are sick. I mean we did have about, gosh, 90% of our employees that were affected over the last couple of quarters. But the real issue now is that as we -- as they begin to reopen, not all of their customer sites are excited about having outsiders come in. And so that's kind of slowing down. We do have a pretty good backlog over there. And our factory is up and running kind of at full blast, but we're not able to recognize all the revenue until we get on site and complete the work.

Domestically, I think it's really more of a comparison issue. We had a record 2022, really, really robust. And remember, the Test business did not experience the same kind of decline during the pandemic that a lot of other businesses did. They were running and gunning in the entire time and saw substantial growth. So while I think on a year-over-year basis, we're seeing a little bit of a decline there, I think the business is still doing very, very well.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

Got it. Got it. And just one last question. On USG, you've mentioned the unfavorable mix. Do you expect any kind of mix shift as the year progresses? Or should we kind of bake the current mix into the margin profile on a go-forward basis?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

No, I think it's going to normalize as we get into the second half of the year. I mean we do see a lot of activity. We've had a number of our highest margin type product lines that were a little bit restrained for shipping reasons and that sort of thing. But we expect that, that will normalize through the second half of the year.

Operator

(Operator Instructions) Our next question comes from the line of Jon Tanwanteng from CJS.

Ross Kesselman

This is Ross Kesselman, associate at CJS, standing in for John. Looking at the guidance, you only raised by the amount that you beat by. Does this mean that the Q1 strength was a one-off and you don't expect similar momentum going forward? Or are you just building a bigger cushion? Or are these other -- are there other kind of ways to interpret it?

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

I would say that we're not trying to build a cushion or anything. If you look at the second half, I mean, it still has good growth characteristics. So it's not really like it's backing off per se. It's -- so you're right, the second quarter kind of flows to the year, but we still see good growth dynamics in the full year outlook, and that's what's embedded in the $3.55 to $3.65.

Ross Kesselman

If I can sneak in one follow-up. Can you talk about the aftermath of the Doble Conference and if you're seeing the types of engagement you want to see versus pre-COVID? How much of the strength is recovery? And how much of it is new business, such as acquisitions or infrastructure spending making its way to the utilities and renewables?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Well, that's a great question. One of the things I'm really excited about is that when I had a chance to go to the Doble Conference again this year, and we were back up to normal attendance, which is a strong indicator that the utilities have kind of gotten past COVID. For a long -- throughout the -- even up to last year, they were restricting people from traveling and that sort of thing.

But listen, I think a lot of the activity we're seeing now is actually new activity. I think a lot of the pent-up demand that we may have seen during the pandemic is kind of behind us. We're seeing very, very robust investments from utilities or renewable customers. Some of that is stimulated by the Inflation Reduction Act and the infrastructure bill that were passed in the last few years. But really, if you think more fundamentally, when you look at all these net 0 targets that are coming out from government and industry, that all points to a very substantial requirement that a grid being built out in a more fullsome way. And so what we're seeing is a lot of that, I would say, the early parts of that investment coming to fruition.

Operator

Our next question again comes from the line of John Franzreb with Sidoti & Company.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

I just want to ask the question about the cash flow. I mean we have the cash outflow just under $15 million operating cash flow in the first half. And you suggested that it'd be only down $20 million to $30 million. That certainly suggests really good cash collections in the second half. What's driving that?

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Yes. I think mainly, if you look at the receivables impact in the first half of the year, we saw receivables build a fair bit, especially when compared to last year, when they actually went down a little bit. We see that a little bit in Aerospace & Defense Group, where we just have sales growth. We expect that to come in through collections in the second half.

And then also in the Test business, we had a little bit of a build in receivables there, kind of had some business mix issues going on with project versus more kind of product shipments. So that hurt us in the first half. But again, we expect those collections to come in strong in the second half. So we feel good about that.

And then we also have, in some of the big other project businesses, just the timing of when we receive some of the customer funding on those projects for different milestones and such is kind of weighted towards the back half. And so we -- that's the other kind of key driving it there.

John Edward Franzreb - *Sidoti & Company, LLC - Senior Equity Analyst*

Okay. And anything on the inventory front? Because I noticed the inventory, I don't know, relative to the year-end, has ticked up a bit...

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Yes, it has. I mean I would say that we're probably not going to flush quite as much inventory out as we come to year-end as what you maybe you've seen from us in the past. That's one of the reasons that we're kind of talking about the past due backlog sticking with us a little bit longer. As we move forward, that's going to drive some more inventory there. So you'll see that maybe moderate down a little bit, but not a huge flush because we're still going to be working some of these issues as we cross into the next fiscal year.

Operator

Our next question comes from the line of again, Jon Tanwanteng with CJS..

Ross Kesselman

Can you talk about the uplift from the Columbia program in terms of magnitude and frequency of deliveries? Will it be similar to Virginia, where you have a big delivery every year in the fourth quarter?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

I do think we're going to get a lift from Columbia, but I don't think we're far enough along to know whether that's going to -- which quarter that's going to typically come in each year. Don't forget that on that part of our business, we're recognizing our revenue on a cost accumulation basis rather than a unit delivery basis. And so that will smooth out the way that, that looks from a revenue perspective.

Where I think you're going to see it be a bit lumpy is on the cash side. We get very large payments as milestones are achieved. And so that will be much more lumpy. And I think on the order side, you should expect it to be a little bit lumpy on the order side. But from a revenue perspective, it should be a little smoother ramp.

Operator

Thank you so much. All right. At this time, there are no further questions. So I would now like to turn it back over to Bryan Sayler for closing remarks.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Well, listen, thanks, everyone, for taking time to chat with us. We're excited about our business, and we're looking forward to talking to you again next quarter.

Operator

All right. Thank you so much for your participation in today's conference. This does conclude the program. You may now disconnect.