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PRESENTATION

Operator

Good day, and welcome to the ESCO Q4 2017 Earnings Conference Call. Today's call is being recorded. With us today are Vic Richey, Chairman and Chief Executive Officer; Gary Muenster, Vice President, Chief Financial Officer. And now to present the forward-looking statement, I would like to turn the call over to Kate Lowrey, Director of Investor Relations. Please go ahead.

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

Thank you. Statements made during this call regarding the amounts and timing of 2018 and beyond, EPS, adjusted EBITDA, EBITDA, EBIT, EBIT margin, growth, non-cash depreciation and amortization from recent acquisitions, tax rate, profitability, sales, cash flow, order, success of new products, success in completing additional acquisitions, the results of recent acquisitions and cost reduction activities, and other statements, 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, whether as a result of new information, future events or otherwise.

In addition, during the call, the company may discuss some non-GAAP financial measures in providing 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 Vic.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

Thanks, Kate, and good afternoon. As noted in the release, we're wrapping up '17 in a strong fashion, which Gary will describe in a moment. I'm happy to report we delivered on our earlier expectations of EBITDA and EPS. Setting aside the numbers for a second, I'm most satisfied with our recent M&A activities as we've added 4 great companies this year, supplementing the 3 we acquired in 2016. With these new partners, we've not only added great companies to our portfolio, we also added strong management teams who share our vision and our values.

As we look toward the future, we plan to build on both the organic and acquisition successes we've achieved over the past 2 years, and we will continue to aggressively address the normal market challenges we face every day. This gives me a favorable view of our future, and our goal remains unchanged, and that is to increase long-term shareholder value.

Before I give my perspective on our outlook for '18, I'll turn it over to Gary to wrap up '17 with a few financial comments and to summarize our '18 outlook.

Gary E. Muenster - *ESCO Technologies Inc. - CFO, EVP and Director*

Thanks, Vic. I'm pleased with the '17 financial results and very proud of what we accomplished this year in the way of acquisitions, which better positions the company for achieving our long-term growth objectives across the portfolio. At the start of the year, we set our financial goals centered around EBITDA, which we expected to be in the range of $122 million to $124 million and with GAAP EPS expected in the range of $2.16 to $2.26 a share, and we also described several non-cash items that would be impacting our GAAP results.

Given our additional M&A activities completed late in the fiscal year, coupled with the corresponding GAAP required non-cash purchase accounting charges from these acquisitions, our GAAP earnings became less comparable as the year progressed. As a result, adjusted EBITDA and adjusted EPS became more important operating performance measures when looking at our comparative results. This adjusted approach is consistent with our view of '16's operating performance.

So touching on a few financial highlights from '17. For the year, we reported $123 million of adjusted EBITDA, which is slightly better than our previous expectations of $122 million communicated in August. This represents a $22 million and 22% increase over '16's adjusted EBITDA of $101 million.

During Q4, we reported a record-high quarterly adjusted EBITDA of $43 million, which reflects a 34% increase over the comparable $32 million noted in Q4 of last year. All 4 operating segments contributed to the Q4 earnings increase as follows: Filtration delivered a 22% EBIT margin; Doble, within USG, came in above 28%; and Test reported a 16% EBIT margin. Of special note, over the past 6 months, Test delivered $89 million in sales at a 15% EBIT margin, reflecting our lower cost structure. Our adjusted EPS of $2.22 a share in '17 increased over 9% from the $2.03 reported in '16. Q4's adjusted EPS of $0.79 a share increased 18% compared to Q4 '16's adjusted EPS of $0.67.

Sales increased $115 million or 20% year-over-year with organic sales increasing about 4.5%, supplemented by an M&A sales contribution of about $90 million. Entered orders were $737 million, reflecting a book to bill of 1.07 and increasing our end-of-year backlog by $51 million or 16% from the start of the year. Our orders increased $161 million or 28% over the $576 million in orders received last year. All 4 operating segments also had positive book to bills for the year led by the Test business, which recorded nearly $200 million in orders. And I'm pleased to report that this strong order trend continued into the first 6 weeks of fiscal '18, which Vic will discuss later in his commentary.

And finally, cash provided by operating activities was $67 million, resulting in net debt of $229 million and a reasonable 2.2 leverage ratio. Our significant credit capacity and available liquidity have us well positioned to execute our long-term strategy. As we enter '18, I'm confident that our current backlog and our expected order profile supports our outlook as described in the release.

So now turning to '18. As noted in the release and as discussed in my earlier comments, given the significant increase in our recent M&A activities comparative GAAP EPS amounts become a bit more complicated. As an example, non-cash depreciation and amortization from the recent acquisitions is expected to increase over $7 million, or $0.18 a share in '18 compared to '17. As such, management will continue to emphasize adjusted EBITDA as a supplement to GAAP EPS as we believe this is more relevant metric to be considered when measuring operating performance on ongoing basis and is a better measure for determining ESCO's enterprise value.

For 2018, we expect adjusted EBITDA to increase between 15% and 17%, resulting in $141 million to $143 million of adjusted EBITDA, which compares to the $123 million we reported in '17. To bridge our expected adjusted EBITDA to our GAAP EPS, in the release, I've called out a few items, including higher non-cash depreciation-amortization charges, which I mentioned at $0.18; additional interest expense impacting GAAP EPS by $0.12; and the estimated tax rate differential, which impacts GAAP EPS by $0.07. These result in a total EPS impact of $0.37 in '18 compared to '17. As these -- as a result of these incremental charges, '18 EPS on a GAAP basis is expected to be in the range of $2.30 to $2.40 a share, and that obviously assumes no additional M&A activities during the year, which could impact this range depending on their timing, the profit contributions and the related purchase accounting.

On a quarterly basis, '18's EPS profile is expected to be back half weighted but with a more pronounced second half earnings contribution when compared to '17. So when comparing '18's guidance to last year, we're expecting meaningful increases in sales at USG and Test, along with higher sales of aerospace products at PTI, Crissair and Mayday within the Filtration group. Filtration continues to benefit from the strong commercial aerospace market, but its growth in '18 is muted by: PTI's reduced sales of a low-margin industrial, automotive product driven by a specific customer's desire to move to a foreign competitor offering a substantial price reduction; and by the timing of VACCO's SLS sales as this program transitions from design and development revenue to production hardware. VACCO's future margin will benefit significantly once the SLS program begins its launches, where our content is over $13 million per launch.

Test sales are expected to increase in the mid-teens with the projected EBIT margin at 13%. This view is supported by Test's ongoing and strong opening balance sheet, a catch-up of the 2017 program delays, recent large program wins as well as its lower cost structure, which we validated in the last 6 months of its performance.

USG sales are expected to grow over 37% with EBIT margins over 21%. This is despite our continuing investment in new products and solutions as well as an increased focus on international sales and marketing when compared to '17. The sales increase reflects the full year impact of USG's recent M&A activities coupled with growth from recent new product introductions such as the DUCe, protection hardware, software applications and the rationalization of our sales channels.

Lastly, corporate costs are expected to be significantly higher in '18 due to the additional non-cash amortization of the identifiable purchase accounting assets recognized on the corporate books. I'll be happy to address any specific financial questions when we get to the Q&A, and so now I'll turn it back over to Vic.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

Thanks, Gary. Entering fiscal '18, I'm confident all of our businesses are in a solid financial condition with known and quantifiable growth opportunities. We're well positioned to deliver our projected results in '18 and in the out years.

As I've noted previously, we're not immune to the economic headwinds that many industrial markets face. But with that said, I strongly believe the breadth and diversity of our end markets in the specific niches which we operated in, provide us with the protection to mitigate a lot of these pressures. While we're not without challenges, I like the position we're in across our various businesses and anticipate that we can achieve growth rates in '18 and beyond that exceed those of our defined peer group as well as the broader industrial markets. I'll provide a couple of specific thoughts and comments on individual businesses entering '18.

In Filtration, we expect to deliver solid results in '18, and I'm comfortable with our outlook for 6% to 7% growth in EBITDA in the segment. We are well positioned on several fronts in Filtration, including the continued up cycle in commercial aerospace as well as additional technology we're providing for submarines and surface ships, which are critical for the U.S. Navy.

We recently won a large multiyear contract at Westland to supply mission-critical proprietary hardware for surface ships. At VACCO, we were awarded a follow-on order for the next lot of Virginia Class submarines. So taken together with our Westland outlook, we have tangible and profitable growth embedded in our naval product offerings for many years to come.

Mayday continues to expand its product offering, including entry into the aerospace MRO market, where we see strong growth in a market we only recently entered. Several existing customers have already placed meaningful MRO orders, which we can build upon.

Our Technical Packaging group's future has improved, given our scale and leadership positions across several growth markets and geographies. We recently expanded our production capacity at our facilities in Poland and England. This provides a capability to deliver highly engineered products to customers in the medical, pharmaceutical and consumer markets throughout Europe.

In USG, we see solid growth opportunities across the global platform, including hardware, software and services. We're also seeing numerous opportunities for our expanded product offerings, both internally developed and acquired. Our rep and distribution network rationalization is nearly complete, and I'm really impressed with the quality of our sales channel partners. This process is very key as we integrate our new partners into Doble. We need to ensure that we are able to service our customers in the most effective and efficient manner possible.

Our entering into the renewable market with the acquisition of NRG was an important move in '17. We look forward to enhancing our position in this fast growing market in '18 and beyond.

At Test, we're seeing the results of our past cost reductions materialize as anticipated. Our reduced cost structure and ongoing operational improvement initiatives support our 13% EBIT margin expectations. Test sales growth, while appearing a bit aggressive given our history, is supported by several metrics such as opening backlog and the nearly $30 million of new business awards in October and through today.

I feel good about the growth opportunities we have across all our businesses in '18, and I can see tangible avenues for additional growth in future years.

Regarding our recent M&A, I'm pleased with the integration process across-the-board. This complex process is nearly complete and showing favorable sales and earnings opportunities. Within USG, I like our ability to enhance our overall growth strategies and past customer relationships where applicable.

Commenting on my longer-term view for the total business, we continue to see meaningful sales and EBIT growth across our business, consistent with our previous communications. Acquisitions remain a key component of our ability to meet our longer-term growth targets, and we continue to evaluate additional opportunities.

We certainly have the balance sheet capacity to do more M&A, and we have the management bandwidth to handle this additional growth within our current operating infrastructure. But we will continue to remain disciplined in our approach. Our focus remains constant that we continue to improve our operational performance and to execute on our growth opportunities both organically and through acquisitions.

I'd be glad to answer any questions you have now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Jon Tanwanteng with CJS Securities.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

You mentioned that you have more capacity for more M&A after doing quite a lot of business -- or transactions in the past year. One, just how much time and -- are you guys actually spending on that? Are there a lot of opportunities? What do valuations look like? Any more color on just the whole M&A process and pipeline would be helpful.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

Yes. It's remained pretty active. Honestly, we -- obviously, we had a lot of success over the past 2 years, and we see ample opportunities going forward. And we think a lot about why that is because probably before 2 years ago, we weren't seeing as much traffic. And I think it's a matter of a lot more things coming to market, and then I think we have proven our ability to be successful in some of these acquisitions. So I think we're getting on more people's radar screens and getting access to more of those acquisitions. Plus, we have a focused activity here to go out and seek competitors, partners, people that we're aware of in the market. So it remains pretty robust.

Gary E. Muenster - *ESCO Technologies Inc. - CFO, EVP and Director*

And I think, John, from the valuation side, if you look at our last 5, 6 or 7 deals, it certainly doesn't feel like we overpaid for those relative to the multiples we paid. And I'd say the things in the pipeline today are generally within that bandwidth. There's not things we're looking at that are 12 and 13x EBITDA. So I think the future performance will look like the past, and then the sizes certainly appear digestible.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Great. And then just in terms of the expectations you have for both cost and sales synergies in USG and in Filtration. What are you building into expectations for next year?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

We've not built a lot of synergies just because it usually takes a year to kind of figure that out. So we don't want to build something in there kind of betting on it to come. We're still in a process of doing that. But I would say, there's no hard numbers assumed, and what we have in the forecast is probably the most succinct way to answer that.

Jonathan E. Tanwanteng - *CJS Securities, Inc. - MD*

Okay, got it. And then any color on the packaging space and that segment, why you expect that to be flat going forwards?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

Yes. So I would say the flatness that we're seeing this year is probably not going to be long-term. What I would say is the attrition rate in what we saw in the European acquisition was a little higher than what we'd anticipated. Just some simple things like the razor market, which we did -- have participated with our Plastique acquisition there. It's amazing that the Internet razor business is really forced -- and we see it with the razor manufacturers in how they're all struggling. As a result of that, where they were maybe using higher-end package, historically, they're basically competing on price now, and one place they can take out price is on packaging. So we've seen a little more attrition in some of those areas at Plastique than what we'd anticipated.

Operator

And our next question will come from the line of Liam Burke with B. Riley.

Liam Dalton Burke - *FBR Capital Markets & Co., Research Division - Analyst*

Vic, on the Filtration side of the business, you're looking for a significant step-up in EBITDA growth in '18. Is it primarily the absorption of upfront investments on the contracts beginning to catch up? Or is there other things in that expectation?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

I'd say that the biggest thing we have is a pretty big pickup at our Mayday business, both as a result of getting them onboard fully now 11 months versus -- or 12 months versus 11 months. I think the efficiencies are going to be higher there. And then as I mentioned, this MRO business has tripled year-over-year. I'd say that's the biggest piece. And then Westland as well, we have been waiting on a contract there, which, as I mentioned earlier in the call, we did get that. So that had some impact on us in '17, and now we have that contract in place, we'll be able to deliver that in '18. So I'd say those are the 2 biggest impacts year-to-year.

Liam Dalton Burke - *FBR Capital Markets & Co., Research Division - Analyst*

Okay. And then on the NRG and Morgan Schaffer acquisitions, those businesses, as I understand it, carry lower operating margins. Part of the cost synergies were presumably to integrate those businesses. Looks like fourth quarter, you're better sequentially but still lower year-over-year. Do you expect to make continued progress on those 2 acquisitions? Or have you pretty much got as much cost out as you can?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

Well, I'd say that -- well, let me talk separately about the 2 businesses. I mean, NRG is not really going to be integrated within Doble. It's a freestanding business. I think where we'll see margins improve there is as we continue to grow that business, and maybe we can help them with some of the efficiencies. So we're not going to get the same type of synergies that we would with the company we're going to integrate. With Morgan Schaffer, as you know, we had bought their product historically and integrate it with a system of ours. So just having that lack of a second markup, if you will, I think will be helpful there. And then as we get their new product at a little higher production rate into the field, I think that will help as well. And then we're also finishing up, as I mentioned, the integration of the sales channels, and so that has some inherent cost savings as well. And we're very fortunate we got some really strong people there. In fact, we were in the process of looking for somebody for Doble to run the European sales operation. Fortunately, there was somebody at Morgan Schaffer that filled that role for us, so it allowed us have an internal candidate to fill a role like that. There's a couple other places where we were able to do that as well.

Operator

(Operator Instructions) And our next question will come from the line of Ethan Potasnick with Needham & Company.

Ethan Jeremy Potasnick - *Needham & Company, LLC, Research Division - Research Assoc - Medical & Diagnostics, Advanced Industrial & Display, Vision & Imaging Technologies*

This is Ethan Potasnick filling in for Sean Hannan. Similar to a previous question, I'm wondering about the mix of revenues in USG. Could you maybe share how much is coming from service and software and I guess, how that is trending? And is that part of 2018 expectations?

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

Well, I'll let Gary put some tight numbers or tighter numbers on it. Obviously we don't want to give specifics. But I'd say both with sales and software, that's trending up. The acquisition we made a couple of years ago, the Software business, that business has grown pretty significantly. I mean, it's a fairly small business but grown pretty significantly. And then we've had a focus on Software at Doble as well in services, so we see both of those areas trending up.

Gary E. Muenster - *ESCO Technologies Inc. - CFO, EVP and Director*

And so, Ethan, I'd ask you to think about the pieces that we had, so if we just split them into individually what they are, Morgan Schaffer is generally a hardware business. They supply products, so there's not -- I mean, there is some services there, and there is some software. But it's predominantly 90-plus percent would be added into the product bucket. On NRG, they have a better mix of services and some software applications. So that's probably about 60% hardware and 40% the other bucket. And then the Vanguard piece is almost nearly all hardware. So as you think about that added to what Doble's historical mix was between those allocated pieces, you will see hardware becomes a bigger piece of it because we added the Vanguard and Morgan Schaffer piece of that. So -- but it doesn't dominate it to the point or to the expense, if you will, of the Software and its favorable margins. So as Vic said, the Software business organically is growing faster, but it's the law of small numbers. And then you're going to see a disproportionate growth in hardware just because of the acquisitions.

Ethan Jeremy Potasnick - *Needham & Company, LLC, Research Division - Research Assoc - Medical & Diagnostics, Advanced Industrial & Display, Vision & Imaging Technologies*

Okay. And then I know you guys talked about this a little bit in the prepared remarks, but I was wondering if you could possibly share what kind of growth should we see percentage wise within each segment and then also kind of at the EBITDA level for 2018.

Gary E. Muenster - *ESCO Technologies Inc. - CFO, EVP and Director*

Yes. I would say, if you look across the sales platforms there, let's start with Filtration. Like -- we did mention a little bit of headwind. We have about $7 million or $8 million of product that we're not going to go forward with because of some extraordinary pricing conditions that it's already a low-margin business. We're not going to give the stuff away. So that part of the business goes away. So let's call that $7 million or $8 million as we go into '18, and that's at PTI. The good part is, like I said, it's not aerospace. It's low-margin industrial and automotive. So I'd say, the way I would look at that as a group in Filtration, you're probably talking somewhere in the neighborhood of 2% or 3% because of that headwind there and because of the timing on the VACCO transition from development into production. The nice part is there's a significant margin trade to the positive on that that's worth about 2 full points of margin at VACCO. So you're actually going to see, despite the kind of flattish sales, they're going to actually have improved operating performance there, operating profit margin there. So if you were to use that as a group at 2% or 3%, I'd hold the packaging group flat. As Vic alluded to, there's some attrition there so holding that, give or take, $1 million around where they're at. And then the Test really comes from, if you think of the large technology program that we talked about last year that had some construction-related timing things from its headquarters. We pick up that. Plus, we pick up the momentum from the backlog -- significant backlog growth. So I would think of the Test business, as I mentioned in there, high teens to 15%, validated by those 2 metrics. And then on the USG side, the growth is going to be north of $60 million, combination of dollars. The combination of the acquisitions for the full year but then the inherent organic growth in there is attractive as well. So hopefully, you could follow all those pieces of that.

Ethan Jeremy Potasnick - *Needham & Company, LLC, Research Division - Research Assoc - Medical & Diagnostics, Advanced Industrial & Display, Vision & Imaging Technologies*

Okay. And then finally, maybe if you could discuss contribution assumptions for growth internationally in 2018.

Gary E. Muenster - *ESCO Technologies Inc. - CFO, EVP and Director*

As far -- on the revenue side or profit or what?

Ethan Jeremy Potasnick - *Needham & Company, LLC, Research Division - Research Assoc - Medical & Diagnostics, Advanced Industrial & Display, Vision & Imaging Technologies*

Yes, revenue and profit, please.

Gary E. Muenster - *ESCO Technologies Inc. - CFO, EVP and Director*

Okay. So if you look at Morgan Schaffer, obviously, they're based in Canada, so I'd say about 50% of their business happens in the U.S. and 50% happens around the world. So if you peg them at $23 million, $24 million, you could take half of that in that regard. Vanguard, at $11 million or $12 million is almost predominantly U.S., so I'd say 20% of that is international. And then on NRG, it's probably a little closer to 50-50. So if you peg them at $45 million or something like that and put that net relationship, that should help. Within the aerospace business, there's not a whole lot -- or within the Filtration business, there's not a whole lot of international content. And then at -- in Packaging, it's about 50-50 because Plastique is a big chunk of that $80 plus million we have there. And then Test is probably 50-50 as well. I can't do all that math in my head at the same time, but I would be comfortable saying about 30% or 33%.

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

(inaudible)

Gary E. Muenster - *ESCO Technologies Inc. - CFO, EVP and Director*

Historically, Kate mentioned that we're -- historically, we'd be in the upper 20s, and now we'll be in the low 30s as a percentile or a percent of international content.

Operator

And I'm showing no further questions at this time. So now it's my pleasure to hand the conference back over to Mr. Vic Richey, Chairman and Chief Executive Officer, for some closing comments and remarks.

Victor L. Richey - *ESCO Technologies Inc. - Chairman, CEO and President*

Okay. Well, thanks, everybody. I look forward to talking to you on the next call. Thank you.

Operator

Ladies and gentlemen, thank you for your participation on today's conference. This does conclude the program, and we may all disconnect. Everybody, have a wonderful day.
