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PRESENTATION

Operator

Good day, and welcome to the ESCO Technologies First Quarter 2022 Earnings Conference Call. Today's call is being recorded. With us today are Vic Richey, Chairman and CEO; Chris Tucker, Vice President and CFO. And now to present the forward-looking statement, I would like to turn the call over to Kate Lowrey, Vice President of Investor Relations. Please go ahead.

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

Thank you. Statements made during this call regarding the timing of recovery and growth of our end markets, the amounts and timing of 2022 and beyond revenues, impacts of COVID and COVID variants and recovery expected as a result of COVID vaccines, recovery in commercial aerospace and utility markets, impacts of supply chain issues and cost inflation, availability of labor, adjusted EPS, adjusted EBITDA, cash, shareholder value, the timing of Block V deliveries, success in completing additional acquisitions, success in integrating acquisitions, the results of cost reduction efforts 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 operation 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 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 Vic.

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

Thanks, Kate, and thanks, everybody, for joining today's call. At the risk of being redundant, I'd like to start the call off again, by thanking our employees across the company for their ongoing efforts to manage the business. There continues to be a lot of challenges to overcome on a regular basis. We continue to see supply chain challenges with delivery, cost inflation and the Omicron variant of COVID impacting our businesses.

Despite of that, our team continue to demonstrate tremendous resilience. Our employees are working very hard in doing all they can to support our customers and drive the business forward and for that, I'm very appreciative. The business has continued to gain momentum as we start fiscal '22. Two of our 3 business segments delivered organic sales growth in the first quarter. We expect all 3 segments will deliver organic growth in the remaining 3 quarters. We have a lot of confidence in that outlook due to our continued strong order output.

If you recall, the fourth quarter of fiscal '21 had order growth of more than 30%. While for the first quarter of '22, we achieved order growth of more than 40% compared to prior Q1. Our backlog is at a record level, and that bodes well for the balance of fiscal '22 and beyond. Chris will get into some of the financial details in a few minutes.

I'll start off with some top-level commentary on each of our business segments. Starting with A&D, we see the recovery continuing for this business. We continue to monitor the commercial aerospace markets closely. There'll likely be some more disruptions with travel as a pandemic situation continues, we're undoubtedly seeing higher levels of business activity from our commercial aerospace customers.

2020 and 2021 were really tough years in this market, so we're glad to see the growth returning. For A&D overall, we saw enter orders grew by 38%. Admittedly, we were kind of coming off a low base, but it is great to see the backlog rebounding like this. You saw in a press release a mention of challenges regarding supply chain performance and labor availability. Those challenges are definitely being felt by the A&D group.

In particular, our California-based businesses of VACCO, PTI and Crissair are seeing challenges as we work to ramp to higher levels of business activity. We did miss some sales in the quarter because of these challenges. But the teams are highly focused on increasing capacity to meet our customer demand, and we're confident that these are just timing issues within the year.

The last thing I wanted to mention regarding A&D was our acquisition of NEco, which we were able to close in the first quarter, and we're excited about what the NEco brings to our portfolio. This business will fold into our PTI subsidiary, bringing a solid management team with great product technologies. We're very happy to have them on board.

Similar to A&D, our test business also had a great orders performance in the first quarter. Orders were nearly $68 million for the first quarter compared to $43 million in the prior year first quarter. So the growth is significant and broad-based with double-digit increases in all global markets.

Sales growth was a little lighter in Q1, which we expected, and we're planning to see strong sales performance over the coming quarters for test. We continue to face some challenges with profit margins during the first quarter for test. The margins were slightly down compared to what we had in our internal plans.

And as you saw in the press release, they're also down versus prior year. This has been a key focus for us. No doubt the inflation challenges are acute for test, so we have programs around cost management and price realization to help drive the margins as we move forward. This segment is our largest user of freight services, and as we all know, they are higher cost increases in this area, which is also impacting our margins.

Margin expansion needs to come as we grow this business. That's a key part of our value story here, and we're focused on achieving that result. For USG, the story in Q1 was a bit mixed. We have the expected sales contributions from the recent acquisitions, so it was nice to see that coming through. Integration of acquired businesses is going well and is on track. We also saw another strong quarter for NRG, so things continue to go very well in the renewable space. We did experience some challenges at Doble. Approximately $3 million of the sales shortfall was related to supply chain challenges with our contract manufacturer.

We also had tough comps over last year's Q1 when customers release some funding for calendar year-end purchases. We didn't see a repeat of that during this first quarter, but the comparison ease for Doble over the coming quarters and we expect the growth to kick back in during Q2 and Q3.

We continue to feel strongly that the utility markets have very favorable growth characteristics over the long term, and we also feel that the portfolio of companies that we put together will be very well positioned to take advantage of this growth.

Overall, the quarter came in right on top of the internal projections we had when the quarter started. The high order activity supported a higher level of sales, but we couldn't get that out the door given the supply chain and labor challenges. At the end of the day, we're on track for the '22 expectations that we laid out in November. The plan is back-end loaded, but that's consistent with our original projections and supported our backlog. Bottom line, we feel good about where we are after the first quarter.

Now I'll turn it over to Chris.

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

Thanks, Vic. I'll start with an overview of the consolidated financial performance in the quarter. Sales in the first quarter were up 9% compared to last year. Excluding the impact of acquisitions, sales were down 1% with growth from the Aerospace & Defense and Test businesses being offset by a decline in the Utility Solutions group. The acquisitions added $15 million to sales in the first quarter.

Adjusted EBIT margins were 9.3% in the quarter compared to 11.1% in the prior year quarter. The margin decline was driven by decreases in the test and USG businesses. Interest expense in the quarter was $733,000 compared to $541,000 in the prior year due to higher borrowing levels. Taxes were 22.3% in Q1 compared to 22.5% in the prior year.

All these items delivered adjusted EPS of $0.46 per share below prior year's $0.52 per share, but consistent with our internal forecast. Operating cash flow in the quarter was $1.9 million compared to $24.8 million last year, the decrease was mainly due to milestone payments received last year, which did not repeat this year and also payoffs of accrued expenses that exceeded prior year amounts.

Inventory increases were unfavorable to cash in the quarter, but this was more than offset by good performance on accounts receivable and accounts payable. Capital expenditures were $14.1 million in the quarter compared to $6 million in the prior year quarter. This increase was driven by the purchase of the NRG headquarters building in Q1. We were presented with a unique opportunity to purchase the building at a favorable price relative to annual rents and drive a cost reduction for this business.

Turning to segment performance. Highlights in the quarter are as follows. A&D did see a return to growth in the quarter with reported sales up 5.4%. Excluding the impact of the NEco acquisition, these businesses delivered 4.1% sales growth. In Q1, we saw return -- the return of growth in the commercial aerospace markets with an increase of 11% driven by our PTI subsidiary.

Military Aerospace was very strong with 36% growth. Crissair and Mayday were key drivers of this growth. The Navy business grew 4%, while sales to industrial customers, which are a smaller part of the overall segment were down 43%. As Vic mentioned previously, we did see very strong order growth by the A&D group in Q1. Orders were up 38% with good activity across the military and commercial aerospace markets as well as Navy business.

PTI, Crissair, Mayday and Westland all posted significant order gains and were the drivers of the 38% increase for the business. USG saw reported sales growth of 16.4% in the quarter. Excluding the impact of the Altanova and Phenix acquisitions, revenues were down 10.2%. This decline was driven by Doble, which saw sales come in approximately $7 million below prior year. About $3 million of this was driven by the supply chain challenge, as Vic mentioned earlier, with the balance related to soft end markets.

The renewables business at NRG had another strong quarter and delivered 21% growth. Adjusted USG EBIT margins in the quarter were 21.8% compared to 24.5% in the prior year Q1. The reductions were driven by deleverage on the sales decline at Doble and dilution from acquisitions.

Orders for USG in Q1 came in at $66.2 million, which was a 36% increase. Backlog finished at $94.4 million compared to $44.9 million in the prior year quarter. Approximately $34 million of this increase was driven by the acquisitions. For the Test business, we saw sales growth of 4.2% in the quarter. The growth was led by strength in China, which is continuing to see very high levels of activity for test and measurement projects. We did see margin pressure in this business during the quarter as adjusted EBIT margins went from 12.9% in the prior year to 9.2% in the current quarter. The business is experiencing inflation driven by materials, labor and freight as they manage increasing demand. We're very focused on driving cost containment, productivity and price increases to offset these impacts as we move forward.

On the orders front, we saw continued strength in the pace of business for Test. Orders were $67.9 million in the quarter, which is an increase of over 50% compared to last year. The top line outlook for this business is strong with order strength being experienced in all world areas. That represents the summary for Q1 financial performance. As Vic mentioned, it looked like we could get a little better -- do a little better than our internal projections as the orders were so strong during the quarter. But with persistent supply chain and labor challenges, we ended up a bit constrained on the top line. But we are still on track to deliver the year as laid out during our November earnings announcement and call.

If we turn to the guidance in the release, we reiterated the earnings per share guidance for fiscal '22 calling for adjusted EPS in the range of $3.10 to $3.20 or growth of 20% to 24% this year. This earnings per share range assumes 2022 sales in the range of $815 million to $835 million or growth of 14% to 17%. We're not breaking out guidance by quarter for '22, but we do expect only modest EPS growth in the second quarter and very strong growth in Q3 and Q4. We are watching closely as the Omicron variant was disruptive across the economy in January, creating more employee absences and supplier disruptions as well. It appears that things are stabilizing. And as you can see, we certainly have the backlog in place to drive to the guidance range.

So now I'll turn it back over to Vic.

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

Thanks, Chris. Since I touched on quite a few of my thoughts earlier in my commentary, I'll just offer a few more comments before we move into Q&A. We feel good about the start of 2022. We're excited about the forecast we have out there.

Lots of growth coming as we move into the second quarter and beyond. Backlog supports the outlook, and we feel that ESCO is a good place right now. The cycle of our different businesses are starting to kick in, and that bodes well, not just for '22, but the future years as well.

All our subsidiary management teams will be here in St. Louis next week, I can assure you we'll be focused on all the activities that must take place to get '22 delivered. We see the businesses again in April for session more focused on long-term growth and profitability. It's always a fun time of the year knowing we'll have 2 in-depth touch points coming up. This allows us to drive proper alignment with the operating leadership. It moves us toward our ultimate goal of profitable growth, officially use the capital and higher returns.

So with that, I think we're ready for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question from the line of Tom Moll from Stephens.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Analyst*

I wanted to start on Doble today. If I heard you correctly, Chris, I think you said for the quarter, the change was down $7 million, which was the $3 million from supply chain issues at your contract manufacturer and then another $4 million on the tough compares from the budget flush at the end of the last calendar year. So did I hear those numbers right? And can you give any more context around it?

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

Yes, you got it right. I would say, last year in Q1, the growth wasn't explosive in the segment. I think it was around 3%. And but we were still kind of newer into the pandemic at that point. And honestly, we expected the numbers to be a fair bit lower last year. We did see that kind of flush of year-end stuff you mentioned that kind of gave us that growth a year ago. So that's kind of the reference to that and the softer end markets this year where we didn't see a similar kind of activity. But you had it right on the $7 million and the $3 million.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Analyst*

And just in terms of any context you can share on the issue there with the contract manufacturer. Does it feel like some, all of that has been resolved as you go into Q2 or that might be a nagging headwind for some time?

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

I would say more is going to resolve itself over the next 6 months. I mean I'd like to say it's all behind us, but it's almost all chip issues. I mean, the boxes are built, ready to go, but we do have some chip shortage at those places.

But I do want to make sure everybody understands we're not sitting on our hands just waiting for things to happen. I mean we redesigned about 90 boards at Doble last year to make sure we could keep up with this. So we didn't get all the way there. But had we not gone through that process over the past 12 months, I think the impact of the supply chain would have been much more significant.

And that's probably something that we're going to continue to do. I mean I'd say through the first half of this year as these things kind of flush themselves out.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Analyst*

Just moving to the higher level here, again around USG and maybe Doble specifically. In the release, you pointed to some of the themes that are probably become a little better known at this point just in terms of the overall electric utility market impacted by some of the reduced consumption potentially pandemic related.

At the same time, in your outlook, I think it's pretty safe to assume you're implying growth for Doble on a full year basis. So if you could just help us reconcile those 2 data points or provide any context, that would be appreciated.

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

Yes. I think if you go back to last year, a little bit, Tommy, again, it's a little bit -- I hate to talk about the comps too much, but we had quite a soft second quarter there. And then even in the third and the fourth, we didn't see the business kind of recover the way we are expecting from those pandemic levels. So we expect growth really as we go into the second quarter, just based on kind of how weak it was a year ago.

And then again, we feel like the second half of the year the overall activity levels should continue to stabilize. And I would tell you, in the fourth, we have pretty conservative numbers in. So overall, it's just a little bit of easier comps as we move through the year and kind of continuing to get into it, let's say, hopefully, a more normalized environment in those markets.

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

Yes. I would just add. I mean I think it's not I'd like to say those are all really hard things that we can point to. Where we really get our comfort that we're going to see that kind of growth over the remainder of the year is really talk from the customers. And so we have a lot of people that are constantly interfacing with the customers. And so we kind of can gauge where their sentiment is, what kind of buying activity they see.

The other thing, I think, is going to be really important for us is over the past year, everything that we did with the customers was virtual. And so we've not had our client conference last year. We didn't have the life of the transformer in person, as, we're doing that this year. And so while I think attendance will be certainly less than it's been historically, given any people in the same room, getting excited, having them see our new products.

And I think it's just kind of important to remember, we did introduce a number of new products over the second half of last year. And I think those will get traction in the remainder of this year. So I do think that although the overall utility space isn't picking up as quickly as we hoped. I think for us with the areas that we're in, we're going to see some growth this year.

Operator

Our next question will come from now John Franzreb from Sidoti.

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

Given the recent increases you're seeing in material and labor costs, where are you having the most success amongst your businesses in raising prices to offset those costs? And by what magnitude can you do it by?

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

Yes. So probably the 2 biggest places are in our Test business, although it takes some time to pick that up to be able to realize that because you increase the price, we already have contracts and that is such a quick turn business that you don't necessarily get on one contract or maybe on the next one. So we had some success there. It's on the aerospace side as well. I think we've seen a good bit of opportunity. And then pieces of our utility business. But I would say that's led less broad-based.

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

Okay. And when you look at the portfolio in a broad sense, which businesses are you most concerned that there's still excess inventory in the channel that you have to work through before you reach maybe a revenue equilibrium?

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

I don't really view that there's a lot of inventory -- finished inventory that the customer has, they have to work through for the most part. I think the fact that our order levels have been so high over the past 2 quarters is kind of evidence of that. I mean there's probably some where people are -- just like we're trying to get ahead of things and buying more product, buying more raw material I'm sure there's some of that with our customers.

I think the vast majority of it is just the pickup of the business. So I don't think there's a lot of inventory out there that has to be worked through. You have to remember, particularly on some of the commercial aerospace, they stopped buying for a while. I mean if you look at 737, they just stop buying. And so now as that ramps up, they want it yesterday. So that's the other challenge you always have when you have these kind of quick upticks.

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

Okay. And just one more. In light of the recent acquisitions, were there any cost savings benefits that you might be able to realize in the coming year that you want to call out and let us know about?

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

So yes, we're looking at -- I would say on the utility side, I don't think as much cost savings as it is leveraging the technology and the sales force that we have, the rep network and those type of things. So I think what we're going to see there is more throughput. We're going to get more orders as a result of having those together because, again, as we've talked about some of the last calls, it truly is a matter of having a stronger presence in Europe and Asia. And I think that's going to help not only the businesses that are already serving that market, but we think there'll be some pull-through of Doble products in those markets and vice versa. They're some of the products that are being sold currently in Europe will be able to bring some of those back in the U.S.

So I think that's really the play on that side. With NEco, which is a relatively small acquisition, we are going to move them out of their current facility into PTI facility. So we'll be able to take some significant costs, again, although in a small business out of that business.

Operator

(Operator Instructions) Our next question will come from the line of Jon Tanwanteng from CJS Securities.

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

I actually just wanted to follow-up on that previous question, just about Altanova and how you're expanding in Europe. How is that going? Kind of have you seen that pull through of your products yet? Or is it still going to take some time to realize those kinds of revenue synergies?

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

I think it's going to take a little bit. We need a little bit of time, and we've assumed some pick up across the business this year, but it really kicks in next year because the big thing we've done so far is kind of rationalized the organization. and the sales force. And again, kind of making sure we have the best reps in each of the areas, making sure people are focused on the right thing. It's getting them trained on each other's products. And so that's a bit of a of a process, if you will.

The next step will be kind of looking at the products, making sure we're selling the best products of each company in each location. So I think you'll see the big pickup with that combination in late this year and going into the next year.

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

Understood. And then just moving on to the Test business. What's driving the strength and the activity that you're seeing there? That's a pretty big orders number. Is that sustainable, number one? And then number two, I guess, when do you get back to your historical margins there with the inflation the way it is and the offsets that you're trying to ramp up?

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

Sure. So I'd say the biggest and I think we talked about on the last call are these filters that we're making for the EMP filters that we're making for data centers. And we do those for some commercial customers, but the largest driver right now is the U.S. government. And so they're putting a lot of data centers in and it's not like they're shared data centers. So each of the different agencies have their own data centers that's been a big, big driver for us this year. And everything they're telling us, and I think they have good insight into the next couple of years is that piece of the business is pretty sustainable going forward.

The interesting thing, which is different than what we've seen in past years is we typically would have a very large project kind of flowing through, right? We'd have a large automotive project or large defense projects that are flowing through coming out of backlog, going through the sales channel. And right now, we don't have those yet we're able to grow the business. Now some of those opportunities are still out there, but it's very encouraging to me that we're able to grow the business at the same time, not pulling those big projects through.

The second half of your question, as I mentioned earlier, I think it's -- it's going to take a little time. We're now pricing some of those cost increases into the bids. And so I think you're going to see pretty steady margin growth throughout the year for 2 reasons. One, I think we have a higher level of volumes are going to be leveraging our overhead. And then the other one is some of these price increases have -- should be hitting next quarter and then I think even more so in the subsequent 2 quarters.

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

Okay. Great. And then lastly, just a higher-level question. What's giving you the confidence to reiterate your guidance for the year? I think I get the demand side, that seems pretty evident. But what's your thinking about when and how the supply chain issues resolved? Or is it more of a pricing pass-through that you're aiming for it as opposed to seeing a relief from the inflation and labor and supply chain issues.

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

So it's both of those. And I would say the other thing is we're putting in additional capacity to be able to ramp up the business. And so for instance, in our Test business, because it is kind of outsized growth that we're seeing. So we've leased an additional facility, we'll have that up and running in the second half of the year. We're moving some of the lower-end products into a different location to make sure that we have all these filters in one place where we can perform on those.

We're adding another shift in our facility in Mexico to be able to manage some of the growth. So it's really a combination of more capacity, pricing should be better, particularly in the second half of the year. And the supply chain, I think we're understanding it better. And so I think as you understand it better, you make some of the changes you have to make to be able to work through that process.

Operator

And I'm not showing any further questions in the queue at this moment. I'd like to turn the call back over to the speakers for any closing remarks.

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

Okay. Well, thank you everybody for their interest, and we'll end the call now and look forward to talking to you in our next call.

Operator

And this concludes today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.
