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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the First Quarter 2023 ESCO Technologies Earnings Conference Call. (Operator Instructions) Please be advised that today's conference call is being 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 applicable laws or 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 the 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. Thanks, everyone, for joining today's call. It's really great to be on the call for the first time as CEO, here at ESCO. Our year is off to a great start, and I'm excited to talk about the financial results. But before that, I'd like to say a few words on the transition to my new role. Overall, the process has gone very smoothly. I've been able to relocate here to St. Louis with my family, and we love it here. We've really hit the ground running as the new calendar year got started. And I've had a chance to go out and visit every subsidiary at least once and a few couple more than once. So it's been a pretty busy start to the year, but an exciting one for me personally, and I'm really energized to be in the new role. Vic and ESCO's Board of Directors continue to be very supportive of me and the role. And we just finished up a set of board meetings last week, where we were able to take the directors out to visit the factories at a few of our subsidiary sites. The business has a lot of really cool things going on, and we have some really neat capabilities there. It was fun to allow the board of directors to kind of get a close-up look at that. So I want to thank the board, and I want to thank Vic for their ongoing support of me and of ESCO. Their dedication continues to be crucial to our overall success.

So with that, let me pivot it over to the quarterly results. We had a really great start to fiscal 2023 with all 3 of our business segments posting nice increases in both sales and earnings. Across the company, we continue to see favorable dynamics in the markets that we serve. We have really strong businesses that are serving very healthy end markets. So our outlook really remains positive. So having said that, we still see some challenges. All of us have seen headlines indicating improvements in supply chain conditions. And while we've seen some relief on the raw material side, availability of skilled labor continues to be a significant challenge. Due to the technical nature of ESCO's product portfolio, the labor shortage continues to be a drag on our overall growth, particularly at our A&D and Utility Solutions Group. Our operating leadership in each of those businesses is managing through the challenges effectively as they have been for the past year or so. But it's important to understand that we continue to face a pretty difficult environment. The good news is that the underlying demand for our products and services continues to be very strong. Our first quarter ending backlog of $718 million represents an increase of more than 12% compared to the prior year first quarter. So Chris will get into some of the financial details in a few minutes, but I did want to offer some top-level commentary about each of the business segments. Let's start with Aerospace & Defense, where we had another great quarter. Sales increased by 18% and adjusted EBIT dollars were up by over 25%. It's been exciting to engage with these businesses since taking my new role. And there's a lot of exciting things that are happening across the platform. The commercial aerospace business continues to see robust demand environment, while Navy and space business are really working on some important programs. These businesses are newer to me, but we're really fortunate to have strong management teams with deep knowledge about those industries, and they're really showing me the ropes as I get used to the new role. Also, as you probably saw in the press release, we did close on an acquisition for this group on February 1. CMT Materials will now be part of our Globe business, which is based in the Boston area. We're excited to welcome CMT and their employees to the ESCO family. They bring with them exciting technologies and capabilities which will strengthen our naval offerings and provide ESCO exposure to some anticipated growth in the unmanned submersible vehicle market as it matures.

Next is the Utility Group, where we had a strong quarter. Revenue growth was nearly 12% and adjusted EBIT margins expanded from 21.8% to 22.7%. The core utility business continues to be solid as our customer base invests in their infrastructure, and we continue to see backlogs grow. On the renewable side, the growth continues to exceed expectations. As most of you know, 2021 and '22 were both 20% plus years of growth for NRG, but the growth story remains intact as we look forward. NRG is certainly benefiting from a strong market, but I'm particularly pleased by the results from new product developments and utility scale solar. I mentioned before, the component supply issues have been -- have improved a bit compared to prior year, but shortages do impact our operations, and this has been pretty noticeable overall on the utility side. Our teams are aggressively addressing the issue. We are making some progress, but we expect that to take another quarter or so to resolve.

Lastly, let's touch on the Test business, where we had a nice quarter of sales growth and EBIT margin expansion. Q1 sales were up by 19% and EBIT was up over 35%. So a really good quarter for the Test business. As you saw in the press release, orders did decline in the Test segment compared to the first quarter of the prior year. Overall, we think the outlook here is still positive. And you should remember that we had outlined lower growth expectations for Test, when we gave our initial guidance back in November. For Q1 in particular, we had some exceptionally high orders in the prior year related to power filters as well as test and measurement products in the U.S. and China. That activity did not repeat during Q1 of this year. And so our orders came in as expected.

So to summarize across the overall business, it really is a great start for ESCO this year. We're on a good path as we look forward to achieve the guidance that we gave you back in November. All 3 businesses delivered nicely and our backlog position really positions us well for the balance of 2023.

So now I'll turn it over to Chris to give you some more financial highlights on the first quarter.

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

Thanks, Bryan.

Everyone can follow along on the chart presentation. We'll 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 over 16%. Adjusted EBIT up over 31% and adjusted EPS was up over

30%. Another strong growth quarter for ESCO. Orders growth in the quarter was 2%. We will get into those details in a moment, but we did see good growth in 2 of our 3 business segments on the orders line. Overall, the order trends have remained robust, and our December '22 backlog of $718 million is a record and demonstrates the strength of the overall business.

Next on Chart 4, we'll get into the segment results, starting with Aerospace & Defense. Solid performance continues here with sales up 18% and adjusted EBIT up 25% and margins expanded by nearly a full point to 15.3%. The ongoing commercial aerospace recovery led the sales growth as we saw increases of 30% from this market. Beyond that, we still saw good growth from other parts of the business with Defense Aerospace, Navy and Space, all up more than 10%. Orders were also good with growth of 8%, driven by Navy and commercial Aerospace strength.

The next business is on Chart 5, Utility Solutions Group, where we also had a very strong start to the year. Sales growth was 12% with high levels of activity from the electric utility customer base and explosive growth from the renewables business. Adjusted EBIT margins were up 0.9 points as we did see favorable leverage on the sales increase. Orders were very strong in the quarter with growth of 21%. The core utility space delivered order growth of 18% and saw strength on a global basis. The renewables business continued to deliver exceptional growth at 35%. Backlogs at $137 million are elevated in part due to supply chain challenges mentioned by Bryan previously.

The final segment we'll talk about is Test, on the next chart. Another strong quarter for this group, with sales up 19% and EBIT up 36%. Really nice margin expansion here as we saw solid leverage on the volume increases. Orders did drop by 24% during the quarter. You see on the chart that we had more than $20 million of large bookings last year for power filters and project activity that did not repeat in this year's first quarter. Overall, the book-to-bill in Q1 of fiscal '23 was still at 1.0, and the orders were in line with projections at the beginning of the quarter. So we still feel good about the '23 outlook for the Test business.

The next chart, Chart 7, is our first quarter cash flow highlights. Operating cash flow declined by almost $11 million during the first quarter. Working capital was unfavorable in the quarter with inventory and accounts payable, driving an unfavorable impact compared to last year's first quarter. Capital spending was down just over $9 million in the quarter compared to last year, and acquisition spending dropped by nearly $16 million as there were no deals closed in Q1 this year and last year had the NEco acquisition in the A&D Group. On share repurchases, we completed just over $4 million in this quarter compared to $10 million in the prior year quarter.

Chart 8 is our guidance. The full year outlook does remain intact. We did take out the lower end of the range. You'll recall that the prior guidance was $3.45 to $3.60 per share on an adjusted basis. We have tightened that up to $3.50 to $3.60 per share in the current outlook. For the second quarter, we expect a range of $0.68 to $0.74 per share on an adjusted basis. The outlook for the second quarter reflects a somewhat lower forecast in the Test business as they manage ongoing disruptions in China due to COVID policies. We view this as a timing issue. And as mentioned above, we see the Test forecast for the full year is still intact.

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 a lot of my thoughts earlier, but I do have a couple more comments before we move to Q&A. You saw the numbers from Chris. So obviously, a great start to the year for ESCO with strong financial performance. This is really a great company. We're operating in healthy end markets and serving some really great customers. So, I want to take a moment to just thank all of our employees across the company. As I mentioned before, I've had a chance to visit all of our subsidiary locations since taking over, and everybody's really been welcoming I really appreciate that. But more importantly, everybody has been really busy, and they're working really hard. We're growing, and we're managing a number of challenges that could put a lot of strain on people, and I'm really grateful for their dedication and for their efforts.

So with that, we can start the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Tommy Moll of Stephens.

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

So I wanted to start on the revenue outlook. Just comparing the guidance that you gave last quarter and then the quarter you just reported. If I just go through the segments, for A&D, I think it was 10% to 13% year-on-year, USG 5% to 7%, Test 3% to 5%. Those were kind of the ranges you gave us last quarter. And each of the 3 segments you blew away above the high end of the range in the first fiscal quarter. So is there some cause for a big deceleration in growth as you go through this year? Or are those ranges potentially biased higher after what you just reported in the first quarter.

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

Yes, Tommy, I would say -- this is Chris. I would say that we're probably biased towards the higher end of the ranges. I wouldn't say we would redo the ranges I would say you're absolutely right. We kind of expected the growth to be a little bit more front-end centered as we came into the year with our backlog position. Certainly, Q1 was a little better than we planned. But it's consistent with our overall plan that we're still going to get growth for the balance of the year, but the growth will moderate from those first quarter levels.

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

And is that moderation more just timing of backlog or comps? Or is there something underlying that you anticipate to decelerate as you go through the year?

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

Yes. I would say really more just comps. If you look at last year, again, our growth was a little lower in the first half, and then we had really strong double-digit growth on an organic and reported basis last year in the third and fourth quarter. So you just come into tougher comps. We still have, as you know, high levels of backlog and a good outlook. But it's hard to get those big double-digit growth when you got comps like that coming in this year.

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

Yes. Understood. I wanted to pivot to commercial aero, where you reported a I think it led the segment. And I'm just curious what inning it feels like we're in, in this recovery, you've strung several good quarters together in a row here, you're going to start lapping over those. Does it still feel like early innings? Or any context you could provide would be helpful.

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

Yes. I would say honestly, Tommy, it's a little hard to say what we would say is that we feel like the recovery still has legs. As far as what inning we're in, if you look out a couple of years at kind of industry projections, they still have pretty robust double-digit growth expectations just kind of in the build rates. If you look at kind of single-aisle dual aisle type forecast. The industry is still struggling to kind of ramp up throughout '22 and now in '23, the build rates aren't quite where the OEMs want them. And so all that tells us that we should still see some pretty good runway in front of us. And again, it's hard for me to say what inning. I don't know if we're in the middle of the game yet. I'd say we're maybe not to the middle of the game yet, but we've got -- we do feel pretty good that the outlook is still pretty robust there.

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

Yes. I think the innings thing is throwing us off. I think we feel pretty good about the overall growth, Tommy. Each of the major OEMs are ramping up I think there's some question as to how quickly and how effectively they're going to be able to ramp up because in commercial aerospace, there's still a fair amount of supply chain disruption across the board. And so they're struggling to get back to where they want to be, but there's certainly underlying strength in the overall segment.

Operator

(Operator Instructions) I'm showing no further questions at this time. I'd like to turn the call back over to management for any closing remarks.

One moment. It looks like we do have a question. Our next question comes from Tommy Moll.

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

I start thinking I'd be in the back of the queue. So I either jump in front of someone or we can just have a conversation with the 4 of us today, but...

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

Well, there's more questions, looks like. So go ahead.

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

Okay. While I'll just ask the one follow-up, I was going to wait until the end of the call for. But just on cash flow, and Chris, you called out some of the headwinds in the first quarter. And I appreciate you don't provide specific guidance on this issue. But is there any even qualitative or even better quantitative way you could frame the progression there? Or what kind of conversion might be reasonable to expect for the year? Just anything to help us model would be helpful.

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

Yes. You're right. I mean, we don't really give firm guidance there. What I would say is that we are typically seasonally low. Q1 is always the low point for us. This quarter, no doubt that will be the case for this year as well. We look at the free cash flow conversion for the full year. I think we're trying to drive that into the 80%, 90% range, Tommy, to get quantitative on you. That's maybe a little below where we've been through the last couple of years, but we've had cash can kind of come in chunks a little bit. So -- and we are investing a little bit in capital right now as well. So that counts against that ratio, but that's -- hopefully, that kind of tells you where we're driving towards.

Is operator still on? Do we have another question?

Operator

Yes. I apologize. Jon Tanwanteng.

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

Hi, can you hear me?

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

Hi, Jon.

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

Hi, Jon.

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

I was curious what gives you the confidence that Test will come back going forward? I know there's been some disruption in China. Are you getting indications from your customers that those orders are going to come back and make it into the year? I know sometimes there's a timing issue there. Just give us a little more color on that.

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

Yes, we still feel pretty good about where the Test business is. We are going to have -- we have forecast that the second quarter is going to be adversely affected by the COVID stuff that's going on in China right now. We do have several parts of the business are continuing to do quite well in terms of the underlying market demand. We have a huge backlog there that we're working through. And so that gives us a high level of confidence about our ability to deliver the financials for the year.

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

Okay. Great. Could you give us a little more color on CMT, just what kind of growth rates it has and the margins that are underlying it and kind of the synergies that you're expecting out of that business as you fold them into the sub business?

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

Yes. So CMT is a small business. We're not going to expect that, that's going to have a meaningful impact in FY '23. But it's a business that has exposure to some really interesting technologies that we think are really emerging for the Navy. And so we do expect that over the 2- to 5-year time frame, that we're going to see substantial growth in that overall business. Margins today are modest, but we are going to be integrating it into our Globe production facility. So we'll be able to take some costs out and really improve margins going forward.

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

Okay. Great. And are there more like that behind CMT? And how does the pipeline look today?

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

Well, so we have a pipeline. I don't think I have anything that's imminent for you, but we are constantly working on those things, and we're developing additional opportunities as we speak.

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

Okay. I was wondering if you could talk a little bit more about the constraints that you're facing, both from a supply and labor perspective. Number one, which one is actually the bigger issue for you right now? Is it still supply, or do you see that improving and maybe labor becomes the issue going forward? And kind of if there's anything you can do at this moment to address that?

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

Yes. I think the bigger issue right now for us is the labor shortage. And that affects us at a couple of different levels. Not only does it affect us directly, but also affects all of our suppliers. So things like outside processing, pieces like that, where they're struggling to get ramped back up to the full speed. We do have a couple of places with some discrete electronic components that are starting to cause some growth issues. So we're able to kind of maintain our original plans, but we're having a hard time scaling up to some demand that we're -- some increased demand we're seeing in the marketplace in a couple of places. But we think that's going to resolve itself in 2 or 3 months. But listen, it's still challenging and every day is a new adventure when it comes to supply chain.

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

Okay. Got it. Bryan, one last one for you. Just you've been in the job for about a month now. And just wondering what high level thoughts you have about the direction of the company and kind of what you may be thinking about changing. I know we've spoken before about that, but if those thoughts are evolving, I'd love to hear kind of what opportunities you should...

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

Well, I won't be announcing any major strategic adjustments today. But I -- first of all, listen, I think we're in a great place. As I've said in my comments, this is a really nice business with great exposure to some growing end markets. The biggest thing, I think that we will be changing is trying to improve the amount of collaboration and interaction between the subsidiaries. So that's something that's already begun. We will be doing a kind of a strategic overall review over the next 3 months. That's our kind of our normal strategic planning process occurs in April. And so we're making a few changes to some of the criteria that we're asking our subsidiaries to look at to kind of open up the aperture just a little bit in terms of things that we would consider both in terms of organic and inorganic activity. And so I don't have anything specific to announce, and I probably wouldn't if I did. But we're definitely going to make a few changes that we think are going to put us in a better position to kind of grow the business and expand our margins.

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

Got it. If I could sneak one more in there, Chris. I don't know if you answered this before, I was trying to get in the queue. But any thoughts on capital and cash flow and kind of when you might see that moving positive for you.

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

Yes. Yes. We did talk about that a little bit, Jon. I think obviously, Q1 is kind of typically our seasonal low point. We saw that again this year. We're driving kind of that full year free cash flow conversion, hopefully, in the 80%, 90% range. That's kind of what we've targeted for the full year. Predicated a little bit on capital continuing to increase a little bit this year. We've got some programs. We're trying to invest in for capacity in our facilities and stuff around corporation. So that's driving the capital a little higher this year, but that's kind of the framework we're driving towards this year.

Operator

(Operator Instructions) I'm showing no further questions at this time. I'd like to turn the call back over to management for any closing remarks.

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

Well, listen, everybody, thanks a lot for participating in the call today. We're pretty excited about the direction we're heading in. We've had a good quarter, and we think we're going to have a good year. So we'll talk to you next time.

Operator

Thank you. Ladies and gentlemen, this does conclude today's conference. Thank you all for participating. You may now disconnect. Have a great day.
