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PRESENTATION

Operator

Good day, and welcome to the ESCO Q2 Conference Call. Today's call is being recorded. With us today are Vic Richey, Chairman and CEO; Gary Muenster, who is retiring as Vice President and CFO; and Chris Tucker, Senior Vice President and CFO.

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 timing of recovery and growth of our end markets, the amounts and timing of 2021 and beyond revenues, COVID impacts and recovery expected as a result of the COVID vaccine, recovery in commercial aerospace, adjusted EPS, adjusted EBITDA, cash, shareholder value, the timing of Block V deliveries, success in completing additional acquisitions 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 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. As you saw in the press release, we do have some management changes here, which we've been working on for some time. So you'll be hearing from Chris in a few minutes. In addition to that, we have David Schatz here with us who recently replaced Alyson as our General Counsel.

So before we get into the details of the quarter, I'd like to start off by introducing and welcoming Chris Tucker who joined us a few weeks ago as the newest member of our executive management team. Chris will be serving as Senior Vice President and Chief Financial Officer, replacing Gary who previously announced his retirement.

Chris comes to us from Emerson, where he served in numerous financial leadership roles with increasing responsibilities over the years. He also led their Investor Relations group for several years.

I'll turn it over to Chris to give you a little more background on his experience. Chris.

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

Hello everyone, and thanks Vic for the introduction. It's great to join all of you today. I just wanted to take a minute and give a brief introduction of myself before we jump into details of the Q2 performance. A lot of this was covered in the press release announcing my hiring, but I'll provide a little more color here on the phone. As you know, I'm joining ESCO from Emerson, where I spent the last 24 years of my career. Emerson's a great company, and I had a great experience there. I started off in the corporate accounting and finance team back in 1997 and finished up as the Group CFO for one of their two business platforms.

And of course, there were several important stops in between those 2 bookends. During my time there, I had a chance to work on a variety of operational issues, business development opportunities and overall value creation strategies. I also led the investor relations effort for a few years during my tenure there, which was a good bit of training for calls like we're doing right now. My prior experiences have put me in a strong position as I transition to this new role. I'm very excited to be part of Vic's team here at ESCO.

Gary has been extremely helpful as we've worked together over the last few weeks, and everyone from the corporate staff to the Board of Directors has been collaborative and great to work with. ESCO is really a great company and has a lot of exciting initiatives going on really across all the businesses. I'm excited to be here and to start building on Gary's legacy of strong financial leadership as we move into the future.

With that, I'll turn it back over to Vic and Gary for a more detailed discussion of Q2 and the rest of the year.

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

Thanks Chris, and welcome aboard, we'll look forward to working with you. I'd be remiss if I didn't mention today's COVID environment, and how we continue managing around its impact on our aerospace and utility businesses. I think our results demonstrate we are succeeding. Since the beginning of the pandemic, our primary goal has remained the same. Provide a safe working environment, and to protect the health of our employees. And today, we're really encouraging our staff to get fully vaccinated for the benefit of all.

Our solid operating results in Q2 and for the first 6 months of the year, coupled with our increasing liquidity demonstrate that the measures we've taken over the past 12 months has significantly mitigated COVID's impact on earnings, and I believe it will allow us to continue successfully navigating through this challenge. Our previous cost reduction actions, along with our enhanced focus on operational efficiency will benefit ESCO going forward as things continue to move toward a more normal state. And I'm confident that our disciplined approach to operating the business will result in continued success throughout the balance of the year.

While Gary will provide the financial details, I'll offer some top level commentary to set the tone. While our Q2 and year to date A&D sales were significantly lower than prior year due to COVID's impact on commercial aerospace, our portfolio diversity allowed us to mitigate this headwind as we were able to hold our ESCO consolidated, adjusted EBITDA constant at $31 million in Q2 compared to the pre-COVID Q2 results from last year. Additionally, we were able to increase our fiscal '21 year to date adjusted EBITDA and adjusted EPS from the prior year, despite a 6% decrease in sales. This improvement was delivered by solid contributions from our other operating units, and as a result of favorable sales mix and meaningful cost reductions across the company.

From the segment level, there are several positives to report. Within A&D, we're seeing signs of recovery in the commercial aerospace as passenger boardings continue to increase, and more airlines are adding idle aircraft back into service. Our Navy and space businesses have remained strong and well-funded, and our outlook for near term growth opportunities continue to materialize in both of these areas. Our Test business continues to outperform, as we saw sales growth in both Q2 and year to date with increasing margins as our project execution remains solid. We expect Test's outlook to remain positive, driven by the strength of its served markets, including 5G.

Our USG business while reporting a softer Q2 than originally projected, reported a solid first half of the year from both the sales and adjusted EBIT perspective. USG delivered an adjusted EBITDA margin of 26% for the first 6 months of the year, up from approximately 22% in the prior year's first half. This is a result of year end spending captured in our first quarter, along with our lower cost base. Overall, the fundamentals of our portfolio remain strong and our goal remains the same, to create long-term shareholder value.

Now I'll turn it over to Gary.

Gary E. Muenster - *ESCO Technologies Inc. - Retiring EVP & CFO*

Thanks Vic. I'll briefly touch on the financial results laid out in the press release. As we continue navigating through what we hope is the near end of COVID, our number one financial priority remains the same. Increasing and maximizing our liquidity to position us for future M&A growth and increased investment in new products and solutions. We have a rock solid balance sheet today, and we are poised to use it to our advantage.

I'll highlight the significant cash we've generated this year as we've set a record for cashflow during the first half. It is the highest in our history. We delivered free cash flow conversion at 134% of net earnings for the first 6 months. Clearly, our working capital initiatives are producing solid results. Today, we have approximately $760 million of liquidity at our disposal, between cash on hand and available credit capacity, while carrying a modest leverage ratio of 0.23. We fully realize that while this is a positive metric, it is not the ideal capital structure given the historically low cost of debt. And with that said, we're committed to putting our balance sheet to work.

One of our primary objectives in the near term is to add leverage to fund acquisitions. With our focus directed at bringing on new businesses that provide an ROIC well in excess of our cost of capital, as we believe this return spread is a cornerstone of value creation. In the release, we've called out a couple of discrete items, which are described in detail and are excluded from the calculation of adjusted EBITDA and adjusted EPS in both years presented. So I will not repeat them here.

I'll now touch on a few comparative highlights noted in the release. We beat the consensus estimate of $0.55 as we reported Q2 adjusted EPS of $0.59 a share. This compares to the $0.68 a share in the prior year of Q2. Considering Q2 of this year was influenced by the COVID operating environment, I'm pleased to report that we delivered adjusted EBITDA of $31 million in the current period, which is equal to the $31 million we reported last year in Q2, pre COVID. More impressively, this was achieved despite the noted sales decline in Q2 that Vic mentioned earlier. Our Q2 adjusted EBITDA margin increased to 19% from 17% last year. Year-to-date, our adjusted EBITDA increased to over $60 million with an 18% margin up from 17% prior year-to-date. Over the past year, we took several cost reduction actions across the company. And as a result, we were able to increase our Q2 and year-to-date gross margins to 38.1% and 38.7%, respectively.

We reduced our Q2 and year-to-date SG&A spending by 3% in both Q2 and year-to-date periods compared to prior year. These favorable outcomes were achieved despite including the acquisition of ATM in October, which is not yet at full operating capacity during its transition to Crissair. And it was done despite our continued spending on R&D and new product development. Amortization of intangibles and interest expense both decreased while tax expense as a percent of pre-tax income increased in Q2 and in the first half as we had several large tax strategies implemented last year, which benefited the 2020 comparative rates, but were not repeated in the current year. Q2 orders were solid as we booked $176 million in new business and ended the quarter with a backlog of $522 million with a book-to-bill of 106%.

A bright spot worth mentioning was the order volumes recorded in our commercial aerospace businesses, which grew their backlog $7 million during the quarter. As we move through the balance of the year, I'll remind you that our DOD businesses led by our participation on the Block V contract for additional Virginia class submarines where we booked several large orders during fiscal 20. will be delivering products against those orders, which are multi-year programs, which will mathematically reduce the optics of our book-to-bill. Consistent with our November communications and from a directional perspective, we can point to several areas where we see positive momentum. Our commercial aerospace and utility end markets are showing some degree of customer stabilization which supports our current outlook, suggesting a movement toward continued recovery in the second half of fiscal '21.

The increasing distribution of the COVID-19 vaccine is anticipated to benefit and accelerate the recovery of commercial air travel and utility spending with customers resuming more normal buying patterns. While we solidly beat Q2 and are ahead of our original plan at the halfway point, we still expect the second half of '21 to be slightly favorable in comparison to the second half of fiscal '20, given the various elements of recovery that we're anticipating. We expect to show growth in fiscal '21 adjusted EBITDA, adjusted EPS as compared to fiscal '20 with an adjusted EBITDA, reasonably consistent with that -- which was reported in 2019.

If we complete any additional acquisitions during the year, it is expected that these would contribute to the expectations I just mentioned.

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

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

Since I touched on quite a few of my thoughts early in my commentary, I'll offer a few qualitative comments about our end markets and our expectations for the balance of the year. Starting with our A&D segment, as I mentioned, we're seeing some signs of modest recovery in commercial aerospace. We expect continuous softness over the next 3 months. We're starting to see stabilization in the OEM build rates and increase in airline passenger traffic and flight miles. Just as we saw in Q1, the defense portion of our A&D business is and will remain strong for the foreseeable future given our backlog and platform positions. We also see the current situation in aerospace market as an opportunity for ESCO as we've been made aware of some situations where other suppliers or competitors are not fulfilling their customer requirements. And those customers have reached out to us to see if we can step in and satisfy their demands.

Our Test business delivered another really solid quarter by beating our internal expectations and delivering an EBIT margin of 13%. Test's outlook remains solid given the diversity of its served markets. As I noted on a previous call, when USG had a really strong first quarter, we expected USG sales to be down in Q2 before returning to more normal levels in the second half of the year. And that's what we've seen, but the positive is increased margin contribution USG delivered in Q2 and year-to-date compared to prior year. As the COVID vaccine gets more widely distributed throughout utility service personnel, we expect USG market to come back online more quickly as they can relax within today's social distancing guidelines and utility service personnel can return to their normal site visit routines.

We recently visited with our USG management teams and I remain pleased with the enthusiasm surrounded their new products and solutions. And we continue to see NRGs end markets improving as new investments in renewable energy are increasing in both wind and solar. Our solar revenues have been growing far better than anticipated and we expect that trend to continue.

Moving on to M&A, we continue to evaluate several opportunities and we expect to take action on these opportunities to grow our businesses as we have in the past. Our board is extremely supportive of our M&A strategy. Our current balance sheet provides us with plenty of liquidity to allow us to add to our existing business.

To wrap up, we delivered a solid second half and first quarter from both a cashflow and earnings standpoint. As we move through the second half of our fiscal '21, our plan is to continue to focus on the fundamentals and look for opportunities to leverage our existing cost structure through M&A, to create additional operating efficiencies, and ensure we are well positioned for long-term success.

So with that, I'll be a happy to take any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question is coming from the line of Tommy Moll with Stephens.

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

Vic, I wanted to start on A&D. It sounds like you exceeded your internal expectations as quarter on the top end bottom lines. Is there any context you could give us there about what came in better than expected? And then a related follow on, as you look ahead, it sounds like there may be some structural benefit to your margins after some of the costs out last year. At the same time as the end markets recover, presumably there would be some OPEX you'd look to layer back in. So what kind of incrementals should we be thinking about, or what's the approach as you balance those competing considerations?

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

Sure. So on your first question, as far as what we saw in A&D, we see a couple things. The non-commercial aerospace part of our business, the Space, the Navy and the small amount of defense Aviation, were a little better than what we anticipated. In addition to that, while the commercial aerospace is still a bit behind schedule and it is recovering, but we were able to get a good bit of nonrecurring engineering from customers for some new product development. So that really helped because it's not something we had initially anticipated getting this quarter in this first half of the year. So I would say those are the major things that we saw to the upside.

As far as your second question, it certainly, you saw the leverage. I mean, particularly USG where our sales were down and our margins were up pretty significantly. And that's really just a matter of the cost that we took out really across the business in the second half of the year. And so what we have to do, I mean, when the business starts to grow again, obviously, we're going to have to add some folks, but I do think we've reset the bar on the cost structure and we're going to be very, very diligent about adding any costs back. And I think we will be able to as a result of that have better margins than what we've seen in the past in some of these businesses.

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

That's all helpful. Just as a follow-up I want to talk about balance sheet and M&A. It sounds like optimizing your capital structure and acquisitions are 2 sides of the same coin. So if we fast forward to a natural comfort zone or an optimized balance sheet in your mind, what were the brackets around where you're comfortable with leverage? And if you think about that without putting an exact time frame around it, but just the most likely scenario to get from point A to point B, is that probably one larger acquisition? Should we think about it a longer dated time horizon with multiple deals? Any context you could give us there and any more context on the pipeline, just how active it is, buy-sell expectations, would be helpful as well.

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

Sure. Sure. So obviously, we can handle a good bit of debt now, we're not going to go out and do it too quickly or too large of acquisitions. I mean, typically where we've been successful is larger acquisitions, somewhere between $20 million and $100 million, $150 million, something like that, purchase price. So you can expect that's what we'll continue to do. There are some opportunities out there that are bigger. I mean, I think we would have to take a hard look at those as well, but I think we've been pretty successful in integrating smaller, middle-sized business into our portfolio. The pipeline is really strong. I mean, I'm surprised. It's like we're getting a new book every couple of days or at least once a week. And so there's a lot of activity out there.

I think everybody's aware, it's a very competitive market right now. So we work hard to try to get into areas before there's an auction, before there's an auction with a lot of strategics at least, but the amount of money out there is pretty amazing right now. So I had thought, going into the pandemic, that maybe the multiples would be coming down. And unfortunately, that's not what's happened. And so I think we have to be realistic about what we're going to do as we add to the business. We'll probably looking a lot harder at returns now than maybe the multiples that we're paying because that's what I think really makes most sense at the end of the day, looking for opportunities where we can really see some synergies in the businesses that we acquire.

Gary E. Muenster - *ESCO Technologies Inc. - Retiring EVP & CFO*

And Tommy, this is Gary. Let me add something to that because the philosophy is not going to change with me going away and Chris coming on. But the first part of your question on the comfort level, one thing we do for the board as Vic mentioned, they're very supportive. I think I might've mentioned it to you when we spoke after Q1. Is we keep a mathematical profile in front of them and just being this under-leveraged today, we just had board meetings last week.

And if we were to spend roughly $250 million and bring along $25 million of EBITDA with 10x obvious multiple, that would only put us at 1.5x leverage. And to carry that math exercise a step forward, if Vic's posts were 2.5x, we could spend another $230 million, which together says we could spend $450 million and a 10x multiple will only be levered up to 2.5x, which I think from an ideal capital structure is not something that would be uncomfortable. I'm not implying, that's what we have in the pipeline, but just to put some posts around how this map carries forward. It'd be ideal if we could find 450 million to spend and bring along 45 million of EBITDA. But really, just calibrating 2.5 is something that would be extraordinarily comfortable for a company of our size.

Operator

(Operator Instructions) Next question will be coming from the line of Jon Tanwanteng of CJS Securities.

Peter Lucas - *CJS Securities - Analyst*

it's Pete Lucas for Jon. You answered a lot of the questions previously. Just wondered if you could talk about how you look at potential infrastructure bill. All seems like it would be positive for you, but just wondering, any specifics in there that you guys are focused on?

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

Yes, I mean, we get that question a lot. It's so ill-defined right now, it's hard to say. I don't think there's any downside to this, that's for sure. I do think that some of the things will be going into renewable energy. Some things will be going into the grid. Those kinds of things I think should be, have the potential to be very helpful to us, but it is pretty ill-defined. It's probably the biggest area where we would see a positive impact. I mean the other thing I think that we look at a lot is what the defense budget is. Right? I mean a good bit of our business now is A&D and it looks like that's holding up pretty well. And as we've talked about before, I mean, we really think more about it in the area where we participate.

So you're looking at the Naval side of it, particularly submarines, which is the vast majority of our, much of our product goes and that's really rock solid, and I don't anticipate that changing at all. And then the other thing, obviously looking at it from a budget perspective is NASA, we have a great position on the SLS program and that appears to be very solid as well. So I think the infrastructure bill gets a lot of attention as it should. I think that will be helpful to us, but as we look at those other 2 budgets in many ways are just as important to us.

Peter Lucas - *CJS Securities - Analyst*

Great. And last one for me, as far as the Test business, a competitor of yours was recently sold. Just wondering if that's changed the competitive environment at all or anything special you're seeing there?

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

No, the reality is we didn't compete with them a lot because they're really very focused on aerospace and defense. We do some of that, but I'd say that that's a business it's a bit different than ours. We do some work with them. In fact, we're doing some work with them now, that will continue, they work more on the sensor side. I think we have a good bit more of a footprint on the chamber side and on the absorber side. And that's a place where we have teamed historically and hope to continue doing that going forward.

Operator

Next question will be coming from the line of John Franzreb with Sidoti.

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

Just to follow up on, on the Test segment, you've talked about it turning to more normalize level. Are we talking about normalized level of pre-COVID or normalized level in line of what you do in the second half of fiscal 2020?

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

The Test -- I'm a little confused. I mean, are you talking about the Test business or the Aerospace business?

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

The Test business.

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

The Test business has been pretty -- it's been pretty solid. I mean, I think year over year, we're within a couple million dollars. I think we're up a couple million dollars thus far this year over last year. So that's promising -- and the margins higher, for sure. So I mean, if you look at the 3 segments, the Test businesses has been the one has been least impacted by COVID thus far.

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

And what's driving the margin improvement in testing?

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

I think the big thing is project execution. We have some in mix. I mean, we've been getting more EMP filters and more components, but I'd say the biggest, and those carry a higher margin than the underlying chamber business. But I'd say that, so it's that, and it's just project execution. The, just the overall process that they go through and execution on large projects is improved over the past several years.

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

Okay. And then USG, you said that the opening up post COVID restrictions will be beneficial to the business. Are you starting to see any kind of pickup in order activity, be it, the spring related turnaround easing, or any kind of activity that kind of backs up that thesis?

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

Yes, I'd say the activity level certainly has picked up, I think for a couple of reasons, they're kind of entering the test season if you will. And so that's when they typically started buying things and then the, just people getting back to work. I mean, the issue is, I'd say most utilities have historically they've been doing more work from home than a lot of other in the markets. And so as you're getting back into the office, that's really helped that activity as well.

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

Okay. Go ahead.

Gary E. Muenster - *ESCO Technologies Inc. - Retiring EVP & CFO*

Sorry to interrupt. Just to supplement what Vic said, if you look at the Q2 order profile and in the back of the release there, you'll see that the order book is up about 10% in Q2. So that's a precursor to the conversation that, that Vic just alluded to, which is evidence that the momentum's starting there. It's generally a quick turn business in the backlog. It's not, I'm going to get an order on Monday and ship it on Tuesday. So seeing that growth in Q2 is certainly beneficial.

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

Excellent. And just one last question, you kind of alluded to it. I think in response to another question about costs coming back, how much staffing do you think you still need to add this year? And in what segments do you think the most definitely you would be bringing back?

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

So I would say the areas where we would probably be adding some folks, and we're not talking large numbers. Like I said, the people done a good job of managing this, but if some of the programs ramp up, particularly on the Navy side, there's some specific people we need to add there. We're always looking to improve our engineering workforce or add to our engineering workforce. And so as, as things return to normal and we're able to, afford more of that, I'm sure we'll be adding some, some folks in the technical areas as well.

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

Okay. But that's not going to be a large number as your saying overall?

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

No, I don't think so. I mean, I think it'd be, look at sheer numbers. What we'll see is as sales pickup in the commercial aerospace side, we're going to have to add some direct labor people. But obviously that, that funds itself. We wouldn't be adding those folks unless we had to work for them to perform on.

Operator

(Operator Instructions)

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

Okay. So I think we're done. So I'm going to end the call by saying thanks to Gary and Alyson for their long-term support of our value creating mission here at ESCO and for their passion and commitment to the company. You're both going to be missed. We were fortunate to have Chris and Dave to step in and help lead the company to continued success. So thanks to everybody. And I look forward to talking to you in the next call.

Operator

And this concludes today's SKOQ2 conference call. Thank you everyone for your participation. You may now disconnect.
