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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Fourth Quarter 2022 ESCO Technologies Earnings Call.

(Operator Instructions)

Today's call is being recorded. On the call today, we have Vic Richey, Chairman and CEO; Chris Tucker, Senior Vice President and CFO; and Bryan Sayler, President, Utility Solutions Group. And now I would like to turn the conference over to your first speaker today, Kate Lowrey, Vice President of Investor Relations. Kate, you may 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 Vic.

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

Thanks, Kate, and thank you, everyone, for joining today's call. We've got a lot to cover today, but I want to start off by introducing everybody to Bryan Sayler. By now you've all seen a press release from September 12 and also the commentary from the release we issued today. Bryan is about to take over as CEO on January 1 and is joining us on today's call. I really feel good about our transition plan, and we thought this call would be a good chance for Bryan to say a few words and to start to engage in a quarterly earnings process.

Let me turn it over to Bryan for a brief introduction.

Bryan Sayler

Thanks, Vic, and hello to everyone on the call today. I'm really grateful to have a chance to talk to all of you. I know you've seen the details from the press release, but I am excited to be taking this step. I've been at ESCO for over 25 years. Vic and the team here have built a tremendous company during his time as CEO. I know I speak for the entire team when I say that we're all very thankful for his contributions over a 37-year career at ESCO. The company is in a very strong position, and I'm looking forward to engaging with the teams around the company as we work to continue our momentum and drive the growth of our business forward. I'd also like to thank the Board of Directors for the confidence that they are showing by placing me in this role, and I'm very eager to get started.

On a personal note, I am currently in the process of relocating to the St. Louis area as we speak, and we'll certainly be ready to hit the ground running by January 1. I also look forward to engaging with all of you in the investment community. Once I get established here in St. Louis, I'll work with Kate and Chris to set up some investor outreach. There will be a lot to focus on as I take over and certainly meeting with investors will be a big priority.

So with that, I'll turn it back over to Vic.

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

Okay. Great. Thanks, Bryan. Let me say again, how excited I'm for the transition we have in front of us. I have the utmost respect for Bryan and the full Board is very confident as he takes over. Our succession planning process was rigorous, and Bryan is the right leader to move us forward. Congratulations, Bryan.

With that, let me pivot into the quarterly results. We really had a tremendous finish to the year. In a lot of ways, this was a very challenging year. You've all heard a lot about the ongoing supply chain and labor challenges. At ESCO, we felt those pressures throughout the year. So it's tough sledding for much of the year. That makes it very gratifying to be on the call today announcing these record results.

For the full year, we achieved many records, sales of $858 million, adjusted EPS of $3.21 a share, operating cash flow of $135 million and a year-end backlog of $695 million, all record amounts. We have meaningfully improved financial contributions from all 3 segments and tremendous efforts by thousands of employees around the company. Our portfolio of businesses all have strong market positions, which is very evident from the numbers we put up this year. Across the company, we've seen favorable end market dynamics, and we feel really good about the long-term outlook for all 3 business platforms.

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. Starting with A&D, where we had a great quarter. Sales increased 30% and adjusted EBIT dollars were up over 60%. This business had a few soft years with big negative impact from the pandemic. 2022 represented a nice year of recovery for A&D, but we think the recovery still has room to run. The commercial aerospace markets have led the recovery, with PTI, Crissair and Mayday seeing significant order increases. We also have sizable Navy, Space and Defense Aerospace businesses in A&D and those markets are also strong. This business is nicely diversified across different aerospace and defense markets, and we see good momentum as we move into 2023.

Next is Utility Group, where we also had a strong quarter. This business was a little uneven in 2021 coming out of the pandemic. But over the last 3 quarters of fiscal 2022, we have really seen the business stabilize and strengthen. It's clear that the North American utility customers have started spending again as they work to bolster capacity and to improve their infrastructure. Additionally, the renewable space continues to be a bright spot for us, and NRG has now delivered 2 years in a row of sales growth in excess of 20%. The other exciting thing for the Utility group is some of the new product launches that Bryan and the team have completed. In particular, the new Calisto dissolved gas analyzer is a very exciting new product that's gaining good momentum in the marketplace.

The supply chain issues have been difficult here, especially given the electronic components involved. The teams have continued to work these issues and are able to deliver really strong growth in 2022. Lastly, let's touch on the Test business, where we had a nice quarter of sales growth and

EBIT margin expansion. Q4 sales were up 8% for Test, a good number given the significant growth we've posted over the last several quarters. This business also has diversity in end markets, and we have seen strength across several different markets with health care, telecom, automotive and data center customers all having a high level of activity in 2022.

The other good news for Test in Q4 was a margin expansion. An EBIT margin of 17% in Q4 is a really great number for this business. And I know the team is focused on continuing to drive margin improvement as we move forward. To summarize a bit, it really was a good year for ESCO on a number of fronts. At the beginning of the year, we gave earnings per share guidance of $3.10 to $3.20 a share. When that guidance was delivered, there was not an expectation that supply chain and labor challenges would be with us all year. That is really one of the reasons we feel so good about the year. We slightly exceeded the EPS range in spite of the headwinds that were well beyond what we anticipated. It's a big testament to our employees across the company, and always, I'm very thankful for the tremendous effort to deliver this record year.

Now I'll turn it over to Chris.

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

Thanks, Vic. As we have done in the last few quarters, we're going to use a chart presentation to walk through the financial results. Starting on Chart 3, we have the overall financial highlights for the fourth quarter. As Vic mentioned, we had a great quarter, and this chart illustrates that very well. Sales were up nearly 25%. Adjusted EBIT was up over 50% and adjusted EPS was up over 42%, a great growth quarter for ESCO.

The chart does show orders down approximately 5%. That is a function of last year's fourth quarter acquisition of Altanova and Phoenix. The acquired backlog came through as orders last year, so it makes for a pretty tough comparison. Overall, the order trends have remained robust and our record year-end backlog of $695 million demonstrates the strength of the business. The last thing I wanted to highlight on this chart was organic sales growth of 19%. 2 of the 3 business platforms grew at over 20% organically to drive this very strong finish to 2022.

Next, on Chart 4, we'll get into segment results, starting with A&D. A great finish to the year here as well with nearly 30% sales growth and EBIT margins up over 4 points. Commercial aerospace recovery led to sales growth as we saw sales increase by 50% in this market. This was led by our PTI and Mayday subsidiaries. Beyond that, we still saw explosive growth from other parts of the business with Defense Aerospace, Navy and Space, all up more than 20%.

The teams here have been managing a number of supplier and labor challenges. So it was great to see them work through those issues and deliver this quarter. On the next chart, we have the Utility Solutions Group, where we also had very strong sales performance. Organic sales growth was 21% overall with high levels of activity from electric utility customer base and the renewables business. EBIT margins were down 0.6 point as we did see some unfavorable mix here, but EBIT dollars were up 33%.

The acquisition impact was favorable in the quarter with Altanova and Phoenix adding 16 points of growth. Going forward, these businesses will be folded into the base company, but we are very excited about the progress made with both acquisitions during their first year as part of ESCO.

The last segment to talk about is test, a good finish to the year for this group, with sales up 8% and EBIT margins up 1.7 points, really nice margin expansion here as we saw solid leverage on the volume increase, and we also saw good impacts from pricing actions. Orders did drop for Test during the quarter. Last year in Q4, we saw significant orders in the Power filter product line, so that is the main driver of the decrease. We still have a 19% increase in backlog compared to prior year-end. So the business had some nice runway as we move into '23.

Next on Chart 7. I'll take a snapshot of the full year results. As you saw in the press release, it was a record year for ESCO on many fronts. The sales performance was strong with a 20% increase driven by 13% organic and 7% from recent acquisitions. Adjusted EBIT margins expanded 0.8 points and adjusted EPS was up 24% as we saw favorable impacts from volume leverage, price and cost reductions, which more than offset the inflationary impacts of material and labor. Orders were up over 20%, resulting in $695 million year in backlog with good growth from all 3 segments.

Chart 8 has the cash flow highlights. Operating cash flow increased to $135 million, a great result as we had lagged on cash flow through the first 3 quarters. Capital spending was up just over $5 million and acquisition spending dropped significantly with 2021 including ATM, Altanova, and

Phoenix, while 2022 included only the NICO acquisition. We did restart a share repurchase program in 2022, and we're able to buy back $20 million worth of stock during the year.

Chart 9 has full year highlights for each of the segments. I'm not going to read through every number here. Obviously, for us, this is a really good-looking chart with lots of arrows pointing in the up direction, double-digit increases of sales and EBIT for all 3 business segments. So 2022 was really a good year of recovery for both A&D and USG after the pandemic had negatively impacted those businesses in '20 and '21. And then for Test, we really had continued growth after good performance throughout the pandemic period.

The last chart will be our guidance for 2023. We are expecting another year of growth in '23 with sales growth of 6% to 8% and adjusted EBIT dollar growth of 10% to 15%. In the press release, we detailed the growth expectations by segment. We expect A&D to lead the sales growth with low double-digit growth, followed by USG with mid-single-digit growth and Test expecting low single-digit growth.

From an EPS perspective, we are planning for growth in the range of 8% to 12%, slightly lower than the EBIT growth as we expect increases in interest expense given the current interest rate environment. Overall you're looking at another year of nice growth after the great year we had in 2022.

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

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

Thanks, Chris. Since I touched on it quite a few of my thoughts earlier in my commentary, I'll just offer a few more comments before we move into Q&A. You saw the numbers from Chris, but obviously, a great year for ESCO with, and I'll say this for the last time, record financials on a number of fronts. Even better than continued growth is being projected as we go into next year. So the growth isn't over for ESCO, and we feel that the momentum is strong heading into 2023. The company is on very solid footing and it's a good time for the leadership transition we discussed earlier.

Bryan is more than capable, and I know he'll do a great job as he moves into the CEO role. It's been a real honor for me to be the CEO at ESCO for the last 20 years, and I've really enjoyed my interactions with the investor community over that time. With that, we can start Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question will be coming from Jon Tanwanteng of CJS Securities.

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

First of all, congrats on your semi retirement and Bryan, on your promotion. We look forward to working with you. And you guys didn't mention on the call, but congrats on a successful SLS launch, I know you had parts on there in the program. My first questions, I was wondering if could break out what the year-over-year I guess order or bookings changes would have been, if you normalize for the impact of Phoenix and Altanova in the USG business because you put all that backlog at once, I don't know if you could break out what it would look like just with that single quarters worth of orders in those businesses?

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

Yes. It was worth about $25 million, Jon, of backlog that came in last year in Q4. So we can do that math real quick, but that's -- that was the impact in the prior year numbers.

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

Okay. We can do that separately. I guess the other question is, especially with the Test orders coming down, I know you mentioned the last year, there was an unusual timing item, but is there any chance that you might be seeing a demand slowdown in any way, shape or form just based on the headwinds you've seen in mobile device and a lot of your customers in the wireless businesses there?

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

Yes. I mean I think that -- I wouldn't say we would call it a slowdown from kind of broad economic impacts or anything. I would say that, that power filter business was really seeing explosive growth a year ago. That was driven by some specific data center buildouts and things that are going on. That has moderated a little bit. I think as that whole again, supply chain works to kind of get the data center buildouts done, it's just taking a little longer. So we're seeing that work stretch out a little bit.

We're able to keep up with demand, but other parts of the supply chain aren't. So we've seen that order book kind of slow down a little bit. And I wouldn't say we see any kind of broad weakness beyond that. We are still seeing some good activity on automotive, same with some of the telecom stuff. So we feel good there. But we're also just in general, coming up against higher comps. And that's why if you look in the guidance, we kind of had a lower growth expectation in for them relative to the other 2 segments. So fundamentally, just kind of as they've gotten this much bigger, this much faster, we expect the growth to be a little bit more moderate going forward.

Vic, I don't know if you have anything else to add.

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

Yes. No, I think it's all good. I agree with everything you said. Just back to the data centers for a minute. I mean, I think the long-term opportunity there is great. I mean, there's no sign that, that's going to slow down. If anything, I think it will continue to accelerate. But as Chris alluded to, part of the problem is just people's ability to get the centers built. I mean as anybody has done a type of construction over the past year knows it's hard to get concrete, it's hard to get steel. It's hard to get a lot of those basic things as well as just get the people to come to the work. But look, I think the business, as you know, that's the 1 business that was not impacted during COVID and so they continued to grow. And I think they will. And the entered orders that we had this past year were a record by probably $60 million. So it's been a good year for those guys.

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

Got it. And then just to maybe follow on a little bit with that. Just your general observations on the supply chain and how much better it's getting and how much more room or how much more, I guess, you wanted to catch up before you feel comfortable with the supply and timing that's out there?

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

It's a little spotty. I would say it's better than it was last quarter. I'd say the place we're probably still having some issues. We still have some issues on the component side. And then outside processing in a couple of businesses, the A&D business has still been a bit of a challenge because most of those outside processors are very small businesses. And I think some of them as particularly the commercial aerospace business has picked back up, a lot of them have had a hard time keeping up with that growth.

And so I'd say there, but it certainly is getting better. I'd say the other challenge though right now that is not getting better is workforce availability. So that's an area where I think everybody has continued to struggle a little bit.

Operator

(Operator Instructions)

We have a follow-up question from Jon.

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

I was wondering if you could talk about the unfavorable mix you saw in USG, kind of what went into that and what you're expecting out of that business as you go forward?

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

Yes. The main driver there was the security business that we have. We call it the DUCe business as an acronym there. But that's a business where we sell hardware kind of upfront and then we get kind of a service revenue stream over multiple years on that. So as that hardware goes out, that's a little bit lower margin. I would say, a fair bit lower margin. This utility is a high gross margin business. So it's still kind of mid-thirties but well below the overall average there. So that was really the main driver. We saw a lot of growth in that business with those hardware shipments in Q4 was a pretty big driver of the growth. And so that was the #1 factor.

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

Yes. The good news with that business, though, is you usually get the cash up front. So 1 of the reasons our cash was as good as it was this year was largely driven by payments on those contracts.

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

Got it. That makes sense. I was wondering also if you could talk a little bit more about your capital allocation priorities going forward. Obviously, rates are going higher. Help me think about the M&A pipeline versus repurchases or the use of cash as you're looking ahead?

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

Yes. I think I would say pretty consistent framework that we're looking at as we head into '23, Jon. As we said, we did about $20 million of share repurchases in '22. We'll probably target a similar amount for '23 as we kind of get that program going again. But obviously, the acquisitions is kind of the key piece there. If we see something bigger than we would maybe dial back. To me, I think the pipeline is okay. We are seeing some things come through a little bit right now on the deal side. Again, I wouldn't characterize it as a totally stuffed pipeline or anything, but we do have a little bit of activity there.

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

Okay. Great. Just a question on the EPS guidance for next year. What's the implied interest expense or interest rate that you're using to arrive at that?

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

So on average, for '22, we had about 2% interest rate, and we're looking at something more in the 6% plus range for next year. We're -- we'll be a little bit better than that in Q1 for some of the 3- and 6-month money we had locked up coming into the quarter. But overall, as we get through the year, we're expecting it to be 6% plus.

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

Okay. Fair enough. And then just I was wondering, as you look at the A&D business, it seems like that there's been a fairly good recovery, as you mentioned, what's the limit for that business as you get towards the full recovery as maybe wide body returns and international travel returns? How much better can it be than it was, I guess, before the pandemic? I know you've taken share through the past 3 years. Just help us understand what the upside is as we get to a full recovery?

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

Well, I think we would say we feel like it's -- we had a couple of pretty tough years, and this was a nice kind of recovery, but we still have some legs to go there. I mean I think it was certainly kind of single-aisle driven platforms that are kind of driving a lot of the sales growth that we put up this year. And I think even with some of our businesses like Crissair and Mayday if you compare them back to the '19 levels, they're just -- they've still got a fair bit to go to get there.

Now their order books have been pretty good, but it's been a little bit slower to materialize through the sales line. And so the double-aisle stuff is, again, I think, still out in front of us from a sales perspective, and that we expect to kind of carry on for that's -- you're talking in years there, I think, before you get back to kind of prior peaks.

As far as the overall single aisle, the only thing I would say about that is, if you hear kind of a lot of the commentary from the big OEMs out there, I think they're generally not quite to the build rates they're trying to get to. So if you look at those forecasts, again, those still show pretty nice growth out over the next coming years.

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

Yes. I think another way to think about it is we were really ramping that business up when the pandemic hit. I mean we had the best first quarter we'd ever had and then the pandemic hit and kind of the bottom fell out.

So I think if you go back and look at pre-pandemic, I mean, I think when it gets back to full recovery we'll be above that in addition to just that kind of that normal growth, I mean, we have won some additional projects, particularly on the space side and on the Navy side with Westland's really recovered nicely. So I think that longer term, and I'm not talking 5 years from now. I'm talking about a couple -- over the next couple of years, I think we'll get back above the levels that we had going into the pandemic.

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

Okay. Great. And then the same kind of question on just the USG business. Are your utility customers at the back towards where they were pre-pandemic? Or is there more room to grow and kind of how much?

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

Yes. I think the quick answer there is the domestic business is kind of back. I think they're kind of back at the level they were previously the -- the European business is still not back and the Asian business. So I think we'll see some growth there over the next couple of years. And then as I mentioned in my prepared comments, we have had some new product developments, which I think will add a little upside as well.

Operator

(Operator Instructions)

Our next question will be coming from John Franzreb of Sidoti.

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

Just curious about the pricing versus cost equation, how much of headwinds is higher inflationary costs still impacting you? And when do you expect to maybe be in equilibrium with price increases kind of matching up to those higher input costs?

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

Yes. I would say, by the fourth quarter, we kind of got ahead of that a little bit. I think you saw that in the test margins. I think you saw that in the A&D margins as well. Even in the utility side, I think we've done a good job on the price there to stay in front, but we talked about some of the mix issues there earlier that caused the margins to hold back a little bit. So we would say, in general, that we feel like we've priced pretty well, and we're kind of favorable in that equation right now, John.

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

And when you think about the cadence of revenue for this year, is it -- how heavily weighted is into the second half of 2023 relative to the first half as far as order deliveries and timing?

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

Yes, I'd say the sales growth is a little bit more -- it's not super back-end loaded from a growth perspective. If you look at the year-over-year growth, so because of the backlog, we're coming in with. But from a margin and EBIT perspective, it's a little more back-end loaded. But fundamentally, we think the sales growth will be pretty even, a little lower Q1 than a little higher Q2, Q3 and then maybe a little lower Q4 or something like that.

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

Got it. And just on the balance sheet. Why not be more aggressive in paying down debt and a higher interest rate environment?

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

Yes. We honestly -- what you see in the September financials there, we had some -- we had a really strong cash flow really late in the year, so we ended up with pretty high cash and a little higher debt. We've already kind of fixed a lot of that here since we started fiscal '23. And yes, we're definitely going to be managing the debt pretty aggressively given the interest rate environment as we move forward.

Operator

This concludes the Q&A session. I would like to turn the call back over to Vic Richey, Chairman and CEO, for closing remarks. Go ahead, sir.

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

Okay. Thanks so much for everybody joining us, and I look forward to Bryan and Chris talking to you next quarter. Thank you.

Operator

This concludes today's conference call. Thank you, and you may all disconnect. Have a great rest of your evening.