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Q1 2019 ESCO Technologies Inc Earnings Call

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CORPORATE PARTICIPANTS

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Kate Lowrey *ESCO Technologies Inc. - Director of IR*
Victor L. Richey *ESCO Technologies Inc. - Chairman, President & CEO*

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

Operator

Good day, and welcome to the ESCO Technologies First Quarter 2019 Earnings Conference Call. Today's call is being recorded.

With us today are Vic Richey, Chairman and CEO; Gary Muenster, Vice President and CFO.

And now to present the forward-looking statement, I would like to turn the call over to Ms. Kate Lowrey, Director of Investor Relations. Please go ahead.

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

Thank you. Statements made during this call regarding the amounts and timing of 2019 and beyond, EPS, adjusted EPS, EBITDA, adjusted EBITDA, cash flow, debt, growth, profitability, sales, costs, productivity, tax rate, 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 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 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. Before I hand it over to Gary to provide some detailed insight into the first quarter financials, I'm going to make a couple of comments. We had a solid first quarter across the business and our outlook for the year remains the same as we communicated entering the year. It was a good start to the year with the first quarter being a little stronger than expected, and this trend took a little pressure off the -- normal second half ramp up. Once again, I think the first quarter results demonstrate the earnings power of the business at higher sales volumes, and continue to be a testament supporting our multi-segment, multi-industry strategy.

We had a solid performance across most every business. The only soft spots we had were in our packaging business and in the renewable energy space, both of which we think are simply timing related.

As we look to the rest of the year, our solid order performance in Q1 enhances our confidence in meeting our commitments for the year.

I'll now provide a little insight into the individual businesses.

The aerospace, space and navy markets are all strong and look to remain that way for the next several years. Aircraft manufacturers continue to ramp up production across several airframes, and the aftermarket, and the recently entered MRO market, both remain strong. Additionally, we continue to identify new opportunities with our space business. And our outlook for increased submarine production shows growth for many years to come. The previously announced move of VACCO's aircraft products to PTI is on schedule and is expected to be completed in the third quarter.

Our utility business is in a solid position, and the acquisitions we've rolled into Doble over the past several years are making a meaningful contribution. We continue to look for complementary businesses to acquire in the utility space, which have products and services that we can add to our global distribution network. Additionally, we will look to expand our USG solution offerings into adjacent markets through a combination of internally developed products and software, supplemented with acquisitions.

As noted in the press release, we completed the sale of Doble's Watertown, Massachusetts facility during the quarter. We identified several facilities in Marlborough which will fit our requirements. This will allow us to co-locate all of our Boston area personnel in a single purpose-built facility. And we're confident this move will improve efficiency, enhance our competitiveness and enable us to better service our customers.

Our Test business is off to a solid start for the year. The core business remains solid, and the growth markets we're currently accessing include 5G, electric vehicle motor testing and EMP shielding. Their recently implemented ERP system has enhanced their ability to more effectively manage the business and improve their forecasting accuracy.

In January, we moved our existing Chinese operations into a new facility in Tianjin which will enhance our productivity and increase capacity to support future growth in this region. We recently signed a long-term fixed price lease on this facility which gives us operating stability in a known cost structure. The Packaging business always has a relatively soft first quarter due to project timing, primarily in our European business.

This year was no exception. But with that said, we remain confident in our ability to hit full year forecast.

European consolidation activity we announced going into the year is on track and should be completed this summer. A good number of our employees agreed to relocate to our other locations, which will aid in a smooth transition.

As you recall, the acquisition of Plastique was primarily to access the European medical and fiber markets. And today, we're seeing a lot of positive momentum in both areas. Across Europe, the move from plastic to more sustainable solutions, such as fiber, is happening quickly, and we're well positioned to take advantage of this opportunity. Additionally, to support our European growth, last year, we built a state-of-the-art medical clean room in Nottingham, and we will have another one in place this year in Poznan, Poland.

On the M&A front, there continues to be a lot of activity with opportunities being brought to us by investment bankers and with businesses that we've identified through our operating units. Since activity on this front doesn't always result in completed transactions, we have taken a prudent approach and have not included any nonorganic growth in our '19 forecast. But with that said, we're working hard to make something happen on this front, and I am encouraged by the number and quality of opportunities we're currently evaluating. Our board is very supportive of our M&A strategy, and our current credit facility provides us with plenty of liquidity at a reasonable price.

So in summary, we delivered a solid first quarter, the balance of the year looks good and we're working hard for some upside. I'll now turn it over to Gary.

Gary E. Muenster ***ESCO Technologies Inc. - Executive VP, CFO & Director***

Thanks, Vic. Since the Q1 results, of both periods presented were impacted by several unique, non-operating items that we called out in the previous release, such as the gain on the Doble building sale, certain restructuring and cost-reduction actions that we've undertaken, and last year's impact of U.S. tax reform. I will focus my prepared remarks on the adjusted numbers, as these are more relevant measures of our operating performance when compared to expectations and to prior year. Also, using adjusted numbers is consistent with our previous financial statement presentations and related management commentary for the past few quarters.

As noted in the release, we reported Q1 '19 adjusted EPS of $0.47 a share, which is $0.02 above the top of our guidance range of $0.40 to

$0.45 a share, it's $0.03 above the analyst consensus estimate of $0.44 and $0.14 or 42% above Q1 '18 adjusted EPS of $0.33 a share.

I commented during the November earnings call that we ended fiscal '18 by delivering extraordinary fourth quarter when measured on nearly all financial metrics, and I highlighted that Q4 was our best quarter on record. When you end the year with the quarter of that magnitude, one can be concerned that the Q4 performance was achieved at the expense of the succeeding Q1, which, in our case, Q1 is historically our lowest quarter of the year.

So for Q1 of '19, I'm very pleased to report that not only did we follow up on an exceptionally strong Q4 with another solid quarter in Q1, but we also delivered the highest first quarter sales, EBIT, EBITDA and adjusted EPS in our history. Comparing Q1 of '19 to Q1 of last year, on an adjusted basis, we increased sales 5% with both Filtration and Test up 10% each. We increased adjusted EBIT by 21%, increased adjusted EBITDA by 14%, increased adjusted EPS by 42% and paid down net debt to $179 million, and lowered our leverage ratio to 1.5%. The increased profit percentages that I mentioned are well above the percentage increase in sales, which clearly demonstrates the earnings power we can deliver when we grow our sales.

As Vic mentioned, exceeding the top of our expectations for Q1 bodes well for the balance of the year and provides us with protection against any unanticipated downside surprises. Since the earnings release lays out the key points and highlights on the Q1 results, I'll dispense with repeating them here so we can get to the Q&A.

So for my final comments on the quarter, I also remain confident with our fiscal year outlook and our ability to generate cash flow from operating activities to further reduce debt. Coupled with our credit capacity and available liquidity, we're well positioned to effectively execute our M&A strategy to support further growth, both organically and through acquisitions, all while maintaining our focus on ROIC and increasing shareholder value.

So now I'll turn it back over to the operator to begin the Q&A section.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Jonathan Tanwanteng with CJS Securities.

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

Just any impact from the government shutdown on your businesses. It doesn't seem like you gave in your guidance is pretty line with what you said last quarter, but I just wanted to make sure.

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

No, there is no impact.

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

Okay. Got it. And then as we look at the NRG business, which has struggled a little bit over the last year, how do you see the prospects for that in the next years or so? What's going on in that industry and end market?

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

I think it's longer term still a very solid business. I mean, obviously, that march towards your renewables is kind of unrelenting, if you will, and that's good. We just had a couple of issues that the market, I think, is trying to take a little bit of a pause and part of that as a result of the tax law change and a lot of the developers really focused on getting projects that they already started, completed in that time frame. So as you know, much of NRG's products really goes in the front end of that. So I think some of those things just got pushed out a couple of quarters. But I think in the longer term, we're still very confident in the business, and we're working on some new product developments, which I think, will expand our product offering in that area and give us a little more stability as the market moves forward.

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

Okay, great. And then I didn't hear you mention the VACCO move of the aerospace business. Is that ahead of you still? Or did you do that in the quarter?

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

No, I'm sorry, I did mention that. It is on track. We'll get that done. We're due to start manufacturing in the new -- the PTI facility in May.

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

Okay, great. And then finally, just a quick update on the M&A environment. I know you mentioned some in your prepared comments and in the press release. But just any color on the valuations that you're seeing out there, the number of opportunities compared to where you were maybe 90 days ago?

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

Yes, I'd say that it's picked up a bit. The fourth quarter -- our first quarter is always a little light because of the holidays and everything, and activity kind of stalls a little bit. So I would say, I'm pretty happy with what's going on. As far as the valuations, on aerospace side, particularly, if they get into a -- with their auction format, they get pretty expensive. So what we really excel was be able to find small privately owned businesses that -- where the owner really wants to make sure that the employees go to a good place and it's a good fit rather than just going to the highest bidder. And so we really work those pretty hard through our operating units to be able to identify those types of businesses. And so when we do that, the multiples don't get quite as bad. We're also seeing some things on the Utility side as well, and that's a mix of things that people are bringing to us and the companies that we've identified as well. So I'd say it feels pretty good right now, as far as a number of opportunities that are out there. And these kind of unfold on their own pace unfortunately, and we can't force those things. But we're staying busy and working on a number of things.

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

Okay, great. I'm sorry, one more and I'll jump back in queue. You've seen high-profile bankruptcy in the energy sector, mostly due to the lack of equipment monitoring and then reliability out West. Are you seeing increased interest in your Doble business due to Utilities being concerned about the quality of their equipment and safety that's -- as a result of under maintenance and not quite paying attention or investigating enough new grades?

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

Well, those -- I think that will happen, we've not seen a lot of it yet, but between something like that where certainly maintenance is an issue, when you look at companies that have gotten fined recently for not meeting NERC requirements, we think those types of things really play to our strengths. So while they're not immediate, certainly, I think there will be a refocus on those areas in the fairly near term. Because look, Utilities will spend a lot more on maintenance if they didn't have other priorities ,and priorities get shifted by -- for a number of reasons, and one of those is regulatory. And certainly, I think the regulatory environment in that area not everywhere obviously, but in that area, and particularly, that seems to be tightening up a bit. And so as a result of that, I think we will see more opportunity and capital spending on the maintenance side of things. Just to add one thing, it's not only regulatory but kind of public perception as well. If you have issues like you had in California and people start putting pressure on Utilities to do things differently. That can be as strong or stronger than regulatory requirements.

Operator

(Operator Instructions) And I'm showing no further questions at this time. I'd like to turn the call back to Mr. Vic Richey for any further comments.

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

Okay. Well, thank you, everyone. I look forward to talking to you in our next call.

Gary E. Muenster ***ESCO Technologies Inc. - Executive VP, CFO & Director***

Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.