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ESE - Q1 2017 ESCO Technologies Inc Earnings Call

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PRESENTATION

Operator

Good day and welcome to the ESCO first quarter 2017 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 statements, 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 2017 and beyond EPS, EBITDA, EBIT, EBIT margin, growth, profitability, sales, cash flow, orders, success of new products, success in completing additional acquisitions, the results of recent acquisitions and other statements, which are not strictly historical, are forward-looking statements within the meaning of the Safe Harbor Provisions of 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 statement.

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 weather as a result of new information, future events or otherwise. In addition, during the 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.

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

Thanks, Kate. And good afternoon. Before I turn it over to Gary for his financial commentary, I'll provide an update on the status of the integration and operating performance of our most recent acquisitions. Starting with technical packaging, both Fremont and Plastique continue to perform ahead of our original financial expectations. We continue to see several meaningful opportunities to grow these businesses, and expand our medical, pharma and fiber pack product offerings both domestic and internationally.

The management teams in place when we acquired both companies have proven very capable. Coming from a relatively small private company environment, I've been really impressed with the way the teams adapted their skill set so quickly into a public company world which you can appreciate is not an easy task. As a result, we've been able to promote several key managers in the positions of increased responsibility.

With Westland, we not only acquired an outstanding company and a meaningful contributor to the protection of the US naval fleet, but also a solid management team, who are deep on talent and solidly committed to our business and our success. This has allowed the integration to go smoothly and efficiently. I'm pleased to see Westland outperform expectations in Q1 and I anticipate continued solid performance over the balance of the year. Wrapping up on the Westland, I had the opportunity to spend time with our President and I'm impressed that not only with his product knowledge and industry expertise, but with the deep relationships he's established across our customer base.

I'm certain these factors will allow Westland to increase it's product contributions over time, as we continue to develop new products and highly engineered applications to meet our customers increasing requirements. Lastly, with Mayday we not only acquired a unique set of high end process skills, covering a broad range of products and applications, but also a very energetic, and knowledgeable management team. The production work flow demands are very dynamic as they change frequently, with short notice delivery schedules.

This requires a management mindset that's both agile, yet highly processed focused given the tight tolerances and demanding specs that leave no margin for error. Our Mayday team is strong, experienced and well positioned to take on any challenges thrown their way. The integration has gone smoothly and is on schedule. And I'm pleased to report that our Texas teammates seem excited to be a part of ESCO, as they see the growth opportunities in front of them.

So to wrap up, it's always been my strongly-held belief that to be successful with M&A, you not only have to find the right company but more importantly, you have to find the right management teams to lead the organization and take your strategic investment and vision and make it a reality. I think we've accomplished those objectives with all of our new partners. Now, I'll turn it over to Gary for a few financial highlights before providing you with some operational commentary.

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

Thanks, Vic. At the start of the year, we laid out our detailed guidance for Q1 as well as for the full year and noted that our quarterly earnings profile was back end loaded similar to years' past. Our Q1 EPS was projected to be in the range of $0.35 to $0.40 a share on a GAAP basis and additionally we indicated our GAAP earnings were impacted by some non-cash purchase accounting charges related to our recent acquisitions.

We described and quantified these incremental charges related to the inventory step-up of Mayday, as well as additional or incremental non-cash depreciation and amortization charges that were expected to be incurred as a result of our recent M&A actions.

As noted in the release, we delivered Q1 GAAP EPS of $0.41 a share, which beat the top end of the expected range, despite some timing related sales head wind at Test and VACCO. We were able to beat the top end of our earnings targets as Doble's Q1 sales and earnings came in well ahead of plan.

Coupled with the continued strength of our commercial aerospace platform, which once again delivered outstanding results. Westland and Mayday's contributions were better than expected in Q1, as they delivered a combined $13 million in sales, with EBIT margins well above their earlier commitments. Mayday's inventory step-up charge recorded in Q1 was approximately $1 million.

And as we noted in the financial tables within the release, depreciation and amortization increased $1.7 million in Q1 compared to the comparable prior-year quarter. So on an EBITDA basis, we increased our Q1 contribution significantly despite incurring a $1 million inventory step-up charge of Mayday. We're confident that the timing related shortfalls in Q1 at Test and VACCO will not impact our outlook for the year.

And as confidence is validated by the significant level of Test orders booked in Q1, that we expect to convert to sales over the remainder of the year, as well as VACCO's legacy space and Navy business in backlog, that is scheduled for completion in the next few months. A few other Q1 highlights include the strength of our entered orders, especially as I noted in Test, which reported a 1.66 book to bill. I'm also pleased to report that each of our operating segments delivered positive book to bill, which increased our backlog by $37 million or 11% since the start of the year.

Additionally, we beat our cash flow forecast in Q1, as we delivered $16 million of net cash provided by operating activities, and ended the quarter with net debt of approximately $128 million, and a very reasonable leverage ratio of approximately 1.5. Given our solid start to the year, our EPS and EBITDA outlook for the balance of 2017 remains consistent with the expectations communicated earlier. We continue to expect 2017's EBITDA to increase between 21% and 23%, and be in the range of $122 million to $124 million compared to the 2016's adjusted EBITDA of $101 million.

So given today's outlook, we remain well positioned to achieve our financial goals as we continue to see meaningful sales, EBIT and EBITDA growth across each of our business segments in 2017 and in the longer term, we expect to exceed the growth rates of our defined peer group and the broader industrial market in total. Our Q2 EPS guidance is projected to be in the range of $0.37 to $0.42 a share on a GAAP basis. And as a reminder, this includes the remaining balance of Mayday's inventory step-up charge, and the quarterly impact of incremental depreciation and amortization as we communicated previously.

So I'll be happy to address any specific financial questions when we get to the Q&A and I'll turn it back over to Vic.

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

Thanks, Gary. I'm pleased with our quarter one results from a lot of perspectives. Mainly because of the way we exceed our earnings commitment, despite the sales head wind at Test and VACCO. Exceptional performances were delivered by Doble, and our aerospace businesses more than offset the timing issues noted. I firmly believe our Q1 results once again validated one of our major benefits of maintaining our multi-segment business platform. Given our diversity of end markets, we can usually manage around various operational stress points, given that we have several alternative paths to achieve success.

In Q1 I believe we did what we do best. I'm proud that our collective management teams came together to deliver operating results, which again exceeded our internal expectations, despite the noted challenges. Since Gary covered the financial details in his commentary, I'll focus my comments on the balance of 2017. Looking at the business today and the opportunities and challenges in front of us, I remain confident that all of our businesses are in solid financial condition, with known and quantifiable growth opportunities and we're well positioned to deliver commitments in 2017 and the out years.

As I've regularly commented during our earnings calls, we are not immune to economic head winds, many industrial markets are facing today. With that said, I firmly believe the breadth and the diversity of our end markets and the specific niches that we operate in, continue to provide us with a protection to mitigate this pressure as is evidenced in Q1. I'll provide a few brief comments on individual businesses. In filtration we continue to expect the segment to deliver solid results in sales growth, EBIT and EBITDA contributions and cash flows during 2017.

We remain well positioned on several fronts, including the continued upcycle in commercial aerospace, contributions from Westland and Mayday, growing opportunities in space, on the SLS program and unparalleled technology on Navy submarine and surface ships, which are critical to our national security. Our technical packaging groups outlook is solid, as we have meaningful scale and market leadership positions across several growth markets and geographies.

We're well positioned in the global markets to provide highly engineered products to customers in the medical, pharmaceutical and consumer markets. Given this positive outlook, we are making additional investments in this business, by adding a medical clean room in the UK, and by expanding the manufacturing plant in Poland to capitalize on its lower manufacturing costs and adding additional capacity for fiber packaging. I remain confident the opportunities we are seeing globally set us up nicely today and in the out years. Moving on to Doble, we are seeing some easing of the spending constraints within the electric, utility capital budgets, and we set our growth expectations around these opportunities.

We continue to see additional upside opportunities in our software and service applications, which can help mitigate any slower than expected budgetary spending. During Q1, we saw solid performance from our new products, such as the M Series, DoblePRIME and DUC, coupled with the strength of our software offerings, I remain enthusiastic about Doble's future.

At Test while Q1 sales performance was below plan, due to the timing of orders from one of our key customers our real disappointment was that the temporarily lower sales masked the real impact of the cost savings we implemented last year. As the year progresses and a strong backlog converts to meaningful, quarterly sales increases, we expect to deliver our EBIT margin commitments established earlier. As I noted in my opening comments, I'm really pleased with our recent M&A activity and while we've been busy completing and integrating these deals, we're not done.

Acquisitions remain a key component of our ability to meet our longer term growth targets and we continue to evaluate several exciting opportunities. We certainly have the balance sheet capacity to do more M&A, and we have the management bandwidth to handle this additional growth within our current operating infrastructure. But we will continue to be disciplined in our approach and not lose focus on improvement in our returns.

Wrapping up, I'm pleased with Q1 results and I remain confident that our outlook for 2017 remains solid. As you know, in business you never get to declare victory, so as we move forward throughout the year, our focus remains constant. Continue to improve our operational performance, and to execute our growth opportunities both organic and through acquisitions because this is how we'll increase shareholder value. I'll now be glad to answer any questions you have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Sean Hannan, with Needham & Co. Your line is now open.

Sean Hannan - *Needham & Company - Analyst*

Thanks. Good evening, folks. Can you hear me?

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

Yes.

Sean Hannan - *Needham & Company - Analyst*

Okay. Great. Thanks for taking my question here. So first question I have is specific to Doble. I was looking to see if I could get a little bit more color around the momentum you're seeing. So you called out a couple of products and services. As I first think about new products, want to get some viewpoints from you in terms of how long this momentum might be able to sustain, maybe based on, you know, product cycles you've observed in the past. Also want to get a little bit more of color around services and in addition to that then, the software piece, the arms platform and to what degree that that's still making progress in the background. You know, a good viewpoint beyond just the highlights that you had mentioned for the quarter, would be helpful. Thanks.

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

Okay. So that was a really long question.

Sean Hannan - *Needham & Company - Analyst*

Yes. That was. I apologize.

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

If I don't answer the whole thing come back and we'll try to clean it up. Things are going well at Doble, specifically some of the new products. As you know, most of the products at Doble are very long-live products. Once we implement them, get into the field, they'll be there for a long time.

The key products I specifically talked about with the M product, which is a product we introduced probably in the last, you know, 18 months. It's replacing some of our other products. Although not one for one, but that is really off to a strong start.

I'd say the sales for that product have been a little bit above what we thought they were going to be and that is a product that's going to go be in the field for quite some time. It also is a product that's going to go into our lease pool, which as you know is a very good part of our business, because you have some predictability in it. Also, on the software side, as you mentioned, whether it be arms or some of the things we've got through ENOSERV, that's been going well. The arms is a long sales cycle. But we are starting to get some good traction there.

But this ENOSERV is a business we bought in Tulsa, a software business. It has been a real success. We don't talk a lot about it, it's a fairly small business. As I say, it's really exceeded expectation and given us another product to take to the market. And then with the DUC system, the Doble Universal Controller, we have two pretty significant sales in the first quarter on that product. And we see that accelerating as we go forward. So I would say that, you know, Doble is really doing well.

And that's a traditional products that we continue to sell, that's gone well. We've got new product introductions in the early stages, I would say. And then we really emphasize the service side, particularly internationally. What we're finding is getting some of those customers, having them understand the services, us doing some work for them, like we're doing with Saudi, gets us engrained with the engineers, helping them understand our capability and our capacity and then what we're able to do then is take that and turn those into hardware sales as well. So whether that be at Saudi or some other place in the Middle East where we're starting to see success or South Africa, we're really kind of leading with the services and then able to follow up with the hardware sales.

Sean Hannan - *Needham & Company - Analyst*

Okay. That's great. And then you had mentioned Saudi. Is there any conversation at this point in the game, given you're really kind of a few years into this and on to, you know, you've completed some stages. Is there any conversation you have with them in terms of once you get beyond the baseline testing, being able to formalize a more substantial or kind of follow-on arrangement or relationship?

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

You know, it's been a real success story. We're in the third year of the contract with them. In addition to the service side, we have sold a decent amount of hardware. I don't think this is a contract that's going to just come up to, you know, end of the year and stop. I think they really see the value of what we're providing and I think there's going to be a long return opportunity for us, a longer-term relationship that's not defined at this point. There have been conversations about that, but it's really too early to tell. But I would say the customer has been exceptionally appreciative of what we've been able to do. And I think we've gotten them a long way. You know, that is, there's a lot of work to be done there if they choose to go forward. I'm pretty sure they'll be working with us, they've been very happy with the support they've gotten from the team.

Sean Hannan - *Needham & Company - Analyst*

That's great. And then last question here, I'll jump back in the queue. The packaging business, I'm not sure if I caught the commentary around why the margins were a little soft there. Want to get a better understanding around that. I know obviously you're still working through, you know, some integration. But I was surprised by the margin, number one. And then number two, if you can elaborate on, if I heard correctly, you're going to be making some additional investments within that business. At least it seemed to me that you had mentioned it was that for business. Just want to understand that a little bit better. Thanks.

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

As far as the margins it's really two things. The business Plastique that we bought in Europe, their first quarter is always pretty soft, because their big quarter is kind of the second, well, from the second half of the second quarter and the third quarter. So, theirs is a pretty seasonal business, we knew that. So this quarter is always soft. So that's part of it. The other piece of it is the KAZ product, the thermoscan thermometer covers, you know, was a pretty mild flu season last year. They had a good bit of inventory left, so they pulled back on the production of that product in the first quarter.

Now it's back up at full production, as of January. We're selling about $1 million a month there. But that was pretty significantly cut back in the first quarter. So those are really the two thing that impacted. I don't have a concern about the margins for the year. It's just that this first quarter, probably the first half of the second quarter is soft as a result, primarily the timing of the Plastique. And then as far as investment, yes, when we made the acquisition, the plan always was to make the investment there, because the plant they have in Poland, it's a good plant, but it's not big enough for the work we have in the pipeline.

So we want to get that in place, so that, you know, as that business comes in, we're able to fulfill it. And we've already gotten a good bit of the work, a good bit of the orders that are going to fill those new machines in the factory. The other thing that I mentioned was the medical clean room in the UK. One of the primary reasons we wanted to have the operation in Europe, was because we weren't able to effectively service the medical clients out of the US, just because of the shipping costs. And so what we committed to do was to set up a clean room, facilitize that with the same equipment that we use in our US based business so that we'd be able to service those customers. And so we're in the process of doing that.

I think all of those investments will be completed by the middle of the summer and we'll be up and running in both of those locations and able to support those customers.

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

And hey, Sean, let me put a couple of numbers around what Vic was saying relative to the seasonality. So in Q1 you'll notice in the release I called out Plastiqe did about $7 million in revenue and their annual run rate is about 36. So, if you're looking at annualizing that seven, obviously that's 28. So you can see when you're running it at that lower volume, you're getting stuck with a lot of overhead, because there's a lot of manufacturing. And then on the KAZ business, it tends to be about $900,000 a month. So, you know, say somewhere between $2.5 million or so would be the impact of that. And that's almost a fully automated process. So when that business is not coming through, there's a lot of overhead sitting on those machines that aren't being put through. So those are the two -- that's the math around Vic's commentary.

Sean Hannan - *Needham & Company - Analyst*

Very helpful. Thanks so much.

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

You got it.

Operator

Next question comes from Jon Tanwanteng, with CJS Securities. Your line is now open.

Jon Tanwanteng - *CJS Securities - Analyst*

Hi, gentleman. If you could, what was the magnitude of the timing delays you saw at VACCO and Test and are they going to fall in the March quarter, which you saw delayed?

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

It won't. I'll let Gary talk about the magnitude. I don't think we'll be fully recovered in the second quarter. I think it's going to be really the third and fourth quarter before we're able to get those pulled through, primarily because of the timing of the orders and customer acceptance of some of the VACCO product.

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

Jon, numbers around that on the VACCO side, relative to our November conversation, VACCO is about $2.7 million or $2.8 million light on the revenue and the Test business with the order profile was about $2 million to $2.2 million. So, together it's about $5 million.

Jon Tanwanteng - *CJS Securities - Analyst*

Got it. That's very helpful. And then could you talk a little bit more about the opportunities at Westland and at VACCO, if sub-orders or delivery schedules do increase to three a year, and how pricing may actually play into that if the orders do increase? I understand these are longer term prospects given the lead times for these submarines.

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

So, I'll try to get the numbers right. We have $6 million to $8 million of content on the submarine. On a typical submarine. So if those build rates go up, you'll see that type of pull-through. That's at VACCO. We have additional at Westland. So two of them together, somewhere between $8 million and $10 million a ship set. You can see if they do increase production it will have a pretty significant impact. Those are both fairly profitable businesses.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay. Great. And then finally, can you talk a little bit more, give us an update on near term plans for M&A? Are you taking time to digest Mayday and Westland right now or are you still active in the market and if you are, just talk about environment of evaluations you are seeing out there? Thanks.

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

Sure. So as I mentioned at the start of the discussion, the integration, I wouldn't say it's completed. But we're very far down the road. These three acquisitions have probably been three of the most easily integrated that we've had. I wasn't just talking about the management team to make them feel good, people have really jumped on board with these things. We also used some internal resources to help with the integration.

We're fortunate to have finance person to put it in at Mayday for a while after we made that transition. And also we have a transition service agreement with the prior owners. So it's been a very easy transition and I'd say we're almost complete there. So we are certainly back out and looking for additional acquisitions. There are several things out there that we see of interest. I'd say the valuations have not been crazy. I'd say they've been and I think you've seen from what we've bought more recently, we've been able to get three quality companies for a reasonable, a multiple and we see that continuing, at least the things we're looking at now.

So the activity over the past 18 months have been very good for us, we're happy we're able to get four things done over the past 18 months. And, you know, our hope is to continue to do that. I think you'll see us continue to do the type of acquisitions that we've done over the past 18 months. I think the size that (inaudible) approach of those businesses are what we really do well. So we'll continue to remain disciplined and look for opportunities like those. I think they're good opportunities out there.

Jon Tanwanteng - *CJS Securities - Analyst*

Great. Thank you very much.

Operator

(Operator Instructions). Our next question comes from the line of Sean Nicholson, with SBH. Your line is now open.

Sean Nicholson - *SBH - Analyst*

Good afternoon. Gary, this is probably more for you. You guys obviously are disclosing more around EBITDA, which I think is great. You know, on the EBITDA margins, though, looking at the projections, by my math it looks like FY17, you know, margins around a little over 18% if you include corporate costs. You know, 22%, if you kind of look at an operations basis, excluding corporate. Is that in the ballpark?

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

I think that's pretty spot on, you know, when we gave the guidance range of the EBITDA, you know, we said kind of a 123, 124 kind of number. And so if you use that as the peg and put the revenue projections we're talking about, I think on a consolidated basis, you can get a little north of 18. And then on an operations basis, and I don't mean backing stuff out, just not counting the corporate costs and that sort of thing, it's, yes, it's pretty close to 22.

Sean Nicholson - *SBH - Analyst*

Okay. You know, I don't know if you have this kind of a view of your recent M&A transactions at Clarcor and I think they traded at 16 times, Zodiac Aerospace I think went over 26 times. You know, you guys are right around that 12, 13 times EBITDA. Is there still opportunity to increase the EBITDA, dollars and margins? I mean, from what you guys can assume in the business today? Trajectory?

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

Yes. I'd start with the operational side and then Vic can do the M&A side, because I think obviously as long as we keep buying stuff at less than what we're trading for, I think it adds value. But, you know, while we're doing well with the integration of these businesses, there's still some inefficiency because we have a lot of corporate people involved and there just not out at the subsidiaries doing their own thing yet.

Once they get going through our processes and integrate those, where they're doing it, I think there's a little bit an upside in the longer term relative to that. Plus I think what I'm seeing from the numbers is when you look at these smaller companies like a Mayday and Westland that were stand alone in private equity, no offense to private equity, but I think customers have a feel for private equity that, you know, we going to do business with the same folks five years from now. I thinking about part of a bigger company is where that enthusiasm is the folks on our side at Westland and Mayday talked to me, they're excited to be part of a big company, because now when they're talking to customers, they know that the stake in the ground is put there.

And it's going to be a part of ESCO and will not be flipped six months from now or a year from now. Both of those thing will bode well in the longer term from what we have. And Vic's comments on the M&A, we're not going to buy fixer-uppers.

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

Yes, follow up a little bit. And the companies we bought certainly were not and I would say previous owners did a nice job of investing in the business and making sure that they had what they needed. Having said that, obviously being a part of a larger company, we can make larger investments. I would say, particularly in the sales and marketing side, where maybe they couldn't put enough people out in the field. We have a lot of people in the field already. I think we can capitalize on the fact that we have maybe broader customer relationships, we have some thoughts on other markets we can get into. And I think just having that is probably our biggest opportunity.

I think we'll get more on the growth of these businesses and we will, you know, just doing a better manufacturing. Because we're doing a pretty good job. I think we can add some things there, just because any time you have a larger business, or often you have a larger business, there's more expertise within the organizations to help. But we don't buy fixer-uppers and we're not going to in the future. That's not who we are. We don't have the bandwidth to go fix businesses. We certainly can help manage businesses. But that's not what we're planning to do.

Sean Nicholson - *SBH - Analyst*

Okay. That's helpful. Thank you very much.

Gary Muenster - *ESCO Technologies, Inc. - EVP & CFO*

Thank you, Sean.

Operator

I'm showing no further questions in queue at this time. I'd like to turn the call back to Mr. Richey for closing remark.

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

Okay. Well, thanks, everybody, for your questions and comments today. Look forward to talking to you at the next call.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program and you may now disconnect, everyone, have a great day.
