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EDITED TRANSCRIPT

ESE - Q2 2015 ESCO Technologies Inc Earnings Call

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Kate Lowrey *ESCO Technologies, Inc. - Director of Investor Relations*

Vic Richey *ESCO Technologies, Inc. - Chairman and CEO*

Gary Muenster *ESCO Technologies, Inc. - Vice President and CFO*

CONFERENCE CALL PARTICIPANTS

Jon Tanwanteng *CJS Securities - Analyst*

Ben Hearnsberger *Stephens, Inc. - Analyst*

PRESENTATION

Operator

Good day, and welcome to the second quarter 2015 ESCO Technologies, Incorporated, 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 Kate Lowrey, Director of Investor Relations. Please go ahead.

Kate Lowrey - *ESCO Technologies, Inc. - Director of Investor Relations*

Thank you. Statements made during this call regarding our 2015 and beyond EPS, EBIT, tax rates, future growth, profitability and revenue, margins, sales, orders, market share, product development, acquisitions, capital allocation strategy, corporate costs 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 operation 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.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Thanks, Kate, and good afternoon. Before I give my perspective on the quarter, I'll turn it over to Gary for a few financial highlights.

Gary Muenster - *ESCO Technologies, Inc. - Vice President and CFO*

Thanks, Vic. As noted in the release, our second quarter earnings exceeded our internal expectations. In February, we expected Q2 EPS to be in the range of $0.27 to $0.32, and I'm pleased to report that we beat the top end of our EPS range by a penny, as we delivered $0.33 a share despite a higher than expected effective tax rate, which negatively impacted Q2 EPS by approximately $0.02. The earnings increase was driven by the continued strength of the commercial aerospace market at PTI and Crissair and better-than-expected performance at Doble.

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At the start of the year, we committed to a set of financial goals, which are well defined and remain clearly in focus today. We will continue to execute on our financial plan, deliver solid earnings results that meet or exceed our expectations, position the Company for sustainable, long-term earnings growth, enhance our focus on returns, and follow our capital allocation plan. Given our Q2 results, I think we achieved each of these.

During Q2, the impact of foreign currency was immaterial. As a reminder, for comparative purposes, the 2014 results exclude the charges related to the Crissair facility consolidation completed last year. I'll call out a few highlights from the release to allow you to better understand the underlying results.

Q2 sales increased $4 million from the prior year, primarily due to a 12% increase in sales at Doble. Test sales increased $1 million, and filtration sales were essentially flat due to the lower SLS program sales at VACCO. A bright spot within filtration is highlighted by the continued strength of PTI and Crissair's commercial aerospace sales, which increased over 13%, or $4 million, in Q2, which offset the $4 million decreased noted at VACCO.

PTI's Q2 EBIT margin was 21%, and Crissair delivered 28% EBIT in Q2 driven by the operating efficiencies being realized from last year's facility consolidation. Doble's EBIT came in better than planned, driven by higher-than-expected international sales and additional software and service business. Doble's Q2 EBIT margin was lower than prior year Q2 due to the timing of their worldwide client conference, which was in March of this year and April of last year.

Test sales in EBIT were below plan due to the issues of trying to project the exact timing and completion surrounding the significant number of projects in process at any given time throughout the respective quarters.

Corporate costs were higher than last year, primarily as a result of additional professional fees and other costs surrounding the acquisition of ENOSERV. The Q2 effective tax rate increased over prior year due to the amount of discrete tax benefits recognized in the respective quarterly periods, as well as changes in the mix of international versus domestic pre-tax earnings.

On the balance sheet, we continue to maintain a modest level of net debt outstanding, which was $38 million at March 31. We remain committed to our capital allocation strategy, which includes share repurchases and dividends. As such, we returned about $6 million to shareholders during the second quarter. We expect to continue to opportunistically repurchase shares in the open market during the balance of 2015, as we continue to be supported by a strong balance sheet.

A significant highlight of Q2 as well as for the first six months of the year is the continued strength of our entered orders. We booked $142 million in orders in the second quarter, reflecting a $13 million increase in backlog, resulting in a $348-million backlog at March 31.

Filtration had a book-to-bill of 120%, with each of the group members contributing to the sizable increase. Doble generated 111% book-to-bill, driven by additional international service orders and higher than expected hardware business. The order strength at the halfway point bodes well for the sales outlook over the balance of the year.

Our EPS guidance and remaining outlook for 2015 is unchanged from $1.70 to $1.80, and is well supported by our Q2 and six-month results. Reporting a solid start for the first six months certainly provides additional comfort in our ability to achieve our full-year stated goals.

Regarding Q3, we are guiding EPS to be in the range of $0.38 to $0.42 a share. It is important to note that the first half of the year came in above our original forecast, both from an EBIT and EPS perspective.

When compared to the current Q2, we are expecting sequentially meaningful increases in both sales and EBIT during Q3, which drives the noted EPS increase range. Q3 consolidated EBIT dollars are expected to increase over 20% compared to Q2, led primarily by Doble's additional sales volume. Lastly, we expect a more normal tax rate in Q3 of approximately 34%.

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

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Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Thanks, Gary. As an ongoing reminder, the three-year outlook we communicated during our Investor Day last September includes growing our top line 10% and increasing EPS 15% on a compound basis. Considering our solid start over the first six months of the year, coupled with our continued order strength, we believe these longer-term goals are reasonable and remain achievable.

Although the M&A pipeline continues to be challenging due to the high multiples being paced for quality assets, we continue to work aggressively to expand our footprint within filtration and at Doble.

While certainly it's still early on, I'm pleased with the initial reaction to the ENOSERV acquisition and with the positive contribution they've made. While attending the Doble client conference, I was impressed with the number of clients who sought me out to express their positive thoughts on the acquisition.

Additionally, I was very impressed with the ENOSERV team members who participated in the conference. I firmly belief their future growth opportunities are tangible and well defined and will result in a meaningful contribution to Doble's expanding sales and operating margins.

We continue to explore additional acquisition opportunities, with a primary focus on adding capabilities and solutions to USG and Fluid Flow. Across the Company, our core businesses continue to present us with long-term, organic growth opportunities that, when supplemented with our M&A strategy, create an exciting outlook for ESCO over the next several years.

In filtration, our year-to-date EBIT is well ahead of plan, and we remain bullish on our underlying growth and profitability, driven by our recent aerospace program wins and coupled with having some sizable programs, such as the A350, continue to move towards full production.

The major OEM aircraft manufacturers continue to be bullish on their outlook, and this up-cycle is creating an exciting outlook for our business. The year-to-date order book is also well ahead of plan and continues to provide additional upside opportunities over the balance of the year.

The test business remains solid, both from a top line and bottom line perspective. [SEL] will contain several additional large projects, which we're in the process of negotiating. These opportunities, once the POs are signed, are expected to deliver solid profitability over the balance of 2015 and beyond.

As you know, we've made several significant investments at Doble over the past few years, which were necessary to accelerate their growth, both domestically with new products and solutions as well as internationally by entering new markets. As we review the first six months of Doble's performance, I think we are clearly seeing the results of these investments, and we expect them to continue to accelerate in the future.

We are well positioned for solid organic growth and have the capacity, both from a financial and management bandwidth perspective, to augment our growth with appropriate acquisitions. We look forward to an exciting and successful remainder of the year. We can now turn it over for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question-and-answer session. (Operator Instructions). Jon Tanwanteng, CJS Securities.

Jon Tanwanteng - *CJS Securities - Analyst*

Good afternoon, guys. Very nice quarter.

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Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Hey, Jon.

Gary Muenster - *ESCO Technologies, Inc. - Vice President and CFO*

Thanks, Jon.

Jon Tanwanteng - *CJS Securities - Analyst*

So I'm just doing the math with your Q3 guidance. If your 2015 expectations are consistent with your prior $1.70 to $1.80 and your Q3 somewhere in the high end, does that mean that Q4 should be somewhere between $0.54, $0.64, around that area?

Gary Muenster - *ESCO Technologies, Inc. - Vice President and CFO*

That's correct.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay.

Gary Muenster - *ESCO Technologies, Inc. - Vice President and CFO*

As we have in the past, Jon, our fourth quarter is always our strongest, and so looking at the sequential step from Q2 to Q3, we see that 20%-plus move in EBIT dollars, and then, obviously, sequentially from Q3 to Q4, you'll get a pretty meaningful pop there as well driven by sales growth across the platform.

Jon Tanwanteng - *CJS Securities - Analyst*

Got it. And then can you just quantify the risk of larger projects, maybe in the test segment? As you get close to the end of the year, what's the risk of them pushing out?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Yes, we're in pretty decent shape. I mean, we were just down there a couple weeks ago and met with the guys, went through it on a detailed basis, and there are a couple of -- everything that we need is either in backlog or currently being negotiated, so unless these negotiations drag on for a significant amount of time, we should be fine with those opportunities.

And in fact, what we'll do, because these are the bigger opportunities and the bigger projects that we're negotiating now with customers that we've done a lot of work with, so we would go ahead and start building that product to ensure that we'll be able to make those deliveries. It's not a -- there's always risk, but it's not a significant amount at this point.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay, thanks. And then just touching on the Doble business and the international strength that you're seeing, is that mostly the Middle East, and should we expect further strength there?

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Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Yes, it's doing real good. The Middle East project is going well. We hope to get a re-up of that before too long for the next 12 months. We're also seeing good strength in Mexico and South Africa.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay, great. I'll jump back in queue. Thanks.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Okay.

Operator

(Operator Instructions). Ben Hearnsberger, Stephens.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Looking at the test business margin, it came in a little bit below our expectation, and in the press release, you mentioned some work you're doing on the cost side of the equation to kind of help margins there. Can you take us through some of those initiatives?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Sure. Some of the things we've been doing, we've -- some of it's basically blocking and tackling. I mean, we've worked hard on the overtime, on the planning process to make sure that we have the factory level loads so we don't have to work overtime. We've been working hard on the freight side of it, which doesn't seem like a big deal, but when you're shipping product around the world, it's a big deal.

We did have a reduction in force last week, both here in the US and Europe, so there are a number of things like that that we've been working. I would say there's nothing out of the ordinary. It's really just good business sense, and we're just trying to get some of the things cleaned up to make sure that we're in a position to get those margins up to a reasonable place in the last half of this year, and then going into next year, I think we'll be in a much better position.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Okay. And then it sounds like your aerospace business has remained strong and you're really not seeing any impact from lower fuel. Can you just comment on what -- kind of what you're seeing further out? Are the risks that you think you have to your aerospace business giving if we assume a lower fuel environment?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Everything we've seen -- we studied that a good bit and talked to a number of people and done some research, and while that always comes up, I think the reality is we don't see that changing. I mean, if you think about what the airlines have or what Boeing Air must have in backlog, they have multiple years of backlog in place, so let's say something did happen and some of that went away. It would not impact us in the near term, first of all.

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Second of all, people talk a good bit about the fuel prices, but the reality is even with the lower fuel price, people want to have a lighter aircraft, they want to have the newer engines, and so they're committed to do that. So if they pull out of the queue and say -- okay, I'm going to push this off for a while, they're probably pushing acquisitions of those aircraft off by five or six years, and I don't think anybody's really willing to do that.

So there's a lot of discussion around that, but we've seen no indication that that's really going to happen. And if it does happen, I think it would be in a very minor way with some of the smaller aircraft -- or some of the smaller airlines.

Ben Hearnsberger - *Stephens, Inc. - Analyst*

Okay, great. I'll jump back in queue.

Operator

Jon Tanwanteng, CJS Securities.

Jon Tanwanteng - *CJS Securities - Analyst*

I just wanted to get a little more color on the aerospace programs that you have out there. Are they ahead of or behind schedule right now, and when do we start to see the inflection point on your P&L?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Yes, the big one is the A350, and I would say that the overall program is delayed from what the original schedule was -- not as a result of anything that we've done, I would say. It's just these new programs always seem to take longer than originally anticipated. But we have a pretty good ramp starting really in 2016 and 2017, and then I think it just goes into full production in 2018.

Gary Muenster - *ESCO Technologies, Inc. - Vice President and CFO*

I'll add one thing to that, Jon. I think just from an order perspective on these new platforms, as we try to lay out the timeframe on when you're going to get these orders for the OEM stuff that's going into production, I'd say we're about -- on the order side, we're about $4 million to $5 million ahead of where we thought we would be at the halfway point relative to new orders, and so now it's just a matter of when do those translate into the P&L.

It's not a 30-day turn, obviously, but I'd say what it gives us is a tremendous amount of confidence in the back half of the year relative to any delivery schedules that we have on the OEM side of the business and then gives us continued strength as we enter 2016. So it's really an order -- it's the order side of the business that's coming in way ahead of plan.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay, great. That's very helpful. And then just could you maybe go through the same line of thought on the defense side, maybe talk about the Virginia and acceleration of the builds there?

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Yes, we're not counting on any acceleration there now, but that program is projected out for the next eight or ten years, so I don't anticipate there being any change to that. I mean, if you have to be in the defense business, I'd say the submarine side is probably a great place to be because

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there's a low rate of production, but it's very predictable and it's all well-funded and there's such a capable weapons system, both from an offensive and defensive perspective, that if something is going to get funded, I'm pretty sure it's going to be the submarine.

So we don't have a lot of concern about that. In fact, we have our orders for the next several years as we sit here today.

Gary Muenster - *ESCO Technologies, Inc. - Vice President and CFO*

Yes, I think one thing to add to that, Jon, is the -- even when you see the materials coming out of electric boat and that sort of thing on how they're stepping up to one and a half boats and that sort of thing, our product is such long lead-time stuff, we're way out ahead of that, so the things that we're delivering today or in the fourth quarter here, those aren't for the boats that are today being launched.

We're probably a year to 15 months ahead of when that boat would be launched, because we're basically -- our product is attached into the core of the submarine, so we're an early build addition, and therefore our product has to be in the shipyard well in advance of when the hull is being constructed. So we don't get the immediate pop of -- when you see the one and a half boats, we don't -- ours isn't going to go up one and a half boats this year.

But it's a cumulative effect situation that, over the next five years, I think you'll see continued strength in that as well as the position that we're getting on the Ohio-class boats as well. That's going to be a nice opportunity for us over the next five to ten years.

Jon Tanwanteng - *CJS Securities - Analyst*

Okay, great. Thanks again, guys.

Operator

We have no further questions at this time. I'd like to turn the call back to Vic Richey for closing remarks.

Vic Richey - *ESCO Technologies, Inc. - Chairman and CEO*

Thank you. So to wrap up, I'm very pleased with our second quarter and year-to-date results, and I'm comfortable that our three-year financial goals remain on track. I'm optimistic about our growth prospects, both short term and longer term. Our priorities remain simple and straightforward -- execute and deliver our commitments in the core business, maintain our focus on new product development, supporting organic growth, and supplement our existing plan with accretive acquisitions around our core business.

Thank you, everyone, and I look forward to talking to you on our next call.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference. Thank you for participating. You may now disconnect.

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