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PRESENTATION

Operator

Good day, and welcome to the ESCO Technologies Third Quarter 2020 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 now 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. We issued a press release earlier today that will be referenced during the prepared remarks on this call. You can find a copy of our press release and our safe harbor statement regarding forward-looking statements made during this call in the Investor Center of ESCO's website at www.escotechnologies.com.

During this call, the company may make forward-looking statements, which are inherently subject to risks and uncertainties, particularly given the unknown impact of the current COVID-19 pandemic and the company's response to these evolving circumstances. Actual results may differ materially from those projected in the forward-looking statements, and the company does not assume any duty to update forward-looking statements.

Please refer to the company's press release for risk factors that may impact any forward-looking statements and for the reconciliation of any non-GAAP financial measures to their most comparable GAAP measures.

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 discuss the third quarter results, I'll provide a brief update on how we're managing the company in this COVID environment. The situation seems to change on a daily basis. So a lot has changed since we last spoke. I think it's important to share some of the details of how we're managing the business in real-time, and how we're positioning ourselves for the future. When a pandemic hit and we saw the first indication of potential economic impact on our business, we did what we did best, we took decisive action. From the start and through today, we continue to take actions that have a clear and precise focus that is to protect our strong financial condition, to deliver products and services and support our customers, all while keeping our employees safe and healthy.

The measures we've taken so far have allowed us to hold our own over the past few months as demonstrated by our third quarter results and our strong financial position. We continue to review additional actions across the organization that will adjust our cost structure to fit our near-term

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sales outlook and support our long-term strategy for profitable growth by strengthening our core. We've demonstrated our operational efficiency and have proven our ability to effectively manage cost to meet changing market demands in the past, and the current situation is no different. We're actively addressing today's business pressures and directing our efforts to come out of this even stronger. We are controlling what's within our control and focusing on the near-term situation without losing our vision for the future. Our actions will have a near-term benefit while maintaining our flexibility to ramp up quickly when demand returns to more normal levels.

ESCO will continue to benefit from leading positions in various niche markets, delivering a set of unique and highly technical products and solutions, specifically designed to meet our customers' needs. This makes it difficult for solutions to be -- our solutions to be replaced by alternative sources. We continue to focus on our future as demonstrated by continued investment in new products across all 3 segments, which will continue to create new opportunities and drive organic growth. Our deep and experienced management team is providing the leadership to manage through this period of uncertainty. Our disciplined approach to operating the business will result in our continued success. Our employees are our most important asset, and I want to say thank you to our manufacturing employees, leadership teams and staff around the world for their hard work and dedication, as you have all demonstrated an extraordinary commitment to the success of ESCO.

I'll now turn it over to Gary.

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

Thanks, Vic. I'll comment briefly on Q3 and the year-to-date operating results, which are laid out in the press release. As Vic noted in his comments, our liquidity position is of the utmost importance to us during this challenging time. And I'm extremely pleased with where we stand today, having nearly $700 million of dry powder at our disposal between cash on hand and available credit capacity, while carrying a modest leverage ratio of 0.95.

I'll touch on a few comparative highlights from the release. Given the backdrop of today's operating environment, I am most pleased to report that we were able to deliver Q3 adjusted EBITDA of $35 million, consistent with the prior year despite the noted sales decline at Doble and within commercial aerospace, which are our most profitable operating units historically. Our Q3 sales decreased only 3% in the current quarter compared to Q3 of last year, and our 9-month year-to-date sales increased 2% year-over-year despite the COVID-19 impact. A&D sales increased $1 million in the quarter and $28 million year-to-date, driven by the addition of Globe's submarine component sales, coupled with additional Navy and space sales at VACCO and Westland, which were offset by softness in commercial aerospace.

Year-to-date aerospace sales at PTI, Crissair and Mayday decreased approximately $4 million or 3% compared to prior year. Test sales increased 9% in Q3 and 2% for the 9 months. Sales were impacted year-to-date by a 3-week shutdown of our Chinese manufacturing facility earlier this year, coupled with some delays at certain installation sites where access was restricted. Chamber project sales continue to be strong, and installation site availability has mostly returned to normal.

USG sales were down due to continued deferrals of various project deliverables as several large utility customers, domestic and international, have realigned their short-term maintenance and spending protocols to focus on uninterrupted power delivery. Maintenance deferrals also reflect various mandates, restricting on-site personnel at substations, large transformers and other customer locations. USG's recent order bookings reflect an increase of additional cybersecurity-related orders, including Doble's DUCe solution, where we have seen strong renewals as well as new customer procurements.

As we noted earlier, we take decisive actions when we see downturns in our outlook, and our Q3 SG&A reduction of $4 million or 10% is evidence of that agility. Our year-to-date SG&A is flat compared to prior year, and that was achieved despite having Globe included in the current year and despite our continued spending on R&D and new product development. Entered orders remained solid in Q3 and are strong year-to-date, where we booked $624 million and ended June with a backlog of $551 million, up 22% from the start of the year.

Our DoD business, led by our participation on the Block V contract for additional Virginia Class submarines drives this strength. I'll remind you that as the year progresses and as we move into fiscal '21, we will be delivering products on these large multiyear programs, which will mathematically reduce the optics of our A&D book-to-bill going forward.

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On the liquidity side, year-to-date, we generated $54 million of cash from continuing operations, or $64 million, ignoring the $10 million pension contribution we made in Q3, which, as I said, resulted in a modest leverage ratio of 0.95 and nearly $700 million of available liquidity. Q3 and year-to-date adjusted EBITDA improved from prior year, with Q3 reflecting a 20.3% margin despite the lower contributions from our highest margin operating units. And finally, Q3 adjusted EPS was $0.76 a share, up from $0.75 a share delivered in Q3 of 2019.

For the remainder of fiscal '20, the COVID-19 backdrop continues to bring along considerable uncertainty around the extent and duration of today's economic circumstances, which makes it difficult to predict how our Q4 operations will be affected using normal forecasting methodologies. And as a result of this uncertainty, we will not be providing Q4 guidance at this time. To supplement Vic's comments on our cost savings actions, we are clearly focused on the right things, and we are working diligently on maintaining and optimizing our cash flow and our liquidity.

Our plan is to prudently manage spending in the short-term and focus on those costs which do not have a negative outcome, which would impact our ability to meet increasing demand or growth in the future.

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

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

Thanks, Gary. I'll offer some qualitative comments about our end markets, but I will emphasize that the situation continues to be very fluid as to the duration of the current end market softness.

In an effort to give you a sense of our thinking and planning, in July, we completed a thorough review of our individual businesses to update our expectations for the near-term impact of COVID-19 across and within our various operating units. These results were shared with you in the earnings release commentary, so I will only touch on a few highlights for emphasis. Starting with our A&D segment, we expect to see continued softness in the commercial aerospace deliveries over the balance of the year, resulting from reduced build rates and lower airline passenger miles.

Recently, we started seeing some signs of recovery, emerging as several air carriers are bringing more of their idle fleet back into service and daily TSA passenger boarding numbers are increasing. The defense portion of our A&D business is and will remain strong for the foreseeable future, given our backlog and our platform positions. Our aerospace supply chain partners continue to be strong. And in some cases, we are seeing some weakness. We're working on bringing some of these products and services back in-house, such as machining and other capabilities that we can replicate.

We also see the current weakness in aerospace market as an opportunity for ESCO. We continue to look at suppliers or competitors to experience financial or operational stress during this crisis, where we might be able to provide assistance via partnering or through an acquisition at a reasonable price. Our test business is expected to be strong over the balance of the year, given a solid backlog and strength of its served markets, including 5G and related communications technologies and the RF Shielding in general.

We expect USG's customer spending softness to continue for the next few months, as they come out of their summer testing protocols and return to their more normal buying patterns. Once some of the social distancing guidelines get sorted out and utility service personnel can return to their normal site visit routines, we expect our service business to return to normal. Utilities have money to spend, and I'm certain that spending will return in the near future as maintenance spending cannot be delayed indefinitely without creating significant risk to grid safety, efficiency or regulatory compliance.

COVID-19 does not change the fundamentals of the global utility industry as society needs reliable, safe and secure power. The critical need to maintain, repair and improve the utility's aging infrastructure is not reduced by this pandemic crisis.

On a positive note, I'm really pleased with USG's pipeline of new products and solutions, especially related to the cybersecurity and related asset hardening solutions. We have several new solutions that have been introduced recently, and based on consumer feedback, these products have been enthusiastically received.

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With regards to NRG and our renewable offerings, I'm pleased to see NRG end markets recovering more quickly as investment in renewable energy has increased in both wind and solar better than we anticipated, and we expect that growth to continue.

Moving on to M&A. We have several actionable deals under evaluation in our pipeline. We're taking a prudent and deliberate approach, and we expect to take action on certain opportunities to grow our business as we have in the past. It does appear that the current environment has brought valuations back to a more reasonable range.

Our Board is supportive of our M&A strategy, and our current balance sheet provides plenty of liquidity to allow us to add to our existing portfolio.

In summary, we delivered a solid first 9 months of the year. And for the balance of the year, our plan is continue to focus on the fundamentals and to look for opportunities to leverage our infrastructure through M&A to create additional operating efficiencies and ensure we are well positioned for success in 2021. We will weather the storm, and we will prosper.

We'll be glad to take any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of John Franzreb with Sidoti & Company.

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

Congratulations on a good quarter.

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

Thanks, John.

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

I guess I want to start with the order trends and what you're seeing across all 3 segments in July versus June. It sounds like things are getting better. But I just wanted you to kind of talk us through what you're seeing there.

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

Yes. I would say that really across the board, we're starting to see a little pick up. I mean it was a pretty good dip for a couple of months, but we have seen a pickup really across the board. I've talked to the guys, the utility segment today, and they did have a solid month this past month, this past month. And so it appears the fourth quarter was a trough, and now we're starting to pull out of that.

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

So are your expectations that the service side rebounds in the first quarter of 2021 along the lines of a normal turnaround season or maybe a better than normal turnaround season based on some of the deferred spending?

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

Yes. It's a little hard to predict. I mean you would think that there's going to be some pent-up demand, but I think there's certainly the work there to be done. So our hope is to be returned to the other -- the earlier levels and the potential for some upside. But this is such a kind of volatile market. It's kind of hard to pin that down. Absolutely, this is what's going to happen, but certainly, we're close to our customers and talking to service companies who also provide services utilizing our equipment to the utilities. And they're all ready, and ready to go. And so I think as soon as this picks up a bit, we should see a solid pickup.

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

Got it. Got it. And in regards to test and 5G, could you provide any insight of how the timing of that rollout is going to be from your perspective? I've been hearing that things are being deferred, a lot of telcos are kind of working on their own backbone versus the 5G rollout. What are you hearing?

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

So I think the 5G is going to go forward. And I think the most important thing for you to understand from our company's perspective, I'd say the timing of the actual rollout to the consumers is probably more in question than it was a year ago. But what I would say is all the testing. If you remember, for our business, we're doing the testing of new development or the components of the handsets, the towers, those type of things. So our testing really takes place in the early phase of this. And I think that's continuing to go. We've seen very strong opportunities there and the orders there, both for some standard products for some upgrades for some systems we had out there as well as new products. So I don't disagree that maybe the actual rollout is going to be delayed some, but we were not really seeing any impact on our business as a result of that just because of where we kind of fall on the continuum of the development cycle.

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

Okay. And I guess one last question, and then I'll get back into queue. Regarding the SG&A, you already highlighted that it was down $4 million or 10%. Could you just remind us, what are the cost actions you are taking? And how much is variable, and how much is fixed of those actions?

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

Yes. I'd say, John, what we do is we -- when this thing first hit the fan a few months ago, we were pretty good cost managers. And what we did is we -- across the company, we pretty much stood on all discretionary spending, such as, obviously, travel that was outside of our control. So we do a lot of traveling around this company with Doble going out to sites. And if that becomes 0, there's an immediate cost saving there, the same with the test. So travel is a big part of it. We deferred some compensation adjustments that might have been coming through in midyear. We deferred those to next year.

So our goal is to try to control cost that didn't have a cost associated with them. So it wasn't like we shut a facility, and that cost us $2 million and would save us $2 million. These were all costs that were trimmed that didn't have associated costs with them. So as we go forward, you'll see some of that pick up as some of these things reopen, we'll get a correlated revenue stream with that when Doble sites open up and when ETS is able to travel. Again, you'll see the G&A move up, but you'll also see the sales and gross margin to go serve that move along with it. So we're really pleased with how we were able to do that without taking draconian steps and cutting people's pay and doing some other things around that, where there's a cost associated with that.

So this level that you see in Q3, I think it will be pretty comparable in Q4 as we go forward. And then as we get into '21 we'll size the SG&A for whatever we see the forecasted revenue looking out as we can maintain that same percentage of sales as we go forward.

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

Yes. I think the thing that I would add, though, I mean, SG&A is one piece of it. But we have been -- as sales have gone down in some locations, obviously, we have the right size of the operations. And those typically fall in the non SG&A bucket, those are direct cost. And so those are things that are going to be going away and will not come back until such time that the sales pick up. So SG&A is a big piece of it, but a lot of what we've done is really more associated with direct cost.

Operator

(Operator Instructions) And our next question comes from the line of John Tanwanteng with CJS Securities.

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

Very nice quarter. My first question is on the commercial aerospace business. I know you mentioned you're seeing some signs of pickup. I was wondering if you could go into a little bit more detail on that, delineate between the OEM side and the aftermarket side. And do you think you're past the trough in that business? Or maybe there's another dip to come depending on production rates or inventory levels in the channel?

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

Well, I mean, John, there's 2 big variables, as you know, and they're both pretty unpredictable. I mean we have build rates from the OEMs now, so that we're building to. And so if those hold, then I think we have clearly understood what that looks like. Now, if there's a second burst of COVID or we have another spike and they have to change their build rates again, that obviously going to have some impact on us. We're not seeing that today, and we're kind of planning for what we've been informed of.

And then the other piece is just a pickup of here in travel, and what we're seeing -- well, I'd say what we saw last month, and I haven't looked at it for a week or so. But given a 25% of what we had pre-COVID as far as people flying. But we do see that starting to pick up some, too. And obviously, that drives our spares business, our service business and our OEM business. And again, I think the big variable there is do we have another spike or not. I was just on a call with a guy, and he said he was on a flight to Montana, and it was totally full. He said it was freaking him out a little bit. But I think it's been a bit of a mixed bag. And so as you know, flights are flying fuller today, but there's still not nearly as many of them. So I think that's the big issue. But it seems, unless things turn south again in a big way that we kind of -- as I mentioned earlier, I think the fourth quarter is kind of the trough that we're experiencing.

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

And John, just add something to that. I think we've talked in the past about we track weekly sales reports. We've done that for a long time, but we paid a lot more attention to it here over the last 3 or 4 months. I'd say if you look at the profile of the last 5 weeks, they are nominally moving in the right direction, as Vic said, in his comments, with aircraft coming back in service and TSA passengers coming through. But again -- so I would say stabilization is probably the best we're looking at right now. If it does go down, we're talking about 1% or 2%, not 10% or 15% because this feels pretty comfortable based on the last 5 weeks of deliveries.

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

Got it. That's very helpful. And then just getting over to the Doble business. We had record heat ways in the south, blackouts across the East Coast when we have that storm come up here. Some of them quite long. Any read-through to the utilities and their maintenance or maybe lack thereof because they skipped it this season? I mean how that flows through to your business when the summer heat dies down and they're free to do service again and kind of -- what kind of bounce back we could see?

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

Yes. Again, we're not -- we're not assuming that there's going to be an upside to this. Our current view is, again, this next quarter, probably kind of consistent with what we've seen, maybe up some in the fourth quarter. And then next year, we're projecting to get back better than they're doing this year, but I think there's still going to be a bit of a ramp. But it really is going to depend on when they get in there and start getting out the sites. I mean some of these sites are just not getting visited right now. And so I think a lot of it depends on what happens when they do get back in the field. Really -- and for us, really the only sites that we've been authorized to go to are the nuclear sites. And so a lot of it is yet to be determined, but certainly, this is an issue with a finite life. The question is how long is that finite life, but they cannot continue to ignore these types of tests.

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

Okay. Fair enough. And then just last for me. What's driving the strength at NRG? I know you mentioned wind energy is coming back. There's a bit of solar product that's being successful now. Just a little more color on the strength you're seeing where it's coming from and kind of how sustainable that is.

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

Some of it, I would say, is focused. The people we have there are a little more focused on the solar side now, and we have some products, but I didn't think we were taking advantage of those as much as maybe we should have. So I'd say the solar side of it has been dramatically better this year. What we anticipated part of that is just investment and part of it is a better focus on that. If you look at it in general, the interest rates being as low as they are. I think it's up a ton because before people were worried about the tax credits. So now that -- and there was a concern that when that went away, that business is going to go away. But the reality is because interest rates are so low and renewable energy is so much closer to traditional energy generation that those investments make a lot more sense than they did even 6, 8 months ago. And so people are jumping in, plus there's just an overriding demand obviously for renewable energy. But now the other economics are making it more favorable than it had previously.

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

That makes sense. If I could ask one more, you declined to provide guidance for the fourth quarter. Just wondering where are the biggest sources of uncertainty in your revenue earnings projections at this point halfway through August?

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

Yes. I would say it's really -- as we talked about, it's commercial aerospace, and if there is going to be any further adjustment, and it's really the recovery of the utility business. I think we have great insight on the rest of it. And we made assumptions on those 2 pieces. But we just don't have enough clarity to really say this is exactly what we think we're going to do just because of those 2 markets are still a little fragile.

Operator

And we do have a follow-up question from the line of John Franzreb with Sidoti & Company.

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

Just on the M&A pipeline. It sounded like you were interested in picking off some companies that are in duress in the aerospace and defense side of the market. Could you talk a little bit about your appetite for maybe a number of companies you may be looking at on that side of the business and maybe the size of those businesses that you're looking at?

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

Yes. So I don't want you to think we're going after distressed companies because that's not -- this not really what we do. I mean a lot of people do that, but we always say we don't want to buy fixer uppers, not on purpose anyway, but we want to buy good, solid companies. I'd say, I would think more 2 things. The companies that we're currently looking at are good, solid companies. But for whatever reason, people decide they don't want to weather the storm any longer. And so they look for an opportunity to exit. I'm not saying that we're not paying close attention to other vendors and people that might have some issues, but we're not really, again, looking for troubled companies.

As far as the size and number, we're going to take a very cautious approach to make sure. I mean we're look -- we've always been may be very aggressive on our due diligence to make sure we understand what we're getting. But that's even more the case now, particularly as we look at forecasting because, look, we're having a little trouble forecasting our business right now. Just as I was talking with John about a minute ago. So forecasting somebody else's business is even more difficult.

I'd say the advantage in the aerospace business, it's a very platform-driven industry. So if you understand exactly what part number somebody is producing, what aircraft are going on, what the build rate is, what the repair cycle is. I mean there's a number of variables there where you can really get very good insight in into what's going on with those businesses. The other thing I would say is -- we're focused a bit more on defense aerospace than commercial aerospace because that's really doing exceptionally well. And so if we can find a business that is leading further that way, I would say that, that would be a preference for us right now, at least for the foreseeable future because there's a lot more stability in the next couple of years.

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

Got it. And one last question. It sounded like there might have been some supply chain issues in the quarter. Was that the case? It sounded like you brought some production in-house or are bringing some production in-house? And can you just kind of quantify maybe what impact that was in the quarter as far as to the P&L? Any additional color would be helpful.

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

Yes. So we really have not had significant supply chain issues. I think what we're trying to say is we paid close attention to that to make sure that we haven't. But what we have done, and we talk a lot about cost savings and people think about cost savings, all they ever think about is cutting people, right? And so we think about it in a lot of different ways. And one thing that we're looking at is bringing more stuff in-house, in-source things.

So I had all the businesses to go look at everything that they subcontract to an outside vendor and say, is this something we can do in-house. Because the reality is, I want to keep as many of our employees employed as possible. And also, it gives you more control over what's going on. And so I've said to everybody, look, if we need to buy additional capital equipment, so we can bring work inside, we should do that. I mean, I think that's a good investment in our business because one thing we -- there's so many things we don't know about COVID, but one thing we do know at some point, it's going to get under control, and business is going to get back to normal. And I want to make sure that we're well positioned to take advantage of that. And so the more we can do in-house where it makes sense, the more I want to do that, both for cost savings, employee retention and having control of our own destiny.

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

And one thing I'll add to that is the other thing, John, when you go out in that market with big strategy like that. It also makes your supply chain aware, you're willing to do that. So in some cases, there's been some immediate cost reductions because those suppliers didn't want to lose the business, and we kind of have a algorithm of where that breakpoint is. And so in some cases, we are looking at bringing things in-house, we actually

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got better pricing from an existing vendor, where we'll get a lower cost structure going forward. So I think, to Vic's point, we're pulling on several levers on that side, which I think has been really effective.

Operator

This concludes today's question-and-answer session. I would now like to turn the call back to Vic Richey for closing remarks.

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

Okay. So thanks to everybody, and I look forward to talking to you on our next call.

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

Thank you.

Operator

Ladies and gentlemen, this does conclude today's conference call. You may now disconnect. Everyone, have a great day.

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