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PRESENTATION

Operator

Good day, and welcome to the Q1 2021 ESCO Earnings Conference Call. Today and [number 39'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 IR*

Thank you. Statements made during this call regarding the amounts and timing of 2021 and beyond revenues, COVID impacts and recovery expected as a result of COVID vaccines, EPS, adjusted EPS, EBITDA, adjusted EBITDA, new products, margins, cash, shareholder value, the timing of Block V orders, 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 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 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 we get into the financials, I'll provide a brief update on today's COVID environment. We continue monitoring the situation on a regular basis, and our primary goals remain the same. Stay ahead of the curve, provide a safe working environment and protect the health of our employees. The decisive actions we've taken and the operating protocols we've implemented since the start of the pandemic were done with a clear focus, which was to protect our strong financial condition, to deliver products and services in support of our customers, all while keeping our employees safe and healthy.

Our solid operating results in Q1, coupled with our strong liquidity position, demonstrates that the measures we've taken will allow us to successfully navigate through this challenge. Our actions will benefit ESCO going forward as things continue to move toward a more normal state. And I'm confident that our disciplined approach to operating the business will result in our continued success throughout the balance of fiscal '21. While Gary will provide the financial details, I'll offer a top-level comment by noting that while our Q1 A&D sales were lower than prior year due to COVID's impact on commercial aerospace, our portfolio diversity allowed us to overcome this headwind as we substantially increased our adjusted EPS from prior year due to the strong performance from our other operating units.

Our Navy business remains strong and well funded, our Test business continues to outperform with increased margins, and our USG business saw some meaningful calendar year-end spending across the utility customer base. Coupled with the cost reduction actions we recently implemented, USG delivered an adjusted EBITDA margin of nearly 25%, up from approximately 19% in the prior year's Q1. We're fortunate to have strong and experienced leadership teams across the company who continues to demonstrate their ability to effectively manage costs to meet market -- meet changing market demands. Our teams are actively addressing the challenges of today while continuing to focus on being even stronger tomorrow.

ESCO will continue to benefit from our leadership positions in several niche markets where we deliver a set of unique and highly technical products and solutions, specifically designed to meet customer needs. This makes it difficult for our solutions to be replaced by alternative sources. The fundamentals of our portfolio remain strong, and our goal remains the same, to create long-term shareholder value.

Now I'll turn it over to Gary.

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

Thanks, Vic. I'll briefly touch on the financial results as laid out in the press release. Navigating today's COVID world, our number one financial priority remains the same, maintaining our substantial liquidity. As I said from the start of the pandemic, when challenging times pop up unexpectedly, cash is king. I'm extremely pleased with the significant cash flow we generated in Q1, as normally our first quarter is the weakest quarter of the year when it comes to cash generation. Following up on the strong cash flow performance of the past year, we kicked off fiscal '21 with a record amount of cash flow, resulting in a free cash flow conversion ratio of 127% of net earnings.

Clearly, our working capital initiatives are taking hold across the company and while impressive today, we have set larger goals for the future. Today, we have approximately $740 million of liquidity at our disposal between cash on hand and available credit capacity, while carrying a modest leverage ratio of 0.38. In the release, we called out a couple of discrete items, which are described in detail and are excluded from the calculation of adjusted EBITDA and adjusted EPS in both Q1 periods. I'll briefly touch on a few comparative highlights.

We reported adjusted EPS of $0.55 a share, which increased $0.12 or 28% from the $0.43 we reported in prior year Q1. The $0.55 also exceeded the consensus estimate of $0.45. Given the backdrop of today's COVID operating environment, I'm pleased to report that we delivered Q1 adjusted EBITDA of over $29 million, which is approximately 4.5% higher than Q1 of last year despite the noted sales decline in A&D that Vic mentioned related to softness within commercial aerospace, which historically, is one of our most profitable operating units.

Total sales in Q1 decreased $9 million compared to Q1 of last year, but Navy and Space sales were up $4 million in A&D, which helped to mitigate the decline in commercial aerospace, and Test and USG sales were up a combined $2 million. Despite the noted increase in USG's Q1 sales resulting from the release of some pent-up demand, Doble continues to expect some near-term deferrals of project deliverables and maintenance work as many utility customers, both domestic and international, are continuing their COVID protocols, reflecting the various mandates restricting on-site personnel at customer locations. Consistent with our earlier communications, we believe the back half of '21 will be stronger than the first half and as vaccine rollouts continue to accelerate, this should allow Doble's customers to return to a more normal operating environment.

We took several cost reduction actions recently and as a result, we increased our Q1 gross margin by 150 basis points to 39.4% and reduced our SG&A spending by nearly 3%. These favorable outcomes were achieved despite adding the recent ATM acquisition in October, which is not fully operating at capacity during its transition to Crissair and despite our continued spending on R&D and new product development to benefit our future. Amortization of intangibles, interest expense and tax expense as a percent of pretax income also decreased in Q1 as we look at all costs and spending similarly.

Entered orders were solid as we booked $158 million of new business and ended the quarter with a backlog of $512 million with a book-to-bill of 97%. As we move forward throughout '21, I'll remind you that our DoD business, led by our participation on the Block V contract for additional Virginia class submarines, where we booked several large orders during fiscal '20, we'll be delivering products against these large multiyear programs, which will mathematically reduce the optics of our book-to-bill going forward. As we work through the year, COVID will continue to bring along some uncertainty, which makes it difficult to predict how our near-term operations will be affected using our normal forecasting methodologies. And as a result of this uncertainty, we will continue our current protocol of not providing finite EPS guidance for the balance of the year.

Consistent with our November communications, from a directional perspective, we can point to several areas where we see positive momentum. Our commercial aerospace and our Utility end markets are showing some degree of customer stabilization, which supports our current outlook suggesting movement towards a recovery in the second half of '21. The increasing distribution of the COVID vaccine is anticipated to benefit and accelerate the recovery of commercial air travel and utility spending with customers resuming more normal buying patterns. While we solidly beat Q1, we still expect the first half of '21 to be slightly down compared to the first half of '20, and the outlook for the second half of '21 is expected to be a favorable comparison to the second half of fiscal '20, given the various elements of recovery that we are anticipating. We expect to show growth in fiscal '21 adjusted EBITDA and adjusted EPS compared to fiscal '20 with adjusted EBITDA and adjusted EPS reasonably consistent with that reported in 2019. If we complete any additional acquisitions during the year, it is expected they would contribute to these expectations.

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

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

Thanks, Gary. I won't spend much time recapping the first quarter. My commentary in the release captures my perspective. But I will offer some qualitative comments about our end markets and our expectations for the balance of the year. Starting with our A&D segment. While we're seeing some signs of modest recovery in commercial aerospace, we expect continued softness over the next 3 to 6 months. We are seeing some stabilization in OEM build rates and increasing airline passenger traffic and flight miles, evidenced by the fact that quite a few air carriers are bringing more of their idle fleet back into service and daily TSA passenger boarding numbers are moving in the right direction. Just as we saw in Q1, the defense portion of our A&D business is and will continue to remain strong for the foreseeable future given our backlog and platform positions. We also see the current situation in aerospace market as an opportunity for ESCO, and we continue to look at suppliers or competitors, where they may be -- we may be able to provide assistance via partnering or through an acquisition.

Our Test business delivered a really solid Q1 by significantly beating our internal expectations and delivering an EBITDA margin of nearly 13% versus 11% last Q1. Test outlook remained solid, given the diversity of its served markets. While USG had a really strong first quarter, coupled with a favorable sales mix driving a solid EBIT margin, we expect USG's sales outlook to be -- we do expect it to be soft for Q2 before returning to more normal levels in the second half of the year.

As the COVID vaccine gets more widely distributed throughout the utility service personnel, we expect the USG market to come back online more quickly as they can relax some of today's social distancing guidelines, Utility service personnel can return to their normal site visit routines. We continue to communicate with and support our Utility customers remotely, and our client service engineers are doing a really good job capitalizing on their relationships with their Utility counterparts to provide real-time solutions. This has been accomplished through a lot of creative means and positions Doble for success when the current site restrictions are eased. I'm pleased with the enthusiasm surrounding USG's pipeline of new products and solutions, and we continue to see NRG's end markets improving as new investments in renewable energy are increasing in both wind and solar. Our new solar product introductions have been growing far better than anticipated, and we expect that trend to continue.

Moving on to M&A. We continue to evaluate several opportunities, and we'll continue taking a prudent and deliberate approach. We expect to take action on these opportunities to grow our business as we have in the past. Our Board is supportive of our M&A strategy and our current balance sheet provides us with plenty of liquidity to allow us to add to our existing portfolio. Regarding our recent acquisition of ATM, I'm pleased to report the integration into our Crissair facility in Valencia, California is on track and should be completed within the next 2 to 3 months, which will further improve ATM's contribution margin.

So to wrap up, we delivered a solid first quarter from both a cash flow and earnings standpoint. As we move through fiscal '21, our plan is continue to focus on the fundamentals and look for opportunities to leverage our infrastructure through M&A to create additional operating efficiencies, ensure we're well positioned for long-term success.

So with that, I'll be glad to take any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Tommy Moll of Stephens.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Analyst*

I wanted to start off on the utility end market. It sounds like, into calendar year-end, there was some good activity there. And then as we look at the current quarter, maybe there's some softness, but then opportunity beyond. I think that's the way you've framed it up qualitatively. So any anecdotes you can give there on the puts and takes would be helpful.

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

Sure, Tommy. And you got it just exactly right. So in the fourth quarter, we often will get some of this kind of money that we'd want to spent before year-end, and we've had a little bit more of it this year than typical. And I guess it's not surprising because the spending has been somewhat restrained over the past 6 months or so. Our second quarter is always the softest quarter for Doble, and so that's not going to be different this year. But I think it's about even with what we saw last year in the second quarter. So not really concerned. That's what our expectations are. And we do think going into the second half, it should pick back up to more normal levels. Because as we've said before, you can delay this testing, but you can't delay it forever. And so my hope is, as we said in our prepared statements, is more and more the Utility folks get vaccinated that they'll allow more on-site visits and support and that type of thing. But yes, it's -- the way you stated it is very consistent with what we see.

Thomas Allen Moll - *Stephens Inc., Research Division - MD & Analyst*

Okay. And I guess for a follow-up, I'll hit on the directional outlook that you've given, really just to make sure we're tracking correctly what you've communicated on the first half compare and the second half compare. Just want to make sure, does that apply to both revenue and EBITDA? And then anything you want to call out maybe in terms of margin differences first quarter -- first fiscal quarter into second fiscal quarter that you want to make sure just to remind folks of would be helpful as well.

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

Okay. I'll take the -- Tommy, I'll take the last part of the question first because that's the easiest. We expect the margin in the back half of the year to be meaningfully higher than the first half of the year and that's a combination. If you look back at our last probably 5 years, it's that same correlation well before COVID and it's a function of 2 things. One, the revenue in the back half of the year has been consistently more heavily weighted. So because of the fixed cost coverage ratio there, we tend to have very strong Q4 margin contributions and usually Q3 is the second strongest. So that is going to continue. So as you think of kind of general correlation of how we're looking at this, historically, when I say historically, I'm talking about 2019 and '18 going backwards, it's kind of in the ballpark of a 40%, 60%, meaning 40% of the revenue and profit came in the first half and 60% in the back. It's probably just a few points different. So if you are putting it somewhere in the neighborhood of 35%, 65%, somewhere in that range, you would get yourself from a weighting perspective, depending on how you've modeled out with what the -- what your end goal is there. So then you could just kind of carry that up to the revenue side because, again, we're looking at the same kind of relationship with 35% to 38% in the first half with the balance coming end of year. So hopefully, that helps you directionally.

Operator

(Operator Instructions) Next question from the line of John Tanwanteng from CJS.

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

You mentioned, I think, that your expectations for the year were mostly unchanged. But just given the strength that you saw in Q1, is there maybe a slightly more positive bias to the year just given what you've seen so far? Or is there maybe something coming up that is a little bit more negative than what you thought before you finished Q1?

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

Just given the environment we're in right now, we're 4 months into the year, and I really would hesitate to make any big changes. I mean we did have a great first quarter. I mean, I think some of that was probably at the expense of the second quarter, to be honest. But we -- if we get something done on the acquisition front or the market -- markets open up a little bit quicker than, obviously, there is a potential for upside. But I would hesitate to make any bold statements here in the middle of February, to be honest.

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

John, just get a step forward. Just our commentary about what we're seeing signs pointing in the right direction, but those signs haven't finalized themselves or put themselves in a finite bucket yet. So where we started the year, we had a pretty decent plan based on the visibility that we had, again, not consistent with our past planning protocols. And when you look at it today, yes, we're off to a good start. But I think the visibility window we have today kind of runs in 3-month cycles instead of 9-month cycles. So we have pretty good clarity in the next -- or the quarter we're sitting in. But back half of the year, we're still taking a cautious approach. There's probably enough balance there to protect the downside, but we don't want to commit this early in the year. And that's been our protocol for years not to come out in February and raise the guidance while you still have, as Vic said, 8.5 or 9 months of time left. So I think it's -- we're off to a really good start, we have enough protection. But until we get more -- the year gets more mature, we're probably not going to comment other than directionally on the recovery and the signs of recovery that we're seeing.

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

Okay. Fair enough. And I just wanted to talk a little bit more about the commercial aerospace business. Are you getting any indication at this point that they're preparing to ramp up production just given the boardings, given that they're taking their planes out of idle fleet or are they still maybe burning up inventory that they have on hand? Just -- are they telling the supply chain to get ready for more coming?

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

They haven't yet. I mean, we see some signs of it, but nobody has called and said, hey, you need to make sure you're ready for this big ramp up. I mean it's -- we track all the indicators pretty closely. And I would say that while things seem pretty solid, we've not gotten any indication anybody's going to pull anything forward at this point.

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

Yes, John, I think the only clarity we've obtained since the last time we spoke was, if you look at the OEM side of it, the build rate certainty was completely uncertain. We didn't know because the customer didn't know if they were going to build 10 planes or 2 planes or 20 planes. And I'd say that we're getting a little more clarity as you get through this stuff that we're getting a reasonable narrowing of that variability in the build rates. So we don't have to throw a dart at the wall and say, hey, Boeing might be building 20 or they might be building 2. Now we're talking about deviation of 2 or 3 planes a month. So that helps us get comfortable with things, but it certainly doesn't, to Vic's point, it doesn't give us the visibility that says, let's rehire people and start spending money.

I'd say on the aftermarket side, what we track is, as Vic said, the TSA boarding profile, who's putting planes back in service and that sort of thing. And I want to remind people that even if a plane is half full, it's still flying. And so TSA boardings are one indicator of what's driving the aftermarket, but it's really a combination of that and plain miles, not just passenger miles. So that's stabilized for us as well. Yes. I mean, it's still down significantly. But again, we're seeing signs directionally that, that looks like it's going to come back faster than the OEM side.

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

Yes. One very anecdotal, but if you look at the TSA numbers, and so they've been tracking since probably December at about 40% -- 38% to 40% of the previous year. But then if you look at the 3 days after the first of the year, the first 3 days of 2021, they jumped up like 55%. And the only thing I draw from that is people are ready to travel. I mean you're going to take -- they really want to travel. And if you look at vacation bookings and cruise bookings and all that, I mean, those are very strong. So I don't think there's any doubt that there's a strong desire there for people to get back to traveling and traveling by air. But it's -- and I think that the vaccine is going to make a huge difference when a lot more people are able to get access to that.

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

Got it. Okay. We don't talk about it too much. Can you talk about the pipeline for Test? My impression was that there were some larger projects that got deferred out of last year just because of the COVID situation. Are those now close to releasing or are they still in a holding pattern? Just kind of talk about the environment there and the demand that you're seeing.

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

I think the very large ones, I think, are still in a bit of a holding pattern. And -- but we're seeing a lot of great activity in smaller chambers and here I'm talking $1 million to $4 million, $5 million of chambers. And so that's really been strong. I mean, the pipeline that we see today is as strong as it was when we were entering last year. So -- and we're seeing a lot particularly in China. It's been a really great market for us recently. But I'd say that the Test market -- I should say that the Test end markets remain pretty strong. So that's an area, if you look at the results over the past 9, 12 months. I mean, that's held up very nicely. And we've not seen anything that's going to change that. And so my hope is that here in some near term, some of these larger ones will start freeing up. But again, we don't need those to kind of make the forecast that we have out there today.

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

Got it. Okay. My last one is just any update on the CFO replacement, Gary? I know you're a hard act to follow so.

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

Yes. Actually, I've been -- I don't get any specifics, but I've been very pleased with the quality of people that are showing a true interest in this. And we've been working this hard. I don't want to get in a lot of detail. But I think that it will be really good candidates we have, and so I think that's something that we'll be able to get done here in the next quarter. So I think Gary will still be here for the next call for sure. But it will be a very orderly transition. He's committed to stay as long as he needs to, to make sure that whoever does replace him will be well schooled in what to do around here. But again, I've been very impressed with the quality of people we've been able to attract.

Operator

Next question from the line of John Franzreb.

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

Yes. I thought you referred to in your commentaries that there might have been some borrowing from the second quarter into the first quarter. Did I hear that properly? And if so, what businesses did you borrow from?

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

Yes. I would say that just what we saw particularly in the Test -- I'm sorry, in the Utility market, I think they had such a strong first quarter. And my assumption is some of that probably got pulled out of the second quarter into the first quarter.

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

Okay. That's in the Utility market. And quick question regarding the tempo of the billings in aerospace and defense. How -- is that second half in A&D followed at 40%, 60% model? Or is it tilted more one way or the other?

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

Well, I think if you look at the A&D market, you're going to see a little more tilting to the back end. Because again, if I just focus on the large programs in that group, large meaning getting an order over $10 million, that's primarily around the submarines and the Space business. So we're in negotiations on the next pool, if you will, of Block V. And so we would expect not many orders on Block V in Q1 and Q2, because again, we got $100 million last year. So we should pick up another lot on the back end of this year. And then within the Space program, at Boeing the space launch system, the Artemis program, SLS, we're in negotiations as we have been. If you get that, it just -- it's a cadence of when they release the core stage numbers. And I think that should give us a nice book-to-bill in the back half of the year. So we're burning off backlog in the first half on the large programs, we'll replenish that. And my guess or prediction for the order -- book-to-bill for the year will be fight to a tie, which to me is a home run, when you're burning off $100 million of running start from last year. So it looks pretty -- the profile looks pretty good. And that's why I wanted to emphasize the cadence of this. The book-to-bill is important, but it's really the sustaining of the backlog number as it burns off and it gets replenished in different quarters. So it's really just a mathematical kind of rejiggering of the quarterly profile, but the year looks great.

Operator

(Operator Instructions)

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

Okay. So I think we've got all the questions that are out there answered. So I appreciate everybody's interest, and we'll talk to you again next quarter.

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

Thank you.

Operator

Thank you. And that concludes today's call. Thank you, everyone, for participating. You may now all disconnect.
