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ESE - Q2 2018 ESCO Technologies Inc Earnings Call

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Andrew Jay Lipke *Stephens Inc., Research Division - Research Analyst*

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PRESENTATION

Operator

Good day, and welcome to the Q2 2018 ESCO Technologies Inc. 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 IR*

Statements made during this call regarding amounts and timing of 2018 and beyond EPS, adjusted EPS, EBITDA, adjusted EBITDA, EBIT, EBIT margin, growth, tax rates and benefits of the new tax bill, repatriation of foreign cash, profitability, sales, cash flow, orders, success of new products, success in completing additional acquisitions and benefits from recent acquisitions, DOD and commercial customer spending 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, and good afternoon.

As noted in our release and as Gary will describe in more detail, we wrapped up the first half of the year in solid fashion. We began the year with Q1 adjusted EPS coming in at the top of our guidance. I'm pleased to report that our Q2 results beat expectations by $0.05. Additionally, our orders and cash flow remained strong. We exceeded our expectations and the balance of the year remains on track.

Now, I'll turn it over to Gary for some detailed financial comments.

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

Thanks, Vic.

As Vic noted, our Q2 and year-to-date results on both a GAAP and adjusted basis came in better than expected across several financial metrics. Given the large GAAP EPS impact of the first quarter's one-time gain resulting from the new tax law, I will focus my commentary on adjusted EPS and adjusted EBITDA as these are more relevant measures of our operating performance when compared to expectations and to prior year.

Before I comment on the Q2 details, I'll recap a few data points that we communicated during previous earnings calls. At the start of the year and before anyone could estimate the impact of the then pending tax reform narrative, we set our original financial goals on a GAAP basis and centered our discussion of expected operating performance around EBITDA, which was expected to be in the range of $141 million to $143 million, reflecting an increase of 15% to 17% over prior year. We also described the timing of several project-related items that were impacting the comparability of our first half compared to prior year's first half and we discussed what was driving these increases in sales and earnings that resulted in our significant back half weighting for this year.

In our February release, we raised our original GAAP EPS guidance to $3.55 to $3.65 a share and raised our adjusted EPS in the range of $2.65 to $2.75 per share. While today, we see some upside to these estimates and we believe our risk to the downside are well-managed, we feel it is both prudent and conservative to maintain our current expectation.

Now, touching on a few financial highlights from Q2. We reported adjusted EPS of $0.48 a share, which beat the top of our guidance by $0.05 a share as each of our operating segments reported stronger-than-expected earnings.

Sales were consistent with our February expectations. And when compared to prior year, sales increased $14 million, primarily driven by our recent M&A contributions.

Test lead the way organically with a 6% increase in sales year-over-year. And within Filtration, commercial aerospace sales remained strong, which helped mitigate the lower industrial automotive sales at PTI that we described at the start of the year, along with lower space sales at VACCO resulting from project timing. USG and Technical Packaging sales were consistent with previous expectations.

Our adjusted EBITDA increased by 6% in the quarter to $28 million, which in turn drove our EPS to the high end of our range.

Year-to-date, cash flow from operating activities was $33 million, also well above expectations, and this was driven by strong cash collections across the company and lower tax payments. This cash flow allowed us to pay down debt and reinforced our view that our significant cash-generating capabilities over the balance of the year as well as our credit capacity and available liquidity have us well-positioned to continue to execute our M&A strategy.

Entered orders were $187 million in Q2 on top of the $200 million recorded in Q1. This reflects a book-to-bill of 1.11 and it increases our March 31 backlog by $40 million or 10% from the start of the year. Test orders of $106 million during the first half on top of last year's $200 million provides us confidence in their ability to achieve the back half of the year financial commitments they've made.

So in closing, we remain on track to meet our financial commitments for the balance of the year and I feel we have sufficient contingency to protect us from unforeseen risks. Additionally, I'm confident that our current backlog and program delivery profile supports our strong outlook for the second half of the year.

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

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

Thank you, Gary.

Continuing the theme from when we spoke last, I remain confident that all our businesses are in solid financial condition with solid growth opportunities and an ability to add and integrate future M&A opportunities. Gary and I just completed our annual midyear planning and strategy meetings at each of our operating segments. And after being on site and seeing where we are positioned in our various end markets and understanding our growth opportunities, I continue to feel confident we're well-positioned to deliver our projected long-term growth objectives, both organic and supplemented by targeted M&A.

I'll provide a few specific thoughts and comments on the individual businesses. In Filtration, we continue to expect solid results in '18 and I remain comfortable with our outlook for 6% to 7% growth in adjusted EBITDA in this segment compared to prior year. All of our served markets remained strong led by these specific items: VACCO and Westland are benefiting from their positions in submarine programs, coupled with an increase in overall spending on U.S. Navy programs; PTI and Crissair will grow as commercial aerospace deliveries and overall OEM build rates continue to increase; and Mayday is experiencing outsized growth as a result of their entrance into the MRO market. The outlook remains positive, driven by new customer wins and additional product requirements from existing customers.

Our Technical Packaging group's outlook continues to improve as a result of our scale, broader footprint and leadership position in several growth markets. Our domestic performance and outlook remains strong as we have a number of multiyear programs in backlog and several others in a pursuit mode.

In USG, we continue to see solid growth opportunities across the global platform, including hardware, software and services. Our rep and distributor network rationalization and our cost reduction actions are complete. And as we look forward, we see clear and tangible sales opportunities, along with margin enhancements, which will benefit the back half of this year as well the future.

Doble recently held its annual global client conference in Boston and reported a record number of clients in attendance. Our customers came away with a high level of excitement as they were able to get an in-depth understanding of Doble's expanded products and solutions now offered with the addition of NRG, Morgan Schaffer, Vanguard and Manta to our USG portfolio over the past 12 months.

Moving on to Test. We had another strong quarter as we generally hit our Q2 sales plan, beat our profit targets by a meaningful amount and remain committed to our EBIT margin expectations for the year. Orders continued to be a highlight in Test as we booked $106 million in new business year-to-date. We continue winning new business in Test across a wide range of end markets, including satellite testing facilities, automotive-related antenna test facilities, electric vehicle motor testing chambers in China and several large projects related to the developing 5G market.

So in summary, I feel good about the growth opportunities we have across all of our businesses and I see tangible avenues for additional growth in future years. Regarding M&A, the pipeline remains robust and we're currently exploring opportunities which would supplement the Filtration and Utility segments. Acquisitions remain a key component of our ability to meet our longer-term growth targets and we have the balance sheet and management capacity to meet our goals while remaining disciplined in our approach. So our focus remains constant to improve our operational performance and to execute on our growth opportunities, both organically and through acquisitions.

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 Drew Lipke.

Andrew Jay Lipke - *Stephens Inc., Research Division - Research Analyst*

I guess, first question I had, just looking at the 3Q guidance that you gave, it implies that the fourth quarter is going to be somewhere around 44% of full year earnings just at the midpoint. Can you kind of go through some of the timing factors that are really driving that because that just seems to be well outside of historical seasonality?

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

So we obviously look at that. And as I mentioned in my comments, we were just out at the operating units and went through that in a lot of detail. Sort of a couple of things that play into that. First of all, we have all the acquisitions for that quarter and we didn't have all of those in last year. The other thing is a big piece of this is the Test business. And as you know, it's very much a project-related business. And those are -- the delivery schedules that we have on several very large projects did take place in the fourth quarter.

I think it's also important to remember that all of that is not things that are produced in our facility. There's some pass-through there so we're getting large pieces of that from third parties as well as a lot of that is actually installation sales, so products that we're producing now which will be installed in the fourth quarter.

The fourth quarter is always big in Filtration business, somewhat driven by the fact that we deliver those large submarine valves in the fourth quarter, and that's always a big piece. So it's pretty consistent with we've seen in past years, but it's obviously a big fourth quarter, but we feel very confident we've got our arms around that.

Andrew Jay Lipke - *Stephens Inc., Research Division - Research Analyst*

Okay. And then, at USG, what was the organic growth in the quarter?

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

It was about 3.5%, 3% to 4%, so somewhere in that range.

Andrew Jay Lipke - *Stephens Inc., Research Division - Research Analyst*

Okay. And are we still thinking full year margin outlook at USG, I think we're kind of talking 21% range before?

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

It's probably a little bit better than that right now. I'd say within 0.5 point to the upside of that just because of the contributions that we're realizing on the Vanguard piece of the business, I think, are coming in better than plan. I think the Morgan Schaffer piece of the pie is coming in better than planned. And that's not accounting for currency, that's just straight up. So I think those 2 factors are giving us a little tailwind as -- on the margin side as we look at the upsized growth there.

Andrew Jay Lipke - *Stephens Inc., Research Division - Research Analyst*

Okay. And then, in USG, you called out the sales synergies. Where are we in terms of international sales growth? How much of Morgan Schaffer and Vanguard kind of opened the door there for you? And can you just talk about some of the tractions that you're seeing there?

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

So Morgan Schaffer is primarily a North American business, but they do, do some internationally. Vanguard and Manta. Manta is a Canadian-based company, but all of their sales are in the -- in North America as well. So we think we have good opportunities with both of those companies to increase their international content. And you got to be aware that historically, both of those being small companies, have very small sales force. And so what we've been able to do is obviously put the full distribution network and sales force available behind those products. So we think that there is a good opportunity to push those products internationally. We're just in the early phases of that, but we do think that's a good opportunity for us.

Operator

Your next question comes from the line of Jon Tanwanteng.

Michael Hagan

This is actually Mike Hagan jumping in for Jon here. I wanted to ask a question specific in the Test business where we saw some solid strength, your thoughts on how sustainable the strength is from both in orders and a margins perspective.

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

Well, I'll address the second part of it first. I mean, as we're able to leverage that business and you look at it on a quarter-to-quarter basis, you will really see that in the second half of the year. We were able to increase sales pretty dramatically without any additional SG&A. So as we're having bigger sales quarters, you'll see those margins go up accordingly.

As far as the sustainability, the other, I mean, it's -- who knows if we'll have exactly the same level of orders we've had and we've had just a fantastic past 12 months in that business. But the thing you've got to think about the business is probably 80% of it we won't see as recurring business, but it's pretty predictable. So whether it be the medical piece or the industrial shielding piece, the components piece, all of that's pretty predictable. And so what really drives that business to the upside are these larger projects, like what we're doing in some of the automotive chambers, what we're doing with some of the defense chambers. And so those are the things that really kind of drive that outsized growth. And today, I would say it continues to look pretty good.

I mean, the other piece of it that will really drive that is the move to 5G. And a lot of people are involved in those markets and we're really the people that companies look to help them with those types of solutions.

So right now, we're feeling really good about that business and the level of backlog that we have today really gives us a lot of comfort not only for this year, but really going into next year as well because a lot of those large projects that we've entered over the past 12 months and, say, have a good bit of sales content in '19 versus just selling everything in '18.

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

Mike, let me add a number around what Vic's commentary is relative to how we can leverage off of the overhead as we ramp up. But I'd ask people to look at Q4 last year in -- where we did a little over $50 million in sales, so that's obviously about $200 million run rate. In Q4 last year, we did about 16.5% EBIT off of that sales level. So as we go to the back half of the year here, 16% is reasonable relative to a $50 million sales profile because, as Vic said, the way we leverage, we don't have to add G&A to get that. So that's how we maintain some of our confidence in the back half of the year because the sales volume will pull through that kind of margin contribution.

Michael Hagan

Gary, I appreciate the color. You actually anticipated my follow-up there. So let me just, if you mind, ask one more question, and just specifically the commentary on M&A. Obviously, you guys are well-positioned there, but your thoughts in terms of the number of opportunities and if you can provide us any color on kind of valuations you see in your target end markets.

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

So the -- there's a number of opportunities that we're looking at now and -- but as you know, you've got to chase a lot of these things to make them happen. I'd say the valuations we're seeing today are not unreasonable. I mean, if you go back and look at type of multiples we paid for the businesses that we've acquired over the past 1.5 year, all of them have been 10 or more except for one. We had to pay up for some, but that was kind of a must-have for us. So if they get the auction, obviously they get more expensive, but what we'd try really hard to do is make sure that we get to those things before they get to auction. And even if they do then, we just -- we're still going to be very prudent about what we think we can do with the business. So as of today, the pipeline's robust and the multiples are not crazy for at least the things that we're looking at.

Operator

(Operator Instructions) Your next question comes from Liam Burke.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

In the USG business, how has the smart monitoring business developed underneath? You've got acquisitions and then you've got your core Doble business. How has that been developing?

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

Which part of it, I'm sorry, Liam?

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

I'm sorry. The smart monitoring in USG.

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

Okay. So I think what you're referring to was our online monitoring.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

Correct. Smart grid.

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

Yes. Yes, I got you. So it's going well. The online piece of it, I mean, obviously that's a more expensive way to test transformers and relays and things like that because you're dedicating a sensor to a specific piece of equipment, but obviously that's where the future is and we're working hard to address that market. Obviously, the Morgan Schaffer piece of it has brought a bit of that with them because a lot what they do is online monitoring and we're supplementing that with some of the things we already had done. So I'd say that we've had good traction there and I think, in the future, that's going to be a big driver for the business.

Liam Dalton Burke - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And in the Filtration business, I know there was some timing on projects, but generally, how is aftermarket been going in that as a percentage of revenue?

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

I'd say on the percentage of revenue as we sit where we are today, it's about -- the aftermarket is about 25% of -- on the aerospace side of the business. Obviously, there's not a whole lot of aftermarket in the submarine side. There's some, but it's not as prevalent. And the reason that relationship might seem awkward is because obviously, on the OEM sale, it includes the manifolds and all that kind of things. So if you're selling to the OEM side on the first install, what -- historically, what we run into is the aftermarket where you're replacing the modules or the filter elements inside of the manifolds. You tend to be at about 25% of the price point. So if you're selling something for $50,000, you're going to get $10,000 in the aftermarket, but you're going to replace that, replicate that multiple times. So that kind of should help you get an understanding why the relationship generally is about 75% OEM and 25% aftermarket because the cost differential or the selling price differential relates to that.

Operator

I'm showing no further questions at this time.

I would now like to turn the call -- conference back to Vic Richey.

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

Okay. Thanks, everyone, for your interest. I look forward talking to you in the next call.

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

Thank you.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation and have a wonderful day. You may all disconnect.
