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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Third Quarter 2023 ESCO Technologies' Earnings Call. (Operator Instructions) Please be advised that today's conference is recorded.

On the call today, we have Bryan Sayler, President and CEO; Chris Tucker, Senior Vice President and CFO. And now I would like to turn the conference over to our first speaker today, Kate Lowrey, Vice President of Investor Relations. Kate, you may now have the floor.

Kate Lowrey - *ESCO Technologies Inc. - VP of IR*

Thank you. Statements made during this call 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, except as may be required by applicable laws or regulations.

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 Bryan.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Thanks, Kate. Thanks, everyone, for joining today's call. We really appreciate you taking some time to get an update from ESCO this afternoon. Our year has gone really well through the first 3 quarters, and I'm excited to talk to all of you about that. But before I do, I'd like to take a moment to thank all of our employees.

ESCO has wrapped up a number of strong quarters with impressive top and bottom line growth. Our industries are growing, but it takes a dedicated and capable team to truly deliver on these positive industry trends. It hasn't been easy over the last few years, but our teams continue to show real commitment and dedication.

Chris and I had a chance in July to visit most of our operating locations, and it's always energizing to see the teams in action and to witness firsthand the success that they're achieving. The teams across the world are very engaged and they're winning. So it's fun to be in a strong culture like that. And again, I just want to say thanks to everyone at ESCO for their tremendous effort and support.

With that, let me pivot over to the quarterly results. We had a really great third quarter with strong sales and earnings growth. Sales increased nearly 14% in the quarter, with positive trends continuing in most parts of our business. On top of that, we had nice margin expansion, which ultimately led to adjusted earnings per share growth of over 20%.

We are very happy with this performance and excited that we have continued to exceed expectations through the first 3 quarters of FY '23. We have over $700 million of backlog now. So the outlook going forward remains positive. We did see orders drop compared to the prior third year -- third quarter of last year. Chris will take us through those details in a few minutes, but that's mostly an issue of timing and due to the lumpy nature of multiyear orders for certain parts of our business. Year-to-date, our book-to-bill ratio is over 100%, and we're optimistic about our growth outlook as we look beyond 2023.

Before Chris gets into the financial details, I did want to offer some top-level commentary about each of our business segments. Starting with A&D, where we had a solid quarter. Sales were up double-digit as we continue to see good momentum in the commercial and defense aerospace businesses. The aircraft components business certainly led the growth this quarter for A&D. The teams executed very well, but this continues to be the part of our business with the most challenges from a supply chain perspective. This continues to constrain the potential growth and contributes to some past-due backlog.

The teams continue to manage this aggressively and we're delivering on the growth, but the challenges industry-wide persists. Orders for Aerospace & Defense were down in the quarter, but again that's mostly a timing issue with some large multiyear orders booked in Q3 of the prior year. The outlook here remains solid with navy, commercial and military aerospace, all expected to drive future growth.

Next up is the Utility Group, which had a really great quarter. Revenue growth was up over 30% in the quarter and adjusted EBIT dollars grew by more than 50%. This business has seen a nice burst of growth in 2023. The core utility customer base continues to invest in their infrastructure, and we're seeing broad growth across all of our product lines with protection testing, condition monitoring and offline testing, all delivering good growth.

On the renewable side, growth continues to exceed even our expectations. 2023 will be a phenomenal year for NRG. The Inflation Reduction Act has provided long-term visibility for renewable infrastructure build-outs and our USG teams that both Doble and NRG are beginning to see benefits from that activity. On the supply chain side, we've seen a big improvement at USG. And while our backlogs are elevated, very little of that is past-due.

Finally, I'll touch on the test business, where we saw a sales decline again in the third quarter, which was in line with what we described during our last conference call. We've seen flattish results domestically as growth paused over last year's strength from Power Line Filters and test and measurement projects. Additionally, we've seen continued weakness in China, where business was significantly impacted as the economy opened back up after the pandemic. Unfortunately, we have not seen business pick up much since that time.

The team here continues to do a great job, and they increased our EBIT dollars in the third quarter despite the lower sales volume. This is good performance and positions us well to capture additional growth as these markets start to recover in the future.

So to summarize, I would say it's been a great 9 months to start 2023. It puts us on a good path overall as we drive to deliver on our targets for the full year, which we are increasing again this quarter.

So now I'll turn it over to Chris to give some more financial highlights on the third quarter.

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Thanks, Bryan. Everyone can follow along with the chart presentation. We'll start on Page 3, where we have the overall financial highlights.

As you can see, we had another great quarter with sales up over 13%, adjusted EBIT up over 24% and adjusted earnings per share up over 22%. We will go through the segment details in a minute, but on the sales side, the Utility Solutions Group delivered exceptional sales growth of over 30% and Aerospace & Defense was also strong at 12% growth. Orders were down in the quarter. You can see they dropped by 16% to $213 million. Again, I will cover this in the segment details, but we had some tough comparisons with large items booked last year. The good news is that backlog still stands at over $700 million as of June 30.

Moving on to Chart 4. We'll start to get into the segment details, beginning with Aerospace & Defense. Starting with orders. You can see the orders in the third quarter were down over 25%. We had some large orders in the space business last year, which are the key driver to the decline.

On the sales side, we are up 12% with organic sales up 8% and the CMT acquisition adding 4 points of growth. The commercial and military aerospace businesses were the key drivers to the overall growth, and we continue to see good momentum there. Adjusted EBIT was up 4.5% in dollar terms and margins were down 150 basis points as improvements from the commercial and military aerospace businesses was offset by margin erosion on some space development contracts.

Next is Chart 5 and the Utility Solutions Group. Here, the performance was exceptional. Orders were up 15% with the renewables business leading that growth. Sales were up nearly 34%. And as you can see on the chart, the Doble services, offline testing, protection testing and condition monitoring product lines all contributed. On the renewable side, with NRG, we once again saw explosive growth, 45% in the quarter. The top line performance for this group overall converted to a nice margin expansion with adjusted EBIT up 330 basis points. This improvement was driven by leverage on the higher sales growth and favorable impacts from price increases, which more than offset inflationary headwinds.

Next is Chart 6, where we have the Test business. A bit of a mixed story here. You can see orders were down nearly 35%. A big drop is last year we had a significant order -- we had significant order activity for test and measurement orders, which did not repeat this year. We have also seen continuing weakness in China as the overall pace of business has been slow since the reopening from COVID earlier in the fiscal year.

Sales were down 7%, but the good news here was that -- was margins as EBIT dollars increased 3.5% even on the lower sales. This is a margin improvement of 150 basis points driven by cost reduction efforts as well as price increases.

Next is Chart 7 and our cash flow highlights. We did see operating cash flow improvement in the third quarter compared to our first 2 quarters, but we are still running behind last year's operating cash flow amount of $42 million. Working capital increases from accounts receivable, inventory and contract assets have been a cash headwind. And we've also seen sizable negative cash impact from higher taxes paid and interest paid.

Capital expenditures are down approximately $9 million year-to-date. You'll recall that last year we had a building purchase at NRG, and that's the main driver of this year's decrease.

Acquisition spending is relatively flat with NEco acquired in fiscal '22 and CMT acquired in fiscal '23. And lastly is share repurchase, where we completed just over $12 million in buybacks this year compared to approximately $20 million through the first 9 months last year.

And the last chart is our guidance chart. You can see here that we are projecting adjusted earnings per share growth in the range of 13% to 15%. We put our initial guidance out in November of last year of $3.45 to $3.60 per share and the midpoint of our guidance has gone up each quarter since then. We are now looking at a range of $3.62 to $3.68, good double-digit growth for the year coming after 24% adjusted earnings per share that we delivered in fiscal '22. This represents 2 strong years for ESCO, and we are excited not only about the strong years in '22 and '23, but what comes next in '24 and beyond.

So that concludes the financial update, and now I'll turn it back over to Bryan.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Thanks, Chris. Since I touched on a number of my thoughts earlier, I will just offer a few more comments before we go to Q&A. You saw the numbers from Chris. So obviously, a great 2023 with very strong financial performance. The company is operating at a high level, and we continue to have confidence as we look to the future. We serve very strong end markets with well-established customers. We have great teams here at corporate and out of the businesses around the world. This forms a powerful combination, and we're excited about what's next for ESCO.

Before Q&A, I did want to mention that we recently published our ESG report covering our 2022 activities. You can find this on the Corporate Citizenship section of our website. I would encourage you to go and take a look at the report. It's got a lot of good information on ESCO's ESG program overall. It also has a nice profile of our NRG business and their capabilities about helping to enable renewable energy. The team here put a lot of work into the report. We hope that you find it useful.

So with that, we can start the Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Our first question comes from Jonathan Tanwanteng at CJS.

Peter Lucas

It's Peter Lucas for Jon. Can you talk a bit more about the Virginia-class timing shift? And does that impact when you expect to generate earnings and revenue from those orders?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Sure. So what's happening right now on Virginia-class is there's a multiyear procurement process that's in place. We do expect that, that's going to take a few more months. We would expect to get some Block 5 expansion orders in the near term, probably within the fourth quarter. And then we expect to see a pretty significant tranche of as many as 12 Virginia-class submarines at some time perhaps early next year.

We are in a really good position on that project, and so we don't think it's going to have any impact on our ability to generate earnings. We might see a modest expansion based upon some additional aspects of the submarines that they're going to be adding going forward.

Peter Lucas

Very helpful. And then jumping to the supply chain issues. Can you give us a little more color on those? Is it your internal throughput, your suppliers or parallel downstream partners? Where are you seeing the biggest issues there?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Well, so we're really talking about the Aerospace & Defense business here at ESCO. The rest of our business seems to have largely recovered. Within the aerospace and defense industry, there's an industry-wide challenge right now with regard to supply chain. The biggest issue is, is that lower tier suppliers are struggling and that has a cascade effect. We're not able to replace suppliers very easily in this industry. And so that kind of puts us in a position where we have to wait for products rather than swapping them out.

So over in the Utility segment, for example, we were able to redesign circuit boards to be able to swap out components for more available type of memory chip or something like that. We don't have that luxury over at Aerospace & Defense.

The good news is we are making good progress and we are driving the growth. But this is really an industry-wide challenge that many companies are facing. And this was a big topic of discussion at the Paris Air Show back in June. I would say the industry consensus is it's going to take several more quarters to really unwind the challenge.

Peter Lucas

And last one for me. Just an update on the M&A environment, what it looks like relatively? Is it more or less attractive compared to the past couple of quarters? And if acquisitions aren't out there, kind of talk about the priority in terms of capital allocation.

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Sure. Yes. So the good news is it's improving. We're seeing more opportunities presently than we have for the last couple of quarters. And based on our market research and intelligence, we are seeing more opportunities that will be coming to market later this year. We do have a couple of good programs that we're engaged on, but I don't think we're close to getting anything done. We certainly don't want to comment on any details. But we feel pretty good about our opportunity to get some investment done in the near term.

Operator

Our next question comes from Tommy Moll at Stephens Inc.

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

Bryan, I want to start on the A&D side of the business. What if any update can you provide from your review of that segment? And then specific to commercial, where the growth rates continue at rather elevated levels, if you look at the build plans and the content that you have spec-ed in, is there any reason to think that the growth momentum in the double-digit range, even if at a moderating rate from this year is unreasonable through your planning horizon?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

So listen, the build rates from Airbus and Boeing, in particular, continue to accelerate, and we're seeing a lot of that benefit in our aircraft businesses. And we feel like we're responding well to that and that we should have growth rates that are in the high single digits over the next year or 2, maybe a touch higher in the shorter term. The biggest challenge for us will be continuing to work through the supply chain piece. And we continue to make progress there. But the orders keep piling up. And so we feel pretty good about where that business is headed.

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

And then in terms of your review of the A&D portfolio, Bryan, any update you can provide there?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Listen, first of all, we've got some great businesses there. We don't have any strategic announcements to make today. I think all the businesses are performing well. We do think that there are opportunities to expand on our position in some of those spaces, in particular, navy and commercial aerospace. And we're looking at ways to do that.

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

Fair enough. I also wanted to ask about Utility or really Doble specifically. Another quarter with an impressive growth rate in the third quarter. It feels like you've hit a good operating cadence post-pandemic where there were some rough quarters there. What is favorably changing in terms of the underlying demand there?

And then if you take a step back, pre-pandemic, even a number of years pre-pandemic, Bryan, I think it's fair to say that was probably a high single-digit kind of market opportunity to go after. Then there were some years leading into the pandemic where that dipped a little bit. Does it feel like in terms of the outlook going forward, there's been a reacceleration in terms of the growth rate of that opportunity?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

I would say that -- so utilities at large -- I think it's really dawned on people that in order to facilitate this clean energy transition we've got to make enormous investments in grid infrastructure. And I think that, that is a big, big driver in the general build-out that we're seeing. I do think that the Inflation Reduction Act and the Infrastructure Act before that have both had a very positive impact. And what's the most positive about it is not the fact that it's short-term money, its long-term money. We've got a 10-year runway here where -- which is giving folks a lot of confidence to go ahead and make big capital investments. And that's really fundamentally healthy for our business.

In addition to that, I think that folks are -- in the utility space are realizing that they really need to get smarter about how they handle these assets. And so the bet that we made a number of years ago on heavy investments in both inorganic and organic development of our condition monitoring capabilities is really helping us there. Some of the new products that we have talked about in the last couple of years are really starting to get some traction. So yes, I'd say we're hitting a pretty sweet spot there.

Overall on the renewable side, we -- I mean that business has been lighter than air this year. It's been very difficult for us to predict exactly what would happen, except for every time we pick up the phone, it's more good news. So that's been a fun story to be a part of.

I guess the bigger question is: Okay, where do we go from here? The reality is that in order to facilitate this transition, there's a lot more investment that needs to be made, and I mean in terms of trillions of dollars and -- worldwide. And we will certainly benefit as those kinds of investments are made.

Operator

Our next question comes from John Franzreb at Sidoti & Company.

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

Congratulations on a great quarter. I'd like to start on the Test side of the business. You've kind of characterized that business as coming out of COVID. China has been an issue just getting in the door. Now China seems to be weakening in and of itself. Can you talk a little bit about what your expectations are in Test in China in the coming quarters? And has the competitive landscape changed in light of that demand environment?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Yes, I would say that the Test business as a whole -- this was our strongest business through the COVID period. While other parts of our business were softening up, the Test business was really strengthening and growing. And fortunately, they've been able to kind of maintain that higher level of overall revenue.

China has been a little bit of a challenge for us this year. We had an exceptional year last year. So on a comparison basis, I think our China business is down very, very significantly year-over-year. The -- we're still making money over there, we're still building product, but the level of demand that we're seeing from customers and our ability to get out on the job sites still is a little bit impaired. We do not believe that, that is a competitive landscape difference. We think that, that's a difference in the fundamentals of the Chinese economy. And I think that's been borne out by what we're seeing in -- as we read about what's going on overall in China. So I mean, the good news is it's a relatively small part of our overall business. It's a reasonably -- a reasonable subset of the Test and Measurement business.

Meanwhile, here in North America, the business has kind of been flattish. And what we're seeing there is a little bit of a transition, probably more EMC and that sort of work and a little less of the wireless activity. We continue to see activity with EV and that sort of thing.

What's been interesting for us this year is our European business has been quite strong, and that's driven probably a little bit by some of the security stuff we're seeing. Yes, we've got a big presence in Finland and they're joining NATO. So it's been a positive. But -- so overall, listen, we still continue to be optimistic about this business, but we're kind of moving along sideways at this kind of upper end of our revenue over the last several years.

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

Got it. Got it. That actually helped a lot. And going back to your utility comments to be sure. The renewable markets are doing well, but more the traditional utility spend, it sounds like you're enthusiastic about the slope of that business going forward. Can you talk a little bit about what you're seeing as far as traditional utility spending? Is it pent-up demand that's coming back? Would you really see a fundamental long-term shift in the demand cycle on the utility side?

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Well, I think it would be wrong for me to say there was no pent-up demand, because during the period that Tommy was talking about a couple of years ago during the pandemic, the way the utilities operated is they kind of took a hands-off approach and said, "Hey, listen, we got to maximize uptime and generation and make sure we keep the lights on and not mess around too much". And then as we came out of the pandemic, a lot of that activity had to be made up for.

I think we're largely past that now and I do think there has been a shift in the way the utilities think about -- particularly about more advanced techniques. We've got new products that are able to satisfy their requirements for digital testing. We've got products now that are enhanced for this condition monitoring piece. We're seeing a lot of activity in those areas.

And listen, utilities are -- they're recognizing the fact -- if you do the math on all these net 0 targets and even if you cut them in half and say that they're -- we're not going to achieve them by 2030 or 2040 or 2050 as has been stated, it still points to enormous amounts of growth. The electric vehicle build-out in and of itself is an enormous demand driver for utilities. And what they see there is revenue streams that they can capitalize on, but they've got to be able to deliver the service. And so they're making the necessary investments now.

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

Fair enough. And just one last question on -- in A&D. My understanding is that some of the lower-tier suppliers -- there's actually a surge by alternative suppliers that might have required some recertification in the process with whatever they're making. Is that not the case? Or is it just going slower than expected? Can you just -- a little clarity there would be helpful.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Well, it's going slower than expected. And I think when you think about it as an industry-wide phenomenon, so just think about the people that are actually doing those recertifications, they're being inundated by requests, right? And it's a very conservative industry that is very change averse. So in a lot of cases, we really are put in a position where we don't have many choices. I mean, we have definitely design changes and we've made changes to material certifications and that sort of thing.

I think the other thing I would point out is if we look at our past due backlog, it's a small number of parts and programs that are driving a large piece of this overall past due. The meat and potato stuff that are going into 737, A320, that sort of thing, most of that is running along nicely. But a lot of our other programs are where you're seeing a lot of the past due. And those are programs of smaller quantities. And so the justification for going through a recertification program is less obvious.

Operator

Our next question is from Tommy Moll at Stephens Inc.

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

Yes. I just wanted to make sure we hit on utility margin today. So thanks for letting me back in here. On an adjusted EBIT basis, you just reported a 23%, which is a ZIP code where you've been before, if you go back far enough in history. But more recently, you haven't been there on any sustained basis. So I'm curious if there's anything onetime favorable in this quarter or if some of the recent margin improvement there feels like a more sustainable base that you can operate at?

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Yes, Tommy, I wouldn't say there was anything particularly onetime in there. Again, we're just kind of obviously driving really nice leverage on the big growth. I think we did see a little bit of favorable mix that was kind of unfavorable earlier in the year, so that helped us slightly. But then, again, it's more just kind of price and cost management and those kind of things.

So listen, we're not going to be there every quarter at that level. But obviously, we're looking to drive back to the historical peaks as we go into '24 and beyond. So that's kind of how I'd answer it. Really nothing special, good leverage and we feel confident about the ability to drive the margins up as we go forward.

Operator

Thank you. I'm showing no further questions at this time. I would now like to turn the conference back to President and CEO, Bryan Sayler, for closing remarks.

Bryan H. Sayler - *ESCO Technologies Inc. - President, CEO & Director*

Well, thanks, everyone -- yes, thanks, everyone. It's been good to talk to you in this quarter, and we'll look forward to talking to you again next quarter.

Christopher L. Tucker - *ESCO Technologies Inc. - Senior VP & CFO*

Thank you.

Operator

Thank you. This concludes today's conference call. Thank you for participating. You may now disconnect.
